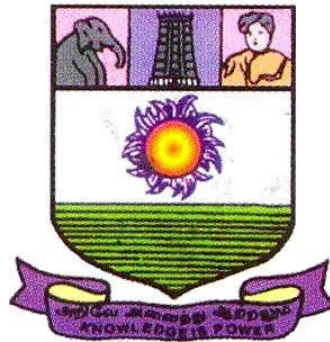


# UG Programme

(Three Year Programme)

## Curriculum, Programme Structure and Course Contents

(Prepared in conformity with LOCF)  
(2023-2024 onwards)



**DEPARTMENT OF COMMERCE**  
**Directorate of Distance and Continuing**  
**Education**  
**Manonmaniam Sundaranar University**  
**Tirunelveli – 627012**

**FIRST YEAR – SEMESTER - II**

**CORE – III: FINANCIAL ACCOUNTING-II**

Subject Code	L	T	P	S	Credits	Inst. Hours	Marks		
							CIA	External	Total
	5				5	5	25	75	100
<b>Learning Objectives</b>									
<b>LO1</b>	The students are able to prepare different kinds of accounts such Higher purchase and Instalments System.								
<b>LO2</b>	To understand the allocation of expenses under departmental accounts								
<b>LO3</b>	To gain an understanding about partnership accounts relating to Admission and retirement								
<b>LO4</b>	Provides knowledge to the learners regarding Partnership Accounts relating to dissolution of firm								
<b>LO5</b>	To know the requirements of international accounting standards								
<b>Prerequisites: Should have studied Accountancy in XII Std</b>									
Unit	Contents								No. of Hours
I	<b>Hire Purchase and Instalment System</b> Hire Purchase System – Accounting Treatment – Calculation of Interest - Default and Repossession - Hire Purchase Trading Account - Instalment System - Calculation of Profit								15
II	<b>Branch and Departmental Accounts</b> Branch – Dependent Branches: Accounting Aspects - Debtors system -Stock and Debtors system – Distinction between Wholesale Profit and Retail Profit – Independent Branches (Foreign Branches excluded) - Departmental Accounts: Basis of Allocation of Expenses – Inter-Departmental Transfer at Cost or Selling Price.								15
III	<b>Partnership Accounts - I</b> Partnership Accounts: –Admission of a Partner – Treatment of Goodwill - Calculation of Hidden Goodwill –Retirement of a Partner – Death of a Partner.								15
IV	<b>Partnership Accounts - II</b> Dissolution of Partnership - Methods – Settlement of Accounts Regarding Losses and Assets – Realization account – Treatment of Goodwill – Preparation of Balance Sheet - One or more Partners insolvent – All Partners insolvent – Application of Garner Vs Murray Theory – Accounting Treatment - Piecemeal Distribution – Surplus Capital Method – Maximum Loss Method.								15

V	<b>Accounting Standards for financial reporting (Theory only)</b> Objectives and Uses of Financial Statements for Users-Role of Accounting Standards - Development of Accounting Standards in India Role of IFRS- IFRS Adoption vs Convergence Implementation Plan in India- Ind AS- An Introduction - Difference between Ind AS and IFRS.	<b>15</b>
<b>TOTAL</b>		<b>75</b>
<b>THEORY 20% &amp; PROBLEMS 80%</b>		
<b>Course Outcomes</b>		
<b>CO1</b>	To evaluate the Hire purchase accounts and Instalment systems	
<b>CO2</b>	To prepare Branch accounts and Departmental Accounts	
<b>CO3</b>	To understand the accounting treatment for admission and retirement in partnership	
<b>CO4</b>	To know Settlement of accounts at the time of dissolution of a firm.	
<b>CO5</b>	To elaborate the role of IFRS	
<b>Textbooks</b>		
1	Radhaswamy and R.L. Gupta: Advanced Accounting, Sultan Chand, New Delhi.	
2	M.C. Shukla T.S. Grewal & S.C. Gupta, Advance Accounts, S Chand Publishing, New Delhi.	
3	R.L. Gupta and V.K. Gupta, "Financial Accounting", Sultan Chand, New Delhi.	
4	S P Jain and K. L. Narang: Financial Accounting- I, Kalyani Publishers, New Delhi.	
5	T.S. Reddy & A. Murthy, Financial Accounting, Margam Publishers, Chennai.	
<b>Reference Books</b>		
1	Dr. S.N. Maheswari: Financial Accounting, Vikas Publications, Noida.	
2	Dr. Venkataraman & others (7 lecturers): Financial Accounting, VBH, Chennai.	
3	Dr. Arulanandan and Raman: Advanced Accountancy, Himalaya publications, Mumbai.	
4	Tulsian, Advanced Accounting, Tata MC. Graw hills, India.	
5	Charumathi and Vinayagam, Financial Accounting, S.Chand and sons, New Delhi.	
<b>NOTE: Latest Edition of Textbooks May be Used</b>		
<b>Web Resources</b>		
1	<a href="https://www.slideshare.net/mcsharma1/accounting-for-depreciation-1">https://www.slideshare.net/mcsharma1/accounting-for-depreciation-1</a>	
2	<a href="https://www.slideshare.net/ramusakha/basics-of-financial-accounting">https://www.slideshare.net/ramusakha/basics-of-financial-accounting</a>	
3	<a href="https://www.accountingtools.com/articles/what-is-a-single-entry-system.html">https://www.accountingtools.com/articles/what-is-a-single-entry-system.html</a>	

**MAPPING WITH PROGRAMME OUTCOMES AND  
PROGRAMME SPECIFIC OUTCOMES**

	<b>PO 1</b>	<b>PO 2</b>	<b>PO 3</b>	<b>PO 4</b>	<b>PO 5</b>	<b>PO 6</b>	<b>PO 7</b>	<b>PO 8</b>	<b>PS O 1</b>	<b>PS O 2</b>	<b>PS O 3</b>
<b>CO1</b>	3	2	3	3	2	3	2	2	3	2	2
<b>CO2</b>	3	2	3	3	3	2	2	2	3	2	2
<b>CO3</b>	3	2	2	3	3	2	2	2	3	2	2
<b>CO4</b>	3	2	3	3	2	2	2	2	3	2	2
<b>CO5</b>	3	3	3	3	3	3	3	3	3	3	3
<b>TOTAL</b>	16	11	14	15	14	12	11	11	15	11	11
<b>AVERAGE</b>	3.2	2.2	2.8	3	2.8	2.4	2.2	2.2	3	2.2	2.2

**3 – Strong, 2- Medium, 1- Low**

## UNIT I

### Hire Purchase and Installments Systems

#### **Hire Purchase and Installment Purchase Systems**

Hire purchase and installment systems are responsible for bringing high value durable goods like cars, Televisions into the reach of middle class and lower middle class people. These systems have revolutionized the world of commerce.

#### **Hire Purchase System Definition:**

According to the Hire Purchase Act 1972 Section 2 (c) " Hire purchase agreement is an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which

- (i) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical installments.
- (ii) The property in the goods is to pass to such person on the payment of the last of such installments.
- (iii) Such person has a right to terminate the agreement at any time before the property so passes.

As Per Section 4 of the Hire Purchase Act 1972, every hire purchase agreement must state:

- The hire purchase price of the goods to which the agreement relates.
- The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash.
- The date on which the agreement shall be deemed to have commenced.
- The number of installments by which the hire purchase price is to be paid, the amount of each of those installments and the date or the mode of determining the date, upon which it is payable and the person to whom and the place where it is payable.
- The goods to which the agreement relates, the manner sufficient to identify them.

Some important terms in the hire purchase system

- 1. Cash price:** This is the retail price of the articles at which they can be purchased immediately for cash.
- 2. Hire purchase price:** is the total amount payable by the buyer, in agreed installments for the goods purchased. This price includes cash price and interest.
- 3. Interest:** This is the additional amount apart from the cash price payable by the buyer as

compensation for postponed payments.

**4. Hire or Installment:** This is the amount payable by the buyer periodically. The installments may be equal or different, depending on agreement.

**5. Down payment:** This is the advance payable by the buyer while signing the hire purchase agreement. It is also a part of the hire purchase price.

**6. Hirer:** The buyer of the goods on hire purchase basis.

**7. Hire vendor or owner:** The seller of the goods on hire purchase basis.

**Main features of Hire purchase system.**

- The hirer or buyer gets possession of the goods on signing the hire purchase agreement and he has the right to use them-
- The ownership of the goods continues to be with the seller or hire vendor. The buyer gets ownership of the goods on payment of the last installment.
- The hirer has the duty to keep the goods in good condition and take reasonable precautions for their safety till the last installment is paid.
- Each installment is treated as hire charges.
- The hirer has the option to return the goods before the last installment is paid.
- The hire vendor can repossess the goods if the buyer fails to pay any installment on the due date. However, permission of the court is needed for repossession, depending on the value of the goods and number of installments paid.
- If goods are repossessed, the value of goods on that date and the installments paid are added and the total hire purchase price is reduced. The balance is payable by the hire vendor to the hirer.

**Installment purchase system or deferred installment system:**

In installment purchase system also, an agreement is entered into by the seller and buyer. An advance or down payment is paid and possession as well as Ownership in the goods is transferred to the buyer. The buyer agrees to pay the balance of amount due in a specified number of installments along with agreed rate Of interest. If buyer fails to pay any installment, the seller cannot repossess the goods. He can sue the buyer in a court for recovery of the dues.

**Special Features of Hire Purchase Agreement**

1. **Possession:** The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.
2. **Installments:** The goods are delivered by the hire vendor on the condition that a hire purchaser should pay the amount in periodical installments.
3. **Down Payment:** The hire purchaser generally makes a down payment i.e. an amount on signing the agreement.
4. **Constituents of Hire purchase installments:** Each installment consists partly of a finance charge (interest) and partly of a capital payment.
5. **Ownership:** The property in goods is to pass to the hire purchaser on the payment of the last installment and exercising the option conferred upon him under the agreement.
6. **Repossession:** In case of default in respect of payment of even the last installment, the hire vendor has the right to take the goods back without making any compensation.

### **Terms used in Hire Purchase Agreements**

1. **Hire Vendor:** Hire vendor is a person who delivers the goods along with its possession to the hire purchaser under an hire purchase agreement.
2. **Hire Purchaser:** Hire purchaser is a person who obtains the goods and rights to use the same from hire vendor under an hire purchase agreement.
3. **Cash Price:** Cash price is the amount to be paid by the buyer on outright purchase in cash.
4. **Down Payment:** Down payment is the initial payment made to the hire vendor by the hire purchaser at the time of entering into hire purchase agreement.
5. **Hire Purchase Installment:** Hire purchase installment is the amount which the hire purchaser has to pay after a regular interval upto certain period as specified in the agreement to obtain the ownership of the asset purchased under a hire purchase agreement. It comprises of principal amount and the interest on the unpaid amount.
6. **Hire purchase price:** It means the total sum payable by the hire purchaser to obtain the ownership of the asset purchased under hire purchase agreement. It

comprises of cash price and interest on outstanding balances.

## Ascertainment of Interest

We know that the hire purchase price consists of two elements: (i) cash price; and (ii) interest. Cash price is the capital expenditure incurred for the acquisition of an asset and (ii) interest is the revenue expense for the delay in making the full payment. Ascertainment of any of these two gives the answer for the other, e.g., if we ascertain the total amount of interest, it becomes very simple to ascertain the cash price just by deducting the amount of interest from the hire purchase price.

Interest is charged on the amount outstanding. Therefore, if the hire purchaser makes a down payment on signing the contract, it will not include any amount of interest. It should be noted that though the installments of a hire purchase agreement may be equal, the interest element in each installment is not the same.

At the time of calculating interest, students may face the following two situations:

- (a) When the cash price, rate of interest and the amount of installments are given; and
- (b) When the cash price and the amount of installments are given, but the rate of interest is not given. Now, let us consider the above two situations.

### **6.1 When the cash price, rate of interest and the amount of installments are given**

In this situation, the total amount of interest is to be ascertained first. It is the difference between the hire purchase price (down payment + total installments) and the cash price. To calculate the amount of interest involved in each installment the following steps are followed:

Step 1: Deduct down payment from the cash price. Calculate the interest at the given rate on the remaining balance. This represents the amount of interest included in the first installment .

Step 2: Deduct the interest of Step 1 from the amount of first installment . The resultant figure is the cash price included in the first installment .

Step 3: Deduct the cash price of the 1<sup>st</sup> installment (Step 2) from the balance due after down payment. It represents the amount outstanding after the 1<sup>st</sup> installment is paid.

Step 4: Calculate the interest at the given rate on the balance outstanding after the 1<sup>st</sup> installment . Deduct this interest from the amount of the 2<sup>nd</sup> installment to get the cash price included in the 2<sup>nd</sup> installment .

Step 5: Deduct the cash price of the 2<sup>nd</sup> installment (Step 4) from the balance due after the 1<sup>st</sup> installment . It represents the amount outstanding after the 2<sup>nd</sup> installment is paid.

Repeat the above steps till the last installment is paid.

**Illustration 1**

Om Ltd. purchased a machine on hire purchase basis from Kumar Machinery Co. Ltd. on the

following terms:

- (a) Cash price ` 80,000
- (b) Down payment at the time of signing the agreement on 1.1.2013 ` 21,622.
- (c) 5 annual installments of ` 15,400, the first to commence at the end of twelve months from the date of down payment.
- (d) Rate of interest is 10% p.a.

You are required to calculate the total interest and interest included in cash installment .

**Solution:**

**Calculation of interest**

	Total ( ` )	Interest in each installment (1)	Cash price in each installment (2)
Cash Price	80,000		
Less : Down Payment	<u>(21,622)</u>	Nil	` 21,622
<b>Balance due after down payment</b>	58,378		
Interest/Cash Price of 1 <sup>st</sup> installment	-	` 58,378 x 10/100 = ` 5,838	` 15,400 – ` 5,838 = ` 9,562
Less : Cash price of 1 <sup>st</sup> installment	<u>(9,562)</u>		
<b>Balance due after 1<sup>st</sup> installment</b>	48,816		
Interest/cash price of 2 <sup>nd</sup> installment	-	` 48,816 x 10/100 = ` 4,882	` 15,400 - ` 4,882 = ` 10,518
Less: Cash price of 2 <sup>nd</sup> installment	<u>(10,518)</u>		
<b>Balance due after 2<sup>nd</sup> installment</b>	38,298		
Interest/Cash price of 3 <sup>rd</sup> installment	-	` 38,298 10/100 = ` 3,830	` 15,400 - ` 3,830 = ` 11,570
Less: Cash price of 3 <sup>rd</sup> installment	<u>(11,570)</u>		
<b>Balance due after 3<sup>rd</sup> installment</b>	26,728		
Interest/Cash price of 4 <sup>th</sup> installment	-	` 26,728 x 10/100 = ` 2,672	` 15,400 - ` 2,672 = ` 12,728
Less : Cash price of 4 <sup>th</sup> installment	<u>(12,728)</u>		
<b>Balance due after 4<sup>th</sup> installment</b>	14,000		
Interest/Cash price of 5 <sup>th</sup> installment	-	` 14,000 x 10/100 = ` 1,400	` 15400– ` 1,400 = 14,000
Less : Cash price of 5 <sup>th</sup> installment	<u>(14,000)</u>		
<b>Total</b>	Nil	` 18,622	` 80,000

Total interest can also be calculated as follow:

$$(\text{Down payment} + \text{installment s}) - \text{Cash Price} = [21,622 + (15400 \times 5)] - 80,000 = 18,622$$

When the cash price and the amount of installment s are given, but the rate of interest is not given

When the rate of interest is not given, but the cash price and the amount of installment s are given, the following steps are followed to calculate the interest:

Step 1: Calculate the total interest by deducting the cash price from the hire purchase price (i.e., down payment + amount of installment x number of installment s).

Step 2: Deduct down payment from the hire purchase price.

Step 3: Calculate the amount of outstanding balance of the hire purchase price at the

beginning of each year.

Step 4: Calculate the ratio of outstanding balance of Step 3.

Step 5: Calculate the amount of interest of each installment on the basis of the ratio of Step 4.

### Illustration 2

A Ltd. purchases a plant on hire purchase basis for ₹ 1,00,000 and makes the payment in the following order:

Down payment ₹ 20,000,

the 1<sup>st</sup> installment after one year ₹

40,000; the 2<sup>nd</sup> installment after two

years ₹ 20,000 and the last installment

after three years.

The cash price of the plant is ₹ 86,000.

You are required to calculate: (i) the total interest and (ii) the interest included in each installment.

#### Solution :

(i) Total interest = Hire Purchase price – Cash price = ₹ 1,00,000 – ₹ 86,000 = ₹ 14,000

(ii) Hire purchase price outstanding at the beginning of each year.

	₹
Hire purchase price	1,00,000
Less: Down payment	<u>(20,000)</u>
(a) Hire Purchase Price outstanding at the beginning of the 1 <sup>st</sup> year	80,000
Less 1 <sup>st</sup> installment	<u>(40,000)</u>
(b) Hire Purchase price outstanding at the beginning of the 2 <sup>nd</sup> year	40,000
Less: 2 <sup>nd</sup> installment	<u>(20,000)</u>
(c) Hire Purchase Price outstanding at the beginning of the 3 <sup>rd</sup> year	20,000
Less: 3 <sup>rd</sup> installment	<u>(20,000)</u>
	Nil

Ratio of (a) : (b) : (c) = 80:40:20 or 4:2:1

Interest of 1<sup>st</sup> installment =  $\frac{4}{7} \times ₹ 14,000 = ₹ 8,000$ . Interest of 2<sup>nd</sup> installment =  $\frac{2}{7} \times ₹ 14,000 = ₹ 4,000$ .

And interest of 3<sup>rd</sup> installment =  $\frac{1}{7} \times ₹ 14,000 = ₹ 2,000$

### When the amount of installment is given but cash price and rate of interest not given

The difference between any two successive installments represents the least amount of interest charged in the last year. The amount of interest for each year is calculated as follows:

Interest for 1 <sup>st</sup> year	= Difference between two successive installments x (N)
Interest for 2 <sup>nd</sup> year	= Difference between two successive installments x

	(N-1)
Interest for 3 <sup>rd</sup> year	= Difference between two successive installment s x (N-2)
Interest for 4 <sup>th</sup> year	= Difference between two successive installment s x (N-3)
Interest for 5 <sup>th</sup> year onwards	= Difference between two successive installment s x (N-4)
Note '_N' denotes the number of installment s.	

### Illustration 3

X Ltd. purchased a machine on hire purchase basis from Y Ltd. on the following terms:

(a) Cash Down payment- ₹ 1,58,500 (b) Four installments of ₹ 2,21,900, ₹ 2,06,050, ₹ 1,90,200 and ₹ 1,74,350 at the end of the 1<sup>st</sup> year, 2<sup>nd</sup> year, 3<sup>rd</sup> year and 4<sup>th</sup> year respectively.

(c) The payment of cash price in each installment is uniform. Compute the amount of interest and total cash price of the machine.

### Solution

Difference between any two successive installments represents the least amount of interest charged in the last year i.e. ₹ 2,21,900 – ₹ 2,06,050 = ₹ 15,850.

Thus, interest for the 3<sup>rd</sup> year = Least amount of interest x 2

$$\text{i.e. } ₹ 15,850 \times 2 = ₹ 31,700.$$

Thus, interest for the 2<sup>nd</sup> year = ₹ 15,850 x 3 = ₹

47,550 Thus, interest for the 1<sup>st</sup> year = ₹ 15,850 x 4

= ₹ 63,400

Thus, allocation of installment between cash price and interest is as follows:

Year	Installment (₹)	Interest (₹)	Cash Price (₹)
1	2,21,900	63,400	1,58,500
2	2,06,050	47,550	1,58,500
3	1,90,200	31,700	1,58,500
4	<u>1,74,350</u>	<u>15,850</u>	<u>1,58,500</u>
Total	<u>7,92,500</u>	<u>1,58,500</u>	<u>6,34,000</u>

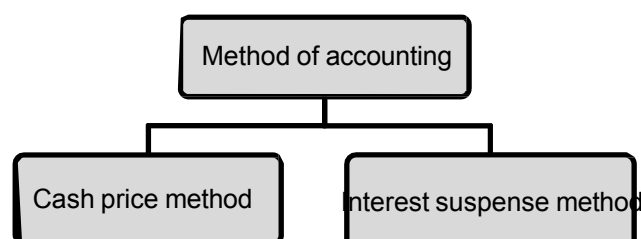
Total cash price = ₹ 6,34,000 + ₹ 1,58,500 = ₹ 7,92,500.

## Accounting Arrangements of Hire Purchase Transaction

### In the Books of Hire Purchaser

There are following two methods of recording the hire purchase transactions in the books of the hire-purchaser:

1. Cash price method
2. Interest suspense method



Asset taken on hire purchase basis should be considered like ordinary purchase.

***However, it is necessary to disclose this fact by classifying it as “Asset on Hire Purchase”. Accordingly, amount due to the hire vendor should also be shown in his books as a liability—“Hire Purchase Creditors” with additional such classifications of amount of hire purchase instalment due and amount of hire purchase instalment not yet***

### Cash price method

Under this method, the full cash price of the asset is debited to the Asset Account and credited to the Hire Vendor Account. At the time of payment of installment, Interest Account is debited and Hire Vendor Account is credited (with the interest on outstanding balance). When installment is paid, the Hire Vendor Account is debited and Bank Account is credited. At the time of preparation of Final Accounts, interest is transferred to Profit and Loss Account and asset is shown in the Balance Sheet at cost less depreciation. The balance due to hire vendor is shown in the Balance Sheet as a liability (alternatively it can be shown as a deduction from Asset Account).

#### *Accounting*

To have proper accounting record, one should know: (1) Date of purchase of the asset; (2) Cash price of the asset; (3) Hire purchase price of the asset; (4) The amount of down payment; (5) Number and amount of each installment; (6) Rate of interest; (7) Method and rate of depreciation; (8) Date of payment of every installment; and (9) Date of closing the books of account.

#### Journal Entries

1.	<i>On entering into the agreement</i> Asset Account To Hire Vendor Account	Dr. [Full cash price]
2.	<i>When down payment is made</i> Hire Vendor Account To Cash/Bank Account	Dr. [Down payment]
3.	<i>When an installment becomes due</i> Interest Account To Hire Vendor Account	Dr. [Interest on outstanding balance]
4.	<i>When an installment is paid</i> Hire Vendor Account To Bank Account	Dr. [Amount of installment]
5.	<i>When depreciation is charged on the asset</i> Depreciation Account To Asset Account	Dr. [Calculated on cash price]

6.	<i>For closing interest and depreciation account</i> Profit and Loss Account To Interest Account To Depreciation Account	Dr.
----	--	-----

However, a firm may maintain Provision for Depreciation A/c instead of charging depreciation

to Hire Purchase Asset A/c. In such case the journal entry is:

Profit and Loss A/c Dr.

To Provision for Depreciation for Asset on Hire

Purchase A/c and naturally, Asset on Hire Purchase is shown at its historical cost. **Disclosure in the balance sheet**

**Assets**

Fixed Assets :

Asset (at cash price)	xxxxxxx.xx
Less : Depreciation	<u>xxxx.xx</u>
	<u>xxxxxxx.xx</u>

**Creditors :**

Hire Purchase Creditors :

Balance in hire vendor's A/c	xxxxx.xx
Installment due	xxxxx.xx
Installment not yet due	xxxxx.xx

**Illustration 6**

On January 1, 2010 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

- (a) The cash price of the van was ` 1,00,000.
- (b) ` 40,000 were to be paid on signing of the contract.
- (c) The balance was to be paid in annual installments of ` 20,000 plus interest.
- (d) Interest chargeable on the outstanding balance was 6% p.a.
- (e) Depreciation at 10% p.a. is to be written-off using the straight-line method. You are required to:
  - (a) Give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 2010 to December 31, 2012; and
  - (b) Show the relevant items in the Balance Sheet of the purchaser as on December 31, 2010 to 2012.

**Solution**

**In the books of HP  
M/s Journal  
Entries**

Date	Particulars		Dr.	Cr.
2010 Jan. 1	Pick-up Van A/c <span style="float: right;">Dr.</span> To FM M/s A/c (Being the purchase of a pick-up van on hire purchase from FM M/s)		1,00,000	1,00,000
—	FM M/s A/c <span style="float: right;">Dr.</span> To Bank A/c (Being the amount paid on signing the H.P. contract)		40,000	40,000

Dec. 31	Interest A/c	Dr.	3,600	
	To FM M/s A/c			3,600
	(Being the interest payable @ 6% on ` 60,000			
—	FM M/s A/c (` 20,000+` 3,600)	Dr.	23,600	
	To Bank A/c			23,600
	(Being the payment of 1 <sup>st</sup> installment along with interest)			
—	Depreciation A/c	Dr.	10,000	
	To Pick-up Van A/c			10,000
	(Being the depreciation charged @ 10% p.a. on ` 1,00,000)			
—	Profit & Loss A/c	Dr.	13,600	
	To Depreciation A/c To Interest A/c			10,000
	(Being the depreciation and interest transferred to Profit and Loss Account)			3,600
2011 Dec. 31	Interest A/c	Dr.	2,400	
	To FM M/s A/c			2,400
	(Being the interest payable @ 6% on ` 40,000)			
	FM M/s A/c (` 20,000 + ` 2,400)	Dr.	22,400	
	To Bank A/c			22,400
	(Being the payment of 2 <sup>nd</sup> installment along with interest)			
	Depreciation A/c	Dr.	10,000	
	To Pick-up Van A/c			10,000
	(Being the depreciation charged @ 10% p.a.)			
	Profit & Loss A/c	Dr.	12,400	
	To Depreciation A/c To Interest A/c			10,000
	(Being the depreciation and interest charged to Profit and Loss Account)			2,400
2012 Dec. 31	Interest A/c	Dr.	1,200	
	To FM M/s A/c			1,200
	(Being the interest payable @ 6% on ` 20,000)			
	FM M/s A/c (` 20,000 + ` 1,200)	Dr.	21,200	
	To Bank A/c			21,200
	(Being the payment of final installment along with interest)			
	Depreciation A/c	Dr.	10,000	
	To Pick-up Van A/c			10,000
	(Being the depreciation charged @ 10% p.a. on ` 1,00,000)			

Profit & Loss A/c	Dr.	11,200	
To Depreciation			10,000
A/c To Interest			1,200
A/c			
(Being the interest and depreciation charged to Profit and Loss Account)			

**Ledgers in the books of  
HP M/s Pick-up Van  
Account**

Date	Particulars	\`	Date	Particulars	\`
1.1.2010	To FM M/s A/c	1,00,000	31.12.2010	By Depreciation A/c	10,000
			31.12.2011	By Balance c/d	<u>90,000</u>
		<u>1,00,000</u>			<u>1,00,000</u>
1.1.2011	To Balance b/d	90,000	31.12.2011	By Depreciation A/c	10,000
			31.12.2011	By Balance c/d	<u>80,000</u>
		<u>90,000</u>			<u>90,000</u>
1.1.2012	To Balance b/d	80,000	31.12.2012	By Depreciation A/c	10,000
			31.12.2012	By Balance c/d	<u>70,000</u>
		<u>80,000</u>			<u>80,000</u>

**FM M/s Account**

Date	Particulars	\`	Date	Particulars	\`
1.1.10	To Bank A/c	40,000	1.1.10	By Pick-up Van A/c	1,00,000
31.12.10	To Bank A/c	23,600	31.12.10	By Interest c/d	3,600
31.12.10	To Balance c/d	<u>40,000</u>			
		<u>1,03,600</u>			<u>1,03,600</u>
31.12.11	To Bank A/c	22,400	1.1.11	By Balance b/d	40,000
31.12.11	To Balance c/d	<u>20,000</u>	31.12.11	By Interest A/c	<u>2,400</u>
		<u>42,400</u>			<u>42,400</u>
31.12.12	To Bank A/c	21,200	1.1.12	By Balance b/d	20,000
			31.12.12	By Interest A/c	<u>1,200</u>
		<u>21,200</u>			<u>21,200</u>

**Depreciation Account**

Date	Particulars	\`	Date	Particulars	\`
31.12.2010	To Pick-up Van A/c	<u>10,000</u>	31.12.2010	By Profit & Loss A/c	<u>10,000</u>
31.12.2011	To Pick-up Van A/c	<u>10,000</u>	31.12.2011	By Profit & Loss A/c	<u>10,000</u>
31.12.2012	To Pick-up Van A/c	<u>10,000</u>	31.12.2012	By Profit & Loss A/c	<u>10,000</u>

**Interest Account**

Date	Particulars	\`	Date	Particulars	\`
31.12.2010	To FM M/s A/c	<u>3,600</u>	31.12.2010	By Profit & Loss A/c	<u>3,600</u>

## 11.16 Accounting

31.12.2011	To	FM M/s A/c	<u>2,400</u>	31.12.2011	By Profit & Loss A/c	<u>2,400</u>
31.12.2012	To	FM M/s A/c	<u>1,200</u>	31.12.2012	By Profit & Loss A/c	<u>1,200</u>

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2010

<i>Liabilities</i>		<i>Assets</i>	
FM M/s	40,000	Pick-up Van	90,000

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2011

<i>Liabilities</i>		<i>Assets</i>	
FM M/s	20,000	Pick-up Van	80,000

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2012

<i>Liabilities</i>		<i>Assets</i>	
	20,000	Pick-up Van	70,000

### Interest suspense method

Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense account. At latter years, as and when interest becomes due, interest account is debited and interest suspense account is credited.

### Journal Entries

1.	<i>When the asset is acquired on hire purchase</i> Asset Account To Hire Vendor Account	Dr. [Full cash price]
2.	<i>For total interest payment is made</i> H.P. Interest Suspense Account To Hire Vendor Account	Dr. [Total interest]
3.	<i>When down payment is made</i> Hire Vendor Account To Bank Account	Dr.
4.	<i>For Interest of the relevant period</i> Interest Account To H.P. Interest Suspense Account	Dr. [Interest of the relevant period]

5.	When an installment is paid Hire Vendor Account To Bank Account	Dr.
6.	<i>When depreciation is charged on the asset</i> Depreciation Account To Asset Account	Dr. [Calculated on cash price]
7.	<i>For closing interest and depreciation account</i> Profit and Loss Account To Interest Account To Depreciation Account	Dr.

**Illustration 7**

*In illustration 6 assume that the hire purchaser adopted the interest suspense method for recording his hire purchase transactions. On this basis, prepare H.P. Interest Suspense Account, Interest Account and FM M/s Accounts and Balance Sheets in the books of hire purchaser.*

**Solution**

**H.P. Interest Suspense Account**

Date	Particulars	\`	Date	Particulars	\`
1.1.2010	To FM M/s A/c (W.N.)	7,200	31.12.2010	By Interest A/c	3,600
			31.12.2010	By Balance c/d	<u>3,600</u>
		<u>7,200</u>			<u>7,200</u>
1.1.2011	To Balance b/d	3,600	31.12.2011	By Interest A/c	2,400
			31.12.2011	By Balance c/d	<u>1,200</u>
		<u>3,600</u>			<u>3,600</u>
1.1.2012	To Balance b/d	1,200	31.12.2012	By Interest A/c	1,200

**Interest Account**

Date	Particulars	\`	Date	Particulars	\`
31.12.2010	To H.P. Interest Suspense A/c	3,600	31.12.2010	By Profit & Loss A/c	3,600
31.12.2011	To H.P. Interest	2,400	31.12.2011	By Profit & Loss A/c	2,400

	Suspense a/c					
31.12.2012	To H.P. Interest Suspense A/c	1,200	31.12.2012	By Profit & Loss A/c	1,200	

## 11.18 Accounting

### FM M/s Account

Date	Particulars	Amount	Date	Particulars	Amount
1.1.2010	To Bank A/c	40,000	1.1.2010	By Pick-up Van A/c	1,00,000
31.12.2010	To Bank A/c	23,600	1.1.2010	By H.P. Interest Suspense A/c	7,200
31.12.2010	To Balance c/d	<u>43,600</u>			
		<u>1,07,200</u>			<u>1,07,200</u>
31.12.2011	To Bank A/c	22,400	1.1.2011	By Balance b/d	43,600
31.12.2011	To Balance c/d	<u>21,200</u>			
		<u>43,600</u>			<u>43,600</u>
31.12.2012	To Bank A/c	21,200	1.1.2012	By Balance b/d	21,200

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2010

Liabilities		Amount	Assets		Amount
FM M/s	43,600		Pick-up Van	1,00,000	
Less: H.P. Interest Suspense	<u>(3,600)</u>	40,000	Less: Depreciation	<u>(10,000)</u>	90,000

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2011

Liabilities		Amount	Assets		Amount
FM M/s	21,200		Pick-up Van	90,000	
Less: H.P. Interest Suspense	<u>(1,200)</u>	20,000	Less: Depreciation	<u>(10,000)</u>	

### Balance Sheet of HP M/s as at 31<sup>st</sup> December, 2012

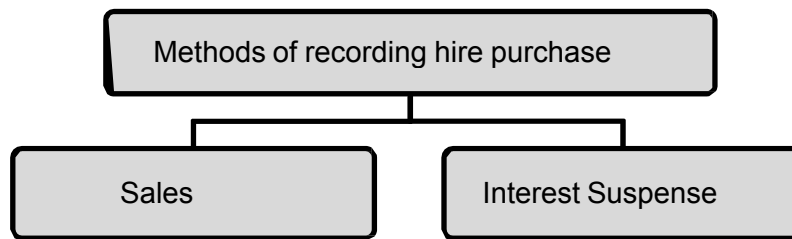
Liabilities		Amount	Assets		Amount
			Pick-up Van	80,000	
			Less: Depreciation	<u>(10,000)</u>	70,000

#### Working Note:

Total Interest = ` 3,600 + ` 2,400 + ` 1,200 = ` 7,200.

### 7.2 In the books of the Hire Vendor

There are different methods of recording hire purchase transactions in the books of the hire vendor. It is selected according to the type and value of goods sold, volume of transactions, the length of the period of purchase, etc. The different methods are



***Sales Method***

A business that sells relatively large items on hire purchase may adopt this method. Under this method, hire purchase sale is treated as a credit sale. The only exception is that the vendor agrees to accept payments in installments and for that he charges interest. Generally, a special Sales Day Book is maintained for recording all sales under hire purchase agreement. The amount due from the hire purchaser at the end of the year is shown in the Balance sheet on the assets side as Hire Purchase Debtors.

**Journal Entries**

1.	<i>When goods are sold and delivered under hire purchase</i> Hire Purchaser Account To H.P. Sales Account	Dr. [Full cash price]
2.	<i>When the down payment is received</i> Bank Account To Hire Purchaser Account	Dr.
3.	<i>When an installment becomes due</i> Hire Purchaser Account To Interest Account	Dr.
4.	<i>When the amount of installment is received</i> Bank Account To Hire Purchaser Account	Dr.
5.	<i>For closing interest Account</i> Interest Account To Profit and Loss Account	Dr.
6.	<i>For closing Hire Purchase Sales Account</i> H.P. Sales Account To Trading Account	Dr.

***It is worth noting that***

- (i) The entire profit on sale under hire purchase agreement is credited to the Profit and Loss account of the year in which the sale has taken place; and***
- (ii) Interest pertaining to each accounting period is credited to the Profit***

***Interest Suspense Method***

This method is almost similar to the sales method, except the accounting for interest. Under this method, the hire purchaser is debited with full cash price and interest (total) included in the hire selling price. Credit is given to the H.P. Sales Account and Interest Suspense Account. When the installment is received, the Bank Account is debited and the Hire Purchaser Account is credited. At the same time an appropriate amount of interest (i.e., interest for the relevant accounting period) is removed from the Interest Suspense Account and credited to the Interest Account. At the time of preparation of Final Accounts, interest is transferred to the credit of the Profit and Loss Account. The balance of the Interest Suspense Account is shown in the Balance Sheet as a deduction from Hire Purchase Debtors.

**Journal Entries**

1.	When goods are sold and delivered under hire purchase Hire Purchase Account To H.P. Sales Account To Interest Suspense Account	Dr. [Full cash price + total interest] [Full cash price] [Total Interest]
2.	When down payment/installment is received Bank Account To Hire Purchaser Account	Dr.
3.	For interest of the relevant accounting period Interest Suspense Account To Interest Account	Dr.
4.	For closing interest Account Interest Account To Profit and Loss Account	Dr.
5.	For closing Hire Purchase Sales Account H.P. Sales Account To Trading Account	Dr.

*The disclosure in balance sheet of the respective parties will be:*

**Balance Sheet of Hire Purchaser**

Assets

**Balance Sheet of Vendor**

Assets

Fixed assets :	Current assets :
Asset on Hire purchase	Hire purchase debtors
Add : Balance in Interest suspense A/c	Less : Balance in Interest suspense A/c
Less : Depreciation	

### Illustration 8

*M/s Delhi Electronics sells colour TVs., on hire purchase basis. Cost per set is ` 14,000, Cash sale price ` 15,500 and hire purchase sale price is ` 16,800 for 12 monthly installments payable by 10th of every month. However, the buyer has to make cash down ` 1,800 at the time of purchase.*

*Hire Purchase transactions (No. of sets) in 2012 - Jan. 10, Feb. 12, March 10, April 12, May 10, June 10, July 10, August 15, Sept. 11, Oct. 20, Nov. 20, Dec. 10.*

*Let us suppose all installments are duly collected. Show necessary Journal Entries.*

### Solution

Various relevant accounting information in relation to hire purchase transactions are computed as follows :

Total No. of Transactions	:	150
Cash down	:	` 1,800 × 150 = ` 2,70,000

### Installments Collected/Due

Transactions	No. of Installments collected			No. of Installments Due		
Jan.	10 × 11	=	110	10 × 1	=	10
Feb.	12 × 10	=	120	12 × 2	=	24
March	10 × 9	=	90	10 × 3	=	30
April	12 × 8	=	96	12 × 4	=	48
May	10 × 7	=	70	10 × 5	=	50
June	10 × 6	=	60	10 × 6	=	60
July	10 × 5	=	50	10 × 7	=	70
Aug.	15 × 4	=	60	15 × 8	=	120
Sept.	11 × 3	=	33	11 × 9	=	99
Oct.	20 × 2	=	40	20 × 10	=	200
Nov.	20 × 1	=	20	20 × 11	=	220
Dec.	10 × 0	=	—	10 × 12	=	120
	<u>150</u>		<u>749</u>	<u>150</u>		<u>1051</u>

*Check:*

Total Installments for 150 hire purchase transactions are 1800 (150×12) of which 749 installments fell due and collected and the balance 1051 installments are not yet paid.

Amount collected for 749 installments

$$\frac{\text{₹ } 16,800 \times \text{₹ } 1,800}{12} \div 749 = \text{₹ } 9,36,250$$

Amount not yet due

$$\frac{\text{₹ } 16,800 - \text{₹ } 1,800}{12} \div 1,051 = \text{₹ } 13,13,750$$

Cash Down = ₹ 2,70,000

Total (₹ 16,800 × 150) = ₹ 25,20,000

Hire Vendor should recognise the amount of installments collected and cash down value (i.e. ₹ 2,70,000 + ₹ 9,36,250) ₹ 12,06,250 as sale. Balance ₹ 13,13,750 is value of goods lying with the customer at hire purchase price. Stock Reserve should be computed and deducted from such amount to show the Hire Purchase Stock at cost.

	$\frac{\text{Price} \times \text{Cost}}{\text{Hire Purchase Price}}$
Goods lying with Hire Purchaser at Hire Purchase Price	₹ 14,000
Stock at cost	= ₹ 13,13,750 $\div$ $\frac{14,000}{16,800}$
	= ₹ 10,94,792

Stock Reserve = (₹ 13,13,750 – 10,94,792) = ₹ 2,18,958

#### Journal Entries

(1) For Cash down at the time of hire transaction	Cash/Bank A/c	Dr.	2,70,000
	To Hire Purchase Sale A/c		2,70,000
(2) When installments fall due	Installment Due A/c	Dr.	9,36,250
	To Hire Purchase Sales		9,36,250
(3) On collection of installments	Cash/Bank A/c	Dr.	9,36,250
	To Installment Due A/c		9,36,250
(4) For installment not due at the year	Hire Purchase Stock A/c	Dr.	13,13,750
	To Trading A/c		13,13,750
(5) For Stock Reserve	Stock Reserve A/c	Dr.	2,18,958
	To Hire Purchase Stock A/c		2,18,958

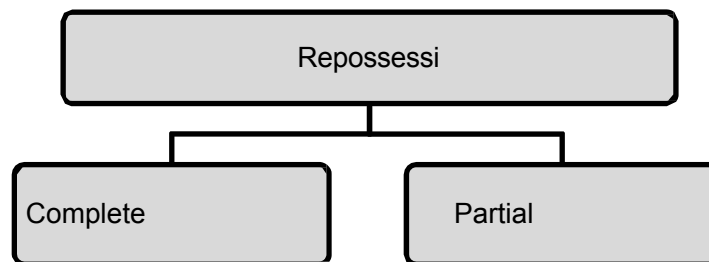
If some installments become due but not collected at the year end, then they would appear in the Balance Sheet as an asset just like Sundry Debtors.

## Repossession

In a hire purchase agreement the hire purchaser has to pay up to the last installment to obtain the ownership of goods. If the hire purchaser fails to pay any of the installments, the hire vendor takes the asset back in its actual form without any refund of the earlier payments to the hire purchaser. The amounts received from the hire purchaser through down payment and installments are treated as the hire charges by the hire vendor. This act of recovery of possession of the asset is termed as **repossession**.

Repossessed assets are resold to any other customer after repairing or reconditioning (if necessary). Accounting figures relating to repossessed assets are segregated from the normal hire purchase entries. Repossessions are then accounted for in a separate “Goods Repossessed Account”.

So far as the repossession of assets are concerned, the hire vendor can take back the whole of the asset or a part thereof depending on the agreement between the parties. The former is called “Complete Repossession” and the latter “Partial Repossession”.



### 8.1 Complete Repossession

The hire vendor closes Hire Purchaser’s Account by transferring balance of Hire Purchaser Account to Goods Repossessed Account.

The hire purchaser closes the Hire Vendor’s Account by transferring the balance of Hire Vendor Account to Hire Purchase Asset/Trading Account and then finding the profit and loss on repossession in Asset Account.

Particulars	Books of hire purchaser	Books of hire vendor
-------------	-------------------------	----------------------

Purchase/Sales	Asset A/c ...Dr. To Hire Vendor A/c	Hire Purchaser A/c ...Dr. To Sales A/c
Installment	Hire Vendor A/c	Cash A/c
Interest	...Dr. To Cash A/c	...Dr. To Hire Purchaser A/c
Repossession	Interest A/c ...Dr. To Hire Vendor	Hire Purchaser A/c ...Dr. To Interest A/c
	Hire Vendor A/c ...Dr. To Asset A/c	Goods Repossessed A/c Dr. To Hire Purchaser

## **Partial Repossession**

In case of a partial repossession, only a part of the asset is taken back by the hire vendor and other part is left with the hire purchaser. The Journal Entries are as usual up to the date of default(excepting entry for payment) in the books of both the parties. As a portion of the asset is still leftwith the hire purchaser, neither party closes the account of the other in their respective books.

Assets are repossessed at a mutually agreed value (based on agreed rate of depreciation which is an enhanced rate). The hire vendor debits the Goods Repossessed Account and credit the Hire Purchaser Account with the value as agreed upon on the repossession. Similarly, the hire purchaser debits the Hire Vendor Account and credits the Assets Account with the same amount. If the repossessed value is less than the book value of the asset, the difference is charged to the Profit and Loss Account of the hire purchaser as '**loss on surrender**'.

For the remaining portion of the asset lying with the hire purchaser, the (Hire Purchaser) applies the usual rate of depreciation and shows the Asset Account at its usual written-down value.

## **Miscellaneous Illustrations**

### **Illustration 9**

*X Ltd. purchased 3 milk vans from Super Motors costing ` 75,000 each on hire purchase system. Payment was to be made: ` 45,000 down and the remainder in 3 equal installment s together with interest @ 9%.*

*X Ltd. writes off depreciation @ 20% on the diminishing balance. It paid the installment at the end of the 1st year but could not pay the next. Super Motor agreed to leave one milk van with the purchaser, adjusting the value of the other two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. X Ltd. settled the seller's dues after three months.*

*You are required to give necessary journal entries and the relevant accounts in the books of X Ltd.*

**Solution**

**In the Books of X Ltd.  
Journal Entries**

		Dr. ( ` )	Cr. ( ` )
<b>I Year</b>			
Milk Vans purchased:			
Milk Vans A/c	Dr.	2,25,000	
To Vendor A/c			2,25,000
On down payment:			
Vendor A/c	Dr.	45,000	
To Bank			45,000
<b>I Year end</b>			
Interest A/c ( ` 1,80,000 @ 9%)	Dr.	16,200	
To Vendor A/c			16,200
Vendor A/c	Dr.	76,200	
To Bank A/c			76,200
Depreciation @ 20%			
Depreciation A/c	Dr.	45,000	
To Milk Vans A/c			45,000
Profit & Loss A/c	Dr.	61,200	
To Depreciation			45,000
To interest all			16,200
<b>II Year end</b>			
Depreciation @ 20%			
Depreciation A/c	Dr.	36,000	
To Milk Vans A/c			36,000
Interest A/c	Dr.	10,800	
(1,20,000 @ 9%)			
To Vendor A/c			10,800
Return of goods to vendor A/c	Dr.	73,500	
To Milk Vans A/c			73,500
For Loss in Repossession:			
Profit/Loss A/c	Dr.	22,500	
To Milk Vans A/c			22,500
<b>IIIrd Year Depreciation</b>			
Depreciation A/c	Dr.	9,600	
To Milk Vans A/c			9,600
Settlement of A/cs			
Vendor A/c	Dr.	57,300	
To Bank			57,300

**Milk Vans Account**

Year		`	Year		`
1	To Super Motors A/c	2,25,000	1 end	By Depreciation A/c	45,000
		_____	II	By Balance c/d	<u>1,80,000</u>
		<u>2,25,000</u>			<u>2,25,000</u>
2	To Balance b/d	1,80,000	2 end	By Depreciation	36,000

				Super Motors (value of	
				2 vans after depreciation for 2 years @ 30%)	73,500
				By P & L A/c (balancing figure)	22,500
				By Balance c/d (one van less depreciation for 2 years) @ 20%	<u>48,000</u>
			<u>1,80,000</u>		<u>1,80,000</u>

### Super Motors Account

Year		\	Year		\
1	To Bank A/c	45,000	1	By Milk Vans A/c	2,25,000
	To Bank A/c	76,200		By Interest @ 9% on	
				\ 1,80,000	16,200
	To Balance c/d	<u>1,20,000</u>			
		<u>2,41,200</u>			<u>2,41,200</u>
2	To Milk Van A/c	73,500	2	By Balance	1,20,000
	To Balance c/d	<u>57,300</u>		b/d By	
		<u>1,30,800</u>		Interest A/c	<u>10,800</u>
3	To Bank A/c	57,300	3	By Balance b/d	<u>57,300</u>

### Illustration 10

A firm acquired two tractors under hire purchase agreements, details of which were as follows:

Date of Purchase	Tractor A 1st April, 2011	Tractor B 1st Oct., 2011
Cash price	14,000	19,000
Deposit	2,000	2,680
Interest (deemed to accrue evenly over the period of agreement)	2,400	2,880

Both agreements provided for payment to be made in twenty-four monthly installments, commencing on the last day of the month following purchase, all installments being paid on due dates.

On 30th June, 2012, Tractor B was completely destroyed by fire. In full settlement, on 10th July, 2012 an insurance company paid ₹ 15,000 under a comprehensive policy out of which ₹ 10,000 was paid to the hire purchase company in termination of the agreement. Any balance on the hire purchase company's account in respect of these transactions was to be written off.

The firm prepared accounts annually to 31st December and provided depreciation on tractors on a straight-line basis at a rate of 20 per cent per annum rounded off to nearest

*ten rupees, apportioned as from the date of purchase and up to the date of disposal.*

You are required to record these transactions in the following accounts, carrying down the balances on 31st December, 2011 and 31st December, 2012:

- (a) Tractors on hire purchase.
- (b) Provision for depreciation of tractors.
- (c) Disposal of tractors.
- (d) Hire purchase company.

**Solution**

**Hire Purchase accounts in the buyer's books**

**(a) Tractors on Hire Purchase Account**

2011				2011			
April 1	To HP Co. - Cash price		14,000	Dec. 31	By Balance c/d	14,000	
Oct. 1	Tractor A		19,000		Tractor A	<u>19,000</u>	33,000
	HP Co. - Cash price		<u>19,000</u>		Tractor B		
	Tractor B		<u>33,000</u>				<u>33,000</u>
2012 Jan. 1	To Balance b/d	14,000		2012 June 30			19,000
		<u>19,000</u>	33,000	Dec. 31	By Disposal of Tractor A/c - Transfer	<u>14,000</u>	
2013 Jan. 1	Tractor A		<u>33,000</u>		By Balance c/d		
	Tractor B		14,000				
	To Balance b/d						

**(b) Provision for Depreciation of Tractors Account**

2011				2011			
Dec. 31	To Balance c/d	3,050		Dec.31	By P & L A/c:		
					Tractor A	2,100	
						<u>950</u>	<u>3,050</u>
		<u>3,050</u>			Tractor B	<u>3,050</u>	
		0				<u>0</u>	

2012				2012			
June30	To Disposal of Tractor account—		2,850	Jan. 1	By Balance b/d		3,050

Dec. 31	Transfer To Balance c/d	4,900	Jun. 30	By P & L A/c (Depn. for Tractor B) By P & L A/c	1,900
		<u>7,750</u>	Dec. 31	(Depn. for Tractor A)	<u>2,800</u>
			2013		<u>7,750</u>
			Jan. 1	By Balance b/d	4,900

(c) **Disposal of Tractor Account**

2012			2012		
June 30	To Tractors on hire purchase—Tractor B	19,000	June 30	By Provision for Depn. of Tractors A/c	2,850
			July 10	By Cash :	15,000
			Dec. 31	Insurance By P & L A/c : Loss	<u>1,150</u>
		<u>19,000</u>			<u>19,000</u>

**Hire Purchase Co. Account**

April 1	To Cash (deposit for Tractor A)	2,000	April 1	By Tractors on Hire Purchase A/c - Tractor A	
April	To Cash—6 instal- 14,000 Sept.			ments @ ` 600	3,600
Oct. 1	By Tractors on Hire Purchase A/c—Tractor B				
Oct. 1	To Cash—deposit for Tractor B	2,680		Hire Purchase A/c—Tractor B	
	19,000 Oct. -			To Cash—3 instal-	
Dec. 31	By Interest A/c : ments @ ` 600 for Tractor A	1,800		For Tractor A @ ` 100	
	for Tractor B			9 months	
	To Cash—3 instal- 900 ments @ ` 800	2,400		For Tractor B @ ` 120 for 3 months	<u>360</u>
Dec. 31	To Balance c/d	<u>21,780</u>			<u>1,260</u>
		<u>34,260</u>			<u>34,260</u>
2012			2012		
Jan. 1	To Cash—6 installment s		Jan. 1	By Balance b/d	21,780

	@ ` 600 for Tractor A	3,600	Jun. 30	By Interest A/c— for Tractor B @ ` 120	720
June	To Cash—6 instalments @ ` 800 for Tractor B	4,800		for 6 months	
July 10	To Cash - final instalment		Dec.31	By Interest - for for 12 months	1,200
July-Dec.	To Cash - 6 installment s @ ` 600 for Tractor A	3,600			
31 Dec.	To Balance c/d				
	1,500 To P & L A/c—unpaid amount	<u>200</u>			
		<u>23,700</u>			<u>23,700</u>

### Illustration 11

A machinery is sold on hire purchase. The terms of payment is four annual installment s of ` 6,000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of ` 6,000.

Show Machinery Account and Hire Vendor Account in the books of the purchaser who defaulted in the payment of the third yearly payment whereupon the vendor re-possessed the machinery. The purchaser provides depreciation on the machinery @ 10% per annum. All workings should form part of your answers.

### Solution

#### Machinery Account

I Yr.	To Hire Vendor A/c	15,533	I Yr.	By Depreciation A/c	1,553
		<u>15,533</u>		By Balance c/d	<u>13,980</u>
II Yr.	To Balance b/d	13,980			<u>15,533</u>
		<u>13,980</u>	II Yr.	By Depreciation A/c*	1,398
III Yr.	To Balance b/d	12,582		By Balance c/d	<u>12,582</u>
		<u>12,582</u>			<u>13,980</u>
			III Yr.	By Depreciation A/c*	1,258
				By Hire Vendor	11,000
				By Profit & Loss A/c	324
				(Loss on Surrender)	<u>12,582</u>

\*It has been assumed that depreciation has been written off on written down value method. Alternatively straight line method may be assumed.

Depreciation has been directly credited to the Machinery Account; it could have been accumulated in provision for depreciation account.

#### Hire Vendor Account

I Yr.	To Bank A/c	6,000	I Yr.	By Machinery A/c	15,533
	To Balance c/d	<u>12,639</u>		By Interest A/c	<u>3,106</u>
		<u>18,639</u>			<u>18,639</u>
II Yr.	To Bank A/c	6,000	II Yr.	By Balance b/d	12,639
	To Balance c/d	<u>9,167</u>		By Interest A/c	<u>2,528</u>
		<u>15,167</u>			<u>15,167</u>
III Yr.	To Machinery A/c	11,000	III Yr.	By Balance b/d	9,167

(transfer)			By Interest A/c	<u>1,833</u>
		<u>11,000</u>		<u>11,000</u>

*Note* : Alternatively, total interest could have been debited to Interest Suspense A/c and credited to Hire Vendor A/c with consequential changes.

**Working Notes:**

		<i>Installment Amount</i>	<i>Interest</i>	<i>Principal</i>
4th Installment		6,000		
Interest	$6,000 \times \frac{20}{120}$	<u>1,000</u>	1,000	5,000
		5,000		
<i>Add</i> : 3rd		<u>6,000</u>		
		11,000		
Installment	$11,000 \times \frac{20}{120}$	1,833	1,833	4,167
Interest		9,167		
		<u>6,000</u>		
		15,167		
<i>Add</i> : 2nd	$15,167 \times \frac{20}{120}$	2,528	2,528	3,472
Installment		12,639		
Interest		<u>6,000</u>		
		18,639		
	$18,639 \times \frac{20}{120}$	3,106	3,106	<u>2,894</u>
<i>Add</i> : 1st				
Installment				
Interest				
		<u>15,533</u>	<u>8,467</u>	<u>15,533</u>

**Illustration 12**

*X Transport Ltd. purchased from Delhi Motors 3 Tempos costing ` 50,000 each on the hire purchase system on 1-1-2010. Payment was to be made ` 30,000 down and the remainder in 3 equal annual installments payable on 31-12-2010, 31-12-2011 and 31-12-2012 together with interest @ 9%. X Transport Ltd. write off depreciation at the rate of 20% on the diminishing balance. It paid the installment due at the end of the first year i.e. 31-12-2010 but could not pay the next on 31-12-2011. Delhi Motors agreed to leave one Tempo*

with the purchaser on 1-1-2012 adjusting the value of the other 2 Tempos against the amount due on 31-12-2011. The Tempos were valued on the basis of 30% depreciation annually. Show the necessary accounts in the books of X Transport Ltd. for the years 2010, 2011 and 2012.

**Solution**

**X Transport Ltd. Tempo Account**

2010			2010		
Jan. 1	To Delhi Motors	1,50,000	Dec. 31	By Depreciation A/c:20% on 1,50,000	30,000
				By Balance c/d	<u>1,20,000</u>
		<u>1,50,000</u>			<u>1,50,000</u>
2011 Jan 1.	To Balance b/d	1,20,000	2011 Dec.31.	By Depreciation A/c	24,000
				By Delhi Motors A/c (Value of 2 tempos taken away)	49,000
				By Profit and Loss A/c (balancing figure)	15,000
		<u>1,20,000</u>		By Balance c/d (Value of one tempo left)	<u>32,000</u>
					<u>1,20,000</u>

2012 Jan. 1	To Balance b/d	32,000	2012 Dec. 31	By Depreciation A/c	6,400
				By Balance b/d	<u>25,600</u>
					<u>32,000</u>

**Delhi Motors Account**

2010			2010		
Jan. 1	To Bank (Down Payment)	30,000	Jan. 1	By Tempos A/c	1,50,000
Dec. 31	To Bank	50,800	Dec. 31	By Interest (9% on ` 1,20,000)	10,800
	To Balance c/d	<u>80,000</u>			
		<u>1,60,800</u>			<u>1,60,800</u>
		0			
2011 Jan. 1	To Tempo	49,000	2011 Jan. 1	By Balance b/d	80,000
Dec. 31	To Balance c/d	38,200	Dec. 31	By Interest (9% on ` 80,000)	7,200
					<u>7,200</u>
		<u>87,200</u>			<u>87,200</u>

2012 Dec. 31	To Bank	41,638	2012 Jan. 1	By Balance b/d	38,200
			Dec. 31	By Interest	<u>3,438</u>
		<u>41,638</u>		(9% on ` 38,200)	<u>41,638</u>

### Working Notes :

(1) Value of a Tempo left with the buyer:

Cost	50,000
Depreciation @ 20% p.a. under WDV method for 2 years [i.e. ` 10,000 + ` 8,000]	(18,000)
Value of the Tempo left with the buyer at the end of 2nd year	<u>32,000</u>

(2) Value of Tempos taken away by the seller:

No. of tempos Two	
Cost ` 50,000 × 2 =	1,00,000
Depreciation @ 30% Under WDV method for 2 years [i.e. ` 30,000 + ` 21,000 ]	(51,000)
Value of tempos taken away at the end of 2nd year	<u>49,000</u>

## 9. Instalment Payment System

In installment payment system the ownership of the goods is passed immediately to the buyer on the signing the agreement. Because of this basic difference the accounting entries under installment payment system are slightly different from those passed under the hire-purchase system. The scheme of entries is as under:

**Books of buyer:** Buyer debits asset account with full cash price, credits vendor's account with full installment price and debits interest suspense account with the difference between full cash

price and full installment price. Interest is debited to interest suspense account (not interest account) because it includes interest in respect of a number of years. Every year interest account is debited and interest suspense account is credited with the interest of current year. Interest account, at the end of the year, is closed by transferring to profit and loss account. The balance of interest suspense account (this is a debit balance) is shown in the balance sheet on the asset side. Vendor is paid the installment due to him and entry for the depreciation is passed in the usual way.

**Books of Seller:** The seller debits the purchaser with the full amount (installment price) payable by him and credits sales account by the full cash price and credits interest suspense account by the difference between the total installment price and total cash price. Seller, like the buyer, also transfers the amount of interest

### **Difference of Hire Purchase Agreement and Installment Payment Agreement**

due from the interest suspense account interest account every year. Interest account is closed by transferring to profit and loss account and the balance of interest suspense account is shown in the balance sheet on the liability side. On receiving the installment the vendor debits cash/bank account and credits purchaser's account.

A hire purchase agreement is a contract of bailment coupled with an option to the hire purchaser to acquire the goods delivered to him under such an agreement. By the delivery of goods to the hire

purchaser, the hire vendor merely pass with their possession, but not the ownership. The property or title to

the goods is transferred to the hire-purchaser, on his paying the last installment of the hire price or complying with some other conditions stipulated in the contract. At any time before that the hire-purchaser has the option to return the goods and, if he does so, he has only to pay the installments of price that by then have fallen due. The right or option to purchase is the essence of hire-purchase agreement. In the event of a default by the buyer (hire purchaser) in the payment of any of the installments of hire price, the vendor can take back the goods into his possession. This is legally permissible since the property in the goods is still with the vendor.

On the other hand, it may have been agreed between the buyer and the seller that the price of the goods would be payable by installments and the property would immediately pass to the buyer; in the event of a default of installments, it would not be possible for the vendor to recover back the goods. He, however, would have the right to bring an action against the purchaser for the recovery of the part of the price that has not been paid to him.

*Analysis of the hire purchase price* : The hire purchase price is always greater than the cash price, since it includes interest payable over and above the price of the goods to compensate the seller for the sacrifice he has made by agreeing to receive the price by installments and the risk that he thereby undertakes. It is thus made up of following elements:

- (a) cash price;
- (b) interest on unpaid installments; and
- (c) a charge to cover the risk involved in the buyer defaulting to pay one or more of installments of price or that of his returning the goods in a damaged condition.

Interest is the charge for the facility to pay the price for the goods by installments after they have been delivered. The rate of interest is generally higher than that payable in respect of an advance or a loan since it also includes a charge to cover the risk that the hirer may fail to pay any of the installments and, in such an event, the goods may have to be taken back into possession in whatever condition they are at the time. A separate charge on this account is not made as that would not be in keeping with the fundamental character of the

hire-purchase sale.

## **UNIT I – Hire Purchase and Instalment System**

### **5 Mark Questions**

<b>Q.No</b>	<b>Question</b>	<b>Level</b>	<b>Category</b>
1	Define Hire Purchase System and state its features.	K1	Remember
2	What is repossession in hire purchase?	K1	Remember
3	Explain the concept of installment system.	K2	Understand
4	How is interest calculated in hire purchase?	K3	Apply
5	What is Hire Purchase Trading Account?	K1	Remember

### **8 Mark Questions**

<b>Q.No</b>	<b>Question</b>	<b>Level</b>	<b>Category</b>
1	Explain accounting treatment under Hire Purchase System.	K2	Understand
2	Discuss default and repossession under hire purchase.	K3	Apply
3	Explain preparation of Hire Purchase Trading Account.	K3	Apply
4	Distinguish between Hire Purchase and Installment System.	K4	Analyze
5	Explain calculation of profit under installment system.	K3	Apply

## UNIT - 2

### ACCOUNTING FOR BRANCHES AND DEPARTMENTAL ACCOUNT

#### INTRODUCTION

A branch can be described as any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company. It must also be noted that the concept of a branch means existence of a head office; for there can be no branch without a head office - the principal place of business. From the accounting point of view, branches may be classified as follows:

Inland Branches which can be further classified as:

Independent Branches which maintain independent accounting records

Dependent Branches for which whole accounting records are kept at Head Office

Foreign Branches

#### DISTINCTION BETWEEN BRANCH ACCOUNTS AND DEPARTMENTAL ACCOUNTS

Basis of difference	Branch	Departmental
1. place	Branch are established by separating them from the head office	Departments are run by attaching them with the main organization under a single roof.
2. Geography	Branches are geographically separated.	Departments are not separated rather existed under a same roof.
3. objective	Branches are the outcome of touch competition and expansion of business	Department are the result of fast human life.
4. Types	Branches are different types like dependent, independent and foreign.	There is no such classification in department because all are common under the same roof.
5. Common cost	Allocation of branch common expenses does not arise.	Allocation of departmental common expenses is a touch job.
6. reconciliation	Reconciliation is necessary for final result of departments.	No reconciliation is necessary because there is a central account division.

#### DEPENDENT BRANCHES

When the business policies and the administration of a branch are wholly controlled by the head office and its accounts also are maintained by it the branch is described as Dependent branch. Branch accounts, in such a case, are maintained at the head office out of reports and returns received from the branch. Some of the significant types of branches that are operated in this manner are described below:

A branch set up merely for booking orders that are executed by the head office. Such a branch only transmits orders to the head office;

A branch established at a commercial center for the sale of goods supplied by the head office, and under its direction all collections are made by the H.O.; and

A branch for the retail sale of goods, supplied by the head office.

Accounting in the case of first two types is simple. Only a record of expenses incurred at the branch has to be maintained.

But however, a retail branch is essentially a sale agency that principally sells goods supplied by the head office for cash and, if so authorized, also on credit to approved customers. Generally, cash collected is deposited into a local bank to the credit of the head office and the head office issues cheques thereon for meeting the expenses of the branch. In addition, the Branch Manager is provided with a 'float' for petty expenses which is replenished from time to time on an imprest basis. If,

however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

## METHODS OF CHARGING GOODS TO BRANCHES

Goods may be invoiced to branches (1) at cost; or (2) at selling price; or (3) in case of retail branches, at wholesale price; or (4) arbitrage price.

Selling price method is adopted where the goods would be sold at a fixed price by the branch. It is suitable for dealers in tea, petrol, ghee, etc. In this way, greater control can be exercised over the working of a branch in as much as that the branch balance in the head office books would always be composed of the value of unsold stock at the branch and remittances or goods in transit. The arbitrary price method is usually adopted if the selling price is not known or when it is not considered desirable to disclose to the branch manager the profit made by the branch.

## ACCOUNTING FOR DEPENDENT BRANCHES

Dependent branch does not maintain a complete record of its transactions. The Head office may maintain accounts of dependent branches in any of the following methods:

### Methods of maintaining accounts of Dependent Branches

- *If Goods are invoiced at cost or selling price:* Debtors Method; Stock and Debtors Method; Trading and profit and loss account method (Final Accounts method)
- *If Goods are invoiced at wholesale price:* Whole Sale branch method

### When goods are invoiced at cost

If goods are invoiced to the branch at cost, the trading results of branch can be ascertained by following any of the three methods: **(i) Debtors Method, (ii) Stock and Debtors method, (iii) Trading and Profit and Loss Account (Final Accounts) Method.**

For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is stated in the head office books to which the price of goods or services provided or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

### Debtors method

This method of accounting is suitable for small sized branches. Under this method, separate branch account is maintained for each branch to compute profit or loss made by each branch. The opening balance of stock, debtors (if any), petty cash (if any), are debited to the Branch Account; the cost of goods sent to branch as well as expenses of the branch paid by the head office, e.g., salaries, rent, insurance, etc., are also debited to it. Conversely, amounts remitted by the branch and the cost of goods returned by the branch are credited. At the end of the year, the value of unsold stock, the total of customers' balances outstanding and that of petty cash are brought into the branch account on the credit side and then the branch account will reveal profit or loss; Debit 'balance' will be the loss suffered by the working of the branch and *vice versa*. If the branch is allowed to make small purchases of goods locally as well as to incur expenses out of its cash receipts, it will be necessary for the branch to supply to the head office a copy of the Cash Account, showing details

of cash collections and disbursements. To illustrate the various entries which are made in the Branch Account, the proforma of a Branch Account is shown below:

### Proforma Branch Account

Particulars	Amount	Particular	Amount
To Balance b/d		By Bank A/c (Cash remitted)	
Cash		By Return to H.O.	
Stoc			
k			
Debtors		By Balance c/d	
Petty Cash		Cash	
Fixed Assets		Stock	
Prepaid Expenses		Debtors	
To Goods sent to Branch		Petty Cash	
To Bank A/c		Fixed Assets	
Salaries		Prepaid Expenses	
Rent			
Sundry Expenses		By Profit and Loss A/c—	
To Profit & Loss A/c—		Loss	
Profit		(if debit side is larger)	
(if credit side is larger)			

Note:

1. Having credited the Branch Account by the actual cash received from debtors, it would be wrong to debit the Branch Account, in respect of discount or allowances to debtors.

2. The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

#### Illustration 1

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office.

From the following, prepare Nagpur branch account in the books of head office by Debtors method:

	`		`
<i>Opening balance (1-1-2011) Imprest Cash</i>	<i>2,000</i>	<i>Bad Debts</i>	<i>1,000</i>
<i>Sundry Debtors</i>	<i>25,000</i>	<i>Discount to Customers</i>	<i>2,000</i>
<i>Stock: Transferred from H.O.</i>	<i>24,000</i>	<i>Remittances to H.O.</i>	
<i>Direct Purchases</i>	<i>16,000</i>	<i>(recd. by H.O.)</i>	<i>1,65,000</i>
<i>Cash Sales</i>	<i>45,000</i>	<i>remittances to H.O.</i>	
<i>Credit Sales</i>	<i>1,30,000</i>	<i>(not recd. by H.O. so far)</i>	<i>5,000</i>

Direct Purchases	45,000	Branch Exp. directly paid by H.O.	30,000
Returns from Customers	3,000	Closing Balance (31-12-2011)	
Goods sent to branch from H.O.	60,000	Stock: Direct Purchase	10,000
Transfer from H.O. for Petty cash expenses	4,000	Transfer from H.O. Debtor	15,000
		Imprest cash	?
		Petty cash expensed	4000

### Solution

In the Books of Buckingham Bros, Bombay Nagpur Branch Account

To Opening		By Bank - Remittances received from branch			
Branch Assets		Cash Sales	45,000		
Stock (24,000+16,000)	40,000	Cash from Debtors	1,20,000		
Debtors	25,000	Cash from Debtors in transit	5,000	1,70,000	
Imprest Cash	2,000	Stock: Transfer from H.O.			15,000
To Goods sent to Branch A/c	60,000	Direct Purchase Sundry			10,000
To Creditors (Direct Purchases)	45,000	Debtors (W.N. 2)			24,000
To Bank (Sundry exp.)	30,000	Imprest			2,000
To Bank (Petty cash exp.)	4,000	Cash (W.N. 3)			
To Net Profit transferred to General Profit & Loss A/c	15,000				
	2,21,000				2,21,000

### Working Notes:

#### Collections from debtors:

	₹
Total remittances (₹ 1,65,000 + ₹ 5,000)	1,70,000
Less: Cash sales	(45,000)
	1,25,000

#### Calculation of Sundry Debtors closing Balance:

	₹
Opening Balance	25,000
Add: Credit Sales	1,30,000
	1,55,000
Less: Returns, Discount, Bad debts & collections (3,000 + 2,000 + 1,000 + 1,25,000)	(1,31,000)
Closing balance	24,000

#### Calculation of closing balance of Imprest Cash

	₹
Opening Balance	2,000
Add: Transfer from H.O.	4,000
	6,000
Less: Expenses	(4,000)
Closing balance	2,000

### When goods are invoiced at selling price

It would be obvious that if Branch Account is debited with the sales price of goods and subsequent to the debit being raised there is a change in the sale price, the amount of debit either has to be increased or reduced on consideration of the quantity of unsold stock that was there at the branch at the time the change took place. Such an adjustment will be necessary as often as the change in sale price occurs.

Moreover the amount of anticipatory profit, included in the value of unsold stock with the branch at the close of the year will have to be **eliminated** before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve.

It may also be necessary to adjust the value of closing stock on account of the physical losses of stock due to either pilferage or wastages which may have occurred during the year. The last

mentioned adjustments are made by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the lost goods), to the Branch Adjustment Account.

### Illustration 2

Harrison of Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording.

Following further details are given for the year ended 31st December, 20X1:

<i>Cost of goods sent to Branch at cost</i>			2,00,000
<i>Goods received by Branch till 31-12-20X1 at invoice price</i>			2,20,000
<i>Credit Sales for the year @ invoice price</i>			1,65,000
<i>Cash Sales for the year @ invoice price</i>			59,000
<i>Cash Remitted to head office</i>			2,22,500
<i>Expenses paid by H.O.</i>			12,000
<i>Bad Debts written off</i>			750
<i>Balances as on</i>	<i>1-1-20X1</i>		<i>31-12-20X1</i>
<i>Stock</i>	<i>25,000 (Cost)</i>	<i>28,000 (invoice price)</i>	
<i>Debtors</i>	<i>32,750</i>		<i>26,000</i>
<i>Cash in Hand</i>	<i>5,000</i>		<i>2,500</i>

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 20X1.

Solution

#### Books of Harrison Branch Stock Account

To Balance b/d	30,000	By Branch Debtors	1,65,000
To Goods Sent to Branch A/c	2,40,000	By Branch Bank	59,000
To Branch Adjustment A/c (Excess of sale over invoice price)	2,000	By Balance c/d	
		Goods in Transit (` 2,40,000 - ` 2,20,000)	20,000
		Stock at Branch	28,000
	2,72,000		2,72,000

#### Branch Debtors Account

To Balance b/d	32,750	By Bad debts written off	750
----------------	--------	--------------------------	-----

To Branch Stock	1,65,000	By Branch Cash- collection (bal. fig.)	1,71,000
		By Balance c/d	26,000
	1,97,750		1,97,750

Branch Cash Account

To Balance b/d	5,000	By Bank Remit to H.O.	2,22,500
To Branch Stock	59,000	By Branch profit & loss A/c (exp. paid by H.O.)	12,000
To Bank (as per contra)	12,000		
To Branch Debtors	1,71,000	By Branch profit & loss A/c [Bal. fig. (exp. paid by Branch)]	10,000
		By Balance c/d	2,500
	2,47,000		2,47,000

Branch Adjustment Account

To Stock Reserve (on closing stock $(48,000 \times 1/6)$ )	8,000	By Stock Reserve opening $(25000 \times 20\%)$	5,000
To Gross Profit c/d	39,000	By Goods sent to Branch A/c	40,000
		By Branch Stock A/c	2,000
	47,000		47,000

Branch Profit and Loss Account

To Branch Expenses (paid by HO: ` 12,000 and paid by Branch ` 10,000)	22,000	By Gross Profit b/d	39,000
To Branch Debtors-Bad debts	750		0
To Net Profit	16,250		
	39,000		39,000

Goods Sent to Branch Account

To Branch Adjustment A/c	40,000	By Branch to Stock A/c	2,40,000
To Purchase A/c - Transfer	2,00,000		
	2,40,000		2,40,000

### Debtors Method

Under this method, the principal accounts that will be maintained are:

The Branch Account;

The Goods Sent to Branch Account; and

The Stock Reserve Account.

Entries in these accounts will be made in the following manner:

	Transaction	Account debited	Account credited
(a)	Goods sent to Branch at selling price	Branch A/c	Goods Sent to Branch A/c
(b)	'Loading' being the difference between selling price and cost of goods	Goods Sent to Branch A/c	Branch A/c
(c)	Returns to H.O. at selling price	Goods Sent to Branch A/c Branch A/c	Branch A/c
(d)	'Loading' in respect of goods returned to H.O.	Stock Reserve A/c	
(e)	'Loading' included in the opening stock to reduce it	Branch Stock A/c	Goods Sent to Branch A/c
(f)	Closing stock at selling price	Branch A/c	Branch A/c
(g)	'Loading' included in closing stock to reduce it to cost		Branch A/c Stock Reserve A/c

It will be observed that entries in the Branch Account in respect of goods sent to a branch or returned by it, as well as those for the opening and closing stock, will be at selling price. In consequence, the Branch Account is maintained at selling price.

Hence the Branch Account will not correctly show the trading profit of the Branch unless these amounts are adjusted to cost. Such an adjustment is effected by making contra entries in 'Goods Sent to Branch A/c' and 'Stock Reserve Account'. In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to cost; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch Account.

### Illustration 3

Harrison of Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording.

Following further details are given for the year ended 31st December, 20X1:

Cost of goods sent to Branch at cost	2,00,000
--------------------------------------	----------

Goods received by Branch till 31-12-20X1 at invoice price	2,20,000
Credit Sales for the year @ invoice price	1,65,000

Cash Sales for the year @ invoice price		59,000
Cash Remitted to head office		2,22,500
Expenses paid by H.O.		12,000
Bad Debts written off		750
Balances as on	1-1-20X1	31-12-20X1
Stock	25,000 (Cost)	28,000 (invoice price)
Debtors	32,750	26,000
Cash in Hand	5,000	2,500

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 20X1.

### Solution

#### Books of Harrison New Delhi Branch Account

To Balance b/d		By Balance b/d	
Stock	30,000	Stock Reserve	5,000
Debtors	32,750	By Goods Sent to Branch A/c	40,000
Cash	5,000	By Bank-Remittance received from the Branch:	
To Goods Sent to Branch A/c (2,00,000 + 20% of 2,00,000)	2,40,000	Cash sales	59,000
To Bank (Exp. paid by H.O.)	12,000	Debtors Collection	2,22,500
To Net Profit Transferred to H.O. Profit and Loss A/c	16,250	<u>1,63,500</u>	
To Balance c/d (Stock reserve on closing stock)	8,000	(W.N.1)	
		(Net of expense)	
		By Balance c/d	
		Stock (including Transit) (W.N.2)	48,000
		Debtors	26,000
		Cash	2,500
	<u>3,44,000</u>		<u>3,44,000</u>

### Working Note:

$$\begin{aligned} \text{Collection from debtors} &= \text{Total collection} - \text{Cash sales} \\ &= 2,22,500 - 59,000 = 1,63,500 \end{aligned}$$

$$\begin{aligned} \text{Closing stock} &= \text{Stock at branch} + \text{Goods sent by H.O.} - \text{Goods received by Branch} \\ &= 28,000 + 2,40,000 - 2,20,000 = 48,000 \end{aligned}$$

## DEPARTMENTAL ACCOUNTING

### Department:

Department refers to activity center (profit or cost center) usually located in the same roof but carrying distinct type of activities.

### Departmental Accounting:

Department accounting or departmental accounting is a system of financial accounting which is used in the organizations whose all works are done through their different departments or departmental stores. Departmental accounts are prepared separately for each department and trial balance will also be prepared. Departmental P&L Account is prepared to ascertain the profit or loss of each department separately and at the end of the year it is transferred to General profit and loss account of the whole organisation.

### Objectives of departmental accounting

The main objectives of departmental accounting are:

- a) To have comparison of the results of a particular department with previous year and also with the other departments of the same concern;
- b) To help the proprietor in formulating policy to expand the business on proper lines so as to optimize the profits of the concern;
- c) To allow departmental managers' commission on the basis of the profits of their departments; and
- d) To generate information, which may be helpful for planning, control, and evolution of performance of each department and for taking various managerial decisions.

### Advantages of Department Accounts:

The main advantages of Departmental accounting are as follows:

- a) It provides an idea about the affairs of each department.
- b) It helps to evaluate the performance of each department.
- c) It helps to reward the Departmental managers and staff on the basis of performance.
- d) It facilitates control over the working of each department.
- e) It helps to compare the result of one department with those of other departments.
- f) It helps the management to formulate the right business policies for the various departments.
- g) It will help in the preparation of departmental budgets.
- h) It helps to calculate stock turnover ratio of each department.

There are two methods that are used in departmental accounting: –

1. Where a separate set of books is maintained for every department.
2. Where all departmental accounts maintain columnar-wise collectively.

### **E. Methods of Departmental Accounting:**

Where individual set of books is maintained

It is method under which every branch of an organization is regarded as separate unit and therefore individual book of accounts are prepared and maintained for every unit. At the end, financial result of every department is calculated and consolidated to find the overall performance and net result of whole organization.

This method of departmental accounting involves huge costs and is preferred only by large scale organizations or where is required by the law. Companies involved in insurance business are the one which are compulsorily required to implement this system of accounting.

#### **Where all departmental accounts are maintained columnar-wise collectively**

Under this technique of departmental accounting, accounts of all branches are maintained collectively in columnar form by central accounts department. In this method for every department a departmental trading and profit and loss account is opened in columnar way altogether. There is a separate column for —Totalll for finding out the results of different departments both on individual and collective basis. Balance sheet is however prepared in a combining form.

For incorporation of purchase and sale of goods, a subsidiary book of accounts is prepared with different columns for different departments. Various subsidiary books prepared are Purchase book, Sales book, Purchase return and Sales return book. Cash book with separate columns of cash purchase and cash sale is also maintained in case of large volumes of purchase and sales done on cash basis.

### **INTER-DEPARTMENTAL TRANSFERS:**

Inter-departmental transfers are made on the following basis:

#### **INTER-DEPARTMENTAL TRANSFER AT COST PRICE**

The price at which one department supplies goods to another department or when some services are rendered by department to the another department is known as Transfer Price. It refers to the charge made for goods and services sold internally. It may be market price if one is available. The transfer price is adjusted with the following amounts:

- Cash discount
- Selling costs (not in internal transfers)
- Margin of profit
- Standard costs.

Recording inter-departmental transfers helps the management in setting up profit centres, fixing responsibility on departmental managers and eventually, evaluates the performance and efficiency of the concerned departments.

#### **STANDARD COST BASED TRANSFER PRICE**

Under this method of pricing the prices may be based on the actual cost or total cost or standard cost or marginal cost. Standard cost is preferred to actual cost as the efficiency of one department is not allowed to pass to another department. When goods are transferred at cost, the fixed cost of supplying department becomes the variable cost of the receiving department.

### **INTER-DEPARTMENTAL TRANSFER AT SALE OR INVOICE PRICE**

The goods may also be transferred from one department to another at sale or invoice price. The department which transfers the goods is known as Transferor department and the department to which goods are transferred is known as Transferee department. In this case, the transferor department retains the normal profit and does not allow the transferee department to increase its profit at the cost of the transferor.

When the goods received are sold out, the load or profit retained by the transferor department becomes the actual profit realized.

But if the goods remain unsold, then there will be unrealized profit in the closing stock. Unrealized profit is the difference between transfer price and the cost price of unsold stock. These reserves are created as follows:

### **FOR CLOSING STOCK**

General Profit and Loss A/c Dr.

To stock reserve A/c

### **AT THE BEGINNING OF THE YEAR**

Stock reserve A/c Dr.

To General profit and loss A/c

### **Illustration No 1**

Z & Co. has two departments. They maintain separate records for each department. You are requested to prepare the Trading A/c and Profit & Loss A/c of each department and a Balance Sheet for the year ended on 31st March, 1989 on the basis of the following information

	Dept.I	Dept. II	Other Balances
Opening Stock (1.4.88) ,	25,000	20,000	
Purchases	2,30,000	1,90,000	
Purchase Returns	2,000	1,000	
Sales	6,33,000	4,92,000	
Sales Returns	3,000	2,000	
Wages & Salaries	1,80,000	1,60,000	
Miscellaneous Charges	35,000	32,000	
Closing Stock on 31.3.89	26,000	24,000	
Sundry Debtors			1,90,000
Sundry Creditors			1,73,000
Plant & Machinery			2,40,000
Leasehold Land			80,000

Buildings		1,20,000
Furniture & Fittings		48,000
Selling Expenses and other overhead expenses		1,28,000
Cash in hand on 31.3.89		8,000
Cash at Bank on 31.3.89		1,10,000
Proprietors Capital A/c		5,00,000

Depreciate Plant & Machinery by 33— 3 %, Building by 5% and Furniture & Fittings by 10%. All unallocated expenses are to be allocated on the basis of net sales of each department.

### Solution 1

In the books of Z & Co					
Departmental Trading and P&L Account for the year ended 31-03-1989					
Dr			Cr		
Particulars	Dept 1	Dept 2	Particulars	Dept 1	Dept 2
To Opening Stock	25000	20000	By sales	630000	490000
To Purchases	228000	189000			
To wages and Salries	180000	160000			
To Gross Profit	223000	145000	By Closing Stock	26000	24000
<b>Total</b>	<b>656000</b>	<b>514000</b>	<b>Total</b>	<b>656000</b>	<b>514000</b>
			By Gross Profit	223000	145000
To S&D Expense	72000	56000			
To Misc. Expenses	35000	32000			
To Depn on Building	3375	2625			
To Depn on P&M	45000	35000			
To Depn on Furniture	2700	2100			
To General P&L	64925	17275			
<b>Total</b>	<b>223000</b>	<b>145000</b>		<b>223000</b>	<b>145000</b>

In the books of Z & Co					
Balance Sheet as on 31st March 1989					
Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	500000		Leasehold Land		80000
Add: Net Profit			Building	120000	
Dept-1	64925		Less: Depreciation	6000	114000
Dept-2	17275	582200			
			Plant & Machinery	240000	
			Less: Depreciation	80000	160000
Sundry Creditors		173000			
			Furniture & Fittings	48000	
			Less: Depreciation	4800	43200

			Stock		50000
			Sundry Debtors		190000
			Cash-at-Bank		110000
			Cash-in-Hand		8000
<b>Total</b>		<b>755200</b>	<b>Total</b>		<b>755200</b>

**Question 2.** S Brothers are leading paper merchants and book sellers. Their wholesale business is in- paper and their retail show room -conducts business in stationery, books and magazines. The following balances are abstracted from their books at the end of their financial year, 31st March, 1997.

	₹		₹
Capital	300000	Rent	60000
Stock (1-4-1996)		Lighting	24000
Paper	200000	Showroom Maintenance	18000
Stationery	50000	Showroom Fittings	180000
Books	100000	Sundry Debtors (for Paper)	100000
Magazines	25000	Sundry Creditors	150000
Purchases:		Salaries:	
Paper	800000	showroom staff	36000
Stationery	300000	Wholesale Business Staff	12000
Books	350000	Showroom Cashier	12000
Magazines	300000	General Office Expenses	44000
Sales:		General Office Salaries	11000
Paper	1000000	Cash and Bank Balances	8000
Stationery	360000		
Books	420000		
Magazines	420000		

You are requested by the firm to prepare their Departmental Trading and Profit & Loss Account for the financial year under reference with help of the following additional information: Closing balance at the end of the year in the various departments were: Paper Z 1, 80,000; Stationery Z 40,000; Books Z 1, 20,000 and Magazines T 30,000. Rent and Lighting are for premises taken on lease, General Office accommodation is negligible. Wholesale department uses 1,500 sq. ft. The balance of 1,500 sq., feet is occupied by the showroom with equal division among stationery, books and magazines. Show room fittings are to be depreciated by 10% p.a.

In the Books of S. Brothers									
Departmental Trading and Profit & Loss									
Particulars	Paper	Stationery	Books	Magazine	Particulars	Paper	Stationery		Magazine
To op Stock	20000 0	50000	10000 0	25000	By Sales	100000 0	360000	42000 0	420000

To purchases	80000 0	300000	35000 0	300000	By cl. Stock	180000	40000	12000 0	30000
To Gross Profit	180000	50000	90000	125000					
<b>Total</b>	<b>1180000</b>	<b>400000</b>	<b>540000</b>	<b>450000</b>	<b>Total</b>	<b>1180000</b>	<b>400000</b>		<b>450000</b>
					<b>By Gross Profit</b>	180000	50000		125000
To Rent (3:1:1:1)	30000	10000	10000	10000					
To lighting (floor area)	12000	4000	4000	4000					
To showroom Maintenance		6000	6000	6000					
To depreciation		6000	6000	6000					
To salaries showroom		10800	12600	12600					
To Salaries Wholesale	12000								
To salaries Cashier		3600	4200	4200					
To General Office	5000	1800	2100	2100					
To General office Expenses	20000	7200	8400	8400					
To Net Profit	101000	600	36700	71700					
<b>Total</b>	<b>1800000</b>	<b>500000</b>	<b>900000</b>	<b>1250000</b>	<b>Total</b>	<b>1800000</b>	<b>500000</b>		<b>1250000</b>

**Question 3.** M/s ABC carried on business as Departmental Stores in Calcutta. The partners A, B, C were in charge of Departments X, Y and Z respectively. The partners are entitled to remuneration equal to 50 % of the profits (without taking the partners remuneration into consideration) of the respective departments of which they are in-charge and the balance of the profits are to be distributed among A, B and C in the ratio of 5:3:2. The following are balance of the revenue items in the books for the year 31.3.1994:

Particulars	Departments		
	X (₹)	Y (₹)	Z (₹)
Opening Stock	151560	96000	80000
Purchases	562800	332400	177600
Sales	720000	540000	360000
Closing Stock	180320	69920	96360
Other Revenue Items:			
Salaries and Wages	192000		
Discount Allowed	5400		
Advertising	9000		
Discount Received	3200		
Rent	43200		
Sundry Expenses	48600		
Depreciation on Furniture & Fittings	3000		

Prepare the Departmental Trading and Profit & Loss Account for the year ended 31.3.94.

Show the distribution of profits amongst the partners after taking into account the following:

Goods having a transfer price of ₹42800 and ₹2400 were transferred from Department X and Y respectively to department Z. The inter-departmental transfers are made at 125% of the cost.

The various items shall be apportioned amongst the three Departments in the following proportions:

Particulars	Departments		
	X	Y	Z
Rent	2	2	5
Salaries	1	1	1
Depreciation	1	1	1
Discount Received	8	5	3

All other expenses: on the basis of sales (excluding inter-departmental transfers) of each department. The opening stock of Department Z does not include goods transferred from other Department but the Closing Stock include ₹34200 valued at the inter-departmental transfer prices.

**Solution 4**

In the books of M/S ABC							
Departmental trading and Profit & Loss Account for the year 31-03-1994							
Dr							Cr
Particulars	Dept. X (₹)	Dept. Y (₹)	Dept. Z (₹)	Particulars	Dept. X (₹)	Dept. Y (₹)	Dept. Z (₹)
To opening Stock	151560	96000	80000	By Sales	720000	540000	360000
To Purchases	562800	332400	177600	By Dept Z	42800		
To Dept Z			42800	By Dept Z		2400	
Dept X			2400				
Dept Y				By Closing Stock	180320	69920	86360
To Gross Profit c/d	228760	183920	143560				
<b>Total</b>	<b>943120</b>	<b>612320</b>	<b>446360</b>	<b>Total</b>	<b>943120</b>	<b>612320</b>	<b>446360</b>
				By Gross Profit b/d	228760	183920	143560
To Salaries & Wages	64000	64000	64000	By Discount Received	1600	1000	600
To Rent	9600	9600	24000				
To Depreciation	1000	1000	1000				
To Discount Allowed	2400	1800	1200				
To Advertising	4000	3000	2000				
To sundry Expenses	21600	16200	10800				
To General P&L	127760	89320	41160				
<b>Total</b>	<b>230360</b>	<b>184920</b>	<b>144160</b>	<b>Total</b>	<b>230360</b>	<b>184920</b>	<b>144160</b>

**UNIT II – Branch and Departmental Accounts**  
**5 Mark Questions**

Q.No

Question

Level Category

1 What is a dependent branch?

K1 Remember

<b>Q.No</b>	<b>Question</b>	<b>Level</b>	<b>Category</b>
2	Define Debtors System.	K1	Remember
3	What is Stock and Debtors System?	K1	Remember
4	Distinguish between wholesale profit and retail profit.	K2	Understand
5	What is inter-departmental transfer?	K1	Remember

### **8 Mark Questions**

<b>Q.No</b>	<b>Question</b>	<b>Level</b>	<b>Category</b>
1	Explain accounting aspects of dependent branches.	K2	Understand
2	Discuss Debtors System with advantages.	K2	Understand
3	Explain Stock and Debtors System in detail.	K3	Apply
4	Describe accounting treatment for independent branches.	K2	Understand
5	Explain departmental accounts and allocation of expenses.	K4	Analyze

## UNIT – 3

### PARTNERSHIP ACCOUNT - I

#### INTRODUCTION

##### Indian Partnership Act, 1932

##### Sec. 4. Definition of “partnership”, “partner”, “firm” and “firm name”.

“Partnership” is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

Persons who have entered into partnership with one another are called individually “partners” and collectively a “firm”, and the name under which their business is carried on is called the “firm name”.

From the above definition of partnership, the essential elements of partnership can be understood as:

“Partnership” is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

##### Merits of Partnership

The partnership form of business organisation enjoys the following advantages:

**1. Ease of Formation:** Partnership is simple to form, inexpensive to establish and easy to operate. No legal formalities are involved and no formal documents are to be prepared.

Only an agreement between two or more persons to carry on a lawful business is required. Even the registration of the firm is not compulsory. Similarly, a partnership can be dissolved easily at any time.

**2. Larger Financial Resources:** It is possible to collect a large amount of capital due to a number of partners. New partners can be admitted to raise further capital whenever necessary. Creditworthiness is also high because every partner is jointly and severally liable for all the debts

of the firm.

**3. Combined Abilities and Judgement:** The skill and experience of all the partners are pooled together. Combined judgement of several persons helps to reduce errors of judgement.

The partners may be assigned duties according to their talent. Therefore, benefits of specialisation are available. Partners meet frequently and can take prompt decisions.

**4. Direct Motivation:** Ownership and management of business are vested in the same persons. There is direct relationship between effort and reward. Every partner is motivated to work hard and to ensure the success of the firm. Losses are shared and there is diffusion of risk.

**5. Close Supervision:** Every partner is expected to take personal interest in the affairs of the business. Different partners can maintain personal contacts with employees and customer's fear of unlimited liability makes the partners cautious and avoid reckless dealings. Management of partnership is cheaper when expert managers are not employed.

**6. Flexibility of Operations:** Partnership business is free from legal restrictions and Government control. Partners can make changes in the size of business, capital and managerial structure without any approval. The activities of partnership business can be adapted easily by changing conditions in the market.

**7. Secrecy:** A partnership firm is not required to publish its annual accounts. Audit of accounts is not essential and no reports are to be filed with the Government authorities. Therefore, the affairs of a partnership business can easily be kept secret and confidential.

**8. Protection of Minority Interest:** Management of partnership is democratic. Every partner has a right to be consulted and express his opinion.

All important decisions are taken with the mutual consent of all the partners. In case a partner is dissatisfied with the majority decisions, he can retire from the firm or give a notice for its dissolution.

**9. Cooperation:** Partnership encourages mutual cooperation and trust amongst people.

Partners work in common for the benefit of all and do their level best to make the business prosperous. They can take more balanced decisions than one man.

**10.Scope for Expansion:** There are greater possibilities for expansion and growth of business. More partners can be taken in to meet the financial and managerial requirements of growing business.

### **Demerits of Partnership**

A partnership suffers from the following limitations:

**1. Limited Resources:** There is a limit to the maximum number of partners in a firm. Therefore, it is not possible to collect huge financial resources. Borrowing capacity of partners is also limited. A partnership firm may not provide the required technical and administrative skills. There may be lack of professional management.

**2. Unlimited Liability:** Every partner is fully liable for the debts of partnership business. Fear of risk may restrict initiative and growth of business. Private properties of partners can also be taken up for business liabilities.

**3.Uncertain Life:** Partnership business suffers from instability. Insolvency, insanity, retirement and death of a partner may cause an abrupt end to business. Any partner can give a notice for dissolution of partnership.

**4.Conflicts:** Lack of confidence, unity and harmony among partners may lead to delayed decisions and inefficiency. Chances of conflict are high because every partner has an equal right to take part in the management of the firm.

**5. Risk of Implied Authority:** Every partner is an agent of the firm. A dishonest partner may cause a great loss to the firm. Other partners may suffer a heavy loss due to the dishonesty or negligence of one partner.

**6.Restriction on Transfer of Interest:** A partner cannot transfer or assign his share in the firm to a third party without the consent of other partners. He has, therefore, to lose the liquidity

of his investment.

**7. Reduced Public Confidence:** A partnership firm does not enjoy high degree of public confidence and prestige. This is because it is free from legal formalities and Government restrictions. Its accounts are not published and public is not aware of exact position of the business.

### **Admission of a Partner**

A new partner can be admitted only with the consent of all the existing partners. A new partner is not liable for any profit or loss occurred before his admission. Such a partner is called a new partner or incoming partner.

#### **Purpose of Admission of a Partner:**

1. For additional capital
2. For progress of the firm
3. For acquiring additional managerial skill<sup>4</sup>.

For reducing competition

**Effect of Admission of a Partner:** Admission of a new partner is a major event in a partnership business. A new admission can take place only with the unanimous consent of all the existing partners. New partners are admitted for several reasons. Additional capital contribution, fresh ideas more contacts etc. are some of the advantages in admitting a new partner. Following are the most important accounting aspects to be considered at the time of admission of a new partner.

1. Change in profit sharing ratio,
2. Accounting treatment of Goodwill,<sup>3</sup>  
Revaluation of assets and liabilities,
4. Treatment of reserves and accumulated profits/losses and<sup>5</sup>.  
Adjustment of Capital Accounts.

**1. Change in Profit Sharing Ratio:** When a new partner comes into the business, old

partner have to adjust his profit share from their portion. Thus, change in profit sharing ratio is the first accounting aspect to be considered on admission of a new partner. In academic accounting, change in profit sharing ratio can be presented in various ways:

***The New Partner's Share is Mentioned without Specifying the Old Partner's Profit Sharing Arrangement.*** In this case, it is to be assumed that the profit available after paying the new partner's share is to be divided by the old partner's share in their old profit sharing ratio. In other words, even though the overall profit sharing ratio changes, the old ratio is still maintained between the old partners, within the new ratio.

### ***Sacrificing Ratio***

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

### ***Old Share of Profit – New Share of Profit***

**2. Accounting Treatment of Goodwill:** As stated earlier, the new partner is required to compensate the old partners for their loss of share in the super profits of the firm for which he brings in an additional amount known as premium or goodwill. This amount is shared by the existing partners in the ratio in which they forego their shares in favour of the new partner which is called sacrificing ratio.

The ratio is normally clearly given as agreed among the partners which could be the old ratio, equal sacrifice, or a specified ratio. The difficulty arises where the ratio in which the new partner acquires his share from the old partners is not specified. Instead, the new profit sharing ratio is given. In such a situation, the sacrificing ratio is to be worked out by deducting each partner's new share from his old share.

**3. Revaluation of Assets and Liabilities:** Revaluation of assets and liabilities is another major step prior to admission or retirement. Revaluation is important, as there are hidden profits or losses in the difference between book value and actual market

value of assets or liabilities. Revaluation is necessary whenever there is a change in profitsharing ratio, even without admission or retirement. The hidden profits or losses should be distributed in the ratio prior to change (old ratio). Revised values of assets and liabilities are brought into books by opening a temporary account called „Revaluation account“. The purpose of revaluation account is to summarise effect of revaluation of assets and liabilities. Revaluation account represents the combined capital account of partners. Any gain on revaluation of asset or liabilities, which are to be credited to partners, will be credited in revaluation account. Similarly, any loss on revaluation will be debited in revaluation account instead of capital accounts. The revaluation account is closed by transferring its net balance to partner"s capital accounts in the profit sharing ratio.

**4. Treatment of Reserves and Accumulated Profits:** Accumulated profits such as general reserve, credit balance in Profit & Loss account etc. will be transferred to the capital accounts of old partners in the old profit sharing ratio. Similarly, accumulated losses shall be transferred to the debit side of old partner"s capital accounts. Therefore, these items will not appear in the new balance sheet.

**5. Adjustment of Capital Accounts:** When the partners change their profit sharing ratio at admission, retirement or any other reason, they also rearrange their capital accounts. Capital contribution is not essentially the basis of profit sharing. However, in most partnerships, capital contribution is considered as the major factor in determining profit sharing ratio. At the time of admission, capital contribution will be raised as an important condition. When a new partner is admitted for a certain share of profit for a certain amount of capital contribution, he would naturally expect the other also to maintain a capital balance matching with their profit share. Admission of a partner is not the only situation when a capital rearrangement is considered. Retirement, death or any other change in profit sharing ratio would prompt rescheduling the capital balances. The basic purpose of following „Fixed capital method" is to maintain a steady capital ratio.

When capital is readjusted on the basis of new partner"s capital contribution, the first step is to determine the revised capital balances of each partner. Readjustment in capital account is

usually done by bringing in or taking out cash. Sometimes, in place of cash transactions, old partners may adjust their capital balances by transferring the excess or deficit in the capital accounts to their current accounts as a temporary measure. Once the capital balances are adjusted, current accounts can be settled in due course.

### **What are Partners and Their Kinds?**

**Meaning:** Minimum of 2 persons are required to form a partnership and maximum of 10 persons in case of banking and 20 in case of others. These persons are individually known as „Partners“ and collectively known as „Firm“.

#### ***Kinds of Partners***

1. *Active Partners:* These are the persons who actively take part in the business, i.e., they are involved in day-to-day affairs of business. They take all the decisions.
2. *Sleeping Partners:* Sleeping partners are those partners who are not actively involved in the business, i.e., they do not take part in the day-to-day affairs of the business. But they do contribute capital and share profits and losses of the business like other partners.
3. *Nominal Partner:* He neither contributes capital nor takes part in the conduct of the business. He is a person with good reputation in the market and lends his name to the firm and makes outsiders believe that he is a partner of the firm.
4. *Partner in Profits Only:* He only shares profit but not the losses. The objective of having such partner is to make use of his capital and goodwill.
5. *Partner by Estoppel:* He is not a partner of a firm in actual. He neither contributes any capital nor share profits or losses of the business. He also does not take part in the conduct of the business. His role is to make the outsiders believe that he is a partner of the firm.
6. *Secret Partner:* As the name suggests, his name is not disclosed to the outsiders as a partner.

7. *Minor Partners:* According to Indian Partnership Act 1932, a minor, i.e., person below the age of 18 years cannot be a partner of the firm. However, with the mutual consent of all the partners, he can be admitted into the partnership for the benefits of the firm.

### **Rights and Obligations of Partners**

All the rights and duties should be clearly defined in the Partnership Deed. If in any case, Partnership Deed is silent on some points, then in that case rights and obligations of the partners are governed by Partnership Act's provisions.

### ***Rights of the Partners***

1. Right to take part in the day-to-day affairs or management of the partnership.
2. If Partnership Deed is silent on the rate of interest on partner's loan, then the partner is entitled to the interest @ 6%.
3. Every partner of the firm has the right to check the books of accounts and records of business.
4. A partner has the right to be indemnified for the expenditure incurred by him to protect the firm from the loss.
5. A partner can use the property of the firm for the purpose of firm's business.
6. Right to retire from the firm in accordance with the terms and conditions of the Partnership Deed.
7. Every partner has the right to continue in the firm unless expelled according to the provisions of the deed.
8. On retirement, right to share profits in the firm earned with the help of partner's share in the firm or interest @ 6% p.a. until the amount due to retired partner is paid off.
9. Right to be consulted before taking important decisions.
10. Right to share the profits equally, in the absence of any agreement.
11. Right to receive interest on capital, if there are sufficient profits.

12. Every partner is co-owner of the firm.
13. Right to act independently in emergency situation to protect the firm from loss.
14. Right to inspect the entry of new partner.
15. Right to dissolve the firm with the consensus, i.e., mutual consent of all the partners.  
But in case, if partnership is at will, any partner can dissolve the firm by giving notice to other partners.

### ***Duties and Obligations of Partners***

1. Every partner of the partnership firm must act in the maximum interest of the firm.
2. Every partner must have mutual trust and confidence in other partners and they should act in faithful manner to each other and the firm.
3. Duty to render true accounts to fellow partners.
4. Duty to compensate the firm for the loss arising out of breach of trust and willful negligence.
5. A partner should not compete with the firm's business by starting his own business.
6. Obligation to share the loss equally in the absence of any agreement between the partners.
7. A partner must not apply firm's property for the accomplishment of his personal tasks.
8. Every partner must act within the scope of their authority.
9. A partner must not transfer his share without the mutual consent of his fellow partners.
10. Every partner must disclose any secret profit made by them.
11. A partner must not make secret profits by using firm's property, if he does so, he must surrender it to the firm.
12. In the absence of any previous contract between the partners, no partner is entitled

to the salary.

## **GOODWILL**

Goodwill is also one of the special aspects of partnership accounts which requires adjustment (also valuation if not specified) at the time of reconstitution of a firm, viz., a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

### **Meaning of Goodwill**

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as “goodwill”.

It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

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

### **Factors Affecting the Value of Goodwill**

The main factors affecting the value of goodwill are as follows:

1. *Nature of Business:* A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.
2. *Location:* If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.

3. *Efficiency of Management:* A well-managed concern usually enjoys the advantage of high productivity and cost efficiency. This leads to higher profits and so the value of goodwill will also be high.
4. *Market Situation:* The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.
5. *Special Advantages:* The firm that enjoys special advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks.

### ***Methods of Valuation of Goodwill***

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

**Average Profits Method:** Under this method, the goodwill is valued at agreed number of years" purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

For example, if the past average profits of a business works out at ` 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be ` 60,000 ( $\text{` } 20,000 \times 3$ ).

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

for the first „few years“. But it is contended that the buyer"s real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. Therefore, it is desirable to value goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

**Normal Profit:**  $\text{Capital Employed} \times \text{Normal Rate of Return}/100$

Suppose an existing firm earns ` 18,000 on the capital of ` 1,50,000 and the normal rate of return is 10%. The Normal profits will work out at ` 15,000 ( $1,50,000 \times 10/100$ ). The super profits in this case will be ` 3,000 ( $18,000 - 15,000$ ). The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years" purchase. If, in the above example, it is expected that the benefit of super profits is likely to be available for 5 years in future, the goodwill will be valued at

` 15,000 ( $3,000 \times 5$ ). Thus, the steps involved under the method are:

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

**Capitalisation Methods:** Under this method, the goodwill can be calculated in two ways: (a) by capitalising the average profits, or (b) by capitalising the super profits.

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

- (i) Ascertain the average profits based on the past few years" performance.
- (ii) Capitalise the average profits on the basis of the normal rate of return to ascertain the

capitalised value of average profits as follows:

Average Profits  $\times$  100/Normal Rate of Return

- (iii) Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill). Capital Employed = Total Assets (excluding goodwill) – Outside Liabilities.
- (iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e., (ii) – (iii).

## **RECONSTITUTION OF PARTNERSHIP**

### **Impact of Admission of a Partner**

Since a new partner gets his share of profit from old partners, he must compensate the old partners for the share sacrificed by them. The amount of compensation given by the new partner is known as goodwill.

Assets and liabilities are revalued because the entire profit and loss due to their revaluation is divided amongst the old partners in their old profit sharing ratio. The new partner should not share such profit or loss because it belongs to the period prior to his admission.



Share of profit given to 'C' =  $\frac{1}{3}$  share

Share acquired by C from A =  $\frac{1}{3} * \frac{2}{3} = \frac{2}{9}$

Share acquired by C from B =  $\frac{1}{3} * \frac{1}{3} = \frac{1}{9}$

A's new share after surrendering  $\frac{2}{9} = \frac{2}{3} - \frac{2}{9} = \frac{(6 - 2)}{9} = \frac{4}{9}$

B's new share after surrendering  $\frac{1}{9} = \frac{1}{3} - \frac{1}{9} = \frac{(3 - 1)}{9} = \frac{2}{9}$

C's share =  $\frac{1}{3}$

Therefore, new profit sharing ratio

$$= \frac{4}{9} : \frac{2}{9} : \frac{1}{3}$$

$$= (4 : 2 : 3)/9 \text{ or } 4 : 2 : 3$$

X : Y = 3 : 1, Z admitted

X =  $\frac{1}{3} * \frac{3}{4} = \frac{1}{4}$  (X surrender  $\frac{1}{3}$  of his

share) Y =  $\frac{1}{4} * \frac{1}{4} = \frac{1}{16}$  (Y surrender  $\frac{1}{4}$  of his share)

Therefore, Z's share =  $\frac{1}{4} + \frac{1}{16} = \frac{(4 + 1)}{16} = \frac{5}{16}$

New profit sharing ratio:

$$X = \frac{3}{4} - \frac{1}{4} = \frac{2}{4}$$

$$Y = \frac{1}{4} - \frac{1}{16} = \frac{(4 - 1)}{16} = \frac{3}{16}$$

$$Z = \frac{5}{16}$$

Therefore,  $\frac{2}{4} : \frac{3}{16} : \frac{5}{16}$

$$= (8 : 3 : 5)/16$$

$$= 8 : 3 : 5$$

Old profit sharing ratio of P =  $\frac{5}{8}$

New profit sharing ratio of P =  $\frac{4}{9}$

P's sacrificing ratio = old ratio - new ratio

$$= \frac{5}{8} - \frac{4}{9} = \frac{(45 - 32)}{72} = \frac{13}{72}$$

Old profit sharing ratio of Q =  $\frac{3}{8}$

New profit sharing ratio of Q =  $\frac{3}{9}$

Q's sacrificing ratio = old ratio - new ratio

$$= \frac{3}{8} - \frac{3}{9} = \frac{(27 - 24)}{72} = \frac{3}{72}$$

Sacrificing ratio =  $\frac{13}{72} : \frac{3}{72}$  or 13 : 3

Profit distributed equally.

(i) For writing off the Goodwill A/c already appearing in the books:

Old Partner's Capital A/c      Dr. (in old  
ratio) To Goodwill A/c



(ii) For bringing goodwill in cash:

Bank A/c                      Dr.

To Premium for Goodwill (with his share of goodwill)

(iii) For distributing the amount of goodwill brought in by new partner:

Premium for Goodwill A/c Dr.

To Sacrificing Partner's Capital A/cs (in sacrificing ratio)

(iv) For transferring the amount of goodwill to old partners in sacrificing ratio:

New Partner's Capital A/c Dr. (with his share of goodwill)  
To Sacrificing Partner's Capital A/cs (in sacrificing ratio)

Calculation of New Profit Sharing Ratio:

N's share =  $1/6$ ; M's share =  $1/6$

Remaining share for K and L =  $1 - (1/6 + 1/6) = 4/6$

This will be divided between K and L in their old ratio, i.e., 3 : 2

Hence, the new share of K =  $3/5 * 4/6 = 12/30$

New share of L =  $2/5 * 4/6 = 8/30$

The new ratio of K, L and M, N =  $12/30 : 8/30 : 1/6 : 1/6$  or  
= 12 : 8 : 5 : 5

Calculation of sacrifice ratio:

Sacrifice made by K =  $3/6 - 12/30 = 3/30$

Sacrifice made by L =  $2/6 - 8/30 = 2/30$

Sacrifice made by M = NIL

Thus, sacrificing ratio among K, L and M = 3 : 2 : 0

### Illustrations

**Illustrations 1:** A and B are partners in a firm sharing profit in the ratio of 4 : 3. They admitted 'C' as a new partner. C brought ₹ 10,000 towards goodwill premium and ₹ 30,000 as capital. New Ratio for profit sharing will be 3 : 2 : 2 for A, B and C respectively. Pass necessary journal entries assuming that goodwill is retained in Business.

**Solution:**

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c                                      Dr.	40,000	
	To C's Capital A/c		30,000
	To Premium for Goodwill A/c		10,000
	(Being the amount of capital and goodwill/premium brought in cash)		

Premium for Goodwill A/c	Dr.	10,000	
To A's Capital			5,000
A/c To B's Capital A/c			5,000
(Being the amount of goodwill transferred to old partners in sacrificing ratio)			

**Working Note:** Calculation of sacrificing ratio:

Sacrificing ratio = Old ratio – New ratio

Thus, A's sacrifice ratio =  $4/7 - 3/7 = 1/7$

B's sacrifice ratio =  $3/7 - 2/7 = 1/7$

As, C has not made any sacrifice, therefore he will not be entitled to any amount of goodwill brought in by new partner.

A and B have sacrificed in equal proportion, therefore they will get equal share in the goodwill brought in by D.

**Illustrations 2:** The Balance sheet of Krishna and Suresh is given below. They share profits and losses in the ratio of 3 : 2.

#### Balance Sheet

Liabilities		Assets	
Capital:		Plant	30,000
Krishna	30,000	Patent	5,000
Suresh	20,000	Furniture	3,000
General Reserve	5,000	Stock	16,000
Creditors	15,000	Debtors	15,000
Joint Life Policy	7,000	Joint Life Policy Investment	7,000
		Cash	1,000
<b>77,000</b>		<b>77,000</b>	

They take Mohan into partnership on following terms:

- (i) Mohan shall bring ` 14,000 in cash for goodwill share and capital for future  $1/5^{\text{th}}$  share in profits.
- (ii) Depreciation on plant and machinery amounted to ` 5,000.
- (iii) Patents were appreciated by ` 8,000.
- (iv) Valuation of goodwill of the firm was to be made at twice the average profit of last 4 years and profits were ` 10,000, ` 9,000, ` 8,000 and ` 13,000.

Prepare Revaluation Account, Partner's Capital Account and Opening Balance Sheet for the firm.

**Solution:**

Dr.		Revaluation Account		Cr.	
Particulars	Amt	Particulars	Amt		
To Plant	5,000	By Patents	8,000		
To Profit Transferred to Capital Account:					
Krishna	1,800				
Suresh	<u>1,200</u>				
	8,000				8,000

Dr.		Capital Account			Cr.		
Particulars	Krishna	Suresh	Mohan	Particulars	Krishna	Suresh	Mohan
To Bal c/d	41,400	27,600	10,000	By Bal b/d	30,000	20,000	10,000
				By Reserves	3,000	2,000	
				By Revaluation A/c	1,800	1,200	
				By Joint Life Policy	4,200	2,800	
				By Cash A/c (Goodwill)	2,400	1,600	
	<u>41,400</u>	<u>27,600</u>	<u>10,000</u>		<u>41,400</u>	<u>27,600</u>	<u>10,000</u>

#### Opening Balance Sheet

Liabilities	Amount	Assets	Amount
Creditors	15,000	Plant & Machinery	25,000
Capital:		Patents	13,000
Krishna	41,400	Furniture	3,000
Suresh	27,600	Stock	16,000
Mohan	<u>10,000</u>	Debtors	15,000
	79,000	Joint Life Policy	7,000
		Cash	15,000
	<u>94,000</u>		<u>94,000</u>

**Working Notes:**

1. Valuation of Goodwill:

Average profit =  $(10,000 + 9,000 + 8,000 + 13,000)/4 = ₹ 10,000$

Goodwill at 2 years purchase =  $10,000 * 2 = ₹ 20,000$

Mohan's share of goodwill =  $20,000 * 1/5 = ₹ 4,000$

Mohan's capital =  $14,000 - 4,000$

= ₹ 10,000

2. Entry for joint life policy:

Joint Life Policy A/c	Dr.	7,000	
To Krishna's Capital A/c			4,200
To Suresh's Capital A/c			2,800

**Illustration 3:** A and B are partners sharing in the ratio of 2/3 and 1/3. Balance Sheet of their firm is as below:

**Balance Sheet**

Liabilities			Assets	
Capital:			Debtors	40,000
A	40,000		Less: R.D.D.	3,600
B	30,000	70,000	Stock	20,000
Reserve Fund		12,000	Building	25,000
Creditors		20,000	Machinery	31,000
Bank Overdraft		15,000	Typewriter	2,600
			Patent	2,000
		1,17,000		1,17,000

Mr. C was admitted as partner on the following terms:

(i) He will get 1/6<sup>th</sup> share in future profit for which he brings goodwill in cash ₹ 10,000.

(ii) R.D.D. is reduced to ₹ 1,600 whereas machinery was appreciated by ₹ 2,600.

(iii) Patents were fully written off.

(iv) Discount on creditors were provided at ₹ 400.

Prepare Revaluation A/c, Partner's Capital A/c and Opening Balance Sheet for the firm.

Dr.		Revaluation Account		Cr.	
Particulars	Amt ( ` )	Particulars	Amt ( ` )		
To Patents	2,000	By Provision for Doubtful Debts	2,000		
To Profit Transferred to: A	2,000	By Machinery	2,600		
B	1,000	By Provision for Discount on Creditors	400		
	5,000		5,000		

Dr.		Capital Account						Cr.	
Particulars	A ( ` )	B ( ` )	C ( ` )	Particulars	A ( ` )	B ( ` )	C ( ` )		
				By Balance b/d	40,000	30,000			
					0				
				By Reserve Fund	8,000	4,000			
				By Revaluation A/c	2,000	1,000			
To Balance c/d	60,000	35,000	19,000	By Premium for Goodwill A/c	10,000			19,000	
				By Bank					
	60,000	35,000	19,000		60,000	35,000	19,000		
			0				0		

#### Opening Balance Sheet

Liabilities	Amt ( ` )	Assets	Amt ( ` )
Sundry Creditors	20,000	Bank	14,000
Less: Provision:	<u>400</u>	Sundry Debtors	40,000
Capitals:	19,600	Less: Provision:	<u>1,600</u>
A	60,000	Stock	20,000
B	35,000	Building	25,000
C	19,000	Machinery	33,600
		Typewriter	2,600
	1,33,600		1,33,600

#### Working Notes:

1. Sacrifice Ratio = Old Ratio – New Ratio  
Sacrifice by A = old  $\frac{2}{3}$  – new  $\frac{3}{6}$  =  $\frac{1}{6}$   
Sacrifice by B = old  $\frac{1}{3}$  – new  $\frac{2}{6}$  = 0

Since B has not made any sacrifice, the ratio amount of premium for goodwill brought in by C will be credited to A.

2. C's capital is not given in the question. He will bring in capital proportionate to his share of profits. C is given  $\frac{1}{6}$ th share of profits, balance  $\frac{5}{6}$ th is shared by A and B. Total capital of A and B after all adjustments is ` 60,000 + 35,000 = 95,000.

Thus, for  $\frac{5}{6}$ th share of profits, the capital = 95,000.

Then total capital of the firm =  $95,000 \times \frac{6}{5} =$  ` 1,14,000.

Therefore, C's capital for  $\frac{1}{6}$ th share profits =  $1,14,000 \times \frac{1}{6} =$  ` 19,000.

3. Calculation of balance at bank:

Amount of cash brought in by C as goodwill = 10,000

Amount of cash brought in by C as capital = 19,000

	29,00
	0
(-) Bank overdraft	15,000
Balance at bank	14,000

**Illustration 4:** A, B, C and D are the partners sharing profits and losses in 6 : 5 : 3 ratio. Balance Sheet is given as below:

Liabilities	Amt ( ` )	Assets	Amt ( ` )
Creditors	18,900	Debtors	26,460
Bills Payable	6,300	Land & Building	45,150
General Reserve	10,500	Furniture	7,350
Capital:		Stock	29,400
A	35,400	Cash	7,140
B	29,850		
C	14,550		
	1,15,500		1,15,500

D was admitted as partner on the following terms:

- (i) He shall get  $\frac{1}{8}$ th share in business future profit for which he should bring goodwill ` 14,070 and capital ` 14,700 in cash.
- (ii) Debtors are raised by ` 2,000 whereas provision for repairs were made at ` 1,320.
- (iii) Furniture were depreciated by ` 920.
- (iv) Partners decided to write off goodwill from book amounting to ` 5,250 as well as to withdraw cash amounting to ` 7,060.

Prepare Revaluation Account, Partner's Capital Account and Opening Balance Sheet for the firm. Also pass necessary journal entries.

### Journal

	Particulars	Amt. Dr. `	Amt. Cr. `
(i)	General Reserve A/c <span style="float: right;">Dr.</span> To A's Capital A/c To B's Capital A/c To C's Capital A/c (Being general reserve transferred to Old Partner's Capital A/cs)	10,500	4,500 3,750 2,250
(ii)	Revaluation A/c <span style="float: right;">Dr.</span> To Furniture A/c To Provision for Repairs A/c (Being reduction in the value of assets and a provision made for o/s repair bills)	2,240	920 1,320
(iii)	Debtors A/c <span style="float: right;">Dr.</span> To Revaluation A/c (Being amount receivable from an old customer)	2,000	2,000
(iv)	Land & Building A/c <span style="float: right;">Dr.</span> To Revaluation A/c (Being increase in the value of land and building)	9,760	9,760
(v)	Revaluation A/c <span style="float: right;">Dr.</span> To A's Capital A/c To B's Capital A/c To C's Capital A/c (Being transfer of profit on revaluation to Old Partner's Capital A/cs)	9,520	4,080 3,400 2,040
(vi)	A's Capital A/c <span style="float: right;">Dr.</span> B's Capital A/c <span style="float: right;">Dr.</span> C's Capital A/c <span style="float: right;">Dr.</span> To Goodwill A/c (Being goodwill appearing in the books written off)	2,250 1,875 1,125	5,250
(vii)	Cash A/c <span style="float: right;">Dr.</span> To D's Capital A/c To Premium for Goodwill A/c (Being the amount brought in cash by D being ` 14,700 for capital and ` 14,070 for goodwill)	28,770	14,070 14,700

(viii)	Premium for Goodwill A/c To A's Capital A/c To B's Capital A/c To C's Capital A/c (Being goodwill brought in by 'D' credited to old partners capital A/c)	Dr.	14,070	6,030 5,025 3,015
(ix)	A's Capital A/c B's Capital A/c To Cash A/c (Being cash withdrawn by A and B)	Dr. Dr.	3,660 3,400	7,060
(x)	Cash A/c To C's Capital A/c (Being cash brought in by C)	Dr.	1,320	1,320

**Dr. Revaluation Account Cr.**

Particulars	Amt (₹)	Particulars	Amt (₹)
To Furniture A/c	920	By Debtor's A/c	2,000
To Provision for Repairs	1,320	By Land and Building A/c	9,760
To Profit Transferred to Capital A/c:			
A	4,080		
B	3,400		
C	<u>2,040</u>		
	9,520		
	11,760		11,760

**Dr. Capital Account Cr.**

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Goodwill	2,250	1,875	1,125	14,700	By Balance b/d	35,400	29,850	14,550	14,700
To Balance c/d	47,760	40,150	20,730		By General Reserve A/c	4,500	3,750	2,250	
					By Revaluation A/c	4,080	3,400	2,040	
					By Cash A/c	6,030	5,025	3,015	
					By Premium for Goodwill A/c				
	50,010	42,025	21,855	14,700		50,010	42,025	21,855	14,700

To Cash A/c	3,660	3,400	22,050	14,70	By Balance	47,760	40,15	20,73	14,70
To Balance	44,10	36,750		0	c/d By Cash		0	0	0
c/d	0				A/c			1,32	
					(Balancing			0	
					Fig.)				
	47,76	40,15	22,050	14,70		47,760	40,15	22,05	14,70
	0	0		0			0	0	0

**Balance Sheet as on....**

Liabilities	Amt ( ` )	Assets	Amt ( ` )
Creditors	18,900	Cash	24,920
Bills Payable	6,300	Debtors	28,460
Provision for Repairs	1,320	Stock	29,400
Capital:		Furniture	6,430
A	44,100	Land and Building	54,910
B	36,750		
C	22,050		
D	14,700		
	1,17,600		
	1,44,120		1,44,120

New profit sharing ratio will be calculated as under:

Share given to D =  $1/8$

Balance of profits =  $1 - 1/8 = 7/8$

A's new share =  $7/8 * 6/14 = 3/8$

B's new share =  $7/8 * 5/14 = 5/16$

C's new share =  $7/8 * 3/14 = 3/16$

D's share =  $1/8$

A : B : C : D =  $3/8 : 5/16 : 3/16 : 1/8 = 6/16 : 5/16 : 3/16 : 2/16$

D brought in ` 14,700 as capital according to his  $1/8^{\text{th}}$  share of profit. Therefore, according to D's capital, the total capital of the new firm will be:

=  $14,700 * 8/1 = ` 1,17,600$

Therefore, A's Capital in new firm =  $1,17,600 * 6/16 = ` 44,100$

B's Capital in new firm =  $1,17,600 * 5/16 = ` 36,750$

C's Capital in new firm =  $1,17,600 * 3/16 = ` 22,050$

D's Capital in new firm =  $1,17,600 * 2/16 = ` 14,700$

**Illustration 5 (Dr. Balance in P & L A/c: R.D.D. adjusted in General Reserve):** The Balance Sheet of Sohan and Madan as on 31<sup>st</sup> Dec. 2006 is set out below. They share Profits and Losses in the ratio of 2 : 1.

**Balance Sheet**

Liabilities	Amt ( ` )	Assets	Amt ( ` )
Sohan's Capital	40,000	Building	20,000
Madan's Capital	30,000	Furniture	6,000
General Reserve	24,000	Stock	12,000
Creditors	16,000	Debtors	60,000
		Cash	6,000
		Profit & Loss A/c	6,000
	1,10,000		1,10,000

They agreed to admit Priya as a partner into the firm on the following terms:

- (i) Priya to bring ` 12,000 as capital and ` 9,000 as a goodwill which is to be retained in the business. He will be entitled to 1/4<sup>th</sup> share of profits of the firm.
- (ii) 50% of General Reserves are to remain as Reserve for Doubtful Debts.
- (iii) Furniture is to be depreciated by 5%.
- (iv) Stock is to be revalued at ` 13,000.
- (v) Creditors of ` 1,000 are not likely to claim and hence should be written off.
- (vi) Rent of ` 400 due not received has not been recorded in the books.

Prepare Profit and Loss Adjustment Account, Partner's Capital Account and Balance Sheet of the firm after admission of Priya.

**Solution:**

Dr.		Profit and Loss Adjustment Account	Cr.	
Particulars		Particulars		
<b>Decrease in Assets</b>		<b>Increase in Assets</b>		
To Furniture (6,000 × 5%)	300	By Stock (13,000 – 12,000)		1,000
To Profit on Revaluation		<b>Decrease in Liabilities</b>		
Sohan (2/3)	1,400	By Creditors		1,000
Madan (1/3)	<u>700</u>	By O/s Rent		400
	2,100			
	2,400			2,400

Dr.		Capital Accounts			Cr.		
Particulars	Sohan	Mohan	Priya	Particulars	Sohan	Mohan	Priya
To Profit & Loss A/c (Loss)	4,000	2,000	-	By Balance b/d	40,000	30,000	-
To Balance c/d	51,400	35,700	12,000	By General Reserves trd. (1/2)	8,000	4,000	-
				By Profit & Loss Adjustment (Profit)	1,400	700	
				By Goodwill Raised	6,000	3,000	
				By Cash/Bank A/c	-	-	12,000
	55,400	37,700	12,000		55,400	37,700	12,000

**Balance Sheet as on 31-12-2006**

Liabilities		Amt ( ` )	Assets		Amt ( ` )
<b>Capital:</b>			<b>Fixed Assets:</b>		
Sohan	51,400		Land & Building		20,000
Mohan	35,700		Furniture	6,000	
Priya	12,000	99,100	Less: Depreciation	300	5,700
<b>Other Liabilities:</b>			<b>Current Assets:</b>		
Creditors	16,000		Stock	12,000	
Less: Adjustment	1,000	15,000	Add:	1,000	13,000
			Adjustment Debtors	60,000	48,000
			Less: R.D.D. (From Gen Res.)	12,000	400
			O/s Rent		27,000
			Cash/Bank		
		11,4100			11,4100

**Working Notes:**

- (i) Sacrifice ratio for goodwill adjustment  
 Goodwill adjusted in the sacrifice ratio of 2 : 1 (i.e., the Old PSR between the old partners).

Dr.		Goodwill Account		Cr.	
Particulars		Particulars			
To Capital Accounts (raised) S (2/3) M (1/3)		By Cash (amount brought in)		9,000	
	6,000				
	3,000				
	9,000				9,000

Dr.		Cash/Bank Account		Cr.	
Particulars		Particulars			
To Balance b/d	6,000	By Balance c/d		27,000	
To Goodwill (brought in)	9,000				
To Capital (brought in)	12,000				
	27,000				27,000

**Illustration 6: (Goodwill – Average Profit Method: Revaluation Loss):**  
Ranade and Kanade were partners and shared the profits in the ratio of  $\frac{3}{5}$ <sup>th</sup> and  $\frac{2}{5}$ <sup>th</sup>.  
On 31<sup>st</sup> December, 2004, their Balance Sheet was as follows:

**Balance Sheet as on 31<sup>st</sup> December, 2004**

Liabilities		Assets		
Sundry Creditors	15,000	Bank		250
Reserve Fund	5,000	Sundry Debtors	22,500	
Capital Accounts:		Less: R.D.D.	250	22,250
Ranade	36,000	Stock		8,500
Kanade	24,000	Investments		12,000
		Plant		15,000
		Building		22,000
	80,000			80,000

On 1<sup>st</sup> January, 2005, Mr. Hegade was admitted to partnership on the following terms.

- (i) He should bring ₹ 18,650 as his capital for his  $\frac{1}{5}$ <sup>th</sup> share.
- (ii) Valuation of the goodwill of the firm was to be made at twice the average profit of the last three years. The profits were as follows: 2004 – ₹ 16,000, 2003 – ₹ 27,000 and 2002 – ₹ 24,500. Hegade is to bring the goodwill in cash equal to his share.

(iii) Before admitting Hegade, R.D.D. was to be raised upto ` 500 only.

(iv) Closing stock was to be valued at ` 7,500.

(v) Appreciate Building by 5%.

Prepare Profit and Loss Adjustment Account, Capital Accounts of the Partners and Balance Sheet of the new firm.

**Solution:**

Dr.		Profit and Loss Adjustment Account		Cr.	
Particulars		Particulars			
<b>Decrease in Assets</b>		<b>Increase in Assets</b>			
To Debtors (Increase in RDD)	250	By Building (22,000 × 5%)	1,100		
To Stock (8,500 – 7,500)	1,000	By Loss on Revaluation			
		R (3/5)	90		150
		K (2/5)	60		
	1,250				1,250

Dr.		Capital Account				Cr.	
Particulars	R	K	H	Particulars	R	K	H
To P & L Adj. A/c (loss)	90	60	–	By Balance b/d	36,000	24,000	–
To Balance c/d	44,310	29,540	18,650	By Reserve Fund	3,000	2,000	–
				By Goodwill Raised	5,400	3,600	–
				By Cash/Bank (brought in)			18,650
							0
	44,400	29,600	18,650		44,400	29,600	18,650

**Balance Sheet as at 1-1-2005**

Liabilities		Amt ( ` )	Assets		Amt ( ` )
<b>Capital:</b>			<b>Fixed Assets:</b>		
R	44,310		Buildings	22,000	
K	29,540		Add: Adjustment	1,100	23,100
H	18,650	92,500	Plant		15,000
<b>Other Liabilities:</b>			Investments		12,000
Creditors		15,000	<b>Current Assets:</b>		
			Stock	8,500	
			Add: Adjustment	1,000	7,500

		Debtors	22,500	
		Less: R.D.D.	500	22,000
		Cash/Bank		27,900
	1,07,500			1,07,500
	0			

**Working Notes:**

(i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 3 : 2 (which is the same as their old PSR between the old Partners)

Dr.		Goodwill Account		Cr.	
Particulars		Particulars			
To Capital Accounts (raised)		By Cash (amount brought in)		9,000	
Ranade (3/5)	5,400				
Kanade (2/5)	3,600				
	9,000				9,000

Dr.		Cash/Bank Account		Cr.	
Particulars		Particulars			
To Balance b/d	250	By Balance c/d		27,900	
To Goodwill (brought in)	9,000				
To Capital (brought in)	18,650				
	27,900				27,900

**Illustration 7 (Decrease in Liability):** Aditi and Anita are partners in a firm sharing profit and losses equally. Their Balance Sheet as on 31<sup>st</sup> December, 20002 was as follows:

**Balance Sheet as on 31<sup>st</sup> December, 2002**

Liabilities		Assets	
Capitals:		Cash	800
Aditi	12,000	Stock	8,000
Anita	10,000	Sundry Debtors	7,200
General Reserve	1,000	Loose Tools	3,000
Sundry Creditors	15,000	Furniture	2,000
Bills Payable	2,000	Motor Van	7,000
		Plant & Machinery	12,000
	40,000		40,000

They agreed to admit Ashwini as a new partner on 1<sup>st</sup> January, 2003 on the following terms:

- (i) She shall have 1/4 share in future profits.
- (ii) She shall bring ` 8,000 as her capital.
- (iii) She shall bring ` 4,000 as her goodwill.
- (iv) Motor van is to be depreciated by 10% and stock is revalued at ` 7,000.
- (v) Plant and Machinery is to be appreciated by 20%.
- (vi) An amount of ` 1,200 included in creditors is no longer a liability and hence, required to be property adjusted.

Prepare (1) Profit and Loss adjustment Account, (2) Partner's Capital Accounts and (3) Balance Sheet of new firm.

**Solution:**

Dr.		Profit and Loss Adjustment Account		Cr.	
Particulars	`	Particulars	`		
<b>Decrease in Assets:</b>		<b>Increase in Assets:</b>			
To Motor Van (7,000 × 10%)	700	By Plant & Machinery (12,000 × 20%)		2,400	
To Stock (8,000 – 7,000)	1,000	<b>Decrease in Liability:</b>			
To Profit on Revaluation		By Creditors		1,200	
Aditi (1/2)	950				
Anita (1/2)	950				
	1,900				
	3,600				3,600

Dr.		Capital Account						Cr.	
Particulars	Aditi	Anita	Ashwini	Particulars	Aditi	Anita	Ashwini		
To Balance c/d	15,450	13,450	8,000	By Balance b/d	12,000	10,000			
				By Gen. Reserve	500	500			
				By P&L Adj. (Profit)	950	950			
				By Goodwill Raised				8,000	
				By Cash (brought in)	2,000	2,000			
	15,450	13,450	8,000		15,450	13,450		8,000	

**Balance Sheet as at 1-1-2003**

Liabilities		Amt ( ` )	Assets		Amt ( ` )
<b>Capital:</b>			<b>Fixed Assets:</b>		
Aditi	15,450		Plant & Machinery	12,000	
Anita	13,450		<i>Add:</i> Adjustment	2,400	14,400
Ashwini	8,000	36,900	Motor Van	7,000	
<b>Other Liabilities</b>			<i>Less:</i> Adjustment	700	6,300
Sundry			Furniture		2,000
Creditors <i>Less:</i>	15,000	13,800	<b>Current Assets:</b>		
Adjustment	1,200	2,000	Stock		
Bills Payable			<i>Less:</i> Adjustment	8,000	7,000
			Debtors	1,000	7,200
			Loose Tools		3,000
			Cash		12,800
		52,700			52,700

**Working Notes:**

(i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 1 : 1 (which is the same as their old PSR between old partners).

Dr.	Goodwill Account	Cr.
<b>Particulars</b>		<b>Particulars</b>
To Capital Accounts (raised): Aditi (1/2)	2,000	By Cash (amount brought in)
Anita (1/2)	2,000	4,000
	4,000	
		4,000

Dr.	Capital Account	Cr.
<b>Particulars</b>		<b>Particulars</b>
To Balance b/d	800	By Balance c/d
To Goodwill (brought in)	4,000	12,800
To Capital (brought in)	8,000	
	12,800	
		12,800

**Illustration 8 (50% Goodwill Withdrawn by Partners):** Sagar and Pankaj are partners in a firm, sharing profits and losses in the ratio of 3 : 2 respectively. Their Balance Sheet as on 31<sup>st</sup> December, 2005 was as under:

**Balance Sheet as on 31<sup>st</sup> December, 2005**

Liabilities	₹	Assets	₹
Sundry Creditors	7,000	Cash at Bank	8,000
Sagar's Capital	32,000	Sundry Debtors	14,000
Pankaj's Capital	22,000	Land and Building	25,000
General Reserve	12,000	Stock	10,000
		Plant and Machinery	12,000
		Furniture and Fixtures	4,000
	73,000		73,000

On 1<sup>st</sup> January, 2006, they admit Atul in the partnership. The terms being that:

- (i) He shall pay ₹ 10,000 as his share of goodwill. 50% amount of Goodwill shall be withdrawn by the old partners.
  - (ii) He shall bring ₹ 12,000 as his capital for 1/4 share in future profit.
  - (iii) For the purpose of Atul's admission, it was agreed that assets be revalued as follows:
    - (a) Land and Building is to be valued at ₹ 30,000.
    - (b) Plant and Machinery to be valued at ₹ 10,000.
    - (c) Stock valued at ₹ 12,000 and furniture and fixtures at ₹ 2,000.
    - (d) A provision at 5% to be made for Doubtful Debts on Debtors.
- Prepare Profit and Loss Adjustment Account, Partner's Capital Accounts and Balance Sheet of the new firm.

**Solution:**

Dr. **Profit and Loss Adjustment Account** Cr.

Particulars	₹	Particulars	₹
<b>Decrease in Assets</b>		<b>Increase in Assets</b>	
To Plant & Machinery (12,000 – 10,000)	2,000	By Land & Building (30,000 – 25,000)	5,000
To Furniture & Fixtures (4,000 – 2,000)	2,000	By Stock (12,000 – 10,000)	2,000

To Debtors (Increase in R.D.D.) (14,000 × 5%)		700		
To Profit on Revaluation				
Sagar (3/5)	1,380			
Pankaj (2/5)	<u>920</u>	2,300		
		7,000		7,000

**Dr. Capital Account Cr.**

Particulars	Sagar	Pankaj	Atul	Particulars	Sagar	Pankaj	Atul
To Goodwill (50% withdrawn)	3,000	2,000	-	By Balance b/d	32,000	22,000	
To Balance c/d	43,580	29,720	12,000	By Gen. Reserve	7,200	4,800	
				By P & L Adj. (Profit)	1,380	920	12,000
				By Goodwill Raised			
				By Cash/Bank (brought in)	6,000	4,000	
	46,580	31,720	12,000		46,580	31,720	12,000

**Balance Sheet as on 1-1-2006**

Liabilities		Amt ( ` )	Assets		Amt ( ` )
<b>Capital:</b>			<b>Fixed Assets:</b>		
Sagar	43,580		Land & Buildings	25,000	
Pankaj	29,720		Add: Adjustment	5,000	30,000
Atul	12,000	85,300	Plant & Machinery	12,000	
<b>Others Liabilities:</b>			Less: Depreciation	2,000	10,000
Sundry Creditors		7,000	Furniture	4,000	
			Less: Depreciation	2,000	2,000
			<b>Current Assets:</b>		
			Stock	10,000	12,000
			Add: Adjustment	2,000	
			Debtors	14,000	13,300
			Less: R.D.D.	700	25,000
			Cash/Bank		
		92,300			92,300

**Working Notes:**

(i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 3 : 2 (which is the same as their Old PSR between the old partners).

Dr.		Goodwill Account		Cr.	
Particulars		Particulars			
To Capital Accounts (raised) Sagar (3/5) Pankaj (2/5)	6,000 4,000	By Cash (amount brought in)	10,000		
	10,000				10,000

Dr.		Cah/Bank Account		Cr.	
Particulars		Particulars			
To Balance b/d	8,000	By Capital (Goodwill)			
To Goodwill (brought in)	10,000	Sagar	3,000		
To Capital (brought in)	12,000	Pankaj	2,000		
		By Balance c/d	25,000		
	30,000				30,000

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## **RETIREMENT**

### **MEANING, CALCULATION OF NEWPROFIT SHARING RATIO AND GAINING RATIO**

When one or more partners leaves the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled.

A partner retires either :

- (i) with the consent of all partners, or
- (ii) as per terms of the agreement; or
- (iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. At the time of retirement the following accounting issues are dealt :

- (a) New profit sharing ratio and gaining ratio.
- (b) Goodwill
- (c) Adjustment of changes in the value of Assets and liabilities
- (d) Treatment of reserve and accumulated profits.

- (e) Settlement of retiring partners dues,
- (f) New capital of the continuing partners.

### **New profit sharing ratio and gaining ratio**

As soon as a partner retires the profit sharing ratio of the continuing partners get changed. The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio. It is

$$\text{Gaining Ratio} = \text{New Ratio} - \text{Existing Ratio}$$

**Various cases of new ratio and gaining ratio are illustrated as follows:**

#### **Retiring partner's share distributed in Existing Ratio :**

In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio. The following example illustrates this :

Tanu, Manu and Rena are partners sharing profits and losses in the ratio of = 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Existing Ratio between Manu and Rena =  $\frac{3}{9}$  and  $\frac{2}{9}$

Tanu's Ratio (retiring partner) =  $\frac{4}{9}$

Tanu's share taken by the Manu and Rena in the ratio of 3 : 2

Manu's gets =  $\frac{4}{9} \times \frac{3}{5} = \frac{12}{45}$

Manu's New Share =  $\frac{3}{9} + \frac{12}{45} = \frac{27}{45}$

Rena's gets =  $\frac{4}{9} \times \frac{2}{5} = \frac{8}{45}$

Rena's New Share =  $\frac{2}{9} + \frac{8}{45} = \frac{18}{45}$

New ratio between Manu and Rena is  $\frac{27}{45} : \frac{18}{45} = 27 : 18 = 3 : 2$ .

Gaining Ratio = New Ratio – Existing Ratio

Manu Gain =  $27/45 - 3/9 = 12/45$

Rena Gain =  $18/45 - 2/9 = 8/45$   $12/45 : 8/45$  3 : 2

You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.

Note: In absence of any information in the question, it will be presumed that retiring partner's share has been distributed in existing ratio.

### **Retiring partner's share distributed in Specified proportions:**

Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

B's Share =  $2/6$

B's share is divided between A and C in the ratio of 1 : 1.

A gets  $1/2$  of  $2/6 = 2/6 \times 1/2 = 1/6$

A's New Share =  $3/6 + 1/6 = 4/6$

C's gets  $1/2$  of  $2/6 = 2/6 \times 1/2 = 1/6$

C's New share =  $1/6 + 1/6 = 2/6$

Gaining Ratio

Gaining Ratio = New Ratio – Existing, Ratio

Gain of A =  $4/6 - 3/6 = 1/6$

Gain of C =  $2/6 - 1/6 = 1/6$

$1/6 : 1/6$

1 : 1 i.e, equal.

### **(i) Retiring Partner's share is taken by one of the partners**

The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of partner's existing share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is  $\frac{2}{11} + \frac{4}{11} = \frac{6}{11}$ , Anuj share will remain unchanged i.e.,  $\frac{5}{11}$ . Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.

**Illustration 1**

Neru, Anu and Ashu are partners sharing profit in the ratio of 4 : 3 : 2. Ashu retires. Find the new ratio of Neru and Anu if terms for retirement provide the following :

- (i) ratio is not given
- (ii) equal distribution of Ashu's share
- iii Ashu's share is taken by Neru and Anu in the ratio of 2 : 1
- (iii) Anu take over the share of Ashu.

**Solution:**

- (i) New profit sharing ratio of Neru and Anu is 4 : 3.
- (ii) Ashu's share =  $\frac{2}{9}$

Neru gets =  $\frac{1}{2}$  of  $\frac{2}{9} = \frac{2}{9} \times \frac{1}{2} = \frac{1}{9}$  Neru's New share =  $\frac{4}{9} + \frac{1}{9} = \frac{5}{9}$

Anu gets =  $\frac{1}{2}$  of  $\frac{2}{9} = \frac{2}{9} \times \frac{1}{2} = \frac{1}{9}$  Anu's New Share =  $\frac{3}{9} + \frac{1}{9} = \frac{4}{9}$

New profit sharing ratio of Neru and Anu is  $\frac{5}{9} : \frac{4}{9}$  or 5 : 4

Gaining ratio is equal  $\frac{1}{9} : \frac{1}{9} = 1 : 1$

Ashu's Share =  $\frac{2}{9}$

Neru gets =  $\frac{2}{3}$  of  $\frac{2}{9} = \frac{2}{9} \times \frac{2}{3} = \frac{4}{27}$

Neru's new share =  $\frac{4}{9} + \frac{4}{27} = \frac{16}{27}$

Anu gets =  $\frac{1}{3}$  of  $\frac{2}{9} = \frac{2}{9} \times \frac{1}{3} = \frac{2}{27}$

Anu's new share =  $\frac{3}{9} + \frac{2}{27} = \frac{11}{27}$

New profit sharing ratio of Neru and Anu is 16 : 11.

Gaining ratio is  $\frac{4}{27} : \frac{2}{27} = 4 : 2 = 2 : 1$

i.e.  $\frac{16}{27} : \frac{11}{27} = \frac{16}{11} : \frac{11}{11} = \frac{16}{11} : 1$  ; 4 : 2 = 2 : 1 **Op**

**L**  
**M**  
**N**  
i.e.  $\frac{5}{9} : \frac{4}{9} : \frac{1}{9} ; \frac{4}{9} : \frac{3}{9} : \frac{1}{9}$  **O**

N

27 9 27 27 9 27

Q

Anu takes over Ashu share fully.

Ashu's share =  $\frac{2}{9}$

Anu gets =  $\frac{2}{9}$

Anu's new share =  $\frac{3}{9} + \frac{2}{9} = \frac{5}{9}$

New profit sharing ratio of Neru and Anu is 4 : 5 Only Anu gains.

### Illustration 2

Ashish, Barmon, and Chander are partners sharing profits and losses in the ratio of 2 : 1 : 2 respectively. Chander retires and Ashish and Barman decide to share the profits and losses equally in future. Calculate the gaining ratio.

#### Solution:

Gaining ratio = New Ratio – Existing Ratio

Hence, Ashish gets =  $\frac{1}{2} - \frac{2}{5}$   
=  $\frac{1}{10}$

Barman gets =  $\frac{1}{2} - \frac{1}{5}$   
=  $\frac{3}{10}$

Gaining ratio between Ashish and Barman is 1 : 3

### 20.2 TREATMENT OF GOODWILL

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS- 10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own.

Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is

credited with his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c	Dr.	(individually)
To Retiring Partner's Capital A/c		

(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio)

### Illustration 3

Mitu, Udit and Sunny are partners sharing profit equally. Sunny retires and the goodwill of the firm

is valued at Rs 54,000. No goodwill account appears in the books of the firm. Mitu and Udit share future profit in the ratio of 3 : 2. Make necessary journal entry for goodwill.

**Solution:**

**Journal**

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	Mitu's Capital A/c Dr		14,400	
	Udit's Capital A/c Dr.		3,600	
	To Sunny's Capital A/c			18,000
	(Sunny's share of goodwill adjusted to remaining partners in their gaining ratio 4 : 1]			

**Note :** Sunny's share of goodwill = Rs.54,000 × 1/3 = Rs.18,000

Gaining Ratio = New Ratio – Existing Ratio

Mitu Gains =  $3/5 - 1/3 = 9 - 5/15 = 4/15$  Udit

Gains =  $2/5 - 1/3 = 6 - 5/15 = 1/15$  Gaining

Ratio between Mitu and Udit = 4 : 1

**When the Goodwill Account already appears in the Books**

Normally the goodwill is not shown in the books of the firm. If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital account

in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)  
 To Goodwill A/c (Existing goodwill written-off)

**Illustration 4**

Tanu, Priya and Mayank are partners' sharing profit in the ratio of 3 : 2 : 1. Priya retires and on the date of Priya's retirement goodwill is valued at Rs.90,000. Goodwill already appears in the books at a value of Rs.48,000. New ratio of Tanu and Mayank is 3 : 2. Make the necessary journal entries.

**Solution:****Journal**

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	Tanu's Capital A/c Dr		24,000	
	Priya's Capital A/c Dr		16,000	
	Mayank's Capital A/c Dr		8,000	
	To Goodwill A/c			48,000
	(Existing goodwill written-off in the books)			
	Tanu's Capital A/c Dr		9,000	
	Mayank's Capital A/c Dr		21,000	
	To Priya's Capital A/c			30,000
	(Priya's share of goodwill adjusted to remaining partners in their gaining ratio 3 : 7)			

**Note :** Priya's share of goodwill = Rs.90,000 × 2/6 = Rs.30,000

Gaining Ratio = New Ratio – Existing Ratio,

Tanu Gains =  $3/5 - 3/6 = 18 - 15/30 = 3/30$

Mayank Gains =  $2/5 - 1/6 = 12 - 5/30 = 7/30$

Gaining Ratio between Tanu. and Mayank = 3 : 7

**20.3 REVALUATION OF ASSETS AND LIABILITIES**

At the time of retirement of a partner the assets and liabilities of the firm are revalued and Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any profit or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose :

- (i) For increase in value of assets:

Assets A/c Dr. [Individually]  
 To Revaluation A/c

(Increase in the value of assets)

- (ii) For decrease in value of assets:

Revaluation A/c Dr.  
 To Assets A/c (Individually)



(iii) A provision for outstanding bill standing in the books at Rs. 1,000 is now not required.

(iv) The value of Land and Building is decreased by Rs.12,000.

Give journal entries and prepare Revaluation account.

### Solution

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	Machinery A/c Dr. Investments A/c Dr. Provision for Outstanding Bill Dr. To Revaluation A/c (Increase in value of Assets i.e. Machinery and investment and reduction in provision)		25,000 2,000 1,000	28,000
	Revaluation A/c Dr. To Land and Building A/c (Decrease in value of assets)		12,000	12,000
	Revaluation A/c Dr. To Mudit's Capital A/c To Mohit's Capital A/c To Sonu's Capital A/c (Profit on revaluation credited to all partners capital A/c in old profit sharing ratio i.e. 3 : 2 : 1)		16,000	8,000 5,333 2,667

### Revaluation account

Dr		Cr	
Particulars	Amount (Rs)	Particulars	Amount (Rs)
Land and Building	12,000	Machinery	25,000
Profit transferred to :		Investments	2,000
Mudit Capital 8,000		Provision for	1,000
Mohit Capital 5,333		Outstanding Bill	
Sonu Capital 2,667	16,000		
	28000		28000

### Treatment of accumulated reserves and undistributed profit

All the balances of Accumulated Reserves, funds and undistributed amount of Profit or Loss appearing in the balance sheet of the firm on the date of retirement/death is distributed amongst all

partners including retiring/deceased partner in their old profit sharing ratio, The following entries are made:

- (i) For distribution of undistributed profit and reserve.

Reserves A/c	Dr	
Profit & Loss A/c (Profit)	Dr.	
		To Partners' Capital A/c (individually)

(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)

- (ii) For distribution of undistributed loss

Partners' Capital A/c	Dr.	(individually)
		To Profit & Loss A/c (Loss)

(Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio)

#### **20.4 SETTLEMENT OF RETIRING PARTNER'S CLAIM**

The amount due to the retiring partner is paid according to the terms of partnership agreement. The retiring partners' claim consists of

- (a) The credit balance of Capital Account;
- (b) His/her share in the Goodwill of the firm;
- (c) His/her share in the Revaluation Profit;
- (d) His/her share in General Reserve and Accumulated Profit;
- (f) Interest on Capital

But, the following deductions are made from his/her Capital Account on account of :

- (a) His/her share in the Revaluation loss;
- (b) His/her Drawings and Interest on Drawings up to the date of retirement
- (c) His/her share of any accumulated losses
- (d) Loan taken from the firm.



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

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

Prepare Revaluation Account and Partner's Capital account.

**Solution :**

It is assumed that Om and Jagdish gaining ratio remains 3 : 1.

(a) Gaining ratio = 3 : 1.

Om gets =  $2/6 \times 3/4 = 1/4$

Om's new share =  $3/6 + 1/4 = 3/4$

Jagdish gets  $2/6 \times 1/4 = 1/12$

Jagdish's new share =  $1/6 + 1/12 = 3/12 = 1/4$

New profit sharing ratio between Om and Jagdish is  $3/4 : 1/4 = 3 : 1$ .

(b)ai' Share of goodwill  $60,000 \times 2/6 = 20,000$

Adjusted through the remaining partners capital account:

Om Capital A/c	Dr.	15,000	
Jagdish Capital A/c	Dr.	5,000	
To Jai Capital A/c			20,000

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

**Revaluation Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Bad debts	2,000	Stock	10,000
Plant	14,000	Building	18,000
Profit transferred to Capital Accounts:			
Om	6,000		
Jai	4,000		
Jagdish	2,000		
	12,000		

			28,000				28,000
<b>Capital account</b>							
Dr.				Cr.			
Particulars	Om (Rs)	Jai (Rs)	Jagdish (Rs)	Particulars	Om (Rs)	Jai (Rs)	Jagdish (Rs)
Capital	15,000	—	5,000	Balance b/d	1,60,000	1,20,000	1,20,000
Bank		1,52,000		General Reserve	12,000	8,000	4,000
Balance c/d	2,77,000	—	1,59,000	Revaluation (Profit)	6,000	4,000	2,000
				Om Capital	—	15,000	—
				Jagdish Capital	—	5,000	
				Bank	1,14,000		38,000
	2,92,000	1,52,000	1,64,000		2,92,000	1,52,000	1,64,000

### **DEATH OF A PARTNER**

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :

- (a) The amount standing to the credit to the capital account of the deceased partner
- (b) Interest on capital, if provided in the partnership deed upto the date of death:
- (c) Share of goodwill of the firm;
- (d) Share of undistributed profit or reserves;
- (e) Share of profit on the revaluation of assets and liabilities;
- (f) Share of profit upto the date of death;
- (g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

- (i) Drawings
- (ii) Interest on drawings
- (iii) Share of loss on the revaluation of assets and liabilities;
- (iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.

The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the

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

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

- (i) Time Basis
- (ii) Turnover or Sales Basis

#### **(i) Time Basis**

In this case, it is assumed that profit has been earned uniformly throughout the year. For example:

The total profit of previous year is Rs. 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is Rs. 31,250 i.e.  $1,25,000 \times 3/12$ , if the deceased partner took  $2/10$  share of profit, his/her share of profit till the date of death is Rs. 6,250 i.e.

$$\text{Rs. } 31,250 \times 2/10$$

## (ii) Turnover or Sales Basis

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

### Illustration 12

Arun, Tarun and Neha are partners sharing profits in the ratio of 3 : 2 : 1 Neha dies on 31st May 2006. Sales for the year 2005-2006 amounted to Rs.4,00,000. and the profit on sales is Rs.60,000. Accounts are closed on 31 March every year. Sales from 1st April 2006 to 31st May 2006 is Rs.1,00,000.

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

### Solution :

Profit from 1st April 2006 to 31st May 2006 on the basis of sales: If sales are Rs.4,00,000, profit is Rs.60,000

If the sales are Rs.1,00,000 profit is :  $60,000/4,00,000 \times 1,00,000$   
= Rs.15,000

Neha's share =  $15,000 \times 1/6 = \text{Rs.}2,500$

Alternatively profit is calculated as

$$\text{Rate of profit} = \frac{60000}{400000} \times 100 = 15\%$$

Sale upto date of death = 1,00,000

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

100

= Rs 15000

### Illustration 13

Nutan, Sumit and Shiba are partners in a firm sharing profits in the ratio 5 : 3 : 2. On 31st December 2006 their Balance Sheet was as under:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors	52,000	Building	60,000
Reserve Fund	15,000	Plant	50,000
Capitals :		Stock	27,000
Nutan                   60,000		Debtors	25,000
Sumit                   45,000		Cash	10,000
Shiba                   30,000	1,35,000	Bank	30,000
	2,02,000		2,02,000

Nutan died on 1 July 2007. It was agreed between her executor and the remaining partners that:

- (i) Goodwill to be valued at  $2\frac{1}{2}$  years purchase of the average profits of the last Four years, which were: 2003 Rs. 25,000; 2004 Rs.20,000; 2005 Rs.40,000 and 2006 Rs.35,000.
- (ii) Building is valued at Rs.70,000; Plant at Rs.46,000 and Stock atRs.32,000.
- (iii) Profit for the year 2006 be taken as having accrued at the same rates that of the previous year.
- (iv) Interest on capital is provided at 9% p.a.
- (v) On 1 July 2007 her drawings account showed a balance of Rs.20,000.
- (vi) Rs.25,950 are to be paid immediately to her executor and the balance is transferred to her Executors Loan Account.

Prepare Nutan's Capital Account and Nutan's Executor's Account as on 1stJuly 2007.

### Solution

- (i) Valuation of Goodwill:

$$\begin{aligned}\text{Total Profit} &= \text{Rs.}25,000 + \text{Rs.}20,000 + \text{Rs.}40,000 + \text{Rs.}35,000 \\ &= \text{Rs. } 1,20,000\end{aligned}$$

$$\text{Average Profit} = 1,20,000/4 = \text{Rs.}30,000$$

Hence, Goodwill at  $2\frac{1}{2}$  year's purchase =  $\text{Rs.}30,000 \times 2\frac{1}{2} = \text{Rs.}75,000$  Nutan's share of goodwill =  $75,000 \times \frac{5}{10} = \text{Rs.}37,500$

It is adjusted into the Capital Accounts of Sumit and Shiba in the

gaining ratio of 3 : 2 i.e. Rs 22,500 and Rs 15000 respectively.

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

$$= \text{Rs.}35,000 \times 6/12 \times 5/10$$

$$= \text{Rs.}8,750$$

(iii) Nutan's Share of Reserve Fund = Rs.15,000 × 5/10

$$= \text{Rs.}7,500$$

(iv) Interest on Nutan's Capital = 60,000 × 9/100 × 6/12

$$= \text{Rs.}2,700$$

### Revaluation accounts

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Plant	4,000	Building	10,000
Profit transferred to		Stock	5,000
Nutan Capital	5,500		
Sumit Capital	3,300		
Shiba Capital	2,200		
	11,000		
	15,000		15,000

### Nutan's Capital account

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Drawings	20,000	Balance b/d	60,000
Nutan's Executor's	1,01,950	Reserve fund	7,500
		Sumit's Capital (Goodwill)	15,000
		Shiba's Capital (Goodwill)	22,500
		Profit & Loss (Suspense)	8,750
		Revaluation A/c	5,500
		Interest on Capital	2,700
	1,21,950		1,21,950

### Nutan's Executor's accounts

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
-------------	--------------	-------------	--------------

Bank	25,950	Nutan's Capital	1,01,950
Nutan's Executor's Loan Transfer	76,000		
	1,01,950		1,01,950

## Dissolution of Partnership

As stated earlier dissolution of partnership changes the existing relationship between partners but the firm may continue its business as before. The dissolution of partnership may take place in any of the following ways:

Change in existing profit sharing ratio among partners;  
Admission of a new partner;

- (1) Retirement of a partner;
- (2) Death of a partner;
- (3) Insolvency of a partner;
- (4) Completion of the venture, if partnership is formed for that; and
- (5) Expiry of the period of partnership, if partnership is for a specific period of time;

## Dissolution of a Firm

Dissolution of a partnership firm may take place without the intervention of court or by the order of a court, in any of the ways specified later in this section. It may be noted that dissolution of the firm necessarily brings in dissolution of the partnership. However, dissolution of partnership would not necessarily involve dissolution of firms.

Dissolution of a firm takes place in any of the following ways:

1. *Dissolution by Agreement*: A firm is dissolved :
  - (a) with the consent of all the partners or
  - (b) in accordance with a contract between the partners.
2. *Compulsory Dissolution*: A firm is dissolved compulsorily in the following cases:
  - (a) when all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;
  - (b) when the business of the firm becomes illegal; or
  - (c) when some event has taken place which makes it unlawful for the partners to carry on the business of the firm in partnership, e.g., when a partner who is a citizen of a country becomes an alien enemy because of the declaration of war with his country and India.
3. *On the happening of certain contingencies*: Subject to contract between the partners, a firm is dissolved :
  - (a) if constituted for a fixed term, by the expiry of that term;
  - (b) if constituted to carry out one or more ventures, by the completion thereof;
  - (c) by the death of a partner;
  - (d) by the adjudication of a partner as an insolvent.
4. *Dissolution by Notice*: In case of partnership at will, the firm may be dissolved if any one of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.
5. *Dissolution by Court*: At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following grounds:
  - (a) when a partner becomes insane;
  - (b) when a partner becomes permanently incapable of performing his duties as a partner;

- (c) when a partner is guilty of misconduct which is likely to adversely affect the business of the firm;
- (d) when a partner persistently commits breach of partnership agreement;
- (e) when a partner has transferred the whole of his interest in the firm to a third party;
- (f) when the business of the firm cannot be carried on except at a loss; or
- (g) when, on any ground, the court regards dissolution to be just and equitable.

<b>Distinction between</b>	<b>Dissolution of Partnership</b>	<b>and Dissolution of Firm</b>
<i>Basis</i>	<i>Dissolution of Partnership</i>	<i>Dissolution of Firm</i>
1. Termination of business	The business is not terminated.	The business of the firm is closed.
2. Settlement of assets and liabilities	Assets and liabilities are revalued and new balance sheet is drawn.	Assets are sold and liabilities are paid-off.
3. Court's intervention	Court does not intervene because partnership is dissolved by mutual agreement.	A firm can be dissolved by the court's order.
4. Economic relationship	Economic relationship between the partners continues though in a changed form.	Economic relationship between the partners comes to an end.
5. Closure of books	Does not require because the business is not terminated.	The books of account are closed.

## 5.2 Settlement of Accounts

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

### (a) Treatment of Losses

Losses, including deficiencies of capital, shall be paid :

- (i) first out of profits,
- (ii) next out of capital of partners, and
- (iii) lastly, if necessary, by the partners individually in their profit sharing ratio.

### (b) Application of Assets

The assets of the firm, including any sum contributed by the partners to make

up deficiencies of capital, shall be applied in the following manner and order:

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

Thus, the amount realised from assets along with contribution from partners, if required, shall be utilised first to pay off the outside liabilities of the firm such as creditors, loans, bank overdraft, bill payables, etc. (it may be noted that secured loans have precedence over the unsecured loans); the balance should be applied to repay loans made by the partners to the firm. (in case the balance amount is not adequate enough to pay off such loans and advances, they are to be paid proportionately). The amount left thereafter is utilised in settlement of capital account balances. Then the surplus if any is divided among partners in their profit sharing ratio.

*Private Debts and Firm's Debts:* Where both the debts of the firm and private debts of a partner co-exist, the following rules, as stated in Section 49 of the Act, shall apply.

- (a) The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilised for payment of their private liabilities.
- (b) The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilised for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets.

It may be noted that the private property of the partner does not include the personal properties of his wife and children. Thus, if the assets of the firm are not adequate enough to pay off firm's liabilities, the partners have to contribute out of their net private assets (private assets minus private liabilities).

## Accounting Treatment

When the firm is dissolved, its books of account are to be closed and the profit or loss arising on realisation of its assets and discharge of liabilities is to be computed. For this purpose, a Realisation Account is prepared to ascertain the net effect (profit or loss) of realisation of assets and payment of liabilities which may be is transferred to partner's capital accounts in their profit sharing ratio. Hence, all assets (other than cash in hand bank balance and fictitious assets, if any), and all external liabilities are transferred to this account. It also records the sale of assets, and payment of liabilities and realisation expenses. The balance in this account is termed as profit or loss on realisation which is transferred to partners' capital accounts in the profit sharing ratio (see figure 5.1).

Dr.		Realisation Account		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
Intangible Assets Land	xxx	Bank Loan Mortgage	xxx		
and Building Plant and	xxx	Sundry creditors Bills	xxx		
Machinery Furniture and	xxx	payables	xxx		
Fittings Loan to other	xxx	Bank overdraft Outstanding	xxx		
parties Bills receivables	xxx	expenses Provision for doubtful	xxx		
Sundry debtors Cash/Bank	xxx	debts Cash/Bank (sale of assets)	xxx		
(payment of liabilities)	xxx	Partner's capital account (assets	xxx		
Cash/Bank	xxx	taken by the partner) Loss	xxx		
(payment of unrecorded liabilities)		(transferred to partners capital			
Partner's capital account Investments	xxx	accounts)	xxx		
(liability assumed by the partner) Profit		Loss (transferred to partners			
(transferred to partners' capital	xxx	Investment Fluctuation Fund	xxx		
account's in their profit	xxx		xxx		
sharing ratio)	xxx				
<b>Total</b>	<b>xxxxx</b>	<b>Total</b>	<b>xxxxx</b>		

Fig. 5.1: Format of Realisation Account

### Illustration 1

Supriya and Monika are partners, who share profit in the ratio of 3:2. Following is the balance sheet as on March 31, 2020.

**Balance Sheet of Supriya and Monika as on March 31, 2020**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Supriya's Capital	32,500	Cash and Bank Stock	40,500
Monika's Capital	11,500	Sundry debtors	21,500
Sundry Creditors	48,000	Less: Provision	500
General Reserve	13,500	for doubtful debts Fixed Assets	21,000
			36,500
	<b>1,05,500</b>		<b>1,05,500</b>

The firm was dissolved on March 31, 2020. Close the books of the firm with the following information:

- (i) Debtors realised at a discount of 5%,
- (ii) Stock realised at Rs.7,000,
- (iii) Fixed assets realised at Rs.42,000,
- (iv) Realisation expenses of Rs.1,500,
- (v) Creditors are paid in full.

Record necessary journal entries at the time of dissolution of a firm.

### Solution

**Books of Supriya and Monika Realisation Account**

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2017 Mar., 31	Realisation A/c To Stock A/c To Sundry Debtors A/c To fixed Assets A/c (Assets transferred to realisation account)	Dr.	65,500	7,500 21,500 36,500
2017 Mar., 31	Sundry Creditors A/c Provision for doubtful debts A/c To Realisation A/c (Liabilities transferred to Realisation A/c)	Dr. Dr.	48,000 500	48,500
2017 Mar., 31	Bank A/c To Realisation A/c (Assets Realized)	Dr.	69,425	69,425

Dissolution of Partnership Firm

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2017 Mar., 3	Realisation A/c To Bank A/c (Creditors and realisation expenses paid)	Dr.	49,500	49,500
2017 Mar., 31	Realisation A/c To Supriya's Capital A/c To Monika's Capital A/c (Realisation Profit transferred to partners' capital account)	Dr.	2,925	1,755 1,170
2017 Mar., 31	General Reserve A/c To Supriya's Capital A/c To Monika's Capital A/c (Profit in realisation transferred to partners' capital accounts)	Dr.	13,500	8,100 5,400
2017 Mar., 31	Supriya's Capital A/c Monika's Capital A/c To Bank A/c (Final accounts due paid to partners)	Dr.	42,355 18,070	60,425

Working Notes:

**Books of Supriya and Monika Realisation  
Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Assets transferred:		Provision for doubtful debts	500
Stock	7,500	Sundry creditors	48,000
Sundry debtors Fixed assets	21,500 36,500	Bank	
Bank Creditors		Debtors	20,425
Realisation expenses Profit	48,000	Stock	7,000
transferred to:	1,500	Fixed assets	<u>42,000</u>
Supriya Capital	1,755		69,425
Monika Capital	<u>1,170</u>		
	2,925		
	<b>1,17,925</b>		<b>1,17,925</b>

**Partners Capital Accounts**

Dr.					Cr.				
Date	Particulars	J.F.	Supriya (Rs.)	Monika (Rs.)	Date	Particulars	J.F.	Supriya (Rs.)	Monika (Rs.)
	Bank		42,355	18,070		Balance b/d		32,500	11,500
						Reserve fund		8,100	5,400
						Realisation (Profit)		1,755	1,170
			<b>42,355</b>	<b>18,070</b>				<b>42,355</b>	<b>18,070</b>

**5.4.1 Journal Entries****1. For transfer of assets**

All asset accounts excluding cash, bank and the fictitious assets, if any are closed by transfer to the debit of Realisation Account at their book values. It may be noted that sundry debtors are transferred at gross value and the provision for doubtful debts is transferred to the credit side of Realisation Account along with liabilities. The same thing will apply to fixed assets, if provision for depreciation account is maintained.

Realisation A/c  
To Assets (Individually) A/c

Dr.

**2. For transfer of liabilities**

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

Liabilities (individually)  
To Realisation A/c

Dr.

**3. For sale of assets**

Bank A/c  
To Realisation A/c

Dr. ] with the same value

**4. For an asset taken over by a partner**

Partner's Capital A/c  
To Realisation A/c

Dr. ] with the amount assets  
are taken over

**5. For payment of liabilities**

Realisation A/c  
To Bank A/c

Dr. ] with the amount at  
which settled



11. *For settlement of any unrecorded liability*
- |                 |     |
|-----------------|-----|
| Realisation A/c | Dr. |
| To Bank A/c     |     |
12. *For transfer of profit and loss on realisation* (Cr. Balance)
- (a) *In case of profit on realisation*
- |   |     |
|---|-----|
| Realisation A/c                             | Dr. |
| To Partners' Capital A/c (individually) A/c |     |
- (b) *In case of loss on realisation*
- |                                      |                      |
|--------------------------------------|----------------------|
| Partners' Capital A/c (individually) | Dr. (Dr. Balance) To |
| Realisation A/c                      |                      |
13. *For settlement of loan by a firm to a partner:*
- |                         |     |
|-------------------------|-----|
| Bank A/c                | Dr. |
| To loan to partners A/c |     |
14. *For transfer of accumulated profits in the form of general reserve to partners' capital accounts in their profit sharing ratio:*
- |   |     |
|---|-----|
| General Reserve A/c                     | Dr. |
| To Partners' Capital A/c (individually) |     |
15. *For transfer of fictitious assets, if any, to partners' capital accounts in their profit sharing ratio:*
- |                                      |     |
|--------------------------------------|-----|
| Partners' Capital A/c (individually) | Dr. |
| To Fictitious Asset A/c              |     |
16. *For payment of loans due to partners*
- |                    |     |
|--------------------|-----|
| Partner's Loan A/c | Dr. |
| To Bank A/c        |     |
17. *For settlement of partners' accounts*

If the partner's capital account shows a debit balance after posting of rebound entries firms. He brings in the necessary cash for which the entry will be:

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

The balance is paid to partners whose capital accounts show a credit balance and the following entry is recorded.

Partners' Capitals A/cs (individually)	Dr.
To Bank A/c	

It may be noted that the aggregate amount finally payable to the partners must equal to the amount available in bank and cash accounts. Thus, all accounts of a firm are closed in case of dissolution.

*Illustration 2*

Sita, Rita and Meeta are partners sharing profit and losses in the ratio of 2:2:1 Their balance sheet as on March 31, 2017 is as follows:

**Balance Sheet of Sita, Rita and Meeta as on March 31, 2017**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
General Reserve	2,500	Cash at bank	2,500
Creditors	2,000	Stock	2,500
Capitals:		Furniture	1,000
Sita 5,000		Debtors	2,000
Rita 2,000		Plant and Machinery	4,500
Meeta <u>1,000</u>	8,000		
	<b>12,500</b>		<b>12,500</b>

They decided to dissolve the business. The following amounts were realised: Plant and Machinery Rs.4,250, Stock Rs.3,500, Debtors Rs.1850, Furniture 750. Sita agreed to bear all realisation paid by the firm expenses. For the service

Sita is paid Rs.60.

Actual expenses on realisation paid by the firm amounted to Rs.450. Creditors paid 2% less. There was an unrecorded assets of Rs.250, which was taken over by Rita at Rs.200.

Prepare the necessary accounts to close the books of the firm.

*Solution*

**Books of Sita, Rita and Meeta**

Dr.		Realisation Account		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock	2,500	Creditors	2,000		
Furniture	1,000	Rita's capital	200		
Debtors	2,000	[Unrecorded assets]			
Plant and Machinery	4,500	Bank [assets realised]:			
Bank [Creditors]	1,960	Plant and Machinery	4,250		
Sita's capital	60	Debtors	1,850		
(realisation expenses)		Stock	3,500		
Profit transferred to:		Furniture	<u>750</u>		10,350
Sita's capital	212				
Rita's capital	212				
Meeta's capital	<u>106</u>				
	530				
	<b>12,550</b>				<b>12,550</b>

Dr.

## Partner's Capital Accounts

Cr.

Date 2017	Particulars	J.F.	Sita (Rs.)	Rita (Rs.)	Meeta (Rs.)	Date 2017	Particulars	J.F.	Sita (Rs.)	Rita (Rs.)	Meeta (Rs.)
Mar. 31	Bank Realisation(asset) Bank		450 5,822	200 3,012	1,606	Mar. 31	Balance b/d Reserve fund Realisation [profit] Realisation (expenses)		5,000 1,000 212 60	2,000 1,000 212 —	1,000 500 106 —
Dr.			<b>6,272</b>	<b>3,212</b>	<b>Bank</b>	Acco unt		<b>6,272</b>	<b>3,212</b>	<b>1,606</b>	Cr.
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)				
Mar. 31	Balance b/d Realisation (assets realised)		2,500 10,350	Mar. 31	Realisation (Creditor) Sita's Capital [expenses] Sita's Capital Rita's Capital Meeta's capital		1,960 450 5,822 3,012 1,606				
			<b>12,850</b>				<b>12,850</b>				

*Illustration 3*

Record journal entries at the time of dissolution of a partnership firm of Vibha, Shobha and Anubha in the following cases:

- Dissolution expenses amounted to Rs. 6,500.
- Dissolution expenses Rs. 7,800 were paid by Anubha.
- Vibha was appointed to look after the dissolution process for which she was given a remuneration of Rs. 12,000
- Shobha was appointed to look after the dissolution work for which she was allowed a remuneration of Rs.15,000. She agreed to bear dissolution expenses. Actual dissolution expenses paid by her amounted to Rs. 11,800.
- Anubha was to look after the dissolution process for which she was allowed a remuneration of Rs. 12,000 she also agreed to bear dissolution expenses. Actual expenses Rs. 9,500 were paid by the firm.
- Anubha looked after the dissolution work for remuneration of Rs. 8,500 and agreed to bear dissolution expenses upto Rs. 6,000. Actual expenses paid by her were Rs. 7,600.
- Vibha was appointed to look after the dissolution work for which she was allowed a remuneration of Rs. 14,000. She agreed to take over investment

of the book value of Rs. 13,000 towards payment of her remuneration. Investments have already been transferred to realisation Account.

**Book of Vibha, Shobha and Anubha**

<i>Date 2017</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit Amount (Rs.)</i>	<i>Credit Amount (Rs.)</i>
(a)	Realisation A/c <span style="float: right;">Dr.</span> To Cash / Bank A/c (Dissolution expense paid by the firm)		6,500	6,500
(b)	Realisation A/c <span style="float: right;">Dr.</span> To Anubha's Capital A/c (Dissolution Expenses paid by Anubha)		7,800	7,800
(c)	Realisation A/c <span style="float: right;">Dr.</span> To Vibha's Capital A/c (Remuneration given to Vibha)		12,000	12,000
(d)	Realisation A/c <span style="float: right;">Dr.</span> To Shobha's Capital A/c (Remuneration allowed to Shobha for looking after dissolution work)		15,000	15,000
(e)	(i) Realisation A/c <span style="float: right;">Dr.</span> To Anubha's Capital A/c (Remuneration allowed to Anubha)		12,000	12,000
	(ii) Anubha's Capital A/c <span style="float: right;">Dr.</span> To Cash /Bank A/c (Dissolution expenses paid by the firm and borne by Annubha)		9,500	9,500
(f)	(i) Realisation A/c <span style="float: right;">Dr.</span> To Anubha's Capital A/c (Remuneration payable to Anubha)		8,500	8,500
	(ii) Realisation A/c <span style="float: right;">Dr.</span> To Anubha's Capital A/c (Dissolution expenses paid by Anubha on behalf of the firm)		1,600	1,600
(g)	No Entry			

***Illustration 4***

Nayana and Arushi were partners sharing profits equally Their Balance Sheet as on March 31, 2020 was as follows:



Bank A/c To Realisation A/c (Assets sold and bad debts recovered)	Dr.		1,57,825	1,57,825
Nayana's Current A/c To Realisation A/c (Half stock take over by Nayana at 10% less)	Dr.		15,750	15,750
Realisation A/c To Nayana's Current A/c To Arushi's Current A/c (Realisation profit transferred to partner's current account)	Dr.		15,575	5,788 5,787
Workman Compensation Reserve A/c To Nayana's Current A/c To Arushi's Current A/c (Compensation fund transferred to partners' Current account)	Dr.		15,000	7,500 7,500
Arushi Current A/c To Arushi's Capital A/c (Current account balance transferred to Capital account)	Dr.		23,287	23,287
Nayana Capital A/c To Nayana's Current A/c (Current account balance transferred to Capital account)	Dr.		12,462	12,462
Nayana's Capital A/c Arushi's Capital A/c To Bank A/c (Final amounts due to partners paid)	Dr. Dr.		87,538 73,287	1,60,825

**Realisation Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Debtors	25,000	Creditors Bank	20,000
Stock	35,000	overdraft Bank:	5,000
Furniture	40,000	Investment	
Machinery	<u>60,000</u>	Furniture	34,000
Bank:		Machinery	30,000
Creditors	20,000	Debtors (90%)	50,000
Bank overdraft	5,000	Stock :	22,500
Outstanding bill	<u>2,000</u>	Bad debts	20,125
Profit transferred to :		recovered	
Nayana's capital	5,788	Nayana's capital (stock	<u>1,200</u>
Arushi's capital	<u>5,787</u>	taken over)	1,57,825
	11,575		15,750
	<b>1,98,575</b>		<b>1,98,575</b>

**Partners' Current Accounts**

Dr.					Cr.				
Date 2017	Particulars	J.F.	Nayana (Rs.)	Arushi (Rs.)	Date 2017	Particulars	J.F.	Nayana (Rs.)	Arushi (Rs.)
	Balance b/d		10,000			Balance b/d			10,000
	Realisation		15,750			Workmen		7,500	7,500
	Arushi's capital			23,287		Compensation Reserve			
						Realisation (profit)		5,788	5,787
						Nayana's Capital		12,462	
			<b>25,750</b>	<b>23,287</b>				<b>25,750</b>	<b>23,287</b>

**Partner's Capital Accounts**

Dr.					Cr.				
Date 2017	Particulars	J.F.	Nayana (Rs.)	Arushi (Rs.)	Date 2017	Particulars	J.F.	Nayana (Rs.)	Arushi (Rs.)
	Nayana's current account		12,462			Balance b/d		1,00,000	50,000
	Bank		87,538	73,287		Arushi's current account			23,287
			<b>1,00,000</b>	<b>73,287</b>				<b>1,00,000</b>	<b>73,287</b>

**Bank Account**

Dr.				Cr.			
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	Balance b/d		30,000		Realisation		27,000
	Realisation		1,57,825		Nayana's capital		87,538
					Arushi's capital		73,287
			<b>1,87,825</b>				<b>1,87,825</b>

*Illustration 6*

Sonia, Rohit and Udit are partners sharing profits in the ratio of 5:3:2. Their Balance Sheet as on March 31, 2017 was as follows:

**Balance Sheet of Sonia, Rohit and Udit as on March 31, 2017**

<i>Liabilities</i>	<i>Amount (Rs.)</i>	<i>Assets</i>	<i>Amount (Rs.)</i>
Creditors	30,000	Buildings	2,00,000
Bills payable	30,000	Machinery	40,000
Bank loan	1,20,000	Stock	1,60,000
Sonia's husband's loan	1,30,000	Bills receivable	1,20,000
General reserve	80,000	Furniture	80,000
Capitals:		Cash at bank	60,000
Sonia	70,000		
Rohit	90,000		
Udit	<u>1,10,000</u>		
	2,70,000		
	<b>6,60,000</b>		<b>6,60,000</b>

The firm was dissolved on that date. Close the books of the firm with following information:

- Buildings realised for Rs.1,90,000, Bills receivable realised for Rs.1,10,000; Stock realised Rs.1,50,000; and Machinery sold for Rs.48,000 and furniture for Rs. 75,000,
- Bank loan was settled for Rs.1,30,000. Creditors and Bills payable were settled at 10% discount,
- Rohit paid the realisation expenses of Rs.10,000 for which he paid Rs.12,000 for completing the dissolution process.

Prepare necessary ledger accounts.

*Solution*

**Books of Sonia, Rohit and Udit**

<i>Dr.</i>		<i>Cr.</i>	
<i>Particulars</i>	<i>Amount (Rs.)</i>	<i>Particulars</i>	<i>Amount (Rs.)</i>
Buildings	2,00,000	Creditors	30,000
Machinery	40,000	Bills payable	30,000
Stock	1,60,000	Bank loan	1,20,000
Bills receivable	1,20,000	Sonia's husband's loan	1,30,000
Furniture	<u>80,000</u>	Bank:	
Bank (Bank Loan)	1,30,000	Buildings	1,90,000
Bank		Bills receivable	1,10,000
[creditors and Bills payable]	54,000	Stock	1,50,000
Bank [Sonia's husbands loan]	1,30,000	Machinery	48,000
Rohit's capital	12,000	Furniture	<u>75,000</u>
(realisation expenses)		Loss transferred to capital accounts:	5,73,000
		Sonia	21,500
		Rohit	12,900
		Udit	<u>8,600</u>
	<b>9,26,000</b>		43,000
			<b>9,26,000</b>

**Partner's Capital Accounts**

Dr.						Cr.					
Date 2017	Particulars	J.F.	Sonia (Rs.)	Rohit (Rs.)	Udit (Rs.)	Date 2017	Particulars	J.F.	Sonia (Rs.)	Rohit (Rs.)	Udit (Rs.)
	Realisation (Loss)		21,500	12,900	8,600		Balance b/d		70,000	90,000	1,10,000
	Bank		88,500	1,13,100	1,17,400		Realisation (renumeration)		—	12,000	—
							General reserve		40,000	24,000	16,000
			<b>1,10,000</b>	<b>1,26,000</b>	<b>1,26,000</b>				<b>1,10,000</b>	<b>1,26,000</b>	<b>1,26,000</b>

**Bank Account**

Dr.				Cr.			
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
	Balance b/d		60,000		Realisation [bank loan]		1,30,000
	Realisation (assets realised)		5,73,000		Realisation [creditors and bills payable]		54,000
					Realisation (Sonia's husband loan)		1,30,000
					Sonia's capital		88,500
					Rohit's capital		1,13,100
					Udit's capital		1,17,400
			<b>6,33,000</b>				<b>6,33,000</b>

Note: No entry has been recorded in firm's books for the actual realisation expenses incurred by Rohit because he gets Rs. 12,000 as his remuneration which has been duly accounted for.

**Illustration 7**

Romesh and Bhawan were in partnership sharing profit and losses as 3:2. Their Balance Sheet as on March 31, 2017, was as follows:

**Balance Sheet of Romesh and Bhawan as on March 31, 2014**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bank loan	60,000	Cash at bank	30,000
Creditors	80,000	Debtors	70,000
Bills payables	40,000	Stock	2,00,000
Bhawan loan	20,000	Investments	1,40,000
Capitals:		Buildings	60,000
Romesh	1,00,000		
Bhawan	<u>2,00,000</u>		
	<b>5,00,000</b>		<b>5,00,000</b>

They decided to dissolve the firm. The following information is available:

1. Debtors were recovered 5% less. Stock was realised at books value and building was sold for Rs.51,000,
2. It is found that investment not recorded in the books amounted to Rs.10,000. The same were accepted by one creditor for this amount and other Creditors were paid at a discount of 10%. Bills payable were paid full,
3. Romesh took over some of the Investments at Rs.8,100 (book value less 10%). The remaining investment were taken over by Bhawan at 90% of the book value less Rs.900 discount,
4. Bhawan paid bank loan along with one year interest at 6% p.a,
5. An unrecorded liability of Rs.5,000 was paid.

Close the books of the firm by preparing necessary ledger accounts.

**Solution**

**Books of Romesh and Bhawan Realisation Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Debtors	70,000	Bank loan	60,000
Stock	2,00,000	Creditors	80,000
Investments	1,40,000	Bills payable	40,000
Buildings	<u>60,000</u>	Romesh's Capital (investment)	8,100
Bank (bills payable)	40,000	Bhawan's Capital (investment)	1,17,000
Bank (creditors)	63,000	Bank:	
Bhawan's capital (loan with interest)	63,600	Debtors	66,500
Bank (unrecorded liability)	5,000	Stock	2,00,000
		Buildings	<u>51,000</u>
		Loss transferred to :	
		Romesh capital	11,400
		Bhawan capital	<u>7,600</u>
	<b>6,41,600</b>		<b>6,41,600</b>

**Partner's Capital Accounts**

Dr.					Cr.				
Date 2017	Particulars	J.F.	Romesh (Rs.)	Bhawan (Rs.)	Date 2017	Particulars	J.F.	Romesh (Rs.)	Bhawan (Rs.)
	Realisation [investment]		8,100	1,17,000		Balance b/d		1,00,000	2,00,000
	Realisation [loss]		11,400	7,600		Realisation [bank loan]			63,600
	Bank		80,500	1,39,000					
			<b>1,00,000</b>	<b>2,63,600</b>				<b>1,00,000</b>	<b>2,63,600</b>

**Bank Account**

Dr.				Cr.			
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
	Balance b/d		30,000		Realisation[creditor]		63,000
	Realisation (assets realised)		3,17,500		Realisation [unrecorded liability]		5,000
					Bhawan loan		20,000
					Realisation (bills payable)		40,000
					Romesh's capital		80,500
					Bhawan's capital		1,39,000
			<b>3,47,500</b>				<b>3,47,500</b>

Note: No entry has been made for acceptance of unrecorded investments by a creditor as part payment of his dues as per rules.

**Illustration 8**

Sonu and Ashu sharing profits as 3:1 and they agree upon dissolution. The Balance Sheet as on March 31, 2017 is as under:

**Balance Sheet of Sonu and Ashu as on March 31, 2017**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Loan	12,000	Cash at bank	15,000
Creditors	18,000	Stock	45,000
Capital		Furniture	16,000
Sonu	1,10,000	Debtors	70,000
Ashu	<u>68,000</u>	Plant and Machinery	52,000
	1,78,000	Loan to Ashu	10,000
	<b>2,08,000</b>		<b>2,08,000</b>

Sonu took over plant and machinery at an agreed value of Rs.60,000. Stock and Furniture were sold for Rs.42,000 and Rs.13,900 respectively. Debtors were taken over by Ashu at Rs.69,000. Creditors were paid subject to discount of Rs.900. Sonu agrees to pay the loans. Realisation expenses were Rs.1,600.

Prepare Realisation Account, Bank Account and Capital Accounts of the Partners.

Solution

**Books of Sonu and Ashu Realisation Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock	45,000	Loan Creditors	12,000
Furniture	16,000	Sonu's capital	18,000
Debtors	70,000	(plant & machinery)	60,000
Plant and Machinery	52,000	Ashu's capital (debtors) Bank:	
Bank (creditors)	17,100	Stock	42,000
Sonu's capital (loan)	12,000	Furniture	<u>13,900</u>
Bank (realisation expenses)	1,600		
Profit transferred to :			55,900
Sonu's capital	900		
Ashu's capital	<u>300</u>		
	1,200		
	<b>2,14,900</b>		<b>2,14,900</b>

**Partners Capital Accounts**

Dr.					Cr.				
Date 2017	Particulars	J.F.	Sonu (Rs.)	Ashu (Rs.)	Date 2017	Particulars	J.F.	Sonu (Rs.)	Ashu (Rs.)
	Realisation [plant and machinery]		60,000			Balance b/d		1,10,000	68,000
	Realisation [debtors]			69,000		Realisation [loan]		12,000	
	Bank		62,900			Realisation [profit]		900	300
			<b>1,22,900</b>	<b>69,000</b>		Bank			700
								<b>1,22,900</b>	<b>69,000</b>

**Bank Account**

Dr.					Cr.		
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
	Balance b/d		15,000		Realisation [creditor]		17,100
	Realisation (assets realised)		55,900		Realisation [expenses]		1,600
	Loan to Ashu		10,000		Sonu's capital		62,900
	Ashu's capital		700				
			<b>81,600</b>				<b>81,600</b>

*Illustration 9*

Anju, Manju and Sanju sharing profit in the ratio of 3:1:1 decided to dissolve their firm. On March 31, 2014 their position was as follows:

**Balance Sheet Anju, Manju and Sanju as on March 31, 2017**

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		60,000	Cash at bank		55,000
Loan		15,000	Stock Furniture		83,000
Capitals:			Debtors		12,000
Anju	2,75,000		Less: Provision for doubtful debts	2,42,000	
Manju	1,10,000		Buildings	<u>12,000</u>	2,30,000
Sanju	<u>1,00,000</u>	4,85,000			2,00,000
Manju's loan		20,000			
		<b>5,80,000</b>			<b>5,80,000</b>

It is agreed that:

1. Anju takes over the Furniture at Rs.10,000 and Debtors amounting to Rs.2,00,000 at Rs.1,85,000. Anju also agrees to pay the creditors,
  2. Manju is to take over Stock at book value and Buildings at book value less 10%,
  3. Sanju is to take over remaining Debtors at 80% of book value and responsibility for the discharge of the loan,
  4. The expenses of dissolution amounted to Rs.2,200.
- Prepare Realisation Account, Bank Account and Capital Accounts of the partners.

*Solution*

**Books of Anju, Manju and Sanju  
Realisation Account**

Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock	83,000	Provision for doubtful debts	12,000
Furniture	12,000	Loan	60,000
Debtors	2,42,000	Anju's capital :	15,000
Buildings	<u>2,00,000</u>	Furniture	10,000
Anju capital (creditors)	60,000	Debtors	<u>1,85,000</u>
Sanju capital (loan)	15,000	Manju's capital :	1,95,000
Bank (realisation expenses)	2,200	Stock	83,000
		Buildings	<u>1,80,000</u>
		Sanju's capital :	2,63,000
		(remaining debtors less 20% of book value) Loss	
		transferred to :	33,600
		Anju's capital	21,360
		Manju's capital	7,120
		Sanju's capital	<u>7,120</u>
			35,600
	<b>6,14,200</b>		<b>6,14,200</b>

Dr.						Partner's Capital Accounts						Cr.		
Date 2017	Particulars	J.F.	Anju (Rs.)	Manju (Rs.)	Sanju (Rs.)	Date 2017	Particulars	J.F.	Anju (Rs.)	Manju (Rs.)	Sanju (Rs.)			
	Realisation (assets)		1,95,000	2,63,000	33,600		Balance b/d		2,75,000	1,10,000	1,00,000			
	Realisation (loss)		21,360	7,120	7,120		Realisation (creditors)		60,000					
	Bank		1,18,640		74,280		Realisation Manju loan (loan)			20,000	15,000			
							Bank			1,40,120				
			<b>3,35,000</b>	<b>2,70,120</b>	<b>1,15,000</b>				<b>3,35,000</b>	<b>2,70,120</b>	<b>1,15,000</b>			

Alternatively, Manju's loan may be first paid through bank account then the amount payable by Manju on account of debit balance in her capital account. Rs. 16,0,120 can be corrected from her.

Dr.				Bank Account				Cr.	
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)		
	Balance b/d Manju's capital		55,000		Realisation (expenses)		2,200		
			1,40,120		Anju's capital		1,18,640		
			<b>1,95,120</b>		Sanju's capital		74,280		
							<b>1,95,120</b>		

#### Illustration 10

Sumit, Amit and Vinit are partners sharing profit in the ratio of 5:3:2. Their Balance Sheet as on March 31, 2017 was as follows:

**Balance Sheet of Sunit, Amit and Vinit as on March 31, 2017**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals:		Machinery	80,000
Sumit	40,000	Investments	1,50,000
Amit	50,000	Stock	10,000
Vinit	<u>60,000</u>	Debtors	35,000
Profit and Loss	10,000	Cash at bank	15,000
Mrs. Amit's loan	40,000		
Sundry creditors	90,000		
	<b>2,90,000</b>		<b>2,90,000</b>

The firm was dissolved on that date. Amit took over his wife's loan. One of the Creditors for Rs.2,600 was not claim the amount. Assets realised as follows:

1. Machinery was sold for Rs.70,000,
2. Investments with book value of Rs.1,00,000 were given to Creditors in full settlement of their account. The remaining Investments were taken over by Vinit at an agreed value of Rs.45,000,

3. Stock was sold for Rs.11,000 and Debtors for Rs.3,000 proved to be bad,
  4. Realisation expenses were Rs.1,500.
- Prepare ledger accounts to close the books of the firm.

**Solution**

**Books of Amit, Sumit and Vinit Realisation Account**

Dr.		Amount (Rs.)	Cr.	
Particulars			Particulars	Amount (Rs.)
Machinery	80,000		Sundry creditors	90,000
Investments	1,50,000		Mrs.Amit's loan Bank :	40,000
Stock	10,000		Machinery	70,000
Debtors	<u>35,000</u>	2,75,000	Stock	11,000
Amit's Capital (wife's loan)	40,000		Debtors	<u>32,000</u>
Bank (realisation expenses)	1,500		Vinit's capital (investment) Loss	1,13,000
			transferred to :	45,000
			Amit's capital	14,250
			Sumit's capital	8,550
			Vinit's capital	<u>5,700</u>
				28,500
		<b>3,16,500</b>		<b>3,16,500</b>

**Partners Capital Accounts**

Dr.		Cr.									
Date 2017	Particulars	J.F.	Amit (Rs.)	Sumit (Rs.)	Vinit (Rs.)	Date 2017	Particulars	J.F.	Amit (Rs.)	Sumit (Rs.)	Vinit (Rs.)
	Realisation				45,000		Balance b/d		40,000	50,000	60,000
	Investment						Realisation				
	Realisation (loss)		14,250	8,550	5,700		(Mrs. Amit's loan)		40,000		
	Bank		70,750	44,450	11,300		Profit and Loss		5,000	3,000	2,000
			<b>85,000</b>	<b>53,000</b>	<b>62,000</b>				<b>85,000</b>	<b>53,000</b>	<b>62,000</b>

**Bank Account**

Dr.		Cr.					
Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
	Balance b/d		15,000		Realisation (expenses)		1,500
	Realisation (assets realised)		1,13,000		Amit's capital		70,750
					Sumit's capital		44,450
					Vinit's capital		11,300
			<b>1,28,000</b>				<b>1,28,000</b>

Note: No entry has been made for the investments taken over by the creditors as per rules.

**Illustration 11**

Meena and Tina are partners in a firm and sharing profit as 3:2. They decided to dissolve their firm on March 31, 2017 when their Balance Sheet was as follows:

**Balance Sheet Meena and Tina as on March 31, 2017**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital :		Machinery	70,000
Meena	90,000	Investments	50,000
Tina	<u>80,000</u>	Stock	22,000
Sundry creditors	60,000	Sundry Debtors	1,03,000
Bills payable	20,000	Cash at bank	5,000
	<b>2,50,000</b>		<b>2,50,000</b>

The assets and liabilities were disposed off as follows :

- Machinery were given to creditors in full settlement of their account and Stock were given to bills payable in full settlement.
- Investment were taken over by Tina at book value. Sundry debtors of book value Rs. 50,000 took over by Meena at 10% less and remaining debtors realised Rs. 51,000.
- Realisation expenses amount to Rs. 2,000.

Prepare necessary ledger accounts to close the book of the firm.

**Solution**

**Books of Meena and Tina - Realisation Account**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Assets transferred :		Sundry creditors	60,000
Machinery	70,000	Bills payable	20,000
Investments	50,000	Tina's Capital (investment)	50,000
Stock	22,000	Meena's Capital	45,000
Sundry debtors	<u>1,03,000</u>	Bank (Debtors)	51,000
Bank (realisation expenses)	2,000	Loss transferred to :	
	2,45,000	Meena's capital	12,600
		Tena's capital	<u>8,400</u>
	<b>2,47,000</b>		21,000
			<b>2,47,000</b>

**Partner's Capital Accounts**

Dr.				Cr.			
Date	Particulars	Meena (Rs.)	Tina (Rs.)	Date	Particulars	Meena (Rs.)	Tina (Rs.)
	Realisation (investment)		50,000		Balance b/d	90,000	80,000
	Realisation (debtors)	45,000					
	Realisation (loss)	12,600	8,400				
	Bank	32,400	21,600				
		<b>90,000</b>	<b>80,000</b>			<b>90,000</b>	<b>80,000</b>

Bank Account			
Dr.		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Balance b/d	5,000	Realisation (expenses)	2,000
Realisation (assets realised)	51,000	Mena's capital	32,400
		Tina's capital	21,600
	<b>56,000</b>		<b>56,000</b>

### **GARNER VS MURRAY RULE**

Dissolution of Partnership Firm means the firm closes down its operations and comes to an end. On the dissolution of the firm, the assets of the firm are sold and liabilities are paid off. The balance, if any, is paid to the partners in settlement of their accounts. If there is shortfall in meeting outside liabilities, it is met by the partners from their private assets. For such settlement Garner Vs Murray Rule is to be applied. When a partner is unable to contribute fully or partially the debit balance appearing in his capital account, the portion of the debit balance which he is unable to contribute is known as insolvency loss. Loss arising on account of insolvency of a partner is not treated as an ordinary business loss to be shared by partners in their profit-sharing ratio. Section 48 of Indian Partnership Act, 1932 requires that the assets of the firm including any sum contributed by partners to make up deficiency of capital are utilized in first place to settle liabilities and partner loan and the rest of the amount, if any, shall be applied in paying each partner. The amount is payable in the ratio of what due to the partners

#### **CASE: GARNER VS MURRAY RULE**

The details of Garner Vs Murray Rule is as follows: Garner, Murray and Wilkins were equal partners with unequal capitals. The assets of the firm on dissolution, after satisfying all the liabilities to creditors and advance from partners was insufficient to repay the capitals in full. There was a deficiency of Rs. 635 and the capital account of Wilkins was showing a debit balance of Rs.263. Nothing could be recovered from

Wilkins owing to insolvency.

### **DECISION OF THE CASE**

The solvent partners are only liable to make good their share of deficiency, and that the remaining assets should be divided among them in the proportion of their capitals

### **EFFECT OF THIS CASE**

The solvent partner should contribute to the deficiency of capital in cash of their share only.

The net effect is that the deficiency of capital of the insolvent partner gets distributed among the solvent partners in the ratio of their last agreed capitals.

### **CRITICISM OF GARNER VS MURRAY RULE**

It does not apply when the firm is having only two partners. It considers only the book capitals of the partners, ignoring the private assets of the solvent partners. If a partner contributed more capital than that of the other partners, he will have to bear more burden than the other partners who had contributed less capital. If a partner having zero capital balance or debit balance, will not have to bear the deficiency of the insolvent partner. Introduction of cash by the solvent partners to make good their share of loss on realization is unnecessary, when the balance of capital accounts of the solvent partners are sufficient to bear the deficiency of insolvent partner.

### **APPLICABILITY OF GARNER VS MURRAY RULE IN INDIA**

Section 48 of Indian Partnership Act 1932 is similar to the Section 44 of the Partnership Act in Great Britain and further there has been no case law in India to deal with such situations. So, in India this is applicable with respect to following considerations: Garner vs Murray is applicable only when there is no agreement between the partners for sharing the deficiency in capital account of insolvent partner. Realisation loss should be divided in the profit sharing ratio in the usual manner.

The solvent partners should bring in cash to make good the loss on realization. Final debit balance of insolvent partner should be distributed amongst the solvent partners in proportion in their last agreed capital.

### **Piecemeal Distribution of Cash Among Partners**

#### **INTRODUCTION:-**

In case of dissolution of partnership firm, if all assets are realized in a single day and settlement of liabilities are done on the same day, and then the process will be very simple and acceptable to all parties concerned. In fact, assets are not realized in a single day but it takes time. For example:-

Collection from debtors in a single day is not possible. Every debtor pays the dues on the terms decided while making sale.

In same way, if we sell the stock, this selling process may take more than one day. Thus, realization of assets is a process spread over a long period.

Now, when assets are realized gradually, the firm has two options:

- (1) To distribute amount after final realization. If this is possible, process of distribution of cash becomes quite simple. But it is the experience of the firm that no one is ready to wait till final realization.
- (2) Second option is to distribute cash as and when it is realized, which is popularly known as piecemeal distribution of cash. In this case question arises regarding priority of payment to the parties, because in piecemeal distribution, cash available is always insufficient to settle full liabilities.

#### **MEANING:-**

When dissolution of any partnership firm, than there is major problem is to collect payments from debtors and realization of any assets as well as payment to creditors. So

that, in the solution of this problem is that when any amount comes in at that time that amount distributed between creditor or partner is known as piecemeal distribution of cash. When there is to distribute this amount to creditor or partner, there is problem that, to whom pay first. So, in following order payment is done:

- (1) First of all realization expenses are paid off. If it is said that realization expenses are estimated, then amount equal to estimate is set aside as reserve and that amount is subtracted from the first installment. Any excess of estimated reserve amount over actual realization expenses is added in last installment and if actual expenses are more than reserve kept, the deficiency is deducted from last installment.
- (2) Reserve for bill discounted and Contingency reserve is also raised from the first installment. Excess or deficit of Reserve for bill discounted is adjusted in the installment related with the maturity date of bill. Contingency reserve is always adjusted from installment, when contingent liability is paid.
- (3) Secured loan and liabilities are paid out of the cash realized by sale of mortgaged asset.
- (4) After settling secured liabilities, unsecured liabilities are settled. It includes sundry creditors, Bills payable, Bank overdraft etc. If the amount available is insufficient for settling all liabilities, then available amount is distributed among all parties in ratio of amount of liabilities. (Amt. is distributed proportionately).
- (5) Then comes the turn of partners' loan, if there is loan from, more than one partner and amount available is insufficient to settle loan A/c fully, then available amount is distributed in proportion of loan given by them.
- (6) After partners' loans are fully paid off, question of redemption of partners' capital arises. If partners' capital is in proportion of their profit sharing ratio, then the

process is simple. Distribute the available amount among partners in their profit sharing ratio.

### **METHODS OF PIECEMEAL DISTRIBUTION OF CASH:-**

Most probably the partners' capital may not be in their profit sharing ratio and at that time a question may arise regarding most reasonable and justifiable distribution. For this purpose two methods are available : (1) Surplus Capital Method and (2) Maximum Loss Method.

#### **❖ Surplus Capital Method or Proportionate Capital Method:-**

In this method, basic assumption is that all partners' capital should be in their profit sharing proportion and if in comparison with profit sharing ratio, capital of any partner is more, then his surplus capital should be redeemed first. For example, A and B are partners in ratio of 3 : 2 and having capital of Rs. 35,000 and 20,000. Now if we compared it with their profit ratio, A's capital must be Rs. 30,000 because B's capital is Rs. 20,000. So A has contributed Rs. 5,000 more which should be redeemed in top priority.

While calculating capital of all partners adjustment regarding General Reserve, Contingency Reserve, Profit and Loss A/c (Debit or Credit balance) should be done. And balance of capital account after this adjustment should be taken into consideration.

In this method, partners' with absolute surplus capital are paid off first, followed by payment to other partners having surplus capital when all partners' capital is adjusted in accordance with profit sharing ratio, then distribution of amount is made in profit sharing ratio.

#### **The surplus capital is calculated as under :**

- (1) Divide adjusted capital of each partner by his profit sharing proportion. The smallest figure should be considered as **BaseCapital**.
- (2) By multiplying base capital with each partner's profit sharing ratio, we can get

relative capital of each partner.

(3) Calculate surplus capital by following method :

Adjusted capita] - Relative capital of a partner = Surplus capital

(4) Divide surplus capital by profit sharing ratio of each partner. The smallest figure should be treated as Revised Base Capital.

(5) Find out relative capital by multiplication of Revised Base Capital with profit sharing ratio.

(6) Find out absolute surplus capital] by deducting revised based capital from surplus capital.

#### ❖ **Maximum Loss Method**

In Maximum Loss Method, it is assumed that the amount of installment which is available for distribution among partners is the last installment and nothing more could be realized further. On this assumption, maximum possible loss is determined as under:

➤ Step one

Maximum Loss. = Total of capital of all partners - Amt. available for distribution

➤ Second step,

This maximum loss is divided among partners in their profit Sharing ratio.

➤ Third step

From Capital of partner, the amount of maximum loss of his share is deducted and the amount available after this deduction is to be given to the partner from the installment.

We shall understand this method with following example.

A and B are partners sharing profit and loss in ratio of 5 : 2 having capital of Rs. 50,000 and Rs. 15,000 respectively. Amt. of first installment received is Rs. 16,000.

Now the process for distribution of this Rs. 16,000 as per Maximum Loss Method will be as under:

Step - 1 Total Capital of A and B = 50,000 + 15,000 = 65,000.

**Step - 2 Determine** Maximum Loss= Total Capital - Amt. available

Rs. 65,000 – Rs. 16,000 = 49,000

**Step -3** Divide amt. of Maximum Loss to partners in their profit sharing ratio

A = 49,000 x 5/7= RS. 35,000 B = 49,000 x 2/7 =Rs. 14,000

**Step - 4** Now, subtract Maximum Loss from each partners Capital.

A Rs. 50,000 - 35,000 = Rs. 15,000 Rs. 16000 distributed

B Rs. 15,000 - 14,000 = Rs. 1,000among A and B

This procedure will be repeated at each installment.Sometimes, it happens that after subtraction of portion of MaximumLoss from partners' capital, the figure shows the debit balance or minus balance. This debit balance of a partner is transferred to remainingpartners in their profit sharing proportion.

## UNIT IV – Partnership Accounts II

### 5 Mark Questions

Q.No	Question	Level
1	What is dissolution of partnership?	K1
2	Define Realization Account.	K1
3	State Garner vs Murray rule.	K1
4	What is piecemeal distribution?	K1
5	What is Maximum Loss Method?	K2

### 8 Mark Questions

Q.No	Question	Level
1	Explain dissolution of partnership and settlement of accounts.	K2
2	Discuss Garner vs Murray theory with example.	K4
3	Explain accounting when one or more partners are insolvent.	K3
4	Describe piecemeal distribution under surplus capital method.	K3
5	Explain Maximum Loss Method in detail.	K4

## UNIT – 5

### ACCOUNTING STANDARDS FOR FINANCIAL REPORTING

#### **Introduction to financial statement**

Imagine a bustling boardroom packed with executives and stakeholders awaiting the release of the company's financial performance. The room falls silent as the CEO proceeds to present the financial statements.

A financial statement is like the GPS of an organization- one that provides you with a picture of its financial performance. The documents can reveal a company's true health and trajectory. They provide a comprehensive snapshot of an enterprise's financial activities and position.

In this exhaustive piece, we delve into the intricacies of financial statements, unraveling the language of numbers while unlocking the insights they offer.

#### **Financial statement - Meaning**

Search for financial statement meaning, and what it will lead you toward is-annual reports that provide a comprehensive summary of an organization's financial transactions and overall financial performance. Enterprises prepare these statements to clearly and accurately represent their financial activities to stakeholders, including investors, creditors, and regulators. The meaning of financial statements lies in their ability to communicate key financial information in a structured and standardized manner. An organization's financials include the balance sheet, income statement, cash flow statement, and statement of shareholders' equity.

- The balance sheet shows an enterprise's assets, liabilities, and shareholder's equity at a specific time, providing insight into its financial position.
- The income statement combines revenues, expenses, and net income or loss over a specific period, revealing the enterprise's profitability.

- The cash flow statement highlights the inflows and outflows of cash, demonstrating the liquidity and cash management of the enterprise.
- Lastly, the shareholders' equity statement shows equity changes, including contributions, distributions, and retained earnings.

### **Objectives of a financial statement**

Financial statements serve several essential objectives that contribute to the overall transparency, accountability, and usefulness of financial information. Most importantly, financial statements provide stakeholders with a clear and comprehensive view of an entity's financial performance, position, and cash flows. They communicate financial information to external users, enabling them to make informed decisions regarding investments, lending, or other business interactions.

Moreover, these financial documents are critical in fulfilling legal and regulatory requirements. They facilitate compliance with accounting standards and financial reporting frameworks.

Finally, they serve as a basis for evaluating the entity's financial health, assessing its profitability, solvency, and liquidity, and identifying trends or patterns that can inform future decision-making.

Overall, the main objectives of creating financial statements include:

1. Providing valuable insights about the financial position and performance of the company.
2. To facilitate better decision-making by external stakeholders, such as investors, creditors, or regulators.
3. Assessing the organization's ability to generate future cash flows.
4. Enhancing transparency and accountability in financial reporting.
5. Meeting legal and regulatory obligations.
6. To support benchmarking and comparison with industry peers.

7. To assist in the evaluation of management's performance and the entity's overall financial health.
8. Serving as a basis for planning, budgeting, and forecasting activities.
9. Providing a historical record of financial transactions for internal and external purposes.

### **Uses of Financial Statements**

#### **1. Bridging the Gap in Management**

Financial statements basically reflect a company's financial performances. They show profits and liabilities of the business. They show how successful a company's decisions have been. Since shareholders have access to these statements, they can gauge their company's performance. This further helps in bridging the gap between lapses in management and expectations of owners.

#### **2. Availing Credit from Lenders**

Every business needs to borrow funds for functioning. They have to rely on lenders like banks and financial institutions for this purpose. Financial statements play a huge role in this purpose. Since they show a company's liabilities, debts and profits, investors can use them to make informed decisions.

#### **3. Use for Investors**

Investors also extensively use a company's financial statements to assess its finances. That helps them figure out how the company's solvency will be in the longer term. Thus, the better a company's financial position is, the greater the investment it will receive.

#### **4. Use for Government**

Governmental policies pertaining to corporates depend heavily on financial statements. This is because these statements depict how companies are functioning in general. The government can use this information to decide taxation and regulatory policies.

## 5. Use for Stock Exchanges

Regulatory bodies like SEBI and stock exchanges like BSE and NSE also use financial statements for many reasons. SEBI can assess a company's internal matters using them to ensure the protection of investors. Even stock advisers require them to frame their quotes. They are also a great source of information for stock traders and investors.

## 6. Information on Investments

The shareholders of a company rely on these statements to understand how their investments are paying off. If a company is earning profits, they might decide to invest even more money. On the contrary, stagnant profits or even losses will prompt them to pull out. Despite all these uses of financial statements, there are some limitations to them as well.

### **Limitations of Financial Statements**

#### 1. Not a reflection of the present Financial Position

Firstly, financial statements do not show how well a company is performing in the present times. This is because they are made at the end of every financial year. Hence, they only depict performances of the previous twelve months. Even the value of assets and liabilities change as money's purchasing power fluctuates.

#### 2. Possibility of Bias

Financial statements might not always be an accurate representation of a company. This happens because they are based on several personal judgments, conventions and internal policies of accountants.

#### 3. The Absence of Vital Information

Accountants might skip a lot of vital information while making financial statements. For example, the nature of agreements signed by the company is important information, but it is never mentioned in annual statements.

#### 4. Lack of Qualitative Information

Although companies portray their numbers and finances in annual statements, a lot of qualitative data is skipped. Hence, details of the company's industrial relations, employees' productivity, etc. are generally missing from these statements.

#### 5. Lack of Details

Financial statements might state the total value of assets, but they do not disclose the nature of these assets. Similarly, a lot of minute details like these do not find mention.

### **Accounting standards meaning and Role**

Accounting standards are a set of principles, rules, and guidelines that govern the preparation and presentation of financial statements. They play a crucial role in the field of accounting by providing a framework for consistency, comparability, transparency, and reliability in financial reporting.

#### **1. Recognition of Financial Events:**

Accounting standards define criteria for recognizing and recording financial events, such as revenue, expenses, assets, and liabilities. For example, revenue recognition standards specify when revenue should be recognized based on the completion of performance obligations, while expense recognition standards dictate when expenses should be recorded based on matching principles (i.e., matching expenses to related revenues).

#### **2. Measurement of Financial Transactions:**

Accounting standards establish guidelines for measuring financial transactions to ensure consistency and comparability in financial reporting. This involves determining the monetary value of assets, liabilities, revenues, and expenses. Common measurement bases include historical cost, fair value, and present value.

#### **3. Presentation of Financial Statements in a Fair Manner:**

Accounting standards prescribe the format and presentation of financial statements to ensure they are prepared in a fair and transparent manner. Financial statements must provide relevant, reliable, and understandable information to users. Standards dictate the structure and content of financial statements, including the balance sheet, income statement, statement of cash flows, and statement of changes in equity.

#### **4. Disclosure Requirements:**

Accounting standards require companies to disclose relevant information in their financial statements to ensure stakeholders are not misinformed. Disclosure requirements include information about significant accounting policies, contingent liabilities, related party transactions, and other material disclosures. These disclosures enhance transparency and help users make informed decisions about the company's financial position and performance.

**5. Regulatory Bodies:** Accounting standards are typically established and enforced by regulatory bodies or standard-setting organizations, such as the Financial Accounting Standards Board (FASB) in the United States, the International Accounting Standards Board (IASB) globally, and other national standard-setting bodies in various countries.

**6. Convergence:** There has been a significant effort towards convergence of accounting standards globally to enhance comparability and consistency across different jurisdictions. Efforts like the convergence between the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) aim to streamline accounting practices worldwide.

**7. Updates and Amendments:** Accounting standards are subject to updates and amendments to address emerging issues, changes in business practices, and evolving regulatory requirements. Standard-setting bodies regularly issue new pronouncements and interpretations to ensure that accounting standards remain relevant and effective.

**8. Impact on Financial Reporting:** Compliance with accounting standards is essential for companies to accurately report their financial performance and position. Adhering to these standards

enhances the credibility of financial statements, builds investor confidence, and facilitates capital allocation decisions.

9. **Professional Judgment:** While accounting standards provide guidance, their application often requires professional judgment to interpret and apply them appropriately. Accountants and auditors play a crucial role in exercising professional judgment to ensure compliance with accounting standards while reflecting the economic substance of transactions.

10. **Enforcement and Oversight:** Regulatory bodies and professional organizations enforce compliance with accounting standards through various mechanisms, including audits, inspections, and penalties for non-compliance. Effective enforcement and oversight are essential to maintaining the integrity and reliability of financial reporting.

### **Development of Accounting Standards in India**

The development of accounting standards in India can be traced back to the Institute of Chartered Accountants of India (ICAI), which is the premier accounting body in the country. The ICAI established the Accounting Standards Board (ASB) on April 21, 1977, with the aim of harmonizing the diverse accounting policies and practices prevalent in India .

The Indian Accounting Standards (Ind AS) were formulated by the ASB, taking into consideration the Indian economic and legal environment, as well as the need to converge with International Financial Reporting Standards (IFRS) . The process of migrating towards IFRS was initiated by the ICAI to increase the acceptability and transparency of the financial statements of Indian corporates on the global platform and among competitors .

The Ind AS are named and numbered in the same way as the IFRS, and they are recommended by the National Financial Reporting Authority (NFRA) to the Ministry of Corporate Affairs (MCA) . The MCA then spells out the accounting standards applicable to companies in India .

The development of Indian Accounting Standards was driven by the growing need for global accounting standards and the recognition by the ICAI and the Government of India that the

International Financial Reporting Standards (IFRS) could not be accepted and adopted as they are. This led to the formulation of Indian Accounting Standards or Indian AS .

### **Significance and Applicability of Indian Accounting Standards**

The Indian Accounting Standards (Ind AS) have significant importance in the Indian business and financial reporting landscape. They aim to enhance the transparency, comparability, and reliability of financial statements, thereby facilitating better decision-making by stakeholders .

The Ind AS are applicable to certain classes of companies in India, as specified by the Ministry of Corporate Affairs (MCA). As of now, the MCA has notified 40 Ind AS .

### **Phases of Adoption of Indian Accounting Standards**

The adoption of Indian Accounting Standards (Ind AS) in India has been carried out in phases. The process started with the issuance of Ind AS on February 16, 2015, by the Ministry of Corporate Affairs. This was followed by the migration of companies to Ind AS from the previously used Accounting Standards (AS) that were not in line with the globally applicable standards and principles (IFRS) .

The phased adoption of Ind AS aimed to ensure a smooth transition for companies and to align with the convergence process towards IFRS. The migration to Ind AS was done based on certain criteria, such as the net worth and listing status of the companies .

The development of accounting standards in India has been driven by the need for global standards and the recognition of the importance of convergence with International Financial Reporting Standards (IFRS). The Institute of Chartered Accountants of India (ICAI) formulated the Indian Accounting Standards (Ind AS) through the Accounting Standards Board (ASB). The Ind AS aim to enhance transparency and comparability in financial reporting and have been adopted in phases by companies in India.

## **Role of International Financial Reporting Standards (IFRS)**

International Financial Reporting Standards (IFRS) play a significant role in the field of accounting and financial reporting. Here are some key aspects of the role of IFRS:

### **1. Global Standardization:**

International Financial Reporting Standards (IFRS) represent a concerted effort to standardize financial reporting practices globally, aiming to ensure consistency, reliability, and comparability across the financial statements of companies operating in different countries. By establishing a common set of accounting principles, practices, and language, IFRS enables stakeholders to better understand and analyze financial information. Its objectives include promoting consistency in financial reporting methodologies, enhancing the reliability of financial statements through rigorous guidelines, and facilitating meaningful comparisons between entities and periods. IFRS encompasses fundamental accounting principles, specific practices, and a standardized language, all geared towards fostering transparency, improving decision-making processes, and facilitating global integration in the financial markets. Adherence to IFRS principles benefits companies, investors, regulators, and other stakeholders by instilling trust, accountability, and efficiency in financial reporting and analysis, ultimately contributing to the stability and transparency of the global financial system.

### **2. Harmonization and Convergence:**

Harmonization and convergence are key principles that underpin the International Financial Reporting Standards (IFRS), driving global consistency and comparability in financial reporting. IFRS actively encourages countries to adopt and align their accounting standards with its framework, fostering harmonization across jurisdictions. By promoting the convergence of accounting standards, IFRS seeks to minimize discrepancies and variations in financial reporting practices among different countries. This alignment facilitates international comparability of financial statements, enabling investors, creditors, and other

stakeholders to make informed decisions regardless of the geographical location of the reporting entity. Furthermore, harmonization and convergence streamline regulatory compliance for multinational companies, reducing the complexity and cost associated with preparing financial statements for multiple jurisdictions. Overall, IFRS's emphasis on harmonization and convergence enhances transparency, promotes investor confidence, and facilitates efficient capital allocation in the global marketplace.

### **3. Transparency and Accountability:**

International Financial Reporting Standards (IFRS) play a crucial role in enhancing transparency and accountability within financial reporting frameworks globally. Through clear guidelines and principles, IFRS empowers companies to present their financial information in a transparent and understandable manner. This transparency ensures that stakeholders, including investors, creditors, regulators, and the general public, have access to accurate and reliable financial data. By adhering to IFRS standards, companies demonstrate a commitment to accountability, as they are required to provide comprehensive and consistent disclosures about their financial performance, risks, and key metrics. This transparency fosters trust among stakeholders and promotes confidence in the integrity of financial reporting processes. Moreover, by facilitating a more transparent environment, IFRS enables stakeholders to make well-informed decisions, ultimately contributing to market efficiency and stability. Overall, IFRS's emphasis on transparency and accountability helps to uphold the integrity of financial markets and promotes investor confidence in the reliability of financial information provided by companies worldwide.

### **4. Facilitating Investment and Capital Flows:**

IFRS serves as a catalyst for facilitating investment and capital flows on a global scale by fostering transparency, comparability, and confidence in financial reporting. When companies adopt IFRS, it aligns their financial reporting practices with internationally recognized standards, thereby enhancing the confidence of investors and lenders. The standardized framework enables stakeholders to easily analyze and compare financial statements across diverse jurisdictions, regardless of geographical boundaries or regulatory

differences. This increased transparency and comparability reduce information asymmetry, mitigating risks associated with cross-border investments and transactions. Furthermore, adherence to IFRS enhances the credibility and reliability of financial information, providing investors with greater assurance regarding the accuracy and integrity of reported data. As a result, IFRS plays a crucial role in attracting foreign investment by providing a common language for financial reporting and facilitating the efficient allocation of capital across global markets. By promoting consistency and confidence in financial reporting, IFRS contributes to the stability and growth of international investment and capital flows, ultimately driving economic development and prosperity on a global scale.

#### **5. Global Recognition and Acceptance:**

The widespread recognition and acceptance of International Financial Reporting Standards (IFRS) across numerous jurisdictions worldwide underscore its importance in facilitating global business operations and cross-border transactions. With over 144 jurisdictions, including the influential European Union, adopting IFRS as their accounting standards, companies benefit from a unified framework that enhances transparency, comparability, and trust in financial reporting. This global acceptance of IFRS streamlines compliance efforts for multinational corporations, eliminating the need to navigate diverse accounting standards and regulatory requirements in different countries. As a result, companies can operate more efficiently across multiple jurisdictions, reducing complexities and costs associated with regulatory compliance. Furthermore, the harmonization of accounting standards under IFRS fosters investor confidence and facilitates cross-border investment by providing consistent and reliable financial information. Overall, the broad recognition and acceptance of IFRS contribute to a more interconnected global economy, enabling companies to capitalize on international opportunities and drive economic growth.

#### **6. Standard Setting and Development:**

The International Accounting Standards Board (IASB) serves as the principal body responsible for the development and maintenance of International Financial Reporting Standards (IFRS). Alongside the IFRS Foundation, the IASB is committed to setting high-

quality global accounting standards that uphold principles of transparency, accountability, and efficiency in financial markets. Through rigorous research, consultation with stakeholders, and deliberation, the IASB formulates and updates IFRS to reflect evolving business practices, economic realities, and regulatory requirements worldwide. The overarching goal is to ensure that financial reporting standards facilitate accurate and reliable communication of financial information, enabling investors, creditors, and other stakeholders to make informed decisions. By setting globally recognized and accepted accounting standards, the IASB and the IFRS Foundation play a vital role in promoting confidence, stability, and integrity in financial reporting on a global scale. Their efforts contribute to the harmonization of accounting practices, fostering transparency and trust in the functioning of international financial markets.

## **7. Financial Stability and Trust**

IFRS significantly contributes to financial stability and fosters trust within the global economy by providing consistent and reliable financial information. Through its standardized framework and principles, IFRS ensures that financial reporting is transparent, comparable, and trustworthy across jurisdictions. This consistency and reliability in financial reporting help to build confidence among investors, regulators, and other stakeholders, fostering a sense of trust in the integrity of financial markets. By enabling stakeholders to make well-informed decisions based on accurate and reliable information, IFRS supports the efficient allocation of capital and resources, thereby enhancing the overall stability of the financial system. Furthermore, the adoption of IFRS promotes international harmonization and convergence of accounting standards, reducing uncertainties and risks associated with cross-border transactions. Ultimately, the widespread acceptance and application of IFRS contribute to the establishment of a resilient and transparent financial ecosystem, which is essential for long-term economic growth and prosperity.

It is important to note that while IFRS is widely adopted globally, some countries, such as the United States, still follow their own accounting standards, known as Generally Accepted Accounting Principles (GAAP). However, there is on-going discussion and consideration of convergence between GAAP and IFRS in the future .

Overall, the role of IFRS is to establish a common framework for financial reporting, promote transparency and comparability, facilitate global investment and capital flows, and contribute to the stability and trust in the global economy.

### **IFRS Adoption vs Convergence implementation plan in India**

#### **Benefits of Convergence of Indian Accounting Standards with IFRS**

The convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS) offers several benefits for the Indian economy, corporate world, investors, accounting professionals, and regulators. Here are the key benefits highlighted in the provided information:

1. **Economic Growth:** The convergence of Indian accounting standards with IFRS is expected to benefit the economy by boosting international trade, creating an environment for efficient capital markets, increasing capital formation, attracting more foreign investments, and contributing to overall economic growth.
2. **Beneficial for the Corporate World:** Financial statements prepared according to international standards provide transparency and comparability, building trust among shareholders and enhancing the image of Indian business entities in the international financial community. This can help Indian companies raise funds from the international market at a lower cost of capital.
3. **Beneficial for Investors:** Convergence with IFRS will result in financial statements being prepared using a common set of language, making it easier for investors to evaluate and

compare financial statements. This saves time, money, and energy, enabling confident comparison of investment opportunities.

4. **New Opportunities for Accounting Professionals:** The adoption of IFRS will create more job opportunities for accounting professionals in India and globally, as the same accounting methods will be followed worldwide, allowing them to sell their expertise in India and the rest of the world.
5. **Helpful for Regulators:** IFRS adoption will simplify financial reporting, making it less complex and reducing costs. This will enable regulators and other interested parties to better understand financial reporting.

#### **Challenges/Costs Associated with the Adoption of IFRS**

Alongside the benefits, there are several challenges and costs associated with the adoption and convergence of IFRS in India:

1. **Need for Regulatory Amendments:** The transition to IFRS requires necessary amendments to the existing regulatory framework governing financial accounting and reporting in India. Differences between IFRS and Indian standards need to be addressed through regulatory changes.
2. **Lack of Skilled and Trained Resources:** Successful implementation of IFRS in India requires a thorough understanding of IFRS, and there is a shortage of adequately trained professionals to accomplish the adoption process.
3. **Complexity in the Financial Reporting Process:** IFRS adoption can introduce greater complexity in the financial reporting process, particularly due to the principle-based accounting regime and fair value measures, requiring training for users, accounting professionals, and auditors.

4. **Burden for SMEs and Accounting Professionals:** Small and medium enterprises (SMEs) in India may face a burden of significant costs due to the implementation of IFRS, with the benefits not necessarily proportionate to the costs incurred.
5. **Level of Awareness:** Effective coordination and communication are required to raise awareness about the potential impact of the conversion to IFRS, both at the country and entity levels.
6. **Taxation:** Convergence with IFRS may lead to changes in tax liability, posing challenges for tax authorities and preparers of financial statements.
7. **Costly Exercise and Scarcity of Resources:** The transition to IFRS may require significant investments in infrastructure, including the implementation of new IT systems, and may lead to additional related costs.

### **IFRS Adoption vs. IFRS Convergence**

IFRS Adoption refers to the application of full IFRS issued by the International Accounting Standards Board (IASB) in a country or jurisdiction, with 100% compliance with the IASB guidelines. It signifies a continuous commitment by the jurisdiction to contribute to the development of IFRS in the future. Examples of countries that have adopted IFRS in its purest form include Israel and South Africa, where regulations require companies to use IFRS as issued by the IASB, regardless of any modifications or amendments made at the time.

On the other hand, IFRS Convergence involves the application of a modified comparative version of IFRS within a country. The country's Accounting Standard Board (ASB) develops high-quality compatible standards that meet the specific conditions of the country while being based on the principles of IFRS. The ASB takes the output of the IASB and makes various amendments, such as giving it a national name (e.g., Ind AS), making textual changes, deferring effective dates, and

deleting certain options. This approach allows for some customization to suit local requirements while maintaining alignment with IFRS principles.

Most professionals, including the IASB, advocate for IFRS adoption as the way to achieve a global common reporting language. Convergence is seen as a preparatory step towards IFRS adoption, but it is not considered a substitute. Convergence alone cannot eliminate all the differences between national standards and achieve uniformity. The IASB emphasizes that convergence is a means to achieve the adoption of IFRS, and a complete adoption is necessary for a country to fully benefit from the global advantages of IFRS in financial reporting.

## **Ind AS**

### **INTRODUCTION**

The Indian Accounting Standard (Ind-AS) is the accounting standard adopted by companies in India and is issued under the supervision and control of the Accounting Standards Board (ASB), which was established as a body in the year 1977. The ASB operates as a committee under the Institute of Chartered Accountants of India (ICAI) and includes representatives from various entities such as government departments, academicians, and other professional bodies like ICAI, ASSOCHAM, CII, FICCI, among others.

The Ind-AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS). These standards are recommended by the National Advisory Committee on Accounting Standards (NACAS) to the Ministry of Corporate Affairs (MCA). The MCA is responsible for specifying the accounting standards applicable to companies in India. As of the present date, MCA has notified 39 Ind-AS, which were applied to companies voluntarily for the financial year 2015-16 and became mandatory from the financial year 2016-17.

The formulation of Ind-AS was a response to the need for Indian accounting standards to be aligned with globally accepted standards, such as the IFRS. The ASB was established to harmonize diverse accounting policies and practices, and the Companies Act mandates that the balance sheets

and income statements of all companies comply with the accounting standards. The transition to Ind-AS was a compromise formula aimed at harmonizing Indian accounting rules with the IFRS.

The adoption of Ind-AS is significant as it aims to boost transparency and increase the acceptability of financial statements of Indian companies worldwide. These standards are formulated keeping the Indian economic and legal environment in view and with the objective of convergence with IFRS standards, as issued by and copyrighted by the IFRS Foundation.

The transition to Ind-AS has not been without challenges. It has necessitated regulatory amendments, required skilled and trained resources, introduced complexity in the financial reporting process, and posed a burden for SMEs and accounting professionals. Additionally, raising awareness about the potential impact of the conversion and addressing taxation-related changes have been identified as challenges associated with the adoption of Ind-AS.

#### **DIFFERENCE BETWEEN IFRS AND IND AS**

<b>IFRS</b>	<b>IND AS</b>
<b>Definition</b>	
IFRS stands for International Financial Reporting Standards, it is an internationally recognised accounting standard	IND AS stands for Indian Accounting Standards, it is also known as India specific version of IFRS
<b>Developed by</b>	
IASB (International Accounting Standards Board)	MCA (Ministry of Corporate Affairs)
<b>Followed by</b>	
144 countries across the world	Followed only in India
<b>Disclosure</b>	
Companies complying with IFRS have to disclose as a note that the financial statements comply with IFRS	Such a disclosure is not mandatory for companies complying with Indian Accounting Standards or IND AS

### **Financial Statement Components**

It includes the following

1. Statement of financial position
2. Statement of profit and loss
3. Statement of changes in equity for the period
4. Statement of cash flows for the period

It includes the following:

1. Balance Sheet
2. Profit and loss account
3. Cash flow statement
4. Statement of changes in equity
5. Notes to financial statements
6. Disclosure of accounting policies

### **Balance Sheet Format**

Companies complying with IFRS need have specific guidelines for preparing balance sheet with assets and liabilities to be classified as current and non-current

Companies complying with IND AS need have no such requirements for balance sheet format, but the guidelines are defined for presenting balance sheet

## **UNIT V – Accounting Standards for Financial Reporting**

### **5 Mark Questions**

<b>Q.No</b>	<b>Question</b>	<b>Level</b>
1	What are accounting standards?	K1
2	State the objectives of financial statements.	K1
3	What is IFRS?	K1
4	Define Ind AS.	K1
5	Distinguish between adoption and convergence.	K2

### **8 Mark Questions**

<b>Q.No</b>	<b>Question</b>	<b>Level</b>
1	Explain the role and importance of accounting standards.	K2
2	Discuss development of accounting standards in India.	K2
3	Explain IFRS adoption vs convergence.	K4
4	Describe the implementation of Ind AS in India.	K2
5	Distinguish between Ind AS and IFRS.	K4

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