

CH – PARTNERSHIP FUNDAMENTALS

Profit & Loss Appropriation Account

Profit and Loss Appropriation Account is an extension of the Profit and Loss Account of the firm. It shows how the profits are appropriated or distributed among the partners.

Profit & Loss Appropriation Account for the year ended....

Particulars	₹	Particulars	₹
To Profit & Loss A/c (Net Loss)	xxx	By Profit & Loss A/c (Net Profit)	xxx
To Interest on Capital		By Interest on Drawings	
X:		X:	
Y:	xxx	Y:	xxx
To Partner's Salaries / Commission		By Loss transferred to Capital (in PSR)	
X:		X:	
Y:	xxx	Y:	xxx
To Reserve (Transfer)	xxx		
To Profit transferred to Capital (in PSR)			
X:			
Y:	xxx		
	xxx		xxx

Appropriation of Profits vs Charge Against Profits

Appropriation of Profits	Charge Against Profits
It means distribution of profits	It means expense
Debited to P&L Appropriation A/c	Debited to Profit & Loss A/c
Cannot exceed available profits	Can exceed available profits
Eg: Partner's Remuneration, Interest on Capital, Distribution of Divisible Profits	Eg: Interest on Partner's Loan, Rent paid to Partner, Manager's Commission etc.

Accounting Treatment of Interest on Partner's Loan (By Partner / To Partner) & Rent to Paid to Partner

(A) Interest on Loan by Partner

(i) Interest on Loan by Partner A/c	Dr.	xxx	
To Loan to Partner A/c			xxx
 (ii) Profit & Loss A/c	Dr.	xxx	
To Interest on Loan by Partner A/c			xxx

(B) Interest on Loan to Partner

(i)	Partner's Capital / Current A/c	Dr.	xxx	
	To Interest on Loan to Partner A/c			xxx
(ii)	Interest on Loan to Partner A/c	Dr.	xxx	
	To Profit & Loss A/c			xxx

(C) Rent Paid to Partner

(i)	Rent A/c	Dr.	xxx	
	To Rent Payable A/c / Bank A/c			xxx
(iii)	Profit & Loss A/c	Dr.	xxx	
	To Rent A/c			xxx

Maintenance of Partner's Capital Accounts

2 Methods:

- (1) **Fixed Capital Method** – Two Accounts are maintained:
 - (i) Fixed Capital A/c – Only additional capital introduced & withdrawal of capital are recorded. It will always have credit balance.
 - (ii) Partner's Current A/c – Remaining transactions like interest on capital, interest on drawings, remuneration, profit/loss etc are recorded
- (2) **Fluctuating Capital Method** – Only 1 Account i.e. Partner's Capital A/c is maintained in which ALL the transactions are recorded.

If question is silent, always assume that firm is following Fluctuating Capital Method.

Appropriation of Profit when Appropriations are More Than Available Profits

Step 1 – Determine the amount payable as appropriations to each partner as per partnership deed normally.

Step 2 – Total the amount of appropriation for each partner separately.

Step 3 – Calculate the ratio of appropriation on the basis of Step 2.

Step 4 – Distribute the available profits in the ratio of appropriation calculated in Step 3.

Calculation of Interest on Capital

On opening balance of Capital A/c xxx

[Opening Balance x Rate /100 x 12/12]

(+) On additional capital introduced xxx
[Amt introduced x Rate/100 x No. of months (Date of introduction to last date)/12]

(-) On capital withdrawn (Drawings against capital) xxx
[Amt withdrawn x Rate/100 x No. of months (Date of drawings to last date)/12]

Interest on Capital to be allowed for the year xxx

Note: If question says that Interest on Capital is to be treated as a charge, then it will be allowed in full, irrespective of the available profits.

Note: If the firm follows Fixed Capital Method, then interest on capital will not be calculated on Current A/c balance.

Calculation of Opening Capital

If in the question, closing capital is given, then opening capital has to be calculated for the purpose of calculation of interest on capital.

Case (A): Fluctuating Capital Method

Closing Capital (given)	xxx
Add: Drawings against profit	xxx
Withdrawal of Capital	xxx
Interest on drawings	xxx
Loss transferred	xxx
Less: Additional capital introduced	(xxx)
Interest on capital allowed	(xxx)
Salary/commission allowed	(xxx)
Profit transferred	(xxx)
Opening Capital	xxx

Case (B): Fixed Capital Method

Closing Capital (given)	xxx
Add: Withdrawal of Capital	xxx
Less: Additional Capital introduced	(xxx)
Opening Capital	xxx

Calculation of Partner's Commission

Case (A): On profits before charging such commission (assume if Q is silent)

Commission = Profit x Rate/100

Case (B): On profits after charging such commission

Commission = Profit x Rate/(Rate + 100)

Calculation of Interest on Drawings

Case (A): Regular Drawings (i.e. Uniform Amount & Uniform Time Interval Between Drawings)

Average period method is used:

Interest on Drawings = Total Drawings x Rate/100 x Avg. Period* x 1/12

* Avg. Period = [Time Left after 1st Drawings + Time Left after Last Drawings] / 2

Note: If date of drawings is not given in question, then take avg. period as 6 months (i.e. half of total no. of months in the year) – CBSE Assumption

Case (B): Irregular Drawings

Simple method or Product method is used:

(i) **Simple Method:**

In this method, IOD is calculated individually for each drawings for the period the amount is withdrawn.

(ii) **Product Method:**

IOD = Total of Product x Rate/100 x 1/12

* Product = Drawings x No. of Months for which Amt is withdrawn

Past Adjustment

Rectification of errors/omissions, after preparation and closing of final accounts, is known as past adjustment. Errors (adjustments) relating to P&L Appropriation A/c are to be covered.

Method 1 – Passing Single Adjustment Entry using Partner's Capital A/c / Current A/c

Step 1 – Prepare an adjustment table & give effect to the given adjustments (errors/omissions) in the adjustment table

Step 2 – Calculate profit / loss on adjustment, and give effect to the same in the adjustment table.

Note: In case of distribution of profit in the wrong ratio, instead of calculating profit/loss on adjustment, reverse the wrong distribution, and then redistribute the **correct** profit/loss in correct ratio.

Step 3 – Calculate net effect of Step 1 & Step 2.

Step 4 – Pass the adjustment entry on the basis of net effect calculated in Step 3.

Illustrative Format of Adjustment Table

	X (₹)	Y (₹)
Adjustment 1	xxx	xxx
Adjustment 2	xxx	xxx
Profit/Loss on Adjustment	xxx	xxx
Net Effect	xxx	xxx

Method 2 – Passing Individual Adjustment Entry for Each Adjustment using P&L Adjustment A/c

(i) For adjustments to be credited to Partner's Capital

P&L Adjustment A/c	Dr.	xxx	
To Partner's Capital/Current A/c			xxx

(ii) For adjustments to be debited to Partner's Capital

Partner's Capital/Current A/c	Dr.	xxx	
To P&L Adjustment A/c			xxx

(iii) For closing P&L Adjustment A/c

(a) Credit Balance of P&L Adjustment A/c – Profit on Adjustment

P&L Adjustment A/c	Dr.	xxx	
To Partner's Capital/Current A/c			xxx

[in PSR]

(b) Debit Balance of P&L Adjustment A/c – Loss on Adjustment

Partner's Capital/Current A/c	Dr.	xxx	
To P&L Adjustment A/c			xxx
[in PSR]			

Guarantee of Minimum Profits to a Partner

- Partner who gets the guarantee – Guaranteed Partner
Partner who gives the guarantee (bears the deficiency) – Guaranteeing Partner
- Deficiency is borne by guaranteeing partner(s) in agreed ratio, out of their share. If question is silent, it is borne by remaining partners in their respective ratio.
- Deficiency arises when - Actual Profit share < Guaranteed Profit
Deficiency = Guaranteed Profit – Actual Profit share
- Journal Entry (for adjustment of deficiency):

Guaranteeing Partner's Capital/Current A/c	Dr.	xxx	
To Guaranteed Partner's Capital/Current A/c			xxx

- Guaranteed partner will be entitled to the guaranteed profit, even if firm incurs losses (unless otherwise agreed).

Minimum Earnings Guaranteed by Partner to Firm

Any deficiency of such earnings will be borne by the guaranteeing partner. Following journal entry will be passed:

Guaranteeing Partner's Capital/Current A/c	Dr.	xxx	
To P&L Appropriation A/c			xxx

CH – GOODWILL

Methods of Valuation of Goodwill

- (A) Average Profits Method
 - (i) Simple Average Profit Method
 - (ii) Weighted Average Profit Method
- (B) Super Profit Method
- (C) Capitalisation Method
 - (i) Capitalisation of Avg. Profit
 - (ii) Capitalisation of Super Profit

(A) Average Profit Method

(i) Simple Avg. Profit Method

Goodwill = Avg. Profit (of Past Years) x No. of Years' Purchase (always given)

(ii) Weighted Avg. Profit Method

Goodwill = Weighted Avg. Profit* x No. of Years' Purchase

* Weighted Avg. Profit = Sum of [Profits x Weights] ÷ Sum of Weights

This method is suitable when profit shows a trend (upwards/downwards) over the years. More weightage (relevance) is assigned to the profits of recent years.

Calculation of Normal Business Profits or Future Maintainable Profits

	₹
Profit/(Loss) of Past Year (before adjustment) (Given)	xxx
Add: (i) Abnormal losses (eg: Loss by fire)	xxx
(ii) Loss on sale of fixed assets	xxx
(iii) Overvaluation of opening stock / Undervaluation of Closing Stock	xxx
(iv) Non-recurring expenses (not expected in future)	xxx
(v) Capital Expenditure treated as Revenue Expenditure (net of depreciation)	xxx
Less: (i) Abnormal gains (eg: gain on sale of fixed assets)	(xxx)
(ii) Overvaluation of closing stock / Undervaluation of Opening Stock	(xxx)
(iii) Non-recurring incomes (not expected in future)	(xxx)
(iv) Income from Non-Trade Investments	(xxx)

(v) Revenue Expenditure treated as Capital Expenditure (net of depreciation)	(xxx)
(vi) Partners' Remuneration	(xxx)
(vii) Any future expenses (like insurance)	(xxx)

Adjusted Profit / Normal Business Profits **xxx**

(B) Super Profit Method

- Goodwill = Super Profit x No. of Years' Purchase
- Super Profit = Avg. Profit (Actual Profit) – Normal Profit
- Normal Profit = Capital Employed (or Avg. Capital Employed) x Normal Rate of Return
- Capital Employed means capital invested in the firm to carry on business. It is calculated as follows:

Partners' Capital A/c (and Current A/c) + Reserves – Existing Goodwill – Fictitious Assets – Non-Trade Investments

OR

Total Assets – Total Outside Liabilities – Existing Goodwill – Fictitious Assets – Non-Trade investments

- Non-Trade Investments means those investments, which are made to earn profits by investing surplus funds, and not for furtherance of business. **If question is silent, assume given investments as NTI.**
- Avg. Capital Employed = (Opening CE + Closing CE) ÷ 2

(C) Capitalisation Method

(i) Capitalisation of Average Profit

Goodwill = Capitalised Value of Business* – Net Assets (i.e. Capital Employed)

* Capitalised Value of Business = Avg. Profit x (100 / Normal Rate of Return)

(ii) Capitalisation of Super Profit

Goodwill = Super Profit x (100 / Normal Rate of Return)

CH – CHANGE IN PROFIT-SHARING RATIO

Calculation of Sacrificing and Gaining Ratio

Sacrificing Ratio

Ratio in which one or more sacrificing partners, sacrifice (forego) their profit share in favour of one or more gaining partners.

Sacrificed Profit Share = Old Profit Share – New Profit Share

Gaining Ratio

It is the ratio in which one or more gaining partners gain profit share from one or more sacrificing partners.

Gained Profit Share = New Profit Share – Old Profit Share

Note: If new PSR is not given, then it can be calculated as follows:

New Profit Share = Old Share (+) Gained Share or (-) Sacrificed Share (as the case may be)

Treatment of Goodwill

- In case of reconstitution, goodwill is calculated to determine the amount by which gaining partner should compensate the sacrificing partner, for their sacrifice in future profits.

Compensation = Total Goodwill x Gained Share

- Accounting Treatment:

Gaining Partners' Capital A/c / Current A/c	Dr.	[in Gaining Ratio]
To Sacrificing Partners' Capital A/c / Current A/c		[in Sacrificing Ratio]

- Existing Goodwill (i.e. Goodwill appearing in the Balance Sheet) – it is to be written off as follows:

Partners' Capital / Current A/c	Dr.	[in Old Ratio]
To Goodwill A/c		[Book Value]

Treatment of Reserves, Accumulated Profits & Fictitious Assets

➤ Reserves & Accumulated Profits:

Reserve A/c	Dr.	[Book Value]
P&L A/c (Cr. Balance)	Dr.	[Book Value]
To Partners' Capital / Current A/c		[in Old Ratio]

➤ Fictitious Assets (Deferred Revenue Exp & Accumulated Losses):

Partners' Capital / Current A/c	Dr.	[in Old Ratio]
To Advertisement Suspense A/c		[Book Value]
To P&L A/c (Dr. Balance)		[Book Value]

Treatment of Certain Special Reserves

Workmen Compensation Reserve (WCR)

It is a reserve created out of profits to meet possible liability of workers' claims like compensation payable in case of an accident. Following cases are applicable for its accounting treatment:

Case 1 – When no information of claim given / claim does not exist

WCR will be distributed normally (refer journal entry discussed above)

Case 2 – When Claim = WCR

WCR A/c	Dr.	[Book Value]
To Workmen Compensation Claim A/c		[Claim Liability]

Case 3 – When Claim < WCR

WCR A/c	Dr.	[Book Value]
To WC Claim A/c		[Claim Liability]
To Partners' Capital / Current A/c		[in Old Ratio]

Case 4 – When Claim > WCR

WCR A/c	Dr.	[Book Value]
Revaluation A/c	Dr.	[Claim (-) WCR]
To WC Claim A/c		[Claim Liability]

* Revaluation Loss will be transferred to Partners' Capital / Current A/c (discussed later)

Note: Workmen Compensation Claim will be shown as liability in the reconstituted balance sheet.

Investment Fluctuation Reserve (IFR)

It is a reserve created out of profits to meet permanent fall in market value of investment from its original cost. Following cases are applicable for its accounting treatment:

Case 1 – When no information of market value given / Market Value = Book Value of Investment.

IFR will be distributed normally (refer journal entry discussed above)

Case 2 – When Market Value < Book Value & Fall in Value < IFR

IFR A/c	Dr.	[Book Value]
To Investment A/c		[Fall in Value]
To Partners' Capital / Current A/c		[in Old Ratio]

Case 3 - When Market Value < Book Value & Fall in Value = IFR

IFR A/c	Dr.	[Book Value]
To Investment A/c		[Fall in Value]

Case 4 - When Market Value < Book Value & Fall in Value > IFR

IFR A/c	Dr.	[Book Value]
Revaluation A/c	Dr.	[Fall in Value (-) IFR]
To Investment A/c		[Fall in Value]

* Revaluation Loss will be transferred to Partners' Capital / Current A/c (discussed later)

Case 5 – When Market Value > Book Value

IFR A/c	Dr.	[Book Value]
Investment A/c	Dr.	[Increase in Value]
To Revaluation A/c		[Increase in Value]
To Partners' Capital / Current A/c		[IFR in Old Ratio]

* Revaluation Gain will be transferred to Partners' Capital / Current A/c (discussed later)

Note: Investment will be shown at market value in the reconstituted balance sheet.

Treatment of Reserves, Accumulated Profits & Fictitious Assets Using Single Adjustment Entry

This concept is applicable if these are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Reserves	xxx
P&L (Cr. Balance)	xxx
Advertisement Suspense A/c	(xxx)
P&L (Dr. Balance)	<u>(xxx)</u>
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Net Gain):

Gaining Partners' Capital / Current A/c	Dr.	
To Sacrificing Partners' Capital / Current A/c		[NE x Gained Share] [NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Net Loss):

Sacrificing Partners' Capital / Current A/c	Dr.	
To Gaining Partners' Capital / Current A/c		[NE x Sacrificed Share] [NE x Gained Share]

Revaluation of Asset / Reassessment of Liabilities

At the time of reconstitution of firm, assets are revalued & liabilities are reassessed, and any profit/ loss arising from such revaluation is transferred to the partners' capital in their old ratio. For this purpose, a nominal account i.e. **Revaluation A/c** is prepared.

Revaluation A/c

Particulars	₹	Particulars	₹
To Assets A/c (individually) (decrease)	xxx	By Assets A/c (individually) (increase)	xxx
To Liabilities A/c (individually) (increase)	xxx	By Liabilities A/c (individually) (decrease)	xxx
To Unrecorded Liabilities A/c	xxx	By Unrecorded Assets A/c	xxx
To Partners' Capital A/c (Remuneration)	xxx	By Loss on Revaluation t/f to Partners' Capital / Current A/c (in old PSR)	xxx
To Cash / Bank A/c (Expenses)	xxx		
To Profit on Revaluation t/f to Partners' Capital / Current A/c (in old PSR)	xxx		
	xxx		xxx

Note: Assets & liabilities will appear in the reconstituted balance sheet at their revised values.

Revaluation of Assets & Reassessment of Liabilities Using Single Adjustment Entry

This concept is applicable if revalued assets & liabilities are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Increase in Asset (incl. Unrecorded Asset)	xxx
Decrease in Liability	xxx
Increase in Liability (incl. Unrecorded Liability)	(xxx)
Decrease in Asset	<u>(xxx)</u>
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Profit on Revaluation):

Gaining Partners' Capital / Current A/c	Dr.	[NE x Gained Share]
To Sacrificing Partners' Capital / Current A/c	Dr.	[NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Loss on Revaluation):

Sacrificing Partners' Capital / Current A/c	Dr.	[NE x Sacrificed Share]
To Gaining Partners' Capital / Current A/c	Dr.	[NE x Gained Share]

CH – ADMISSION OF A PARTNER

Calculation of New Profit-Sharing Ratio & Sacrificing Ratio

Case 1 – When Profit Share of Incoming Partner is given, but sacrifice made by old partner is not given (i.e. Q is silent)

Step 1 – Calculate remaining share i.e. $[1 - \text{Incoming Partner's Share}]$

Step 2 – Divide Step 1 b/w old partners in their old ratio. This will be their new profit-share

* Sacrificing Ratio = Old Ratio

Case 2 – Profit share of incoming partner is given & new PSR of old partners after admission is given.

Step 1 – Calculate remaining share i.e. $[1 - \text{Incoming Partner's Share}]$

Step 2 – Divide Step 1 b/w old partners in the given new ratio. This will be their new profit-share.

* Sacrificing Ratio will be calculated by calculating individual sacrifice of old partners normally (i.e. no short-cut)

Case 3 – Share of New Partner is given, which is acquired from old partners in a particular ratio (say equally or 2:1).

New Ratio of Old Partners = Old Ratio – Sacrificed share (calculated using given ratio)

* Sacrificing Ratio = Ratio (Given) in which new partner acquires his share from old partners

Case 4 – Incoming partner gets his/her share from old partners in a particular fraction (say $\frac{3}{5}$ from X or $\frac{1}{5}$ of X's share)

New Ratio of Old Partners = Old Ratio – Sacrificed share (calculated using given fraction)

* Sacrificing Ratio will be calculated by calculating individual sacrifice of old partners normally (i.e. no short-cut)

Case 5 – One of the old partner retains his share & share of incoming partner is given

Step 1 – Calculate remaining share i.e. $1 - \text{New Partner's share} - \text{Retained Share}$

Step 2 – Divide Step 1 b/w remaining partners in their respective ratios. This will be their new share.

* Sacrificing ratio (of remaining partners) = their respective Old Ratio

Note: If new PSR after admission is given, then sacrificing ratio can be calculated by calculating sacrificed share of sacrificing partners normally (as discussed in previous chapter).

Adjustment of Goodwill

Premium for Goodwill (PFG) – It is the compensation paid by the incoming partner (in cash or kind) to the sacrificing partners for their sacrifice in profit share towards the incoming partner.

$PFG = \text{Goodwill of the Firm} \times \text{New Partner's Share}$

Accounting Treatment of PFG (6 Cases)

Case (1) – When PFG is paid privately (i.e. outside of business)

(1)	Cash / Bank A/c	Dr	[Capital brought in Cash]
	To Incoming Partner's Capital A/c		

* Thus, no separate entry is passed for goodwill adjustment in this case

Case (2) – When PFG is brought in Cash / by Cheque & is retained in the business

(1)	Cash / Bank A/c	Dr	[Capital + PFG]
	To Incoming Partner's Capital A/c		[Capital brought in Cash]
	To Premium for Goodwill A/c		[PFG brought in Cash]

(2)	Premium for Goodwill A/c	Dr.	[PFG in brought in Cash]
	To Sacrificing Partners' Capital / Current A/c		[in Sacrificing Ratio]

Note: If Q is silent, assume that PFG is retained in the business.

Case (3) – When PFG is brought in cash / by cheque & is withdrawn by sacrificing partners (Fully / Partially)

(1) Same as Case (2)

(2) Same as Case (2)

(3)	Sacrificing Partners' Capital / Current A/c To Cash / Bank A/c	Dr.	[in Sacrificing Ratio] [Amt withdrawn]
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Case (4) – When PFG is brought in kind [i.e. in the form of Asset(s)]

(1)	Assets A/c (Individually) To Incoming Partner's Capital A/c To Premium for Goodwill A/c	Dr.	[Value of Assets (given)] [Capital brought in] [PFG brought in]
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(2) Same as Case (2)

Case (5) – When only a part of PFG is brought in by the incoming partner

(1)	. Cash / Bank A/c To Incoming Partner's Capital A/c To Premium for Goodwill A/c	Dr	[Capital + PFG brought in] [Capital brought in Cash] [PFG brought in Cash]
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(2)	Premium for Goodwill A/c Incoming Partner's Current A/c To Sacrificing Partners' Capital / Current A/c	Dr. Dr.	[PFG in brought in Cash] [PFG Unpaid] [in Sacrificing Ratio]
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Case (6) – When no PFG is brought in cash by the incoming partner

(1)	Cash / Bank A/c To Incoming Partner's Capital A/c	Dr	[Capital brought in Cash]
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(2)	Incoming Partner's Current A/c To Sacrificing Partners' Capital / Current A/c	Dr.	[PFG Unpaid] [in Sacrificing Ratio]
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Note: If any of the old partners gains after admission, then such gaining partner's capital / current A/c will be debited with his / her share in the 2nd entry in all the above cases.

Accounting Treatment of Existing Goodwill (i.e. Goodwill appearing in the Balance Sheet)

Old Partners' Capital / Current A/c To Goodwill A/c	Dr.	[in Old Ratio] [Book Value]
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Hidden Goodwill / Inferred Goodwill

Sometimes, value of goodwill or method / information about goodwill valuation is not given in the question, still the question asks us to calculate goodwill and do the necessary accounting treatment. In such a case, value of goodwill is inferred from the net worth of the reconstituted firm. This inferred goodwill is known as "Hidden Goodwill"

Calculation of Hidden Goodwill

	₹
Net worth (or Total Capital) of the Reconstituted Firm (incl. Goodwill) [Capital of Incoming Partner x Reciprocal of Share of New Partner]	xxx
Less: Net Worth (Total Capital) of the Reconstituted Firm Excluding Goodwill [Refer Note]	(xxx)
Hidden Goodwill	xxx

Note: Calculation of Net Worth (or Total Capital) Excl. Goodwill :

Capital of Old Partners (after all adjustments) (+) Capital of New Partner (+) Reserves
(+) Accumulated Profits or (-) Accumulated Losses (as the case may be) (-) Fictitious
Assets (-) Non-Trade Investments (-) Existing Goodwill

OR

Total Assets (incl. cash brought in by the incoming partner) (-) Outside Liabilities (-)
Fictitious Assets (-) Non-Trade Investments (-) Existing Goodwill

Journal Entries:

(1)	Cash / Bank A/c	Dr.	[Capital brought in Cash]
	To Incoming Partner's Capital A/c		
(2)	Incoming Partner's Current A/c	Dr.	[Hidden GW x Share]
	Gaining Partners' Capital / Current A/c	Dr.	[Hidden GW x Gain]
	To Sacrificing Partners' Capital / Current A/c		[in Sacrificing Ratio]

Treatment of Reserves, Accumulated Profits & Fictitious Assets

➤ Reserves & Accumulated Profits:

Reserve A/c	Dr.	[Book Value]
P&L A/c (Cr. Balance)	Dr.	[Book Value]
To Old Partners' Capital / Current A/c		[in Old Ratio]

➤ Fictitious Assets (Deferred Revenue Exp & Accumulated Losses):

Old Partners' Capital / Current A/c	Dr.	[in Old Ratio]
To Advertisement Suspense A/c		[Book Value]
To P&L A/c (Dr. Balance)		[Book Value]

Treatment of Certain Special Reserves

Workmen Compensation Reserve (WCR)

It is a reserve created out of profits to meet possible liability of workers' claims like compensation payable in case of an accident. Following cases are applicable for its accounting treatment:

Case 1 – When no information of claim given / claim does not exist

WCR will be distributed normally (refer journal entry discussed above)

Case 2 – When Claim = WCR

WCR A/c	Dr.	[Book Value]	
To Workmen Compensation Claim A/c			[Claim Liability]

Case 3 – When Claim < WCR

WCR A/c	Dr.	[Book Value]	
To WC Claim A/c			[Claim Liability]
To Old Partners' Capital / Current A/c			[in Old Ratio]

Case 4 – When Claim > WCR

WCR A/c	Dr.	[Book Value]	
Revaluation A/c	Dr.	[Claim (-) WCR]	
To WC Claim A/c			[Claim Liability]

* Revaluation Loss will be transferred to Old Partners' Capital / Current A/c (discussed later)

Note: Workmen Compensation Claim will be shown as liability in the reconstituted balance sheet.

Investment Fluctuation Reserve (IFR)

It is a reserve created out of profits to meet permanent fall in market value of investment from its original cost. Following cases are applicable for its accounting treatment:

Case 1 – When no information of market value given / Market Value = Book Value of Investment.

IFR will be distributed normally (refer journal entry discussed above)

Case 2 – When Market Value < Book Value & Fall in Value < IFR

IFR A/c	Dr.	[Book Value]
To Investment A/c		[Fall in Value]
To Old Partners' Capital / Current A/c		[in Old Ratio]

Case 3 - When Market Value < Book Value & Fall in Value = IFR

IFR A/c	Dr.	[Book Value]
To Investment A/c		[Fall in Value]

Case 4 - When Market Value < Book Value & Fall in Value > IFR

IFR A/c	Dr.	[Book Value]
Revaluation A/c	Dr.	[Fall in Value (-) IFR]
To Investment A/c		[Fall in Value]

* Revaluation Loss will be transferred to Old Partners' Capital / Current A/c (discussed later)

Case 5 – When Market Value > Book Value

IFR A/c	Dr.	[Book Value]
Investment A/c	Dr.	[Increase in Value]
To Revaluation A/c		[Increase in Value]
To Old Partners' Capital / Current A/c		[IFR in Old Ratio]

* Revaluation Gain will be transferred to Old Partners' Capital / Current A/c (discussed later)

Note: Investment will be shown at market value in the reconstituted balance sheet.

Treatment of Reserves, Accumulated Profits & Fictitious Assets Using Single Adjustment Entry

This concept is applicable if these are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Reserves	xxx
P&L (Cr. Balance)	xxx
Advertisement Suspense A/c	(xxx)
P&L (Dr. Balance)	<u>(xxx)</u>
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Net Gain):

Gaining Partners' Capital / Current A/c Dr. [NE x Gained Share]
 To Sacrificing Partners' Capital / Current A/c [NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Net Loss):

Sacrificing Partners' Capital / Current A/c Dr. [NE x Sacrificed Share]
 To Gaining Partners' Capital / Current A/c [NE x Gained Share]

Revaluation of Asset / Reassessment of Liabilities

At the time of reconstitution of firm, assets are revalued & liabilities are reassessed, and any profit/ loss arising from such revaluation is transferred to the partners' capital in their old ratio. For this purpose, a nominal account i.e. **Revaluation A/c** is prepared.

Revaluation A/c

Particulars	₹	Particulars	₹
To Assets A/c (individually) (decrease)	xxx	By Assets A/c (individually) (increase)	xxx
To Liabilities A/c (individually) (increase)	xxx	By Liabilities A/c (individually) (decrease)	xxx
To Unrecorded Liabilities A/c	xxx	By Unrecorded Assets A/c	xxx
To Partners' Capital A/c (Remuneration)	xxx	By Loss on Revaluation t/f to Old Partners' Capital / Current A/c (in old PSR)	xxx
To Cash / Bank A/c (Expenses)	xxx		
To Profit on Revaluation t/f to Old Partners' Capital / Current A/c (in old PSR)	xxx		
	xxx		xxx

Note: Assets & liabilities will appear in the reconstituted balance sheet at their revised values.

Revaluation of Assets & Reassessment of Liabilities Using Single Adjustment Entry

This concept is applicable if revalued assets & liabilities are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Increase in Asset (incl. Unrecorded Asset)	xxx
Decrease in Liability	xxx
Increase in Liability (incl. Unrecorded Liability)	(xxx)
Decrease in Asset	(xxx)
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Profit on Revaluation):

Gaining Partners' Capital / Current A/c	Dr.	[NE x Gained Share]
To Sacrificing Partners' Capital / Current A/c	Dr.	[NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Loss on Revaluation):

Sacrificing Partners' Capital / Current A/c	Dr.	[NE x Sacrificed Share]
To Gaining Partners' Capital / Current A/c	Dr.	[NE x Gained Share]

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CH – RETIREMENT OF A PARTNER

Calculation of New PSR & Gaining Ratio

Case (1) – When a partner retires & no information about new PSR or Gaining Ratio is given

New PSR of Continuing Partners = Old PSR of the Continuing Partners = Gaining Ratio

Case (2) – When continuing partners take Profit Share from the Retiring Partner in an agreed ratio

New Ratio of Continuing Partners = Old Ratio + Gained Share

Gained Share will be calculated on the basis of given ratio.

Gaining Ratio will be calculated on the basis of Gained Share

* Gained Share = New Profit Share – Old Profit Share

Note: Gaining Ratio is the ratio in which one or more gaining partners gain profit share from one or more sacrificing partners.

Calculation of Gaining Ratio if New PSR is Given

Gaining Ratio will be calculated on the basis of Gained Share

* Gained Share = New Profit Share – Old Profit Share

Treatment & Adjustment of Goodwill

- In this adjustment, gaining partners compensate the retiring partner by paying his share of goodwill in gaining ratio.
- If any of the continuing partner also sacrifice as a result of retirement, then such sacrificing partner will also be compensated with his sacrificed share in the goodwill.
- Journal entry for Goodwill Adjustment:

Continuing (Gaining) Partners' Capital / Current A/c	Dr.	[in Gaining Ratio]
To Retiring Partner's Capital / Current A/c		[Sacrificed Share]
To Continuing (Sacrificing) Partner's Capital / Current A/c		[Sacrificed Share]

- Existing Goodwill in the Balance Sheet (i.e. Purchased Goodwill) will be written off in Old PSR:

All Partners' Capital / Current A/c	Dr.	[in Old PSR]
To Goodwill A/c		[Book Value]

Hidden Goodwill

- This concept is applicable where final amount paid to the retiring partner is more than the amount due to such partner after all adjustments.
- Retiring Partner's Share of Goodwill (Hidden Goodwill)
= Amt paid to Retiring Partner in Full Settlement of His Claim (-) Amt Due After All Adjustments

Treatment of Reserves, Accumulated Profits & Fictitious Assets

- **Reserves & Accumulated Profits:**

Reserve A/c	Dr.	[Book Value]
P&L A/c (Cr. Balance)	Dr.	[Book Value]
To All Partners' Capital / Current A/c		[in Old Ratio]

- **Fictitious Assets (Deferred Revenue Exp & Accumulated Losses):**

All Partners' Capital / Current A/c	Dr.	[in Old Ratio]
To Advertisement Suspense A/c		[Book Value]
To P&L A/c (Dr. Balance)		[Book Value]

Treatment of Certain Special Reserves

Workmen Compensation Reserve (WCR)

It is a reserve created out of profits to meet possible liability of workers' claims like compensation payable in case of an accident. Following cases are applicable for its accounting treatment:

Case 1 – When no information of claim given / claim does not exist

WCR will be distributed normally (refer journal entry discussed above)

Case 2 – When Claim = WCR

WCR A/c	Dr.	[Book Value]
---------	-----	--------------

To Workmen Compensation Claim A/c [Claim Liability]

Case 3 – When Claim < WCR

WCR A/c	Dr.	[Book Value]	
To WC Claim A/c			[Claim Liability]
To All Partners' Capital / Current A/c			[in Old Ratio]

Case 4 – When Claim > WCR

WCR A/c	Dr.	[Book Value]	
Revaluation A/c	Dr.	[Claim (-) WCR]	
To WC Claim A/c			[Claim Liability]

* Revaluation Loss will be transferred to Partners' Capital / Current A/c (discussed later)

Note: Workmen Compensation Claim will be shown as liability in the reconstituted balance sheet.

Investment Fluctuation Reserve (IFR)

It is a reserve created out of profits to meet permanent fall in market value of investment from its original cost. Following cases are applicable for its accounting treatment:

Case 1 – When no information of market value given / Market Value = Book Value of Investment.

IFR will be distributed normally (refer journal entry discussed above)

Case 2 – When Market Value < Book Value & Fall in Value < IFR

IFR A/c	Dr.	[Book Value]	
To Investment A/c			[Fall in Value]
To All Partners' Capital / Current A/c			[in Old Ratio]

Case 3 - When Market Value < Book Value & Fall in Value = IFR

IFR A/c	Dr.	[Book Value]	
To Investment A/c			[Fall in Value]

Case 4 - When Market Value < Book Value & Fall in Value > IFR

IFR A/c	Dr.	[Book Value]	
Revaluation A/c	Dr.	[Fall in Value (-) IFR]	

To Investment A/c

[Fall in Value]

* Revaluation Loss will be transferred to Partners' Capital / Current A/c (discussed later)

Case 5 – When Market Value > Book Value

IFR A/c	Dr.	[Book Value]
Investment A/c	Dr.	[Increase in Value]
To Revaluation A/c		[Increase in Value]
To All Partners' Capital / Current A/c		[IFR in Old Ratio]

* Revaluation Gain will be transferred to Partners' Capital / Current A/c (discussed later)

Note: Investment will be shown at market value in the reconstituted balance sheet.

Treatment of Reserves, Accumulated Profits & Fictitious Assets Using Single Adjustment Entry

This concept is applicable if these are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Reserves	xxx
P&L (Cr. Balance)	xxx
Advertisement Suspense A/c	(xxx)
P&L (Dr. Balance)	<u>(xxx)</u>
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Net Gain):

Gaining Partners' Capital / Current A/c	Dr.	[NE x Gained Share]
To Sacrificing Partners' Capital / Current A/c		[NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Net Loss):

Sacrificing Partners' Capital / Current A/c	Dr.	[NE x Sacrificed Share]
To Gaining Partners' Capital / Current A/c		[NE x Gained Share]

Revaluation of Asset / Reassessment of Liabilities

At the time of reconstitution of firm, assets are revalued & liabilities are reassessed, and any profit/ loss arising from such revaluation is transferred to the partners' capital in their old ratio. For this purpose, a nominal account i.e. **Revaluation A/c** is prepared.

Revaluation A/c

Particulars	₹	Particulars	₹
To Assets A/c (individually) (decrease)	xxx	By Assets A/c (individually) (increase)	xxx
To Liabilities A/c (individually) (increase)	xxx	By Liabilities A/c (individually) (decrease)	xxx
To Unrecorded Liabilities A/c	xxx	By Unrecorded Assets A/c	xxx
To Partners' Capital A/c (Remuneration)	xxx	By Loss on Revaluation t/f to Partners' Capital / Current A/c (in old PSR)	xxx
To Cash / Bank A/c (Expenses)	xxx		
To Profit on Revaluation t/f to Partners' Capital / Current A/c (in old PSR)	xxx		
	xxx		xxx

Note: Assets & liabilities will appear in the reconstituted balance sheet at their revised values.

Revaluation of Assets & Reassessment of Liabilities Using Single Adjustment Entry

This concept is applicable if revalued assets & liabilities are to be retained in the books i.e. continued in the reconstituted balance sheet at their old values.

	₹
Increase in Asset (incl. Unrecorded Asset)	xxx
Decrease in Liability	xxx
Increase in Liability (incl. Unrecorded Liability)	(xxx)
Decrease in Asset	(xxx)
Net Effect (NE)	xxx

(A) If Net Effect is +ve (i.e. Profit on Revaluation):

Gaining Partners' Capital / Current A/c	Dr.	
To Sacrificing Partners' Capital / Current A/c	Dr.	
		[NE x Gained Share]
		[NE x Sacrificed Share]

(B) If Net Effect is -ve (i.e. Loss on Revaluation):

Sacrificing Partners' Capital / Current A/c	Dr.	
To Gaining Partners' Capital / Current A/c	Dr.	
		[NE x Sacrificed Share]
		[NE x Gained Share]

Determining the Amount Due to the Retiring Partner

- Amount due to the retiring partner, is determined by preparing Retiring Partner's Capital A/c.
- If the firm is following Fixed Capital Method, then balance of Retiring Partner's Current
- Balance left in the Retiring Partner's Capital A/c after all adjustments, is the final amount payable to the retiring partner.
- Treatment of Amount Due to Retiring Partner:

Case (1) – Amt Due is not paid at the time of retirement (Assumed if Q is silent)

Balance of Retiring Partner's Capital A/c is transferred to Retiring Partner's Loan A/c:

Retiring Partner's Capital A/c	Dr.	[Balancing Fig. of
To Retiring Partner's Loan A/c		Retiring Partner's Capital A/c]

Case (2) – Amt Due is Fully Paid at the Time of Retirement

Retiring Partner's Capital A/c	Dr.	[Total Amt Due]
To Cash / Bank A/c		[Amt Paid]

Case (3) – Amt Due is Partially Paid at the Time of Retirement

Retiring Partner's Capital A/c	Dr.	[Total Amt Due]
To Cash / Bank A/c		[Amt Paid]
To Retiring Partner's Loan A/c		[Amt Unpaid]

Note: Retiring Partner's Loan A/c is shown in the Reconstituted Balance Sheet on liability side.

- Unless otherwise agreed to in the Partnership Deed, retiring partner is entitled to:

(i) Interest @ 6% p.a. till the amount is paid.

OR

(ii) Share of Profit that has been earned using the due amount

at the option of the Retiring Partner.

CH – DEATH OF A PARTNER

The accounting process on the death of a partner is same as that of retirement of a partner, except following differences:

- ✓ Retirement can be planned, since it is voluntary in nature. However, death cannot be planned.
- ✓ Amount due after all adjustments, is paid to the retiring partner, in case of retirement., whereas amount due is paid to the deceased partner's legal heirs, in case of death.

New PSR & Gaining Ratio

It is same as done in Retirement of a Partner.

Treatment & Adjustment of Goodwill

It is same as done in Retirement of a Partner.

Treatment of Reserves, Accumulated Profits & Fictitious Assets

It is same as done in Retirement of a Partner.

Revaluation of Asset / Reassessment of Liabilities

It is same as done in Retirement of a Partner.

Determination of Deceased Partner's Share in Profit / Loss

Case (1) – Final Accounts are prepared on the date of death

Profit / loss is determined normally by preparing Profit & Loss A/c. Deceased partner's share is transferred to his capital, by preparing Profit & Loss Appropriation A/c:

In case of profit:

Profit & Loss Appropriation A/c	Dr.	xxx	
To Deceased Partner's Capital A/c			xxx

In case of loss:

Deceased Partner's Capital A/c	Dr.	xxx	
To Profit & Loss Appropriation A/c			xxx

Case (2) – When profit / loss is to be estimated

Method (1) – Estimation of Profit on Time Basis

In this method, the profit is assumed to have arisen uniformly over the year. The profit used may be previous year's profit or average profit of certain years (depending on instruction given in the question).

Example: X, Y & Z are partners with PSR of 3:2:1. Z died on 30th June, 2021. Profit for the year ended 31st March, 2021 was ₹6,00,000.

In this case, Z's share in profit for the period 1st April, 2021 to 30th June, 2021 will be:
 $₹6,00,000 \times 3/12 \times 1/6 = ₹25,000$.

Method (2) – Estimation of Profit on Turnover Basis

Deceased partner's share in Profit
= [Last Year's Profit / Last Year's Sale] x Sales till Date of Death x Deceased Partner's Share

Accounting Treatment where Profit / Loss is Estimated:

Case (1) – If PSR of the Continuing Partners Does Not Change

(a) When deceased partner's share is a Profit:

Profit & Loss Suspense A/c	Dr.	xxx	
To Deceased Partner's Capital A/c			xxx

(b) When deceased partner's share is a Loss:

Deceased Partner's Capital A/c	Dr.	xxx	
To Profit & Loss Suspense A/c			xxx

Note: Balance of Profit & Loss Suspense A/c will be shown in the reconstituted Balance Sheet as follows:

- ✓ In case of Debit Balance – Asset side
- ✓ In case of Credit Balance – Liability side

Case (2) – If PSR of the Continuing Partners Changes

(a) When deceased partner's share is a Profit:

(i) Profit & Loss Suspense A/c	Dr.	xxx	
To Deceased Partner's Capital A/c			xxx

(ii) Gaining Partners' Capital A/c Dr. xxx
 To Profit & Loss Suspense A/c xxx
 OR

Combination of (i) & (ii):

Gaining Partners' Capital A/c Dr. [in Gaining Ratio]
 To Deceased Partner's Capital A/c xxx

(b) When deceased partner's share is a Loss:

(i) Deceased Partner's Capital A/c Dr. xxx
 To Profit & Loss Suspense A/c xxx

(ii) Profit & Loss Suspense A/c Dr. xxx
 To Gaining Partners' Capital A/c [in Gaining Ratio]
 OR

Combination of (i) & (ii):

Deceased Partner's Capital A/c Dr. xxx
 To Gaining Partners' Capital A/c [in Gaining Ratio]

Computation of Amount Due To Deceased Partner's Executors

It is determined by preparing & balancing the Deceased Partner's Capital A/c.

Deceased Partner's Capital A/c

Particulars	₹	Particulars	₹
To Current A/c (Debit Balance)	xxx	By bal b/d	xxx
To Loan to Partner A/c	xxx	By Current A/c (Credit Balance)	xxx
To Revaluation A/c (Share of Loss)	xxx	By Loan by Partner A/c	xxx
To P&L A/c (Dr.)	xxx	By P&L Suspense A/c	xxx
(Share in Accumulated Losses)		(Share in Profit)	
To Drawings A/c	xxx	By Revaluation A/c	xxx
To Interest on Drawings	xxx	(Share in Profit)	
To P&L Suspense A/c	xxx	By P&L A/c (Cr.)	xxx
(Share of Loss)		(Share in Accumulated Profits)	
To Goodwill A/c	xxx	By Reserves A/c	xxx
To Deceased Partner's Executors' A/c (bal. fig.)	xxx	By P&L Suspense A/c	xxx
		(Interest on Capital)	
		By Salary or Commission	xxx
	xxx		xxx

Note: In case there is debit balance in Deceased Partner's Capital, it is recovered from the private estate of deceased partner.

Note: All Items Debited to the Deceased Partner's Capital A/c = Deductions
All Items Credited to the Deceased Partner's Capital A/c = Additions / Inclusions

Amount due to the deceased partner's executors may be paid:

- (i) In lump sum on death
- (ii) In more than one instalment

Section 37 of the Indian Partnership Act, 1932

If any amount payable to the outgoing partner (i.e. retired / deceased partner) remains unpaid, and no agreement exists in respect of interest on the unpaid amount, then the outgoing partner shall be entitled to **(at the choice of the outgoing partner or his legal representative)**:

- (i) Interest @ 6% p.a. till the date of settlement; or
- (ii) Proportionate share in profit earned using the outstanding amount, i.e.
[Outstanding Amt ÷ (Total Capital of Continuing Partner + Outstanding Amt)] x
Profits from the date of retirement / death to the date of settlement

CH – DISSOLUTION OF A PARTNERSHIP FIRM

Dissolution process starts by preparing the following accounts in the firm's book:

1. Realisation A/c
2. Loan by Partner A/c
3. Loan to Partner A/c
4. Partners' Capital A/c
5. Cash / Bank A/c

Realisation Account

- It is prepared to:
 - ✓ close the books of account of the firm (i.e. assets & liabilities); and
 - ✓ determine profit / loss on realisation of assets & settlement of liabilities.

- Journal Entries:

(i) For closing the "Asset Accounts"

Realisation A/c	Dr.	xxx	
	To Asset A/c (Individually)		xxx

Note: Following items appearing on Asset side of the Balance Sheet will NOT be transferred to Realisation A/c in the above entry:

- Fictitious Assets [Deferred Revenue Expenditure, P&L (Dr. Balance)]
- Cash / Bank A/c
- Debit Balance of Capital / Current A/c
- Loan to Partner A/c

Note: Existing goodwill appearing in the Balance Sheet will also be transferred to Realisation A/c.

(ii) For closing the "Liabilities Accounts"

Liabilities A/c (Individually)	Dr.	xxx	
	To Realisation A/c		xxx

Note: Following items appearing on Liabilities side of the Balance Sheet will NOT be transferred to Realisation A/c in the above entry:

- P&L (Cr. Balance)
- Credit Balance of Partners' Capital A/c & Current A/c
- Loan by Partners A/c
- Reserves (other than Reserves made against Asset)

Note: Provisions & Reserves against an asset is also transferred to Realisation A/c in the above entry. (For eg: Investment Fluctuation Reserve, Provision for Doubtful Debts etc.)

(iii) **For realisation (Sale) of Assets (whether recorded or unrecorded)**

(a) Assets sold for cash

Cash / Bank A/c	Dr.	[Amount Realised]
To Realisation A/c		

(b) Assets taken over by Partner

Partner's Capital A/c	Dr.	[Agreed Amount]
To Realisation A/c		

(c) Asset transferred to settle a liability (For eg: Asset given to creditor)

----- NO ENTRY -----

Note: If question is silent on realisation of any asset, it is assumed that such asset has not been realised. However, as per CBSE guidelines, realised value of asset should be given in the question.

(iv) **For settlement of liabilities (whether recorded or unrecorded)**

(a) Payment of liability in Cash

Realisation A/c	Dr.	[Amount Paid]
To Cash / Bank A/c		

(b) Partner agrees to settle the liability

Realisation A/c	Dr.	[Agreed Amount]
To Partner's Capital A/c		

Note: If question is silent on settlement of any liability, then assume it has been settled in cash at Book Value.

Conceptual Example:

Book Value of Creditor = ₹15,000

Stock (Book Value) = ₹25,000

Creditors took stock of Book Value of ₹12,000 at ₹10,000. Balance Stock realised ₹10,000. Pass journal entries for settlement & realisation.

Solution:

(1) Stock taken over by creditor:

No entry will be passed.

(2) Stock sold for ₹10,000:

Cash / Bank A/c	Dr.	10,000	
To Realisation A/c			10,000

(3) Settlement of balance creditors:

Realisation A/c	Dr.	5,000	
To Cash / Bank A/c			5,000

* Balance Creditors = ₹15,000 (-) ₹10,000
= ₹5,000

(v) **Realisation / Dissolution Expenses**

Case (1) – Borne & Paid by Firm

Realisation A/c	Dr.	xxx	
To Cash / Bank A/c			xxx

Case (2) – Borne by Firm but Paid by Partner (i.e. Paid by Partner on Behalf of Firm)

Realisation A/c	Dr.	xxx	
To Partner's Capital A/c			xxx

Case (3) – Borne by Partner But Paid by Firm (i.e. Paid by Firm on Behalf of Partner)

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

Case (4) – Borne & Paid by Partner

-----NO ENTRY-----

Case (5) – For Payment of Remuneration or Agreed Fixed Amount to a Partner

Treatment of Partner's Loan

(A) Loan by Partner

Following entry is passed for settlement:

Loan by Partner A/c	Dr.	[Book Value]	
To Cash / Bank A/c			[Amt Paid]
To Realisation A/c			[Gain on Settlement]

(B) Loan to Partner

Following entry is passed on receipt of loan (even if Q is silent):

Cash / Bank A/c	Dr.	[Amt Received]	
Realisation A/c	Dr.	[Loss, if any]	
To Loan to Partner A/c			[BV of Loan]

Treatment of Reserves, Accumulated Profits & Fictitious Assets

(A) Reserves & Accumulated Profit

Reserves A/c*	Dr.	[BV]	
Profit & Loss (Cr.) A/c	Dr.	[BV]	
To Partners' Capital A/c			[in PSR]

* Excluding Investment Fluctuation Reserve

(B) Treatment of Fictitious Assets

Partners' Capital A/c	Dr.	[in PSR]	
To Advertisement Suspense A/c			[BV]
To Profit & Loss (Dr.) A/c			[BV]

Treatment of Workmen Compensation Reserve

Example:

Balance Sheet of X & Y as at...(Extract)

Liabilities	₹	Assets	₹
Workmen Compensation Reserve	10,000		

Case (1) – When no claim exist / no information is given

Workmen Compensation Reserve A/c	Dr.	10,000	
To X's Capital A/c			5,000
To Y's Capital A/c			5,000

Case (2) – When Claim < WCR (say ₹6,000)

(i) WCR A/c	Dr.	10,000	
To Realisation A/c			6,000
To X's Capital A/c			2,000
To Y's Capital A/c			2,000
(ii) Realisation A/c	Dr.	6,000	
To Cash / Bank A/c			6,000

Case (3) – When Claim = WCR (i.e. Claim = ₹10,000)

(i) WCR A/c	Dr.	10,000	
To Realisation A/c			10,000
(ii) Realisation A/c	Dr.	10,000	
To Cash / Bank A/c			10,000

Case (4) – When Claim > WCR (say ₹14,000)

(i) WCR A/c	Dr.	10,000	
To Realisation A/c			10,000
(ii) Realisation A/c	Dr.	14,000	
To Cash / Bank A/c			14,000

Treatment of Partners' Current A/c

If the firm follows Fixed Capital Method, and accordingly, Partners' Current A/c Balances appear in the given Balance Sheet, then such Current A/c Balances are closed by transferring them to respective Capital A/cs, as follows:

(i) Debit Balance of Partner's Current A/c (i.e. Asset Side of B/S)

Partner's Capital A/c	Dr.	xxx	
To Partner's Current A/c			xxx

(ii) **Credit Balance of Partner's Current A/c (i.e. Liability Side of B/S)**

Partner's Current A/c	Dr.	xxx	
To Partner's Capital A/c			xxx

Preparation & Settlement of Partners' Capital A/c

After posting all the transactions, Partners' Capital A/cs are closed, by putting the balancing figure in Cash / Bank A/c, as follows:

(i) **When Balancing Fig. is on debit side (i.e. Credit Balance of Capital A/c)**

It shows the final amount due to the partner, which is settled by paying cash:

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

(ii) **When Balancing Fig. is on credit side (i.e. Debit Balance of Capital A/c)**

It shows the final amount due from the partner (i.e. deficiency of capital), which is brought in cash by the partner:

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

Preparation of Cash / Bank A/c

- After preparing & closing all the accounts, finally Cash / Bank A/c (depending on what is given in the B/S of the Question) is prepared. All the transactions along with given opening balance, are posted in the A/c.
- If both, Cash & Bank, is given in the B/S, then it is better to pass all the transactions through Bank A/c only, and close the Cash A/c, by transferring it to the Bank A/c. Alternatively, Bank A/c may be closed by transferring the balance to Cash A/c.
- In the end, Cash A/c / Bank A/c will tally i.e. no balance will be left.

CH – ACCOUNTING FOR SHARE CAPITAL

Issue of Shares

Shares can be issued:

- (i) for cash; or
- (ii) for consideration other than cash (to vendors, promoters, underwriters etc)

Further, shares may be issued:

- (i) at **par** – i.e. Issue Price = Face Value
- (ii) at **premium** – i.e. Issue Price > Face Value
- (iii) at **discount** – i.e. Issue Price < Face Value – prohibited as per Sec. 53 of the Companies Act, 2013, except if issued as “Sweat Equity Shares” under Sec. 54.

Issue of Shares for Cash

When shares are issued for cash, issue price (consideration) may be received:

- (i) in lumpsum i.e. along with application; or
- (ii) in instalments i.e. at different stages – Application, Allotment & Calls (1st, 2ndfinal)

Accounting Treatment

Case (A) – Issue Price is Received in Lump Sum

- (1) Bank A/c Dr. [Application & allotment money received]
To Equity Share Application & Allotment A/c
- (2) Equity Share Application & Allotment A/c Dr. [Application & allotment]
To Equity Share Capital [₹ received towards capital]
To Securities Premium Reserve [₹ received towards premium]

Case (B) – Issue Price is Receivable in Instalments at Different Stages

- (1) Bank A/c Dr. [Application money received]
To Equity Share Application A/c [Application money received]
- (2) Equity Share Application A/c Dr. [Application money received]
To Equity Share Capital [₹ received towards capital]
To Securities Premium Reserve [₹ received towards premium]
[Application money transferred on allotment]

(3)	Equity Share Allotment A/c To Equity Share Capital To Securities Premium Reserve [Allotment money due]	Dr.	[₹ due on Allotment] [₹ due towards capital] [₹ due towards premium]
(4)	Bank A/c Calls-in-Arrears A/c To Equity Share Allotment A/c [Allotment money received]	Dr. Dr.	[₹ received] [₹ not received] [₹ due on allotment]
(5)	Equity Share First Call A/c To Equity Share Capital To Securities Premium Reserve [First call due]	Dr.	[₹ due on 1 st Call] [₹ due towards capital] [₹ due towards premium]
(6)	Bank A/c Calls-in-Arrears A/c To Equity First Call A/c [1 st Call received]	Dr. Dr.	[₹ received] [₹ not received] [₹ due on 1 st Call]
(7)	Equity Share Second & Final Call A/c To Equity Share Capital To Securities Premium Reserve [Second & final call due]	Dr.	[₹ due on 2 nd Call] [₹ due towards capital] [₹ due towards premium]
(8)	Bank A/c Calls-in-Arrears A/c To Equity Second & Final Call A/c [2 nd Call received]	Dr. Dr.	[₹ received] [₹ not received] [₹ due on 2 nd Call]

* Assuming 2nd Call is the final call.

Note: If Q is silent on when premium is to be received, it is assumed that premium is receivable along with allotment money.

Note: If cash book is to be prepared, then all Bank transactions in the above entries will be recorded in cash book.

Issue of Shares for Consideration Other Than Cash

(i) **Purchase of Asset**

Sundry Asset A/c To Vendor's A/c	Dr.	[Agreed Value or Purchase Consideration]
-------------------------------------	-----	---------------------------------------------

OR

Purchase of Business

Sundry Assets A/c (Individually)	Dr.	[Agreed Value]
Goodwill A/c	Dr.	[Balancing fig.]
To Sundry Liabilities A/c		[Agreed Value]
To Vendor's A/c		[Purchase Consideration]
To Capital Reserve A/c		[Balancing Fig.]

* If Agreed PC > Net Asset Purchased => Goodwill

* If Agreed PC < Net Asset Purchased => Capital Reserve

* Net Asset Purchased = Agreed Value of Asset (-) Agreed Value of Liabilities

(ii) **Issue of Shares**

Vendor A/c	Dr.	[Purchase Consideration]
To Equity Share Capital A/c		[No. of shares x F.V. per share]
To Securities Premium Reserve A/c		[No. of shares x Prem. per share]
To Bank A/c (if any)		[Part of PC Paid in Cash]
To Bills Payable A/c		[Accepted, if any]

Note:

No. of shares = [Agreed PC to be Paid by Issue of Shares ÷ Issue Price per share]

Issue price per share = F.V. per share + premium per share (if any)

Accounting Treatment of Calls-in-Arrears

Any of the following 2 methods may be followed:

Method 1 – By Opening Calls-in-Arrears A/c (Refer journal entries discussed above)

Method 2 – Without Opening Calls-in-Arrears A/c i.e. no separate account is opened for the unpaid amount. It remains as balance in the relevant call A/c.

Interest rate on Calls-in-Arrears as per Table F – **10% p.a.**

Accounting Treatment of Calls-in-Advance

Following accounting entries are relevant:

(i) Bank A/c	Dr.	[Call received in Advance]
To Calls-in-Advance A/c		
(ii) Calls-in-Advance A/c	Dr.	[Calls-in-Advance adjusted]
To Relevant Call A/c		

Interest rate on Calls-in-Advance as per Table F – **12% p.a.**

Oversubscription of Shares

It means => No. of shares subscribed (applied) > No. of shares issued

Allotment & Accounting Treatment

Any of the **3 alternatives** may be followed:

Alternative 1 – Reject the excess application & refund the application money, & accept the remaining applications fully. Following accounting entry is relevant:

Equity Share Application A/c	Dr.	[Total Application money received]
To Equity Share Capital A/c		[No. of shares allotted x F.V per share]
To Securities Premium Reserve		[if any]
To Bank A/c		[Application money refunded]

Alternative 2 – Pro-rata Allotment i.e. proportionate allotment [Eg: 2 shares allotted for every 5 shares applied]

Alternative 3 – Combination of Alternative 1 & 2.

Treatment of Excess Application Money in Case of Pro-rata Allotment

Excess Application Money =

[No. of shares applied (-) No. of shares allotted] x Application (₹) per share

Case (1) – If excess is to be adjusted against allotment only (assume if Q is silent):

Adjust against money due on allotment & any surplus remaining will be refunded.

Equity Share Application A/c	Dr.	[Total Application money received]
To Equity Share Capital A/c		[No. of shares allotted x F.V per share]
To Securities Premium Reserve		[if any]
To Equity Share Allotment A/c		[₹ to be adjusted against allotment]
To Bank A/c		[Application money refunded]

Case (2) - If excess is to be adjusted against allotment & future calls (only if Q specifies)

Equity Share Application A/c	Dr.	[Total Application money received]
To Equity Share Capital A/c		[No. of shares allotted x F.V per share]
To Securities Premium Reserve		[if any]
To Equity Share Allotment A/c		[₹ to be adjusted against allotment]
To Calls-in-Advance A/c		[₹ to be adjusted against calls]

Note: Where excess application money is to be adjusted against allotment, and premium is payable along with allotment, then excess money will be first adjusted towards Share Capital. Any amount left is then adjusted towards premium due on allotment.

Calculation of No. of Shares Allotted / Applied in case of Pro-rata Allotment (say for Mr. X)

When no. of shares applied by Mr. X is given:

No. of Shares Allotted to Mr. X =

$[\text{Total No. of Shares Allotted} / \text{Total No. of Shares Applied}]^* \times \text{No. of shares applied by Mr. X}$

When no. of shares allotted to Mr. X is given:

No. of Shares Applied by Mr. X =

$[\text{Total No. of Shares Applied} / \text{Total No. of Shares Allotted}]^* \times \text{No. of shares allotted to Mr. X}$

* In the relevant category of Pro-rata allotment

Calculation of Amt due but not Paid by Defaulting Shareholder on Allotment in Case of Pro-Rata Allotment:

	₹
Amt due on Allotment [No. of shares allotted x Allotment (₹) per share]	xxx
Less: Excess application money adjusted against allotment*	<u>(xxx)</u>
Amt due but unpaid on allotment	xxx

* $[\text{No. of shares applied} (-) \text{No. of shares allotted}] \times \text{Application (₹) per share}$

Undersubscription of Shares

It means => No. of shares subscribed (applied) < No. of shares issued.

Allotment is made to all the applicants (provided minimum subscription is received). Hence, no special accounting treatment is required.

Forfeiture of Shares

- It means cancellation of shares for non-payment of called amount. A notice is required to be given to the defaulting shareholder before such cancellation.
- Amount received on forfeited shares is not refunded, but is transferred to "Forfeited Share A/c".
- Balance of "Forfeited Share A/c" is added to paid-up capital under Subscribed Capital in the Notes to Accounts on Share Capital, till the time these forfeited shares are reissued.

Accounting Treatment

(A) Forfeiture of Shares Issued at Par

Equity Share Capital A/c	Dr.	[No. of Shares Forfeited x FV Called up per share]
To Forfeited Shares A/c		[Amt received on forfeited shares]
To Equity Share Relevant Call A/c / Calls-in-Arrears A/c		[Amt due but not received]

(B) Forfeiture of Shares Issued at Premium

(i) When premium has been received on forfeited shares

Securities Premium Reserve A/c will NOT be debited in the forfeiture entry, since once Securities Premium has been received, it can be utilised only for the purpose specified in Sec 52(2) of Companies Act, 2013.

Equity Share Capital A/c	Dr.	[No. of Shares Forfeited x FV Called up per share]
To Forfeited Shares A/c		[FV received on forfeited shares]
To Equity Share Relevant Call A/c / Calls-in-Arrears A/c		[Amt due but not received]

(ii) When premium has not been received on forfeited shares

Securities Premium Reserve will be debited in the forfeiture entry:

Equity Share Capital A/c	Dr.	[No. of Shares Forfeited x FV Called up per share]
Securities Premium Reserve A/c	Dr.	[Premium Called but not received]
To Forfeited Shares A/c		[FV received on forfeited shares]
To Equity Share Relevant Call A/c / Calls-in-Arrears A/c		[Amt due but not received incl. premium]

Reissue of Forfeited Shares

- It means reissuing the shares that were forfeited (cancelled) by the company.
- Forfeited shares may be reissued at :
 - (i) at Par – when Reissue Price = Paid-up value of reissued shares
 - (ii) at Premium - when Reissue Price > Paid-up value of reissued shares
 - (iii) at Discount - when Reissue Price < Paid-up value of reissued shares

Maximum Permissible Discount on Reissue & Minimum Reissue Price

Maximum Permissible Discount per share = Amt forfeited (i.e. FV received) per share

Minimum Reissue Price = Paid-up Value of Reissued Shares (-) Maximum Discount

Accounting Entries for Reissue

(i) Reissue at Par

Bank A/c	Dr.	[Amt received]	
To Equity Share Capital A/c			[Paid-up Value]

(ii) Reissue at Premium

Bank A/c	Dr.	[Amt Received]	
To Equity Share Capital			[Paid-up Value]
To Securities Premium Reserve A/c			[Premium on Reissue]

(iii) Reissue at Discount

Bank A/c	Dr.	[Amt Received]	
Forfeited Shares A/c	Dr.	[Discount on Reissue]	
To Equity Share Capital A/c			[Paid-up Value]

Calculation of Gain on Reissue of Forfeited Shares to be T/f to Capital Reserve

Following cases are relevant

Case (1) – When all the forfeited shares are reissued

Capital Reserve = Balancing fig. of “Forfeited Shares A/c”

Case (2) – When all the forfeited shares are not reissued

Capital Reserve =

{[Amt Forfeited ÷ No. of shares forfeited] x No. of shares reissued} (-) Discount on Reissue

Accounting Entry for Transfer to Capital Reserve:

Forfeited Shares A/c	Dr.	xxx	
To Capital Reserve A/c			xxx

CH – COMPANY ACCOUNTS – ISSUE OF DEBENTURES

Disclosure of Debentures in the Balance Sheet

- (i) **As Long-Term Borrowings under the head Non-Current Liabilities** – if it is due for redemption after 12 months / operating cycle period (whichever is later) from the Balance Sheet Date.
- (ii) **As Short-Term Borrowings under the head Current Liabilities** – if it is due for redemption within 12 months / operating cycle period (whichever is later) from the Balance Sheet Date.

Note: Classification of debentures as long-term or short-term borrowings is determined on the date of issue of debentures.

Note: If the Question is silent, assume debentures to be Long-Term Borrowings and show under the head Non-Current Liabilities.

Example 1:

Debentures of ₹1,00,000 are issued on 1st April, 2020. They are to be redeemed on 31st March, 2024. How will they be disclosed in the Balance Sheet as at 31st March, 2021?

Answer:

Debentures of ₹1,00,000 will be shown under Long-Term Borrowing under the head Non-Current Liabilities.

Example 2:

Debentures of ₹1,00,000 are issued on 1st April, 2020. They are to be redeemed on 31st January, 2022. How will they be disclosed in the Balance Sheet as at 31st March, 2021?

Answer:

Debentures of ₹1,00,000 will be shown under Short-Term Borrowing under the head Current Liabilities.

Note: Current Maturities Long-Term Debts (Debentures) are shown under Other Current Liabilities under the head Current Liabilities.

Example 3:

Debentures Outstanding on 31st March, 2021 - ₹20,00,000. Out of this, ₹2,00,000 is due for redemption on 31st January, 2022. Remaining debentures are to be redeemed after 31st March, 2022. How will they be disclosed in the Balance Sheet as at 31st March, 2022.

Answer:

₹2,00,000 will be shown under Other Current Liabilities under the head Current Liabilities (Current Maturities of Long-Term Debts).

Remaining debentures of ₹18,00,000 will be shown under Long-Term Borrowings under the head Non-Current Liabilities.

Issue of Debentures

- Debentures may be issued:
 - (i) for cash
 - (ii) for consideration other than cash
 - (iii) as collateral security
- Debentures issued for cash / consideration other than cash may be issued:
 - (i) at Par => Issue Price = Face Value
 - (ii) at Premium => Issue Price > Face Value
 - (iii) at Discount => Issue Price < Face Value

Issue of Debentures for Cash

Where debentures are issued for cash, issue price may be collected / received:

- (i) in lumpsum (i.e. along with application); or
- (ii) in instalments (i.e. along with application, allotments & calls)

Case (i) – When Issue Price is Received in Lumpsum

(i)	Bank A/c	Dr.	xxx	
	To Debenture Application & Allotment A/c			xxx
(ii)	Debenture Application & Allotment A/c	Dr.	xxx	
	To% Debentures A/c			xxx

Case (ii) – When Issue Price is Received in Instalments

(i)	Bank A/c	Dr.	xxx	
	To Debenture Application A/c			xxx
(ii)	Debenture Application A/c	Dr.	xxx	
	To% Debentures A/c			xxx
(iii)	Debenture Allotment A/c	Dr.	xxx	
	To% Debentures A/c			xxx

(iv)	Bank A/c To Debenture Allotment A/c	Dr.	xxx	xxx
(v)	Debenture First Call A/c To% Debentures A/c	Dr.	xxx	xxx
(vi)	Bank A/c To Debenture First Call A/c	Dr.	xxx	xxx
(vii)	Debenture Second & Final Call A/c* To% Debentures A/c	Dr.	xxx	xxx
(viii)	Bank A/c To Second & Final Call A/c*	Dr.	xxx	xxx

* Assuming Second Call to be the final call

Note: Face Value of Debentures is credited to% Debentures A/c

Issue of Debentures at Premium

- In such a case, premium received / receivable is credited to “**Securities Premium Reserve**”. It is a **capital receipt** for the company.
- If question is silent on when the premium is receivable, it is assumed to be receivable along with allotment money.

Issue of Debentures at Discount

- Discount allowed is debited to “**Discount on Issue of Debentures A/c**”, since it is a **capital loss** for the company.
- If question is silent on when discount is to be allowed, it is assumed that it has been allowed on allotment, and allotment money is taken as net of discount.

Oversubscription of Debentures

- It is a situation when company receives more applications than number of debentures issued i.e., **No. of Applications > No. of Debentures Issued**.
- In such a case allotment is done by following any of the **3 alternatives**:
 - (1) Reject excess application & refund application money received on the same
 - (2) Pro-rata or Partial Allotment
 - (3) Combination of (1) & (2)

- In case of pro-rata allotment, excess application money is adjusted against allotment money due, and **if question specifies**, against future calls. Balance left after such adjustment is refunded.

* Excess Application Money = [No. of Debentures Applied (-) No. of Debentures Allotted] x Application Money per debenture (₹)

Undersubscription of Debentures

- It is a situation when the company receives lesser number of applications than number of debentures issued i.e., **No. of Applications < No. of Debentures Issued.**
- No special accounting treatment is required. All the calculations are done on the basis of number of debentures applied.

Issue of Debentures for Consideration Other Than Cash

Debentures may be issued for consideration other than cash to:

- Promoters
- Underwriters
- Vendors:
 - for Purchase of Assets
 - for Purchase of Business

(i) Issue of Debentures to Promoters

(1)	Incorporation Expense / Preliminary Expense A/c	Dr.	xxx	
	To Promoters A/c			xxx
(2)	Promoters A/c	Dr.	xxx	
	To % Debentures A/c			xxx

(ii) Issue of Debentures Underwriters (in lieu of their Commission)

(1)	Underwriting Commission A/c	Dr.	xxx	
	To Underwriters A/c			xxx
(2)	Underwriters A/c	Dr.	xxx	
	To % Debentures A/c			xxx

Note: Incorporation / Preliminary Expense / Underwriting Commission is written off in the year it is incurred from:

- Securities Premium Reserve
- Capital Reserve

(c) Statement of Profit & Loss
in that order.

(iii) Issue of Debentures to Vendors

(1) (a) For Purchase of Asset:

Sundry Assets A/c	Dr.	xxx	
To Vendor A/c			xxx
			OR

(b) For Purchase of Business:

Sundry Assets A/c (Individually)	Dr.	[Agreed Value]	
Goodwill A/c	Dr.	[Bal. Fig.]	
To Sundry Liabilities A/c (Individually)			[Agreed Value]
To Vendor A/c			[Agreed PC]
To Capital Reserve			[Bal. Fig.]

* Net Assets > Agreed PC => Capital Reserve

* Net Assets < Agreed PC => Goodwill

(2) For Issue of Debentures:

Vendor A/c	Dr.	[Agreed PC]	
Discount on Issue of Debentures A/c	Dr.	[if issued @ discount]	
To Bank A/c		[if any]	
To Bills Payable A/c		[if any]	
To % Debentures A/c		[FV]	
To Securities Premium Reserve A/c		[if issued @ premium]	

Note:

No. of debentures = [Agreed PC to be Paid by Issue of Debenture ÷ Issue Price per Debenture]

Issue price per Debenture = F.V. per debenture (+) premium per debenture (if any)
or (-) discount per debenture (if any)

Issue of Debentures as Collateral Security

- Security given in addition to the primary / principal security is known as collateral security. Thus, debentures may be issued as collateral security.
- Collateral security is realised only if loan cannot be recovered by realising primary / principal security.

- Debentures issued as collateral security do not carry any right, till the time loan is being repaid as per agreed terms or on demand.
- Accounting Treatment:

Method 1 – Without Passing any Journal Entry

- No entry is passed for issue of debentures. Only following entry for loan taken is passed:

Bank A/c	Dr.	xxx	
To Term Loan from Bank			xxx
- Loan is shown under Long-Term Borrowings (NCL) / Short-Term Borrowings (CL) (as the case may be).
- The fact that loan is secured by issue of debentures as collateral security is disclosed in the relevant Notes to Accounts.

Example:

Extract of Balance Sheet of as at ...

Particulars	Note no.	₹
EQUITY & LIABILITIES		
Non-Current Liabilities		
Long-Term Borrowings	1	10,00,000

Notes to Accounts:

Note	Particulars	₹
1.	Long-Term Borrowings Term Loan from Bank (Secured by issue of 12,000, 8% Debentures of ₹100 each as Collateral Security)	10,00,000

Method 2 – By Passing Journal Entry

- Under this method, following journal entry is passed for the issue of debentures as collateral security, **in addition to the entry for loan obtained, as discussed in Method 1:**

Debenture Suspense A/c	Dr.	xxx	
To % Debentures A/c			xxx
- Debenture Suspense A/c is shown as a deduction from % Debenture A/c, in the Notes to Accounts.

2	Discount	Par
3	Premium	Par
4	Par	Premium
5	Discount	Premium
6	Premium	Premium

Note: Accounting treatment for Case 1 to 3 is same as normal accounting treatment for issue of debentures, as already discussed earlier.

Case 4 – Issued at Par, Redeemable at Premium

- (i) Bank A/c Dr. [Application Money
To Debenture Application & Allotment A/c Received]
- (ii) Debenture Application & Allotment A/c Dr. [Application Money]
Loss on Issue of Debentures A/c Dr. [Prem. payable on redemption]
To % Debentures A/c [Face Value]
To Premium on Redemption of Deb. A/c [Prem. payable on redemption]

Note: If issue price is receivable in instalments, then “Premium Payable on Redemption” is recorded as loss at the time of allotment of debentures as follows:

- Debenture Allotment A/c Dr. [Application Money]
Loss on Issue of Debentures A/c Dr. [Prem. payable on redemption]
To % Debentures A/c [Face Value]
To Premium on Redemption of Deb. A/c [Prem. payable on redemption]

Case 5 – Issued at Discount, Redeemable at Premium

- (i) Bank A/c Dr. [Application Money
To Debenture Application & Allotment A/c Received]
- (ii) Debenture Application & Allotment A/c Dr. [Application Money]
Discount on Issue of Debentures A/c Dr. [Discount Allowed]
Loss on Issue of Debentures A/c Dr. [Prem. payable on redemption]
To % Debentures A/c [Face Value]
To Premium on Redemption of Deb. A/c [Prem. payable on redemption]

OR

Discount on Issue & Premium Payable on Redemption may be clubbed under “Loss on Issue of Debentures A/c”:

Debenture Application & Allotment A/c	Dr.	[Application Money]
Loss on Issue of Debentures A/c	Dr.	[Prem. on redemption + Discount]
To % Debentures A/c		[Face Value]
To Premium on Redemption of Deb. A/c		[Prem. payable on redemption]

Note: If issue price is receivable in instalments, then “Premium Payable on Redemption” is recorded as loss at the time of allotment of debentures as follows:

Debenture Allotment A/c	Dr.	[Application Money]
Loss on Issue of Debentures A/c	Dr.	[Prem. on redemption + Discount]
To % Debentures A/c		[Face Value]
To Premium on Redemption of Deb. A/c		[Prem. payable on redemption]

Case 6 – Issued at Premium, Redeemable at Premium

(i)	Bank A/c	Dr.	[Application Money]
	To Debenture Application & Allotment A/c		Received]
(ii)	Debenture Application & Allotment A/c	Dr.	[Application Money]
	Loss on Issue of Debentures A/c	Dr.	[Prem. payable on redemption]
	To % Debentures A/c		[Face Value]
	To Securities Premium Reserve A/c		[Prem. on Issue]
	To Premium on Redemption of Deb. A/c		[Prem. payable on redemption]

Note: If issue price is receivable in instalments, then “Premium Payable on Redemption” is recorded as loss at the time of allotment of debentures as follows:

Debenture Allotment A/c	Dr.	[Application Money]
Loss on Issue of Debentures A/c	Dr.	[Prem. payable on redemption]
To % Debentures A/c		[Face Value]
To Securities Premium Reserve A/c		[Prem. On Issue]
To Premium on Redemption of Deb. A/c		[Prem. payable on redemption]

Note: Premium on Redemption of Debenture A/c is shown in the Balance Sheet under the head “Non-Current Liabilities” and sub-head “Other Long-Term Liabilities”.

Interest on Debentures

- Interest on debentures is a charge against profit (i.e., expense) and is payable even in case of loss. It is a part of Finance Cost.
- It is calculated at a fixed rate (p.a.) **on face value** of the debenture.

- Rate of interest is prefixed to the debenture. For example, 8% Debentures => Interest rate is 8% p.a.
- Interest may be payable monthly, quarterly, half-yearly or annually, depending on the terms of issue.
- At the end of the year, interest is transferred to “ Statement of Profit & Loss”, as it is an expense.

➤ **Journal Entries:**

(i) When interest is due

Interest on Debenture A/c	Dr.	xxx	
To Debentureholders' A/c			xxx

(ii) When interest is paid

Debentureholders' A/c	Dr.	xxx	
To Bank A/c			xxx

(iii) When interest is transferred to Statement of Profit & Loss

Statement of Profit & Loss	Dr.	xxx	
To Interest on Debenture A/c			xxx

Writing Off Discount / Loss on Issue of Debentures

- Discount / Loss on Issue of Debentures is a Capital Loss.
- It is written off in the year it is incurred (i.e., in the year of allotment), from:
 - (i) Securities Premium Reserve;
 - (ii) Capital Reserve;
 - (iii) Statement of Profit & Loss
 in that order.

➤ **Journal Entry:**

Securities Premium Reserve A/c	Dr.	xxx	
Capital Reserve A/c	Dr.	xxx	
Statement of Profit & Loss	Dr.	xxx	
To Discount / Loss on Issue of Debentures A/c			xxx

CH – FINANCIAL STATEMENTS OF A COMPANY

Financial Statements

- FS are summarised statements of accounting data, that provides information w.r.t financial position & profitability to various stakeholders (i.e. users).
- It is the final product of the entire accounting process.
- In India, companies prepare their FS as per **Schedule III of The Companies Act, 2013**.
- FS includes:

Balance Sheet (Part I of Schedule III)

- It is also known as “Position Statement”, as it shows financial position of a company on a particular date.
- It is based on following equation:
$$\text{Assets} = \text{Liabilities} + \text{Shareholder's Funds}$$
- It shows historical data.

Statement of Profit & Loss (Part II of Schedule III)

- It shows financial performance of a company during a particular period (i.e. revenue, expenses, profit/loss etc)
- It is also known as “Income Statement”.
- It shows historical data.

Notes to Accounts

- It supports the Balance Sheet & Statement of P&L.
- It gives details of various items appearing in Balance Sheet & P&L Statement.
- It gives other details like explanatory notes for various transactions & events, accounting policies used & any other additional information as may be required by Companies Act.

Cash Flow Statement

- It is prepared as per AS-3.
- It shows inflows & outflows of Cash & Cash Equivalents.

Nature of Financial Statements

- Recorded facts
- Accounting conventions, concepts & assumptions (postulates/pre-requisites) are followed in FS preparation (eg: Historical Cost Concept)
- Accounting Standards issued by ICAI & prescribed in Companies Act 2013, are followed.
- Involves selection of accounting policies (eg: method of inventory valuation)
- Use of accounting estimates. Thus, it involves personal judgement (eg: useful life of asset, provision for doubtful debts etc.)
- FS acts as a source of financial information for various users.

Objectives of Financial Statements

- To provide information about economic resources & obligations of a business
- To provide information about the earning capacity of the business
- To provide information about cash flows
- To judge effectiveness of management
- To provide information about various activities of business
- To disclose accounting policies followed by the business.

Annual Report

- It is a report prepared by a company which provides various statutory, financial & other material information.
- It helps the users to better understand the performance of a company, which enables them to make better & informed decisions.
- Content of Annual Reports (illustrative examples):
 - Report of Board of Directors;
 - Auditor's Report to the shareholders;
 - Financial statements; etc.

Format of Balance Sheet (Part I of Schedule III of Companies Act 2013)

Name of the Company

Balance Sheet as at

(₹ in)

S No.	Particulars	Note No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
	EQUITY AND LIABILITIES			
1.	Shareholder's funds			
	a. Share Capital		xxx	xxx
	b. Reserves & Surplus		xxx	xxx
	c. Money received against share warrants		xxx	xxx
2.	Share application money pending allotment		xxx	xxx
3.	Non-current Liabilities			
	a. Long-term borrowings		xxx	xxx
	b. Deferred tax liabilities (Net)		xxx	xxx
	c. Other long-term liabilities		xxx	xxx
	d. Long-term provisions		xxx	xxx
4.	Current Liabilities			
	a. Short-term borrowings		xxx	xxx
	b. Trade Payables		xxx	xxx
	c. Other current liabilities		xxx	xxx
	d. Short-term provisions		xxx	xxx
	Total		xxx	xxx
	ASSETS			
1.	Non-current assets			
	a. Property, Plant & Equipment			
	i. Tangible assets		xxx	xxx
	ii. Intangible assets		xxx	xxx
	iii. Capital Work-in-progress		xxx	xxx
	iv. Intangible assets under development		xxx	xxx
	b. Non-current investments		xxx	xxx
	c. Deferred tax assets (net)		xxx	xxx
	d. Long-term loans & advances		xxx	xxx
	e. Other non-current assets		xxx	xxx
2.	Current Assets			
	a. Current investments		xxx	xxx
	b. Inventories		xxx	xxx
	c. Trade Receivables		xxx	xxx
	d. Cash and cash equivalents		xxx	xxx
	e. Short-term loans and advances		xxx	xxx
	f. Other current assets		xxx	xxx
	Total		xxx	xxx

(1) Share Capital

- It includes both, Equity Share Capital & Preference Share Capital
- Presentation of Share Capital in Notes to Accounts:

1. Share Capital	₹
Authorised Capital	
..... Equity Shares of ₹..... each	XXX
..... Preference Shares of ₹..... each	XXX
	XXX
Issued Capital	
..... Equity Shares of ₹..... each	XXX
..... Preference Shares of ₹..... each	XXX
	XXX
Subscribed Capital	
Subscribed & Fully Paid-up:	
..... Equity Shares of ₹..... each	XXX
..... Equity Shares of ₹..... each	XXX
Subscribed but not Fully Paid-up	
..... Equity Shares of ₹..... each, ₹..... called up	XXX
Less: Calls-in-Arrears	<u>XXX</u> XXX
..... Preference Shares of ₹..... each, ₹..... called up	XXX
Less: Calls-in-Arrears	<u>XXX</u> XXX
Add: Forfeited Shares Account	XXX
Amount to be shown in the Balance Sheet against Share Capital	XXX

(2) Reserves & Surplus

- Reserve is the amount set aside from profits for following purpose:
 - to meet legal requirements (eg: Capital Reserve, Debenture Redemption Reserve, Capital Redemption Reserve etc)
 - capital receipt (eg: Securities Premium Reserve
 - to meet any liability (eg: Workmen Compensation Reserve) or to strengthen the financial position of the company (eg: General Reserve, Surplus i.e. accumulated profits)
- Heads of Reserves & Surplus prescribed in Schedule III:
 - Capital Reserve
 - Capital Redemption Reserve
 - Securities Premium Reserve
 - Debenture Redemption Reserve
 - Revaluation Reserve
 - Share Options Outstanding A/c
 - Other Reserves (nature & purpose to be specified)
 - Surplus i.e. balance in Statement of P&L (after all appropriations & dividend)

(3) Money Received Against Share Warrants

It is the amount received by the company which are converted into shares at a specified date on a specified rate. The instrument issued against the amount so received as share warrants.

(4) Share Application Money Pending Allotment

Amount received by the company as shares application, against which the company will certainly allot shares. It does not include any application money which has become refundable on account of over-subscription or failure to receive minimum subscription. Such refundable application money is shown under other current liabilities.

(5) Current & Non-current distinction for Assets & Liabilities

An item is classified as current:

- if it is involved in entity's operating cycle or,
- is expected to be realised/settled within twelve months or,
- if it is held primarily for trading or,
- is cash and cash equivalent or,
- if entity does not have on unconditional rights to defer settlement of liability for at least 12 months after the reporting period.

Other assets and liabilities are non-current.

Operating Cycle

It is the time between acquisition of an asset for processing (say raw materials or stock-in-trade) & its realisation into cash & cash equivalents. Where operating cycle cannot be identified, it is assumed to be 12 months.

Case	Operating Cycle (Months)	Period of Realisation/Settlement (Months)	Current/Non-Current
1	10	8	Current
2	10	12	Current
3	10	15	Non-Current
4	12	14	Non-Current
5	15	13	Current
6	15	18	Non-Current

(6) Classification of Non-Current Liabilities as per Schedule III

(a) Long-term Borrowings

- Loan payable by a company after 12 months/period of operating cycle.
- These include:
 - ✓ Debentures
 - ✓ Bonds
 - ✓ Term Loan from Banks/Other Parties
 - ✓ Public deposits
 - ✓ Other loans & advances (nature to be specified)

(b) Deferred Tax Liabilities (Net)

(c) Other Long-term Liabilities

- Trade payables (> 12 months)
- Others (for eg: Premium on Redemption of Debentures/Preference Shares)

(d) Long-term Provisions

- Provision is an estimated amount set aside to meet future liability, the amount of which cannot be determined with accuracy.
- Provision against which liability will arise after 12 months/operating cycle period, is shown under long-term provisions.
- Eg: Provision for Gratuity, Provision for Earned Leave

(7) Classification of Current Liabilities as per Schedule III

(a) Short-term Borrowings

Borrowings which are due for payment within 12 months/operating cycle period.

These include:

- ✓ Loans payable on demand
- ✓ Bank overdraft/Cash credit from banks
- ✓ Loan from 3rd parties (payable within 12 months)
- ✓ Short-term deposits
- ✓ Other Loans & Advances (nature to be specified)

(b) Trade Payables

Trade payable means amount payable **against purchase of goods & services in normal course of business**. These include **sundry creditors & bills payable**.

For example: A Ltd sells its Fixed Assets through Mr. Ram (an agent) & owes ₹10,000 to him, which is payable in 6 months. This liability will not be shown under trade payables It will be classified as other current liabilities.

(c) Other Current Liabilities

It includes:

- ✓ Current maturities of Long-term debts i.e. amount due to be paid out of long term debts, within 12 months/operating cycle period.
- ✓ Interest accrued but not due on borrowings
- ✓ Interest accrued and due on borrowings
- ✓ Income received in advance
- ✓ Unpaid dividend
- ✓ Calls-in-Advance
- ✓ Other payables (nature to be specified)

(d) Short-term Provisions

- Relates to liabilities which are likely to be paid within 12 months.
- Classification:
 - ✓ Provision for Employee Benefits
 - ✓ Provision for Expenses
 - ✓ Provision for Tax
 - ✓ Other provisions (nature to be specified)

(8) Classification of Non-Current Assets

(a) Property, Plant & Equipment (i.e. Fixed Assets)

These are kept for increasing the earning capacity of the business. These are not meant to be sold in the normal course of business (i.e. held for long-term). PPE is categorised as follows:

- (i) Tangible Assets** – These have physical existence i.e. can be seen & touched. For eg: Land & Building, Plant & Machinery, Furniture & Fixtures, Motor Vehicle etc.
- (ii) Intangible Assets** – These do not have any physical existence. For eg: Goodwill, Trademark, Patent, Copyrights, Licenses, Franchise etc.
- (iii) Capital Work-in-Progress** – Tangible Assets under construction. For eg: Building under construction.
- (iv) Intangible Assets Under Development** – For eg: Patents/Intellectual Property under Development.

(b) Non-Current Investments

Investments are of two types:

(i) Trade Investments i.e. investments made in share/debentures of another company to promote its own business/trade.

(ii) Other Investments i.e. investments other than trade investments.

It is categorised as follows:

- ✓ Investment in property
- ✓ Investment in Equity Instruments
- ✓ Investment in Preference Shares
- ✓ Investment in Bonds/Debentures
- ✓ Investment in Govt/Trust Securities
- ✓ Investment in Mutual Funds
- ✓ Investment in Partnership Firms
- ✓ Other Non-Current Investments (Nature to be specified)

(c) Deferred Tax Asset (Net)

(d) Long-Term Loans & Advances

- Loans & advances that are expected to be received back after 12 months/operating cycle period.
- Classification:

(i) Capital Advances: Advances given for acquiring fixed assets, as these advances are received back in the form of an asset (not cash).

(ii) Security Deposits: Deposits given for a long term (i.e. > 12 months/operating cycle period)

(iii) Other Loans & Advances (Nature to be specified): For eg: Long-term loans to employees, Long-term advances to suppliers.

(e) Other Non-Current Assets

- **Long Term Trade Receivables:** Amount receivable against sale of goods/services in normal course of business, after 12 months/operating cycle period. It includes sundry debtors & bills receivables.
- **Others** (Nature to be specified) – For eg: Insurance claim receivable, unamortised expenses/losses.

(9) Classification of Current Assets as per Schedule III

(a) Current Investments

- Those investments which are held to be converted into cash within a short period i.e. 12 months from the date of purchase.
- It includes:
 - ✓ Investment in Equity Instruments
 - ✓ Investment in Preference Shares
 - ✓ Investment in Govt Securities
 - ✓ Investments in Debenture/Bonds
 - ✓ Investment in Mutual Funds
 - ✓ Investment in Partnership Firms

(b) Inventories

- Stock held for the purpose of trade in the ordinary course of business i.e. for manufacturing or trading of goods.
- These include:
 - ✓ Raw material
 - ✓ Work-in-Progress (WIP)
 - ✓ Finished Goods
 - ✓ Stock-in-Trade
 - ✓ Stores & spares
 - ✓ Loose tools

(c) Trade Receivables

- Trade receivable is the amount receivable against sale of goods/services in normal course of business, within 12 months/operating cycle period. It includes **sundry debtors & bills receivables**.
- Disclosure of provision for doubtful debts – Any of the two alternatives may be followed:
 - ✓ Show under short-term/long-term provisions (as the case may be)
 - ✓ Show as deduction from debtors under trade receivables.

(d) Cash & Cash Equivalents

It is classified as follows:

- ✓ Balance with bank
- ✓ Cheques/Drafts in hand
- ✓ Cash in hand
- ✓ Others
- ✓ Earmarked balances with banks (eg: unpaid dividend)
- ✓ Balance with banks held as margin money
- ✓ Bank deposits with more than 12 months maturity (Eg: FD)

(e) Short-term Loans & Advances

Loans & advances expected to be realised within 12 months/operating cycle period, are shown here.

(f) Other Current Assets

It includes:

- ✓ Prepaid expenses
- ✓ Accrued income
- ✓ Interest/dividend receivable
- ✓ Advance tax

(10) Contingent Liabilities

- Liabilities which may or may not arise in future, as these are dependent on happening or non-happening of future uncertain event.
- It is neither recorded in books of accounts nor shown in balance sheet. These are shown as a **disclosure in Notes to Accounts**.
- Examples: Proposed dividend, pending litigation/claim against company etc.
- **Classification:**
 - (i) Claims against company, not acknowledged as debt
 - (ii) Bills receivable discounted from bank, not yet due for payment.
 - (iii) Proposed dividend (of Current Year)
 - (iv) Other claims for which the company is contingently liable

Proposed Dividend

- As per AS-4, "Proposed Dividend" (or final dividend) of current year (i.e. the year for which financial statements are being prepared), is shown as Contingent Liability in the Notes to Accounts.
- Dividend is proposed by the Board of Directors after the final accounts have been prepared & profits have been determined. The proposed dividend is then approved by the shareholder in the Annual General Meeting (AGM). Shareholders can reduce the dividend, but cannot increase it.
- Thus, liability of dividend is contingent upon approval of the same by the shareholders, and hence is treated as a contingent liability. It becomes a current liability, in the next year, i.e. the year in which it is approved.

- For example: Proposed dividend of FY 2020-21 will be shown as a contingent liability in the FS for the year ended 31st March 2021. However, the same will be recorded as a liability in the year it is approved i.e. FY 2021-22.

PART II OF SCHEDULE III – FORMAT OF STATEMENT OF PROFIT AND LOSS

Name of the Company

Profit & loss statement for the year ended

(₹ in)

S No.	Particulars	Note No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Revenue (I+II)		xxx	xxx
IV.	Expenses:			
	Cost of materials consumed		xxx	xxx
	Purchase of Stock-in-trade		xxx	xxx
	Changes in inventories of finished goods, Work in progress and Stock-in-trade		xxx	xxx
	Employee benefit expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and amortisation expense		xxx	xxx
	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V.	Profit before tax (III-IV)		xxx	xxx
VI.	Tax expense		xxx	xxx
VII.	Profit (Loss) after tax for the period (V-VI)		xxx	xxx

(11) Revenue from Operations

- Revenue earned from operating activities (main/principal business activities).
- Revenue for different types of businesses:
 - **Manufacturing/Trading Company** – Net Sales (Sales – Sales Return)
 - **Service Rendering Company** – Fees Earned
 - **Financial Company** – Interest/dividend earned

(12) Other Income

- Income earned from activities, other than operating activities.

- Example: Profit on sale of Fixed Assets, Bad Debts recovered, discount received, interest/dividend income (for non-financial companies) etc.

(13) Cost of Material Consumed

- Here material means raw materials (R/M) used for manufacturing of goods.
- Cost of Material Consumed = Op. Stock of R/M + Purchase of R/M – Cl. Stock of R/M

(14) Purchase of Stock-in-Trade

- It only includes purchase of goods for reselling (not for manufacturing)

(15) Changes in Inventory of FG, WIP & Stock-in-Trade

- Op. Stock of FG/WIP/SIT – Cl. Stock of FG/WIP/SIT

(16) Employee Benefit Expenses

- It means payments made to & for the benefit of employees & workers.
- Presentation of Emp Benefit Exp in Notes to A/cs:

Particulars	₹
Wages	xxx
Salaries	xxx
Bonus	xxx
Staff Welfare Expenses	xxx
Leave Encashment	xxx
Gratuity paid	xxx
Employer's Contribution to EPF, ESI, Superannuation Fund etc	xxx
Medical expenses	xxx
Total (to be shown in Statement of P&L)	xxx

(17) Finance Cost

It includes:

- ✓ Interest paid on loans/deposits/debentures/bank overdraft/ cash credit etc.
- ✓ Loan processing fees
- ✓ Discount on issue of debentures
- ✓ Premium on redemption of debentures
- ✓ ~~Bank charges~~ It is shown under "other expenses"

(18) Depreciation & Amortisation Expenses

- Depreciation: It is the cost of Tangible PPE (Fixed Assets) written off during the year (on the basis of estimated useful life)
- Amortisation: It is the cost of Intangible Asset written off during the year.

(19) Other Expenses

- All remaining expenses are shown under this head.
- For eg: Carriage Inwards/Outwards, bank charges, printing & stationery, legal & professional expenses, rent, postage & courier, travelling expenses, commission expense etc.

Note: Employee benefit expenses & other expenses may also be segregated into direct & indirect expenses in Notes to A/cs.

Importance of Financial Statements

- Shows management performance i.e. report on stewardship function
- Basis for fiscal (taxation) policies of the govt
- Basis for granting of credit
- Basis for prospective investors (i.e. helps in decision making)
- Helps in valuation of existing investment of shareholders
- Aids trade associations in helping their members (eg: labour unions)
- Helps stock exchanges in reporting on financial performance to ensure better transparency for the investors & to protect their interest

Limitations of Financial Statements

- It is based on historical records, and hence does not reflect current situation. FS are only interim reports
- Financial statements are not free from bias, as these includes accounting estimates & personal judgements, such as depreciation, provisions etc.
- Ignores qualitative elements
- Price level change (i.e. inflation) are ignored
- Does not include certain other important/vital information, such as loss of markets or important business contracts/clients/customers etc.
- Suffers with the inherent limitations of accounting (such as window dressing)
- Assets are shown in the balance sheet at unexpired/unamortised cost, & not actually at their actual realisable value.
- FS does not show detailed information, and hence, they may not help the users in decision making.

CH – ANALYSIS OF FINANCIAL STATEMENTS

Meaning

- It is the process of critical evaluation of the financial information contained in the financial statement, to understand & make decisions regarding the operations of the business.
- It involves study of relationship among various facts & figures underlying the financial statements & interpretation thereof. Thus, it includes both, **Analysis & Interpretation**.

Objectives

- To assess profitability & operational efficiency.
- To assess the financial position (or financial health) of the company.
- To ascertain the relative importance of different components of the financial position of the company.
- To ascertain the reasons for change in profitability & financial position.
- To assess the short-term & long-term liquidity & solvency (i.e. ability of the business to repay its debts) position of the business.

Analytical Tools

- **Comparative Statements:** It shows profitability & financial position of an entity over different periods of time in a comparative form. It is commonly used for Balance Sheet & Statement of P&L. It will be covered in detail as a separate chapter.
- **Common Size Statement:** It is also known as component percentage statement. It is used to study key changes & trends in the financial position & operating results of a company. Each component in the statement is stated as a % of a base (i.e. revenue from operations for income statement & total assets/liabilities for balance sheet). To be covered as a separate chapter.
- **Trend Analysis:** It helps in studying the operational results & financial position **over a series of years**, by observing the % change over time.
- **Ratio Analysis:** To be covered in a separate chapter.
- **Cash Flow Analysis:** It is done by preparing a cash flow statement (separate chapter)

Types of FS Analysis

- **External Analysis** – It is done by those who do not have detailed financial records or information i.e. **outsiders**. It is done on the basis of published accounts like Balance Sheet, Statement of P&L, Auditor's Report etc. It is mostly done by investors, lenders, creditors, govt agencies etc.
- **Internal Analysis** – It is done by **management**, as they have access to all the financial information. It is more detailed, comprehensive, extensive & accurate.
- **Horizontal/Dynamic Analysis** – It involves analysis of FS for more than 1 year (i.e. multiple years). It is useful for Trend Analysis & Long-term Planning. Eg: Comparative Balance Sheet & Statement of P&L.
- **Vertical/Static Analysis** – It involves analysis of FS of 1 year only (i.e. of different items for same period). For eg: Ratio Analysis, Common Size Statement.

Inter-Firm & Intra-Firm Comparison

- **Intra Firm Comparison** – It means comparison of different items of an entity over a period of time. It is also known as Time Series Analysis or Trend Analysis.
- **Inter Firm Comparison** – It means comparison of 2 or more entities to determine their competitive position. It is also known as Cross-sectional analysis.

Importance of FS Analysis for Different Users

- **Management** – To assess the efficiency of business & for better decision making, controlling, budgeting etc.
- **Employees** – They are interested in profitability & financial performance for better remuneration & bonus.
- **Shareholders / Investors** – To ascertain the profitability & safety of their investment, and growth potential of the business.
- **Potential Investors** – To ascertain present profitability & financial position, and future prospects of the business, to decide whether to invest or not.
- **Suppliers / Creditors** – To analyse short term solvency / liquidity position to decide whether to provide/extend credit facilities & period or not.

- **Bankers / Lenders / Other Financial Institutions** – To judge short-term solvency & liquidity position (for short-term loans) & long-term solvency & liquidity position (for long-term loans).
- **Tax Authorities** – To ensure proper & correct assessment of tax liabilities.
- **Customers** – To ascertain the potential for long-term continuance of business, especially for dependent & loyal customers.

Limitations of FS Analysis

- Historical analysis
- Price level changes & inflation effects are ignored
- Qualitative Aspects are ignored
- Suffers from all limitations of FS
- Window dressing
- Different accounting policies/practices followed by different companies affects comparability. Moreover, it may be misleading without the knowledge of the changes in accounting procedure followed by the company.
- It is just a study of reports of the company
- Financial statements are prepared on the basis of accounting concepts, and as such does not reflect the current position.

CH – COMPARATIVE & COMMON-SIZE STATEMENTS

Comparative Balance Sheet

Comparative Balance Sheet as at ...

S No.	Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Absolute Change* (₹)	Percentage Change* (%)
			(A)	(B)	(C = B – A)	(C ÷ A x 100)
I.	EQUITY AND LIABILITIES					
1.	Shareholder's funds					
	d. Share Capital					
	(i) Equity Share Capital		xxx	xxx	xxx	xxx
	(ii) Preference Share Capital		xxx	xxx	xxx	xxx
	e. Reserves & Surplus		xxx	xxx	xxx	xxx
2.	Non-current Liabilities					
	e. Long-term borrowings		xxx	xxx	xxx	xxx
	f. Long-term provisions		xxx	xxx	xxx	xxx
3.	Current Liabilities					
	e. Short-term borrowings		xxx	xxx	xxx	xxx
	f. Trade Payables		xxx	xxx	xxx	xxx
	g. Other current liabilities		xxx	xxx	xxx	xxx
	h. Short-term provisions		xxx	xxx	xxx	xxx
	Total		xxx	xxx	xxx	xxx
II.	ASSETS					
1.	Non-current assets					
	f. Property, Plant & Equipment					
	i. Tangible assets		xxx	xxx	xxx	xxx
	ii. Intangible assets		xxx	xxx	xxx	xxx
	g. Non-current investments		xxx	xxx	xxx	xxx
	h. Long-term loans & advances		xxx	xxx	xxx	xxx
2.	Current Assets					
	g. Current investments		xxx	xxx	xxx	xxx
	h. Inventories		xxx	xxx	xxx	xxx
	i. Trade Receivables		xxx	xxx	xxx	xxx
	j. Cash and cash equivalents		xxx	xxx	xxx	xxx
	k. Short-term loans and advances		xxx	xxx	xxx	xxx
	l. Other current assets		xxx	xxx	xxx	xxx
	Total		xxx	xxx	xxx	xxx

* Increase = Positive Change
 Decrease = (Negative Change)

Comparative Statement of Profit & Loss (Income Statement)

Comparative Statement of Profit and Loss for the year ended ...

S No.	Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Absolute Change* (₹)	Percentage Change* (%)
			(A)	(B)	(C = B – A)	(C ÷ A x 100)
I.	Revenue from operations		xxx	xxx	xxx	xxx
II.	Other income		xxx	xxx	xxx	xxx
III.	Total Revenue (I+II)		xxx	xxx	xxx	xxx
IV.	Expenses:					
	Cost of materials consumed		xxx	xxx	xxx	xxx
	Purchase of Stock-in-trade		xxx	xxx	xxx	xxx
	Changes in inventories of finished goods, Work in progress and Stock-in-trade		xxx	xxx	xxx	xxx
	Employee benefit expense		xxx	xxx	xxx	xxx
	Finance costs		xxx	xxx	xxx	xxx
	Depreciation and amortisation expense		xxx	xxx	xxx	xxx
	Other expenses		xxx	xxx	xxx	xxx
	Total expenses		xxx	xxx	xxx	xxx
V.	Profit before tax (III–IV)		xxx	xxx	xxx	xxx
VI.	Tax expense		xxx	xxx	xxx	xxx
VII.	Profit (Loss) after tax for the period (V-VI)		xxx	xxx	xxx	xxx

* Increase = Positive Change
 Decrease = (Negative Change)

Common-Size Balance Sheet

Common-Size Balance Sheet as at ...

S No.	Particulars	Note No.	Absolute Amounts		Percentage of Balance Sheet Total	
			Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
I.	EQUITY AND LIABILITIES					
1.	Shareholder's funds					
	f. Share Capital					
	(i) Equity Share Capital		xxx	xxx	xxx	xxx
	(ii) Preference Share Capital		xxx	xxx	xxx	xxx
	g. Reserves & Surplus		xxx	xxx	xxx	xxx
2.	Non-current Liabilities					
	g. Long-term borrowings		xxx	xxx	xxx	xxx
	h. Long-term provisions		xxx	xxx	xxx	xxx
3.	Current Liabilities					
	i. Short-term borrowings		xxx	xxx	xxx	xxx
	j. Trade Payables		xxx	xxx	xxx	xxx
	k. Other current liabilities		xxx	xxx	xxx	xxx
	l. Short-term provisions		xxx	xxx	xxx	xxx
	Total		xxx	xxx	100	100
II.	ASSETS					
1.	Non-current assets					
	i. Property, Plant & Equipment					
	i. Tangible assets		xxx	xxx	xxx	xxx
	ii. Intangible assets		xxx	xxx	xxx	xxx
	j. Non-current investments		xxx	xxx	xxx	xxx
	k. Long-term loans & advances		xxx	xxx	xxx	xxx
2.	Current Assets					
	m. Current investments		xxx	xxx	xxx	xxx
	n. Inventories		xxx	xxx	xxx	xxx
	o. Trade Receivables		xxx	xxx	xxx	xxx
	p. Cash and cash equivalents		xxx	xxx	xxx	xxx
	q. Short-term loans and advances		xxx	xxx	xxx	xxx
	r. Other current assets		xxx	xxx	xxx	xxx
	Total		xxx	xxx	100	100

Common-Size Statement of Profit & Loss (Income Statement)

Common-Size Statement of Profit and Loss for the year ended ...

S No.	Particulars	Note No.	Absolute Amounts		Percentage of Revenue from Operations (Net Sales)	
			Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
I.	Revenue from operations		xxx	xxx	100	100
II.	Other income		xxx	xxx	xxx	xxx
III.	Total Revenue (I+II)		xxx	xxx	xxx	xxx
IV.	Expenses:					
	Cost of materials consumed		xxx	xxx	xxx	xxx
	Purchase of Stock-in-trade		xxx	xxx	xxx	xxx
	Changes in inventories of finished goods, Work in progress and Stock-in-trade		xxx	xxx	xxx	xxx
	Employee benefit expense		xxx	xxx	xxx	xxx
	Finance costs		xxx	xxx	xxx	xxx
	Depreciation and amortisation expense		xxx	xxx	xxx	xxx
	Other expenses		xxx	xxx	xxx	xxx
	Total expenses		xxx	xxx	xxx	xxx
V.	Profit before tax (III-IV)		xxx	xxx	xxx	xxx
VI.	Tax expense		xxx	xxx	xxx	xxx
VII.	Profit (Loss) after tax for the period (V-VI)		xxx	xxx	xxx	xxx

CH – ACCOUNTING RATIOS

Liquidity Ratios

(1) Current Ratio

- It provides a measure of degree to which current assets cover current liabilities. The excess of current assets over current liabilities provides a measure of safety margin available against uncertainty in realisation of current assets and flow of funds.
- Current Ratio = [Current Assets / Current Liabilities]
- It is expressed as Pure Ratio.
- Ideal Ratio is **2:1**. It should neither be very high, nor be very low.
- Current assets exclude loose tools & stores & spares. Further, provision for doubtful debts should be reduced from Trade Receivables for calculating current assets.

(2) Liquid Ratio / Quick Ratio / Acid Test Ratio

- The ratio provides a measure of the capacity of the business to meet its short-term obligations without any flaw, by establishing a relationship between liquid assets & current liabilities.
- Liquid assets (or quick assets) are those assets which are quickly convertible into cash.
- Liquid Ratio or Quick Ratio = [Liquid or Quick Assets / Current Liabilities]
- Liquid or Quick Assets = Current Assets (-) Prepaid Expenses (-) Inventory
- It is expressed as pure ratio
- Ideal Ratio is **1:1**.

Solvency Ratios

(1) Debt to Equity Ratio

- This ratio measures the degree of indebtedness of an enterprise and gives an idea to the long-term lender regarding extent of security of the debt. It shows extent to which a company depends on borrowed funds.

- A low debt equity ratio reflects more security.
- Debt to Equity Ratio = $[\text{Long-term Debts (or NCL)} / \text{Shareholders' Funds (or Equity)}]$
- **Long-term Debts =**
 Long-term Borrowings (+) Long-term Provisions; or
 Total Debts (-) Current Liabilities; or
 Capital Employed (-) Equity; or
- **Shareholders' Funds (or Equity) =**
 Share Capital (+) Reserves & Surplus; or
 Total Assets (-) Total Debts; or
 Non-current Assets (+) Working Capital (-) Non-Current Liabilities; or
 Capital Employed (-) Long-term Debts
- Working Capital = Current Assets (-) Current Liabilities
- **Capital Employed =**
 Equity (+) Long-term Debts; or
 Non-Current Assets (+) Working Capital; or
 Total Assets (-) Current Liabilities
- It is expressed as pure ratio.
- Normally, 2:1 is considered as an appropriate ratio. However, it may vary from industry to industry.

(2) Total Assets to Debt Ratio

- This ratio measures the extent of the coverage of long-term debts by assets. Thus, it measures "safety margin" for long-term lenders.
- A higher ratio indicates that assets have been mainly financed by owners' funds and the long-term loans is adequately covered by assets.

- Total Assets to Debt Ratio = $[\text{Total Assets} / \text{Long-Term Debts}]$
- Total Assets =
 Non-Current Assets (+) Current Assets; or
 Shareholders' Funds (+) Total Debt (i.e. NCL + CL)
- It is expressed as pure ratio.

(3) Proprietary Ratio

- It measures the proportion of total assets financed by owners' (shareholders') funds, and is useful for unsecured lenders & creditors.
- Higher proportion of shareholders' funds in financing the assets is a positive feature as it provides security to creditors.
- Proprietary Ratio = $[\text{Shareholders' Funds} / \text{Total Assets}]$
- It may be expressed as pure ratio or as percentage.

(4) Interest Coverage Ratio

- It shows the availability of profits to cover interest on long-term debts, and is useful for debenture holders & long-term lenders.
- It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts.
- Interest Coverage Ratio = $[\text{Net Profit before Interest \& Tax} / \text{Interest on LT Debts}]$
- Net Profit Before Interest & Tax (NPBIT) =
 Net Profit After Tax (NPAT) (+) Tax (+) Interest on LT Debts; or
 Net Profit Before Tax (NPBT) (+) Interest on LT Debts
- NPBT = $[\text{NPAT} / (100 - \text{Tax Rate})]$
- It is expressed as "Number of Times".

(5) **Debt to Capital Employed Ratio**

- shows proportion of long term debts in capital Employed.
- Low ratio provides security to lenders.
- Debt to Capital Employed Ratio = [Non Current Liabilities / Capital Employed]

Activity or Turnover Ratios

(1) **Inventory Turnover Ratio**

- It determines the number of times inventory (finished goods or stock-in-trade) is converted into revenue from operations during the accounting period under consideration. It shows whether investment in inventory is proper or not i.e. it shows efficiency of inventory management.
- Inventory Turnover Ratio = [Cost of Revenue from Operations / Avg. Inventory]
- Cost of Revenue from Operations (or Cost of RFO) =
Revenue from Operations (RFO) (-) Gross Profit or (+) Gross Loss; or
Opening Inventory (+) Net Purchase (+) Direct Expense (-) Closing Inventory; or
Cost of Raw Material Consumed (+) Purchase of Stock-in-Trade (+) Change in Inventory of WIP, Finished Goods & Stock-in-Trade (+) Direct Expenses;
[to be used in case of manufacturing company]
- Cost of Raw Material Consumed = Op. stock of Raw Material (+) Purchase of Raw Material (-) Cl. Stock of Raw Material
- Change in Inventory = Opening Inventory (-) Closing Inventory
- Avg. Inventory = [Opening Inventory* (+) Closing Inventory*] / 2
* of Finished Goods
- If no information about Cost of RFO is given, we may use RFO for calculating the ratio.
- It is expressed as “no. of times”.

(2) **Trade Receivables Turnover Ratio**

- This ratio indicates the number of times the receivables are turned over and converted into cash in an accounting period. Higher turnover means speedy collection from trade receivable. This ratio also helps in working out the average collection period.
- Trade Receivables Turnover Ratio = $[\text{Credit RFO} / \text{Avg. Trade Receivables}]$
- Credit Revenue from Operations (Credit RFO) =
Net Credit Sales; or

RFO (-) Cash RFO; or

Gross Credit Sales (-) Sales Return
- Avg. Trade Receivables = $[\text{Opg. Trade Receivables} (+) \text{Clg. Trade Receivables}] / 2$
 - * Trade Receivables = Debtors (+) Bills Receivables
 - * Provision for doubtful debts is NOT deducted for calculation of this ratio
- If no information is given about opening trade receivables, then closing trade receivables may be used instead of avg. trade receivables.
- This ratio is expressed as “no. of times”.
- Debt collection period – It shows time taken on an average to realise trade receivables. It is calculated as follows:
 $[\text{12 months or 365 days} / \text{Trade Receivables Turnover Ratio}]$

(4) **Trade Payables Turnover Ratio**

- It shows number of times on an average, trade payables are settled in an accounting year. Lower ratio means credit allowed by the supplier is for a long period or it may reflect delayed payment to suppliers which is not a very good policy as it may affect the reputation of the business. It also helps in calculating average payment period.
- Trade Payables Turnover Ratio = $[\text{Net Credit Purchase} / \text{Avg. Trade Payables}]$
- Net Credit Purchase = Gross Purchase (-) Purchase Return (-) Cash Purchase
- Avg. Trade Payables = $[\text{Opg. Trade Payables} / \text{Clg. Trade Payables} / 2]$
 - * Trade Payables = Creditors (+) Bills Payable
- It is expressed as “No. of Times”.

- Avg. Payment Period – It shows time taken on an average to settle the trade payables. It is calculated as follows:
[12 months or 365 days / Trade Payables Turnover Ratio]

(5) Working Capital Turnover Ratio

- It helps in ascertaining whether working capital has been efficiently utilised in generating revenue. High ratio indicates effective use of working capital.
- Working Capital Turnover Ratio = [Revenue from Operations / Working Capital]
- Revenue from operations = Net Sales or Sales (-) Sales Return
- Working Capital = Current Assets (-) Current Liabilities
- If no information about revenue from operations is given, we may use cost of rfo.
- It is expressed in “no/ of times”.

(6) Net Assets Turnover Ratio (Capital Employed Turnover Ratio)

- It shows relationship between Net revenue from Operations (i.e. Net Sales) and Net Assets (i.e. Capital Employed)
- Higher Ratio implies efficient utilisation of resources
- Net Assets Turnover Ratio = [Net Revenue from Operations / Capital Employed]

(7) Fixed Assets Turnover Ratio

- It shows relationship between Net revenue from Operations (i.e. Net Sales) and Net Fixed Assets
- Higher Ratio implies efficient utilisation of resources
- Fixed Assets Turnover Ratio = [Net Revenue from Operations / Net Fixed Assets]

Profitability Ratios

(1) Gross Profit Ratio

- It shows relationship between gross profit & sales, and indicates gross margin on products sold. It also indicates the margin available to cover operating expenses, non-operating expenses, etc. Higher gross profit ratio is always a good sign.
- $GP\ Ratio = [Gross\ Profit / Sales] \times 100$
- $Gross\ Profit\ (\%) = Revenue\ from\ Operations\ (-)\ Cost\ of\ Revenue\ from\ Operations$
- Shortcut for calculating GP => $[1 / a]$ of Cost = $1 / (1 + a)$ of Sales.
- Reasons for increase in GP:
 - Increase in sales (selling price) with cost of rfo constant.
 - Decrease in cost of rfo with constant selling price.
 - Combination of above
- * Vice-versa reasons applies for decrease in GP.
- It is expressed in percentage (%).

(2) Operating Ratio

- This ratio shows the operational efficiency of the business, by establishing a relationship between operating cost & revenue from operations.
- Lower the ratio, better it is.
- $Operating\ Ratio\ (\%) = [Operating\ Cost / RFO] \times 100$
- $Operating\ Cost = Cost\ of\ RFO\ (+)\ Operating\ Expenses$
- $Operating\ Expenses = Employee\ Benefit\ Expenses\ (+)\ Depreciation\ \&\ Amortisation\ (+)\ Other\ Operating\ Expenses\ (+)\ Finance\ Cost$
- $Other\ Operating\ Expenses = Office\ \&\ Administrative\ Expenses\ (+)\ Selling\ \&\ Distribution\ Expenses$ [For eg: Rent, Advertisement Expense, Carriage Outwards etc.]
- It is expressed in percentage.

(3) **Operating Profit Ratio**

- It shows the operational efficiency of the business, by establishing a relationship between operating profits & revenue from operations.
- Operating Profit Ratio (%) = $[\text{Operating Profit} / \text{RFO}] \times 100$
- Operating Profit =
GP (+) Other Operating Incomes (-) Other Operating Expenses; or
RFO (-) Operating Cost; or
NPBT (+) Non-Operating Expenses (-) Non-Operating Incomes
- Non-Operating Expenses – Interest on Borrowings, Loss on Sale of Fixed Assets, Loss by Fire etc.
- Non-Operating Incomes – Interest & Dividend received, Profit on sale of fixed assets etc.
- It is expressed in percentage.
- Operating Ratio (%) (+) Operating Profit Ratio (%) = 100%

(4) **Net Profit Ratio**

- It is a measure of net profit margin in relation to revenue from operations. It shows overall efficiency & profitability by establishing a relationship between net profit & revenue from operations.
- Net Profit Ratio (%) = $[\text{NPAT} / \text{RFO}] \times 100$
- NPAT = RFO (-) Cost of RFO (-) Operating & Non-Operating Expenses (+) Non-Operating Income (-) Tax Expense
- It is expressed in percentage.

(5) **Return on Capital Employed (ROCE) or Return on Investment (ROI)**

- It shows the efficiency of the business in utilisation of funds entrusted to it by shareholders, debenture-holders and long-term loans. It measures overall performance or profitability of the business.
- $ROI (\%) = [NPBIT / \text{Capital Employed}] \times 100$
- Net Profit excludes income from Non-Trade Investment & Capital Employed excludes Non-Trade Investment in the above formula. If Q is silent, assume given investments as Trade Investments.
- It is expressed in percentage.

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CH – CASH FLOW STATEMENT

Operating Activities

- These are principal revenue generating activities of the company, and other activities that are not Investing or Financing Activities.
- Examples:

In Case of Non-Financial Companies:

- ✓ Cash receipt from sale of goods / rendering of services
- ✓ Cash receipts from Trade Receivables
- ✓ Cash payment for purchase of goods / availing services
- ✓ Cash payment to Trade Payables
- ✓ Cash payment of Wages, Salaries etc.
- ✓ Cash payment of & refund of income tax (unless they are related to Investing/Financing Activities)
- ✓ Payment of operating expenses
- ✓ Royalty, Fee, Commission received

In Case of Financial Companies:

- ✓ Payment for purchase of securities (purchased on own behalf)
- ✓ Proceeds from sale of securities (held for sale)
- ✓ Payment of interest
- ✓ Receipts of interest & dividend
- ✓ ~~Payment of dividend~~ It is a financing activity for both, financial & non-financial companies
- ✓ Brokerage received by a stock broker
- ✓ Cash payment of & refund of income tax (unless they are related to Investing/Financing Activities)
- ✓ Loans given / taken
- ✓ Payment of salaries, bonus etc to employees
- ✓ Payment for operating expenses

Investing Activities

- It covers acquisition & disposal of Long-term Assets and Other Investments (other than Current Investments)
- Examples:
 - ✓ Payment for purchase of Fixed Assets / Investments
 - ✓ Proceeds from Sale of Fixed Assets / Investments

- ✓ Loans & advances made to third parties (except in case of Financial Companies)
- ✓ Proceeds from repayment of Loans & Advances made to third parties (except in case of financial companies)
- ✓ Interest / Dividend received (except in case of Financial Companies)
- ✓ Income Tax paid on Gain on Sale of Fixed Assets / Investments; etc.

Financing Activities

- These are the activities that result in change in size & composition of Share Capital & Debt (Borrowings). In simple words, these activities relates to finance of the company.
- Examples:
 - ✓ Proceeds from issue of shares (Equity / Preference) including premium, if any
 - ✓ Proceeds from issue of Debentures / Bonds / Loans or any other Long-term / Short-term Borrowings, including premium, if any
 - ✓ Payment for Buy-back of Shares
 - ✓ Payment for Redemption of Preference Shares / Debentures, including premium, if any
 - ✓ Payment of dividend (on both, Equity & Preference Shares)
 - ✓ Payment of Interest (except in case of Financial Companies)
 - ✓ Increase / Decrease in Bank Overdraft / Cash Credit
 - ✓ Dividend Distribution Tax / Corporate Dividend Tax paid; etc.

Other Important Points

- Movement within items of Cash & Cash Equivalents does not result in any flow of Cash & Cash Equivalents. Hence, they are not shown in Cash Flow Statement.

Examples:

- ✓ Cash withdrawn from bank for business
 - ✓ Cash deposited into bank
 - ✓ Sale / Purchase of Current / Short-term Investments; etc.
- Certain transactions do not result in any flow of Cash & Cash Equivalents. These are non-cash transactions. These are also not shown in Cash Flow Statement.

Examples:

- ✓ Depreciation / Amortisation
- ✓ Issue of shares / debentures for consideration other than cash (for example, to promoters, underwriters or vendors)
- ✓ Issue of bonus shares
- ✓ Conversion of debentures / preference shares into equity shares

- Payment of dividend is a part of Financing Activity (Outflow) for both, Financial & Non-Financial Companies.

Format of Cash Flow Statement (Indirect Method) for the year ended ...
[As per Accounting Standard-3 (Revised)]

Particulars	₹	₹
I. Cash Flow from Operating Activities		
(A) Net Profit before Tax and Extraordinary items (Working Note)		xxx
(B) Add: Non-cash and Non-operating Items:		
- Depreciation	xxx	
- Goodwill, Patents and Trademarks Amortised	xxx	
- Interest on Bank Overdraft / Cash Credit	xxx	
- Interest on Borrowings (Short-term & Long- term) & Debentures	xxx	
- Loss on Sale of Fixed Assets / Investments	xxx	xxx
(C) Less: Non-cash and Non-operating Items:		xxx
- Interest Income	xxx	
- Dividend Income	xxx	
- Rental Income	xxx	
- Gain (Profit) on Sale of Fixed Assets / Investments	xxx	xxx
(D) Operating Profit before Working Capital Changes (A+B-C)		xxx
(E) Add: Decrease in Current Assets and Increase in Current Liabilities		xxx
(F) Less: Increase in Current Assets and Decrease in Current Liabilities		xxx
(G) Cash Generated from Operations (D+E-F)		xxx
(H) Less: Income Tax Paid (Net of Tax Refund)		xxx
(I) Cash Flow before Extraordinary Items		xxx
(J) Extraordinary Items		xxx
(H) Cash Flow from (or used in) Operating Activities (I +/- J)		xxx
II. Cash Flow from Investing Activities		
- Proceeds from Sale of Fixed Assets		xxx
- Proceeds from Sale of Investments (Other than Current Investments & marketable securities)		xxx
- Proceeds from sale of Intangible Assets		xxx
- Interest & Dividend received (in case of Non-Financial Companies)		xxx
- Rent received		xxx
- Payment for purchase of Fixed Assets		(xxx)
- Payment for purchase of Investments (Other than Current Investments & marketable securities)		(xxx)

- Payment for purchase of Intangible Assets	(xxx)
- Extraordinary Items (eg: Insurance claim on machinery destroyed by fire)	xxx
Cash Flow from (or used in) Investing Activities	xxx
III. Cash Flow from Financing Activities	
- Proceeds from Issue of Shares and Debentures	xxx
- Proceeds from Other Long-Term Borrowings	xxx
- Increase / Decrease in Bank Overdraft / Cash Credit	xxx
- Payment of Dividend (Final / Interim)	(xxx)
- Payment of Interest on Debentures & Loans	(xxx)
- Repayment of Loans	(xxx)
- Redemption of Debentures / Preference Shares	(xxx)
- Payment of Share Issue Expenses / Underwriting Commission	(xxx)
- Payment for Buy-back of Shares (Extraordinary Item)	(xxx)
Cash Flow from (or used in) Financing Activities	xxx
IV. Net Increase / (Decrease) in Cash and Cash Equivalents (I+II+III)	xxx
V. Add: Cash and Cash Equivalents in the beginning of the year	xxx
VI. Cash and Cash Equivalents at the end of the year (IV+V)	xxx

Working Note - Net Profit before Tax and Extraordinary items:

Case 1: If starting point is Profit as per Statement of Profit & Loss:

Particulars	₹
Profit after Tax as per Statement of Profit & Loss	xxx
Add: Provision for Income Tax made during the year	xxx
Extraordinary Items (Expenses) debited in Statement of Profit & Loss	xxx
Less: Refund of Income Tax credited to Statement of Profit & Loss	(xxx)
Extraordinary Items (Incomes) credited to Statement of Profit & Loss	(xxx)
Net Profit before Tax and Extraordinary Item	xxx

Case 2: If starting point is Difference between Closing & Opening Balance of Surplus i.e. Balance in Statement of Profit & Loss (under Reserves & Surplus):

Particulars	₹
Difference between Closing & Opening Balance of Surplus i.e. Balance in Statement of Profit & Loss	xxx
Add: Provision for Income Tax made during the year	xxx
Extraordinary Items (Expenses) debited in Statement of Profit & Loss	xxx
Dividend Payable (Proposed dividend of previous year) paid during the year	xxx
Interim Dividend paid during the year	xxx
Transfer to Reserves	xxx
Less: Refund of Income Tax credited to Statement of Profit & Loss	(xxx)
Extraordinary Items (Incomes) credited to Statement of Profit & Loss	(xxx)
Net Profit before Tax and Extraordinary Item	xxx

Treatment of Dividend Paid

Types of Dividends:

(i) **Interim Dividend**

It is declared by BOD & paid within 30 days of being declared.

Treatment in CFS:

- ✓ Added to Current Year Profits to calculate “Net Profit Before Tax & Extraordinary Items” under Cash Flow from Operating Activities.
- ✓ Shown as Outflow under Cash Flow from Financing Activities

(ii) **Proposed Dividend (Final Dividend)**

It is proposed by BOD & declared (approved) by the shareholders in the Annual General Meeting (AGM) in the next FY. It is to be paid within 30 days of declaration.

Treatment in CFS:

- ✓ Proposed Dividend of Previous Year is added to calculate “Net Profit Before Tax & Extraordinary Items” under Cash Flow from Operating Activities.
- ✓ Proposed Dividend of Previous Year is shown as outflow under Cash Flow from Financing Activities, assuming it was approved by the shareholders & paid in the Current Year.

Note: No treatment for Proposed Dividend of Current Year is required in the Current Year’s CFS, as it is merely a Contingent Liability.

Treatment of Provision for Tax

Provision for Tax Account

Particulars	₹	Particulars	₹
To Bank A/c (B) (Tax Paid during CY net of refund)	xxx	By bal b/d	xxx
To bal c/d	xxx	By Statement of Profit & Loss (A) (Provision created during CY)	xxx
	xxx		xxx

Treatment in CFS:

- ✓ A => Added to Current Year Profits to determine “Net Profit Before Tax & Extraordinary Items” under Operating Activities.
- ✓ B => Shown as Outflow and deducted from Cash Generated from Operations under Operating Activities

Note: If Question is silent, then it is assumed that provision of Previous Year (i.e., opening balance) is paid during Current Year & Closing Balance is the provision created during the current year. Hence, in such a case Provision for Tax A/c need not be prepared.

Extraordinary Items

- These are incomes / expenses arising from events / transactions that are distinct (separate) from the ordinary business activities of the entity.
- These do not occur frequently or regularly.
- Treatment in CFS:
 - ✓ Added / Subtracted (as the case may be) to Current Year Profits to determine “Net Profit Tax & Extraordinary Items”
 - ✓ Shown as Inflow / Outflow (as the case may be) under relevant Activities (Operating, Investing or Financing)
- Examples:
 - ✓ **Operating Activity** -> Preliminary Expenses written off, Compensation paid to employees under Voluntary Retirement Scheme
 - ✓ **Investing Activity** -> Claim received against Fixed Assets damaged by earthquake, fire etc.
 - ✓ **Financing Activity** -> Payment for Buy-back of Shares

Preparation of Fixed Asset Account

Method 1 – When Fixed Asset A/c is Shown at WDV

Fixed Asset Account (at WDV)

Particulars	₹	Particulars	₹
To bal b/d	xxx	By Bank A/c (Sale) (E)	xxx
To Gain on Sale of Fixed Asset A/c (A) (Statement of Profit & Loss)	xxx	By Loss on Sale of Fixed Asset A/c (B) (Statement of Profit & Loss)	xxx
To Bank A/c (Purchase) (D)	xxx	By Depreciation A/c (C) (Statement of Profit & Loss)	xxx
	xxx		xxx

Method 2 – When Fixed Asset A/c is shown at Original Cost & Accumulated Depreciation A/c (or Provision for Depreciation A/c) is Maintained

Fixed Asset Account (at Original Cost)

Particulars	₹	Particulars	₹
To bal b/d	xxx	By Bank A/c (Sale) (E)	xxx
To Gain on Sale of Fixed Asset A/c (A) (Statement of Profit & Loss)	xxx	By Loss on Sale of Fixed Asset A/c (B) (Statement of Profit & Loss)	xxx

To Bank A/c (Purchase) (D)	xxx	By Accumulated Depreciation A/c (Accumulated dep on Asset sold)	xxx
	xxx		xxx

Accumulated Depreciation Account

Particulars	₹	Particulars	₹
To Fixed Asset A/c (Accumulated dep on Asset sold)	xxx	By bal b/d	xxx
To bal c/d	xxx	By Depreciation A/c (C) (Statement of Profit & Loss)	xxx
	xxx		xxx

Treatment in CFS:

A => Deducted from “Net Profit Before Tax & Extraordinary Items” to determine “Operating Profit Before Working Capital Changes” as it is a Non-Operating Income

B => Added to “Net Profit Before Tax & Extraordinary Items” to determine “Operating Profit Before Working Capital Changes” as it is a Non-Operating Expense (Loss)

C => Added to “Net Profit Before Tax & Extraordinary Items” to determine “Operating Profit Before Working Capital Changes” as it is a Non-Cash Expense

D => Shown as Outflow under Cash Flow from Investing Activities

E => Shown as Inflow under Cash Flow from Investing Activities

Note: Ledger Accounts for Intangible Asset & Non-Current Investments is similar to Fixed Asset A/c.

Preparation of Loan A/c

Loan Account

Particulars	₹	Particulars	₹
To Bank A/c (Loan repaid) (B)	xxx	By bal b/d	xxx
To bal c/d	xxx	By Bank A/c (Loan taken) (A)	xxx
	xxx		xxx

Treatment in CFS:

A=> Shown as Inflow under Cash Flow from Financing Activities

B => Shown as Outflow under Cash Flow from Financing Activities