S 217

DIRECTORATE OF DISTANCE EDUCATION

C
O
M
M
E
R
C
E

M.COM

SECOND YEAR

ADVANCED ACCOUNTING

VOLUME-1

LESSONS: 1-5

Madurai Kamaraj University

Madurai – 625 021

Dear Student

It gives us immense pleasure in welcoming you to the first year M.Com, Degree course through correspondence. While extending our warm welcome we also take this opportunity to wish you a bright academic year. You are expected to take the University examination in all the four papers.

1. Advanced Accounting
2. Financial Management
3. Advanced cost Accounting
4. Investment Management

Each paper carries 100 marks with 3 hour duration for each examination.

Teaching Accountancy through correspondence is not so easy particularly at post graduate level. Though we try to elucidate the principles involved in different chapters with carefully selected illustrations, mere reading of these problems alone will not help you. Accountancy is a subject which requires constant practice. Moreover, as you are going to face the post graduate examination a sound and deep knowledge of the subject matter is normally expected. As such you are directed to work out as many advanced problems as possible on each and every chapter falling under the syllabus. Constant exercise alone will give you courage and confidence to face the University examination. We agree that the time at your disposal is very short. But it is up to you to provide it substantial part of the day towards your study to have a regular systematic preparation. Only sheer hard working during this academic year is going to fetch you a bright and prosperous future, the fruits of which you are going to enjoy throughout your life.

In this lesson we have provided you with the syllabus, list of reference books, list of lessons that you will get in accountancy.

Yours Sincerely,

Staff

SYLLABUS

(Group –A)

2.1. Advanced Accounting

Unit 1: Partnership accounts- Accounting problems related to admission, retirement and death of partner-dissolution and amalgamation of firms-sale to a company.

Unit2: Accounts relating to Hire purchase and installment systems and Royalties

Unit 3: Insolvency accounting (Firms and individuals)

Unit 4: Accounts of joint stock companies- shares, Debentures- Final accounts- Valuation of goodwill and shares – pre-Incorporation and post – Incorporation of profit – Amalgamation, Absorption and Reconstruction (Both Internal and External)

Unit- 5: Liquidation

Unit – 6: Holding Companies

Unit- 7: Accounting for Banking Companies

Unit- 8: Accounts for Insurance Companies

Unit 9: Accounts of Electricity companies including Double Account system.

Unit 10: Accounting for price –Level changes – Human Resources Accounting – Accounting for Lease – Social Accounting.

Books for Reference

1. Sukla M.C and Grewal T.S : Advanced Accounts
2. Gupta R.L. : Advanced Accountancy
3. William Pickles : Accountancy
4. Agarwala A.N. : Higher Science of Accountancy
5. Rup Ram Gupta : Advanced Accounting

Note: Distribution of marks between theory and problem in the ration of 40:60 respectively.

(M.COM, II YEAR)

ADVANCED ACCOUNTING

LIST OF LESSONS

LESSON-1

ACCOUNTS OF PARTNERSHIP FIRMS

1.1 INTROUCTION

A business can be carried on by a person individually or two or more persons collectively. In the first case, the business organization is called Sole trader business. In the second case, it is either termed as a Partnership or a Company or a Co-operative Society. A Sole trader has his own limitations of finance, risk bearing capacity etc., a man with intelligence and capacity cannot do much without capital, and a man with capital without capacity is equally unsuccessful. Hence he may like to join hands with another person to expand his activities. In such a case he will be entering into a partnership with such person.

A partnership of the two will be ideal combination. They divide their work to each other's advantage and earn higher profits.

1.2 GENERAL PRINCIPLES OF PARTNERSHIP ACCOUNTS

Definition: The Indian Partnership Act 1932, Section 4, defines Partnership as "the relations between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

Therefore, the essential or features of a Partnership are:

1) Existence of relationship between two or more persons
2) Agreement between such persons / partners.
3) Agreement to share profits of a business
4) A partner is not entitled to any salary for taking Firm's Business.
5) A partner is entitled to interest on advances at the rate of 6% p.a.

NOTES

Meaning of partnership

Contracts between two or more persons who agree to pool talent and money and share profits or losses are called as partnership.

Definition of partnership:

"The relations between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

NOTES

What is capital account?

An account of the net value of a business at a specified date which is called as capital account.

6) Every partner being joint owner of partnership is entitled to have equal share Capital in the property.

1.3 Partnership Capital Accounts;

Partnership accounts do not represent much difficulty unless there is an admission, retirement, death or dissolution. So, the transactions relative to the partners are recorded in their respective capital accounts.

Capital accounts: The partner will bring different amounts of capital and each partner will have a separate capital account. These are two methods of maintaining capital accounts of partners (i) fluctuating capital method (ii) fixed capital method.

1.3.1 Fixed Capital method

Generally, the respective capital to be brought in by the partners is laid down in the Partnership Agreement. Therefore, it is desirable to maintain the capitals at the same figure throughout the time of partnership. As such the capital is fixed.

1.3.2 Fluctuating Capital method

Drawings, Profits, interest, salary etc., are passed through Current Accounts. If the above items passed through the capital accounts, the respective capitals will continue to fluctuate.

1.4 Distribution of Profit & Losses

1.4.1 Interest on Capitals

In Law no partner is entitled to the interest on capitals unless there is an agreement among the partners. If the Partnership Agreement is silent on this point no interest on capital can be allowed. Interest on capital is generally allowed on capital so that the partner who contributes more than the proportionate capital is properly compensated for this. However, it may not be allowed in cases were partners share profits and losses proportion to their capital contributions. It is desirable that interest be allowed on partners' capitals as it would have been earned if an investment was made elsewhere. This practice enables the profits to be viewed in proper perspective.

It serves to compensate the partners with larger capital contributions, where profits are shared equally or where capitals are equal but profits are shared in unequal proportions.

The students must bear in mind that interest on capital should always be calculated at a given percent from a given period either on the original amount of capital contributed or on the opening balance of capital accounts.

Interest on Capital is a loss or expense to the firm and thus debited to interest on Capital Account and ultimately transferred to Profit and Loss Account. While on the other hand, it is an income or gain to the partners and thus their Current Accounts (or Capital Accounts) are to be credited with the respective amounts of interest on their capitals.

Journal Entry

For the contribution of capital

	Rs.	Rs.
* Cash a/c Dr.		
To Partner's Capital A/c		
(Being the capital received from .... by)		

NOTES

Example

A, B and C enter into a partnership sharing profits and as 4:2:2 and 'A' was already in business and he brings in Rs.20,000 Cash, Rs.1,00,000 worth of Machinery and Rs.10,000 worth of Furniture. B contributes Rs.70, 000 capitals in cash, C is a technical person and he does not contribute any capital. Pass necessary Entries.

Answer

Date	Particulars			Dr.	Cr.
				Rs.	Rs.
	Cash A/c	Dr.		20,000	
	Machinery A/c	Dr.		1,00,000	
	Furniture A/c	Dr.		10,000	
	To A's Capital A/c				1,30,000
	(being the capital received from 'A' by way of different assets)				
	Cash A/c or Bank A/c	Dr.		70,000	
	To B's Capital A/c				70,000
	(being the capital received from 'B' by way of cash)				

NOTES

Journal Entry

1) If the Capital is fluctuating

	Rs.
Interest on Capital A/c Dr.	
To Partner's Capital A/c	
(Being the interest on capital allowed)	

2) If the Capital is fixed:

	Rs.
Interest on Capital A/c Dr.	
To Partner's Current A/c	
(Being the interest on capital allowed)	

N.B. : Interest on capital is an expense or loss of the firm and ultimately transferred to the Profit & Loss A/c.

1.4.2 Partners' Drawings

The Partnership Deed may allow the partners to withdraw money or goods from the business for their domestic purpose. In many places, it is customary for the partners, to be permitted to withdraw sums at fixed or irregular intervals. Usually, a maximum amount as per annum for each partner is fixed by the Deed. For this, either the Partner's Capital Account or an account named as Drawings Account should be debited. When the Drawings Account is debited at the end of the accounting period this account will be transferred to the Capital Account so that net figure will be available.

NOTES

But if the Capital is kept as fixed, the Drawings Account may be called as Current Account. Current Account won't be transferred to fixed Capital Account.

Interest on Drawings

Interest on Drawings also depends upon the Partnership Deed in many cases, whereas, the capitals bear interest the drawings are not chargeable with such interest. The students would do well never to calculate interest on drawings whole working on a problem unless they have been asked specially to do so.

Interest on Drawings should be calculated from the date of the amount withdrawn up to the end of the accounting period. Sometimes the students may be asked to calculate interest on drawings on an average day for 6 months and so on.

1.4.3 Salary to Partners

Sometimes, one of the partners may fully devote his time to the working of the business. In such case he may be allowed an additional benefit in the name of salary to honor his service. Of course, this should be agreed by all the partners. To record this fact, Salary Account should be debited and Capital Account or Current A/c (if any should be credited).

What is commission?

A fee for services rendered based on a percentage of an amount received, collected or agreed to be paid

Commission to Partners

Sometimes, a percentage of profit is paid to a partner for a special service by way of commission. The Commission may be payable

a) Before charging such commission.

b) After charging such commission.

Suppose, A is to get 10% commission on net profit before charging any commission is B is to get 10% commission after charging commission of both A and B. Let it be further assumed that the net profit is Rs.11, 000/-.

A's Commission works out to Rs.11, 000 x $\frac{10}{100}$

= Rs.1, 100

B's Commission is calculated as follows:

		Rs.
Net Profit	=	11,000
Less: A's commission	=	1,100

		9,900

B's Commission Rs. 9,900 x $\frac{10}{110}$ = 900

Final Profit = Rs.9, 900 - 900 = Rs.9, 000

To record this effect.

Commission account should be debited and Partner's Capital or Current Accounts should be credited.

1.4.4 Loan by Partner

A Partner may give loan to the firm in addition to his share of capital. According to the Act this loan will carry 6% interest unless otherwise stated in the deed. If all the partners have agreed more than or less than 6% interest can be provided for the loan at that rate. But we must calculate only at the rate of 6% if no rate of interest for loan is given in the problem. When a partner makes a loan to the firm a separate Loan Account (distinct from Capital A/c) should be opened for him and it will be credited. The loan account together with interest is to be balanced at the end of the accounting period and show as a separate item on the Balance Sheet Liabilities side until it is paid off.

Sharing of Profits and Losses

At what proportion the profits and losses should be shared depends on the agreement made by the partners. They can formulate any such proportion with mutual consent. But if there is no agreement on this issue, it is deemed that the profits and losses are share equally among the partners.

Where the proportion to share the profits is stated in the agreement and there is no mention about the proportion by which losses should be shared, we must assume that the losses also should be shared, we must assume that the losses also should be shared in the same proportion. At the same time, the partners have right to share profits and losses in different ratios. The partners with mutual consent can even exempt a partner from bearing losses.

Before arriving the divisible profit, certain expenses like Partner's Salary, Partner's Commission, Interest on Capital, Interest on Partner's Loan etc., are

NOTES

charged and certain allocation to different funds are made according to the terms contained in the Partnership Deed.

Illustration: 1 (Fixed and Fluctuating Capital Account)

On 1st January 2008 Anand and Arun commenced a business by contributing Rs.30,000 and Rs.20,000 respectively and sharing profits equally, interest on capital is to be allowed at 5% p.a. Their drawings during the year amounted to Rs.3, 000 and Rs.2, 000 respectively. Arun is entitled to get salary of Rs.500 per month. The profits of the firm before calculating interest on capital are Rs.15, 000. Show the capital accounts (a) if they are fluctuating and (b) if they are fixed.

Hints

	Rs.
Profit before the adjustment	15,000
Less: Salary to Arun Rs.500 x 12	6,000
	9,000

Less: Interest on Capital Rs.

'Anand' – 30,000 x $\frac{5}{100}$ = 1,500

'Arun' – 20,000 x $\frac{5}{100}$ = 1,000

2,500

6,500

NOTES

Profit after adjustment distributed among the partner equally

	Rs.
Anand	3,250
Arun	3,250

Solution

a) Fluctuating Capital

Anand Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	3,000	2008 Jan 1	By Bank A/c	30,000
	To Balance c/d	31,750	Dec 31	By Interest on Capital A/c	1,500
				By P & L A/c (1/2 share of profit)	3,250
		34,750			34,750
			2009 Jan 1	By Balance b/d	31,750

NOTES

Arun Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	2,000	2008 Jan 1	By Bank A/c	30,000
	To Balance c/d	28,250	Dec 31	By Interest on Capital A/c	1,000
				By Salary A/c	6,000
				By P & L A/c (1/2 share of profit)	3,250
		30,250			30,250
			2009 Jan 1	By Balance b/d	28,250

b) Fixed Capital

Anand Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Balance c/d	30,000	2008 Jan 1	By Bank A/c	30,000
		30,000			30,000
			2009 Jan 1	By Balance b/d	30,000

NOTES

Arun Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Balance b/d	20,000	2008 Jan 1	By Bank A/c	20,000
		20,000			20,000
			2009 Jan 1	By Balance b/d	20,000

Anand Current A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	3,000	2008 Dec 31	By Interest on Capital A/c	1,500
	To Balance c/d	1,750		By P & L A/c (1/2 share of profit)	3,250
		4,750			4,750
			2009 Jan 1	By Balance b/d	1,750

NOTES

Arun Current A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	2,000	2008 Dec 31	By Interest on Capital A/c	1,000
	To Balance c/d	8,250		By Salary A/c	6,000
				By P & L A/c (1/2 share of profit)	3,250
		10,250			10,250
			2009 Jan 1	By Balance b/d	8,250

NOTES

Illustration: 2

'Rajesh' is a partner in a firm and his capital on 1st January 2009 is Rs.20,000. On 1st July he introduced a further capital Rs.4,000. During the year he had withdrawn Rs.500 at the end of each month. Interest on capital is to be allowed at 5% and 4% interest is to be charged on drawings. Calculate interest on capital and interest on drawings to 31st December 2009.

Hints

1. Interest on capital can be calculated easily.

2. To calculate interest on Drawings by means of Product Method take the following steps.

a) Calculate the number of days or months from the date on which drawings are made to the closing date of the year.

b) Multiply the amount with the number of days or months. Calculate in each case separately.

c) Add up the products.

Interest can be calculated on the total of the products for one day or for one month, as the case may be, at the given rate.

Alternatively, the interest is calculated on the total amount withdrawn at the given rate from the average due date to the closing date of the year.

NOTES

Solution

1. **Interest on Capital**

	Rs.
Interest on Rs. 20,000 for one year	1,000
$\frac{5}{100} \times 20{,}000$	
Interest on Rs. 4,000 for 6 months	
Interest on Rs. 20,000 for one year	100
$\frac{5}{100} \times 4{,}000 \times \frac{6}{12}$	
Total	1,100

2. **Interest on Drawings**

	Rs.
500 drawn on 31st Jan stands for 11 months; Product is	5,500
500 drawn on 28th Feb stands for 10 months; Product is	5,000
500 drawn on 31st March stands for 9 months; Product is	4,500
500 drawn on 30th Apr stands for 8 months; Product is	4,000
500 drawn on 31st May stands for 7 months; Product is	3,500
500 drawn on 30th Jun stands for 6 months; Product is	3,000
500 drawn on 31st July stands for 5 months; Product is	2,500
500 drawn on 31st Aug stands for 4 months; Product is	2,000
500 drawn on 30th Sep stands for 3 months; Product is	1,500
500 drawn on 31st Oct stands for 2 months; Product is	1,000
500 drawn on 30th Nov stands for 1 months; Product is	500
500 drawn on 31st Dec stands for 0 months; Product is	-
6,000 *Total Products*	33,000

Hence, interest on drawings should be calculated on 33,000 @ 4% for one month

NOTES

$$= \frac{4}{100} \quad x \quad 33{,}000 \quad x \quad \frac{1}{12} \quad = \quad Rs.110$$

Alternatively interest can be calculated on the whole amount for the average of the total months

$$= \frac{11+10+9+8+7+6+5+4+3+2+1+0}{12}$$

$$= \frac{6}{12} = 5\tfrac{1}{2} \text{ months}$$

Hence, interest should be calculated on the whole amount of Rs. 6,000 for 5½

months @4% =

$$\frac{4}{100} \quad x \quad \frac{6000}{12} \quad x \quad \frac{11}{2} \quad = \quad Rs.110$$

This amount agrees with the calculation made by the Product Method.

Illustration: 3 Dinesh and Goutham are partners sharing profits in the ratio of 2: 1 with Capitals of Rs. 20,000 and Rs. 20,000 respectively, interest on capital is to be allowed at 6% p.a. and 5% p.a. is to be charged on drawings. During the year 2008, Dinesh and Goutham draw each Rs. 2,000 for their personal use. Goutham is given a salary of Rs. 1,000 for the year which he has not withdrawn. Profit for the year before the above mentioned adjustment is Rs. 8,000. Show the partner's capital accounts.

NOTES

Hints

			Rs.
Profit before the adjustments			8,000
Add: Interest on drawings			
Dinesh - 2,000 x 5/100		100	
Goutham - 2,000 x 5/100		100	
			8,200
Less: Salary to Goutham		1,900	
Interest on Capital:			
Dinesh– 20,000 x 6/100 = 1,200			
Goutham – 10,000 x 6/100 = 600		1,800	3,700
			4,500

Profit after the adjustments distributed among the Partners:

Dinesh 2/3 of 4,500 = 3,000

Goutham 1/3 of 4,500 = 1,500

Solution

Dinesh Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	2,000	2008 Jan 1	By Balance b/d	20,000
	To Interest on Drawings A/c	100	Dec 31	By Interest on Capital	1,200
	To Balance c/d	22,100		By P & L A/c (share of Profit)	3,000
		24,200			24,200
			2009 Jan 1	By Balance c/d	22,100

Goutham Capital A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	2,000	2008 Jan 1	By Balance b/d	10,000
	To Interest on Drawings A/c	100	Dec 31	By Interest on Capital	600
	To Balance c/d	11,900		By Salary	1,900
				By P & L A/c (share of Profit)	1,500
		14,000			14,000
			2009 Jan 1	By Balance c/d	11,900

Illustration: 4

Karthick and Ramesh were partners in a firm sharing profits in the ratio of 3 : 2. Profit for the year 2008 Rs.8, 000 was divided between the partners in the agreed ratio but interest on capital at 5% and drawings at 6% was inadvertently ignored. Without deducting their drawings (Karthick – Rs.4,000 and Ramesh Rs.2,000) but including their share of profit partners' capital accounts stood at Karthick – Rs.30,000 worth of assets. Interest on drawings may be calculated on an average basis for months. Show the Profit and Loss Adjustment A/c and adjust by means of Journal Entry. Also draw the Balance Sheet as at 31st December 2008.

NOTES

Solution: Interest on Capital

Karthick

	Rs.
Capital on 31-12-08	30,000
Less: Profit added (3/5 of Rs.8, 000)	4,800
	---------
* Capital on 01-01-08	25,200

Interest at 5% $\frac{5}{100} \times 25,200$ Rs. 1,260

Ramesh

	Rs.
Capital on 31-12-08	10,000
Less: Profit added (2/5 of Rs.8,000)	3,200

Capital on 01-01-08	6,800

Interest at 5% $\frac{5}{100} \times 6,800$ Rs. 340

NOTES

* Remember the interest on capital should be calculated only on the opening balance of capital. That is why the loaded profit is deducted.

*** Interest on Drawings**

1. Interest on Karthick's drawings for 6 months as 6% p.a.

$$= \frac{6}{100} \times \frac{6}{12} \times 4{,}000 = \text{Rs. } 120$$

2. Interest on Ramesh's drawings

$$= \frac{6}{100} \times \frac{6}{12} \times 2{,}000 = \text{Rs. } 60$$

Profit and Loss Adjustment A/c

Dr. Cr.

	Rs.	Rs.		Rs.	Rs.
To Interest on Capital			By Net Profit		8,000
Karthick	1,260		By Interest on Drawings		
Ramesh	340	1,600		Rs.	
			Karthick	120	
To Profit distributed :			Ramesh	60	180
Karthick (3/5)	3,948				
Ramesh (2/5)	2,632	6,580			
		8,180			8,180

NOTES

Statement to find out the Partner's Capital after adjustment

Details	Karthick	Ramesh
	Rs.	Rs.
Capital on 01-01-2008	25,200	6,800
Add : Profit	3,948	2,632
Interest on Capital	1,260	340
	30,408	9,772
Less : Interest on Drawings	120	60
Capital on 31-12-08 after adjustment	30,288	9,712

Before making these adjustments Karthick's and Ramesh's Capital accounts showed a balance of Rs.30,000 and Rs.10,000 respectively. But now these balances are: Karthick Rs.30,288 and Ramesh Rs.9,712. By these adjustments Karthick's Capital A/c has increased by Rs.288 whereas Ramesh's Capital A/c has decreased by the same Rs.288. To give this effect in Partner's capital accounts, we have to pass the following journal entry.

In the problem it is given that interest on drawings can be calculated on an average basis for 6 months. So interest is calculated for 6 months.

NOTES

			Rs.	Rs.
2008				
Dec 31st	Ramesh's A/c	Dr.	288	
	To Karthick's A/c			288
	(Being the capital account readjusted)			

M/s. Karthick and Ramesh

Balance Sheet As at 31st Decemeber 2008

Liabilities		Rs.	Assets	Rs.
			Assets	34,000
Karthick's Capital	30,288			
Less : Drawings	4,000	26,288		

Ramesh's Capital	9,712			
Less : Drawings	2,000	7,712		
	---------	34,000		34,000

NOTES

Illustration: 5

Manisha, Suguna and Tiruveni were in partnership sharing profits in the ratio of 3 : 1 : 1 respectively, it being provided that in no year should Suguna's share be less than Rs.16,000. The profits for the year ended 31st December 2008 amounted to Rs. 64,000. Show the appropriation by means of a statement.

Solution

Statement showing the appropriation of profit

	Rs.
Profit of the year	64,000
Less: Suguna's guaranteed share of profit	16,000

	48,000
	---------

* This profit of Rs. 48,000 is distributed among Manisha and Tiruveni at the ratio of

Manisha: $\frac{3}{4} \times 48,000 = 36,000$

Tiruveni: $\frac{1}{4} \times 48,000 = 12,000$

NOTES

* As the S's share of 1/5 of Rs. 64,000 is less than the guaranteed share Rs. 16,000, the guaranteed amount is given to S. After deducting this amount from the profit the balance is divided among the partners M and T at their ratio 3: 1

M		S		T
3	:	1	:	1

Illustration: 6

A, B and C are partners, and their Capital Accounts showed the following balances on 1st Jan 2008

A	Rs. 20,000	B	Rs. 10,000	C	Rs. 20,000

On 1st January 2005, they had to the credit of their Current account:

A	Rs. 3,000	B	Rs. 1,000	C	Rs. 2,000

The Partnership agreement provides that the profits upto Rs. 10,000 are to be divided in the proportion of the capital invested by the partners. Any excess of profit is to be divided

A	30%	B	40%	C	30%

During the year A has drawn Rs. 4,000 B - Rs. 1,500 and C - Rs. 3,000. They are entitled on the interest on Capital at 5%. But no interest on drawings was charged. Profit before allowing such interest on Capital was Rs. 25,000. Give the Profit and Loss Account for the year ended 31st Dec. 2008 and Current Account of each partner on the same date.

	Rs.
Total Profit	25,000
Less: Interest on Capital (A 1,000, B -500, C-1,000)	2,500

	22,500

NOTES

First 10,000 rupees in the capital ratio of 2: 1: 2

			Rs.
A	-	$10,000 \times \frac{2}{5}$ =	4,000
B	-	$10,000 \times \frac{1}{5}$ =	2,000
C	-	$10,000 \times \frac{2}{5}$ =	4,000

Rest of the amount in the ratio of 3: 4: 3

			Rs.
A	-	$12,500 \times \frac{30}{100}$ =	3,750
B	-	$12,500 \times \frac{40}{100}$ =	5,000
C	-	$12,500 \times \frac{30}{100}$ =	3,750

NOTES

Solution: **Profit & Loss A/c**

Dr. Cr.

		Rs.		Rs.
To Interest on Capital A/c	Rs.		By Balance b/d	25,000
A	1,000			
B	500			
C	1,000	2,500		
To Profit transferred to current Accounts of :				
A : 10,000 x 2/5 =	4,000			
12,500 x 30/100 =	3,750	7,750		
B : 10,000 x 1/5 =	2,000			
12,500 x 40/100 =	5,000	7,000		
C : 10,000 x 2/5 =	4,000			
12,500 x 30/100 =	3,750	7,750		
		25,000		25,000

NOTES

A's Current A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	4,000	2008 Jan 1	By Balance b/d	3,000
	To Balance c/d	7,750	Dec 31	By Interest on Capital A/c	1,000
				By Profit & Loss A/c	7,750
		11,750			11,750
			2009 Jan 1	By Balance b/d	7,750

B's Current A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	1,500	2008 Jan 1	By Balance b/d	1,000
	To Balance c/d	7,000		By Interest on Capital A/c	500
				By Profit & Loss A/c	7,000
		8,500			8,500
			2009 Jan 1	By Balance b/d	7,000

NOTES

C's Current A/c

Dr. Cr.

		Rs.			Rs.
2008 Dec 31	To Drawings A/c	3,000	2008 Jan 1	By Balance b/d	2,000
	To Balance c/d	7,750	Dec 31	By Interest on Capital A/c	1,000
				By Profit & Loss A/c	7,750
		10,750			10,750
			2009 Jan 1	By Balance b/d	7,750

Illustration: 7

After the accounts of partnership have been prepared it is discovered that for the year 2008 following amounts of interest have been credited upon partner's capital accounts, although no provision is made for interest in the Partnership Deed.

	Rs.
P	500
R	600
S	400

You are required to put through an adjusting entry as on 1st Jan 2009 assuming that their profit sharing profit is 2: 1: 2.

NOTES

	P	R	S
	Rs.	Rs.	Rs.
Interest on Capital already credited in the Capital Accounts of the partners.	500	600	400
Since the interest on Capital is not provided for the Partnership Deed the amounts already credited viz. Rs. 500 + Rs. 600 + Rs. 400 = Rs. 1,500 now to be cancelled. This figure represents the profit which will be distributed again among the partners in the ratio of 2: 1: 2			
To record the division of profit, the Capital accounts of the partners must have been credited for			
To give effect	600	300	600
	+100	-300	+200

(To record the division of profit, the Capital Account should be credited to P Rs.600, R- Rs.300, S- Rs.600, but in the Capital Accounts there is already a credit of Rs. 500- P, Rs.600- R and Rs.400- S for the interest on Capital which should be cancelled. So it is enough to debit the R's Capital A/c with Rs.300 and to credit the P's and S's Capital Accounts with Rs.100 and Rs.200 respectively).

1.2 ADMISSION OF A PARTNER

1.2.1 INTRODUCTION

In an existing one man business there may be the need for the expansion of the business. Under such circumstances, a person may be admitted as a partner. Preliminary, in an existing partnership a new partner can be admitted. with the consent of all partners unless there is an agreement to the contrary.

1.2.2 ADJUSTMENT IN ACCOUNTS

When a person is admitted in established firm, he acquires a right to have a share in its future profits. The existing partners have to surrender a part of their profits to this new partner which they had been higher to enjoying in full. Therefore, it is reasonable incoming partner for making room for him out of their own profits such compensation or reward which the new partner is to bring in for he share that he will receive in the future profits of the business is called "Goodwill".

In addition to the amount of his capital, the incoming partner has to pay for goodwill. It is important to note that on admission as a partner into a firm he acquires the following two legal rights.

1. The right to share in the asset of the firm.
2. The right to participate in the division of the future profits of the firm.

On the basis of the above two legal rights, the new partner asked to make two payments.

1. One for Capital
2. One for Goodwill

1.2.3 RECORDING OF CAPITAL OF A NEW PARTNER

The amount that the new partner pays in for the right to share in the assets of the firm is called his Capital. The Journal Entry for the amount received by way of capital will be:

		Rs.	Rs.
Cash A/c	Dr.		
To New Partner's Capital A/c			
(Being the capital received from new partner)			

The other account that new partner pays as a price for the right to participate in the division of future profits is called Goodwill. For this, the following Journal entry will be passed.

		Rs.	Rs.
Cash A/c	Dr.		
To Goodwill A/c			
(Being the goodwill amount received from new partner)			

Goodwill

Goodwill literally means the good name of a business. It may be defined up some reputation of a firm. A business builds up some reputation after it has contributed for some time. If the reputation is good it will come to acquire a fixed clientele. The existence of goodwill of a firm distinguishes the same from others. If a

NOTES

firm is being situated in a comparable position with others and doing the same nature of trade earns extra profit, then there is some factor favorable in the firm for bringing more and more customers to that particular firm. These factors create goodwill. It is an intangible.

The question of valuation oOf goodwill arises in partnership in the following cases:

1. On the admission of a new partner.
2. On the retirement or death of a partner;
3. On the dissolution of a partnership and
4. On the change in the profit sharing ratio of partners.

As a reward for their (old Partners) efforts in the past and their surrender of right to a fraction of the expected future profits, the new partner pays a certain sum of money for goodwill. Goodwill in this sense, is a reward paid to old partners for the efforts made by them in the past for bringing the firm to the present stage of profit earning capacity and the surrender of their right to a fraction of future profits.

Goodwill is always a partnership property and it goes with the business. Evidently, therefore, the sum received on account of goodwill from a newcomer would belong to the existing partners. But the question arises as to the ratio in which it should be distributed amongst the old partners.

Suppose A and B are partners who share profits in the ratio of 3 : 1. They admit C as a partner for one-fourth share. C pays a premium of Rs. 10,000 towards goodwill in which ratio should the Rs. 10,000 paid in by C be divided between A and B.

Perhaps, this will depend upon now how C has acquired his one fourth share. He may purchase it any one of the following ways

NOTES

1. Entirely from A;
2. Entirely from B;
3. From A and B equally;
4. one fourth from A and three-fourth from B; or
5. three-from A and one-fourth B (i.e.,) in the ratio in which they Originally share profits.

In each case the premium of Rs. 10,000 paid by C will be divided between A and B coin the following manner;

1. A-Rs.10,000
2. B-Rs.10,000
3. A-Rs.5000 and B-Rs. 5000
4. A-Rs.2500 and B-Rs.7500
5. A-Rs. 7500 and B-Rs.2500

To summarize the question of goodwill arising on the admission of new partner may be settled in the following ways;

1. If on the admission of a new partner, the profit sharing ratio as between the old partners does not change, the amount of goodwill is to be distributed in the same ratio.

2. If the profit sharing ratio among old partners changes on the admission of a new partner, the goodwill amount should be divided in the ratio in which old partners are sacrificing for the new partner.

1.2.4 ADJUSTMENTS OF PROFIT SHARING RATIO

Example: 1

[No change in profit sharing ratio among old partners]

Suppose Amid and Basha are equal partners. They admit Chand for a third share in the future profits. He brings Rs. 8,000 by way of goodwill. How much Amid and Basha will get?

NOTES

Answer

There is no change in the profit sharing ratio between Amid and Basha. Hence, Rs. 8,000 will be divided between Amid and Basha equally.

Example: 2

[Change in profit sharing ratio among old partners]

X and Y are equal partners. They admit Z. The future profit sharing ratio is to be 9: 6: 5 as between X, Y and Z, Z brings Rs. 8,000 by way of goodwill. Divide it between X and Y.

Answer

	XYZ	Total	Ratio
Put old ratio	1:1:-	=2	|
Put new ratio	9:6:5	=20	|
Multiply the ratios in such a way that the Total of the two ratios may be equal.	20:20:-	=40	|
Multiply the old ratio by 20 and the new ratio 2 to make it 40	18:12:10	=40	||
Then, calculate simple difference which will give the sacrificing ratio	8:2	=Difference	Sacrificing ratio

NOTES

Rs. 8,000 will be divided between X and Y in the ratio of 2: 8. So, X will get Rs. 1,600 and Y will get Rs. 6,400.

The following example will make it very clear.

1.2.5 GOOD WILL AND ITS ADJUSTMENT IN ACCOUNT

Meaning of goodwill:

An intangible asset valued according to the advantage or reputation a business has acquired (over and above its tangible assets)

Illustration: 1

[Goodwill brought in cash and retained in the business]

Ram and Ranjith are partners sharing profits and losses in the rain of 3: 1 respectively. The goodwill of the business is estimated at Rs. 8,000/- on the date when they admit. Karim as a partner by giving him 1/8th share. Find out the goodwill paid by Karim and record the same by means of Journal Entries.

Solution : Karim will have to pay Rs. 1,000 i.e., 1/8th of Rs. 8,000 as good will (This amount will be divided between Ram and Ranjith in the ratio in which they originally shared profits i.e., 3/4th and 1/4th respectively. The Journal Entries will be):

			Rs.	Rs.
1.	Cash A/c	Dr.	1,000	
	To Goodwill A/c			1,000
	(being the goodwill received from C)			
2.	Goodwill A/c	Dr.	1,000	

	To Ram Capital A/c		750
	To Ranjith Capital A/c		250
	(being the allocation of goodwill among the old Partners in the ratio 3:1)		

The above entries will be made if Karim acquires his 1/8th share from Ram and Ranjith in the ratio in which they originally shared profits. But if Karim acquires his 1/8th share equally from Ram and Ranjith, the goodwill paid by him will be divided between Ram and Ranjith equally. There will be on change with regard to entry 1. The 2nd entry will be changed like this:

		Rs.	Rs.
	Goodwill A/c Dr.	1,000	
	To Ram Capital A/c		500
	To Ranjith Capital A/c		500
	(being the allocation of goodwill among the old Partners in equal shares)		

NOTES

Illustration: 2

Raina and Sarath are partners with a capital of Rs. 15000 and Rs. 10,000. They share profits and losses in the ratio of 2/3: 1/3. They agree to admit Vijay from 1/4th share in future profits Vijay is to bring Rs. 12,000 as his Capital and Rs. 3,000 for his share of Goodwill.

Pass Journal Entries and prepare necessary Ledger Accounts:

(a) If the goodwill amount is retained in the business.

(b) If the goodwill amount is withdrawn by the old partners. Also Calculate the future profit sharing ratio of the partners.

NOTES

Solution

(a) When the good will amount is retained in the business.

		Dr. Rs.	Cr. Rs.
	Cash A/c Dr.	15,000	
	To Vijay Capital A/c		12,000
	To Goodwill A/c		3,000
	(being the capital and goodwill received from Z)		
	Goodwill A/c Dr.	3,000	
	To Raina Capital A/c		2,000
	To Sarath Capital A/c		1,000
	(being the allocation of goodwill among the old partners in the ratio of 2/3rd 1/3rd		

Raina Capital A/c

Dr. Cr.

	Rs.		Rs.
To Balance c/d	17,000	By Balance b/d	15,000
		By Goodwill A/c	2,000
	17,000		17,000
		By Balance b/d	17,000

NOTES

Sarath Capital A/c

Dr.	Rs.		Cr. Rs.
To Balance c/d	11,000	By Balance b/d	10,000
		By Goodwill A/c	1,000
	11,000		11,000
		By Balance b/d	11,000

Vijay Capital A/c

Dr.	Rs.		Cr. Rs.
To Balance c/d	12,000	By Cash A/c (Capital A/c)	12,000
	12,000		12,000
		By Balance b/d	12,000

Goodwill A/c

Dr.	Rs.		Cr. Rs.
To Raina Capital A/c	2,000	By Cash	3,000
To Sarath Capital A/c	1,000		
	3,000		3,000

Figures in brackets indicate successive steps in that account.

NOTES

(b) When the goodwill amount is withdrawn by the old partners

Dr. Cr.

		Rs.	Rs.
	Cash A/c Dr.	15,000	
	To Vijay Capital A/c		12,000
	To Goodwill A/c		3,000
	(being the capital and goodwill received from Vijay)		
	Goodwill A/c Dr.	3,000	
	To Raina Capital A/c		2,000
	To Sarath Capital A/c		1,000
	(being the allocation of goodwill among the old partners in the ratio of 2/3rd 1/3rd		
	Raina Capital A/c Dr.	2,000	
	Sarath Capital A/c Dr.	1,000	
	To Cash A/c		3,000
	(being the goodwill withdrawn by Raina and Sarath)		

NOTES

Raina Capital A/c

Dr. Cr.

	Rs.		Rs.
To Cash A/c	2,000	By Balance b/d	15,000
	15,000	By Goodwill A/c	2,000
To Balance b/d	17,000		17,000
		By Balance b/d	15,000

Sarath Capital A/c

Dr. Cr.

	Rs.		Rs.
To Cash A/c	1,000	By Balance b/d	10,000
	10,000	By Goodwill A/c	1,000
To Balance b/d	11,000		11,000
		By Balance b/d	10,000

Vijay Capital A/c

Dr. Cr.

	Rs.		Rs.
To Balance c/d	12,000	By Cash A/c (Capital A/c)	12,000
	12,000	By Balance b/d	12,000
			12,000

NOTES

Goodwill A/c

Dr. Cr.

	Rs.		Rs.
To Raina Capital A/c	2,000	By Cash	3,000
To Sarath Capital A/c	1,000		
	3,000		3,000

Calculation of Future Profit Sharing Ratio

Vijay has been given $1/4^{th}$ share of the total profits.

Now Raina and Sarath will share the remaining ¾ (i.e., 1 – ¼) in their original ratio, i.e., $2/3^{rd}$ and $1/3^{rd}$

In future Raina share will be a $2/3^{rd}$ of $¾ = 2/3 \times ¾ = ½$

Sarath share will be $1/3^{rd}$ of $¾ = 1/3 \times ¾ = ¼$

Future Ratios will be Raina ½ Sarath ¼ and Vijay ¼.

Raising of Goodwill

Sometimes the incoming partner is not in a position to pay the amount of the goodwill agreed upon in cash. In that case, a Goodwill Account is opened and debited with the agreed value and the old partners Capital Accounts are credited in the proportion in which the share profits.

The Journal Entry will be as follows:

		Rs.	Rs.
	Goodwill A/c Dr. To Old Partner's Capital A/c (being the goodwill amount raised and its distribution between the old partners in the		

	original prcfit sharing ratio)		

Goodwill Account may then appear as an Asset on the Balance Sheet.

NOTES

Entries for the Treatment of Goodwill

Method	Journal Entry	Remarks
1. When Goodwill is brought in by the new partner and the same is retained in the business.	Cash A/c Dr. To Goodwill A/c (being the receipt of goodwill from the new partner)	
	Goodwill A/c Dr. To Old Partner's Capital A/c (being the allocation of goodwill between the old partners in the ratio of -----)	In the Sacrificing Ratio
2. When Goodwill is brought in by the new partner and the same is withdrawn by the old partners.	Cash A/c Dr. To Goodwill A/c (being the receipt of goodwill from the new partners)	
	Goodwill A/c Dr. To Old Partner's Capital A/c (being the allocation of goodwill between the old partners in the ratio	In the Sacrificing Ratio

NOTES

	of -----) 217 Old Partner's Capital A/c Dr. To Cash A/c	
3. When Goodwill Account is raised and written back.	(being the goodwill withdrawn Goodwill A/c ------)	
4.	Goodwill A/c Dr. To Old Partner's Capital A/c (being the goodwill account raised and its distribution between the old partners in the ratio of ------)	In the old Profit Sharing Ratio
	All (Including New Partners Capital Account) Dr. To Goodwill A/c (being the goodwill accounts written off)	In the New Profit Sharing Ratio
5. When Goodwill is paid privately (i.e., outside the business by the new partner to the old Partners.)	No accounting record is made in the books of the firm.	

N.B. : Goodwill A/c will appear in the Balance Sheet in this case

*Sacrificing Ratio is equal to Old Ratio, if profit Sharing ratio of old partners Inter se does not change.

Where Goodwill already exists in the books of the Firm

If the old partners already have goodwill account in their books, it is generally revalued at the time of admission of a new partner and the necessary adjustment is made consequent upon revaluation of goodwill.

(a) If the Goodwill A/c appears at its full value no premium will be Payable by the new partner and hence no adjustment will be made on account of goodwill.

(b) If the Goodwill A/c appears at a figure lower than its prior value. Then the Goodwill Account will be raised to its full value and the old Partner's Capital A/c excess amount of goodwill.

(c) If the Goodwill A/c stands at a figure higher than its true value the excess amount is written off against the old partner's capital accounts in their old profit sharing ratio by debiting Capital A/c and Crediting Goodwill A/c.

Illustration: 3

Following is an abridged Balance Sheet of Mani and Nash as a 31st December 2009.

		Rs.		Rs.
Capital Account:	Rs.			
Mani	10,000		Cash	3,000
Nash	8,000	18,000	Sundry Assets	9,000
	--------		Goodwill	10,000
Sundry Creditors		4,000		
		---------		----------

	22,000		22,000

NOTES

The admit Bond on 1-1-2010 as a partner who is unable to pay goodwill in cash but pays Rs. 10,000 as his capital. The goodwill of the firm is to be valued at 2 years purchases of 3 years average profits. The profits for the 3 years were Rs. 6,000, Rs. 6,500 and Rs. 8,500. This new sharing ratio is 3/7th. 1/7th and 3/7th respectively between Mani, Nash and Bond Make Journal Entries and show the Balance Sheet of the new firm.

Solution:

Goodwill-2 year's purchases of 3 year's average profits

$$= \frac{(6,000 + 6,500 + 8,500)}{3}$$

$$= \frac{21,000}{3} = 7,000$$

$$= 2 \times 7,000 = \text{Rs. } 14,000$$

(Here, the Goodwill A/c stands at Rs. 10,000 in the books. But the value is Rs. 14,000. Therefore, the Goodwill A/c will be raised to its value by debiting the Goodwill A/c for Rs. 4,000 (Rs. 14,000 – Rs. 10,000) and crediting the old partner's Capital Accounts i.e. Mani & Nash equally, No original profit sharing ratio is given in the problem. As such, they might be equal Partners.

NOTES

Journal

Date	Particulars	Dr.	Cr.
		Rs.	Rs.
2010	Cash Dr.	10,000	
Jan 1	To O's Capital A/c		10,000
	(being the Capital received from Bond)		
	Goodwill A/c Dr.	4,000	
	To Mani Capital A/c		2,000
	To Nash Capital A/c		2,000
	(Being the additional goodwill Rs. 4,000 rose on Bond admission Rs. 14,000. Rs.10,000)		

Balance Sheet of the Firm

As at 1st Jan, 2010

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	4,000	Cash 10000 + 3000	13,000
Capital Accounts:		Sundry Assets	9,000
		Goodwill	14,000
Mani 12,000			
Nash 10,000			
Bond 10,000	32,000		
	----------		----------

NOTES

	36,000		36,000

Profit Sharing Ratio Calculation

Example – 1

A and B trading in partnership business, share profits 2/3 and 1/3. C is admitted for a share of 1/4th of the future profits. Adjust the profit sharing ratio of A, B and C.

Answer

C is to be given	=	¼ [Deduct this from 1 for balance]	
Balance ¾	=	[(i.e.)] 1 – ¼]	
A's Share, therefore, is	=	¾ x 2/3 = ½	2
B's Share, therefore, is	=	¾ x 1/3 = ½	1
C's Share 1			

Example – 2

X and Y are partners sharing profits and losses in the ratio of ¾. They admit Z and agree to give him 1/4th of the profits. Z acquires his share ¼ equally form both. Find out ratio between X,Y and Z:-

Answer

Z is to be given ¼

Z acquires half of this [1/4 x 2] from Z and the other half from Y [Deduct 1/8 from each]

X's share, therefore, is	=	¾	-	1/8	=	5/8	5
Y's share, therefore, is	=	¼	-	1/8	=	1/8	1
Z's share, therefore, is	=	¼					2

Z's share

X : Y : Z

5 : 1 : 2

N.B.: [Suppose Z acquires his $1/4^{th}$ share entirely from X then the ratio of X ¾ - ¼ = 2/4 and Y ¼ as well as = ¼]

Example – 3

P and Q are sharing profits and losses in the proportion of 5:3. Then agreed to take R into partnership and give him 5/16 share of profits. If R acquires his 4/16 from P and 1/16 from Q. What would be the new profit sharing ratio?

Answer

R is to be given = 5/6 of which he acquires 4/16 from P and 1/16 from Q.

P = 5 4 10 – 4 6

--- - --- = -------- = --- = 6

8 16 16 16

NOTES

$$Q = \frac{3}{8} - \frac{1}{16} = \frac{6-1}{16} = \frac{5}{16} = 5$$

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

P: Q: R

6: 5: 5

Example – 4

M's is admitted in a firm with a share of 1/4th profits of the firm. He contributes Rs. 9,000 as his capital to which amount the capitals of other two partners, k and L shall be adjusted. They were sharing profits a 2 : 1. Find the required capital of K and L.

M's is to be given = 1/4

Deducting this from 1 that is left is = 1 – ¼ = 3/4

K's share, therefore, is 2/3 x ¾ = 1/2

NOTES

L's share, therefore, is 1/3 x ¾ = 1/4

M's share......... 1/4

If M's capital is Rs. 9,000 then the total capital should the 9,000 x 4/1

= 36,000

K's share, therefore, should be = Rs. 36,000 x ½ = Rs.18,000

L's share, therefore, should be = Rs. 36,000 x ¼= Rs. 9,000

M's share Rs. 9,000

Example - 5

A and B sharing profits in proportions of three-fourth and one fourth. They admit C into partnership for a fifth share in future profits. C has to bring in sufficient capitals representing his share. The capital of A and B after making all adjustments are Rs. 30,000 and Rs. 10,000. How much C should bring by way of capital?

Answer

Capital of C is determined like this:

C has been given = 1/5

So, A & B's combined share is (1- 1/5) = 4/5

A's Capital after all adjustments Rs. 30,000

B's Capital after all adjustments Rs. 10,000

Rs. 40,000

NOTES

Therefore this figure of Rs. 40,000 presents $4/5^{th}$ of the total capital. If so, 1/5 of the total capital 1/5 x 40,000 x 5/4 = Rs.10,000. Hence C should bring Rs.10,000 as his capital.

Example – 6

Same facts as given in Example 5 except that the capitals of A and B are Rs.25,000 and Rs.15,000. A and B should adjust their Capitals in the new profit sharing ratio and any surplus or deficit should be made up by bringing in or withdrawal of sufficient cash.

Answer

We have already arrived at Cs capitals Proportionate capitals of A and B in their new profit sharing ratio :

C	=	$1/5^{th}$ share			=	Rs.10,000
(1-1/5) =	4/5 x ¾ A	=	$3/4^{th}$ Share	=	Rs.30,000	
(1-1/5) =	4/5 x ¼ B	=	$1/5^{th}$ Share	=	Rs.10,000	

As such, A should bring a further sum of Rs.5,000 (Rs.30,000 – Rs.25,000)

As such, B can withdraw his excess amount of Rs.5,000 (Rs.10,000 – Rs.15,000)

Alternatively, A's Current A/c should be debited for Rs.5,000 and B's Current A/c should be credited for Rs.5,000.

NOTES

1.2.6 REVALUATION OF ASSETS & LIABILITES

Meaning of Revaluation:

A new appraisal or evaluation

It is normal procedure for the incoming partner to make it a condition that before the new firms constituted, the assests and liabilities of the old firm should be properly valued. It is also necessary in the interest of the incoming partner to make through scrutiny of the existing Balance Sheet of the old firm at the time of his admission. If the assets and liabilities are overvalued or undervalued they are brought to their actual values by means of revaluation. Some were ordered items of assets (Like Joint Life Insurance Policies) and liabilities (Like Contingent Liability) may be brought into an account.

All such adjustments which are mutually agreed upon between the old partners and the incoming partner are the effected (passed) through a special account termed as "Revaluation Account" or Profit and Loss Adjustment Account" when valuation of some assets increase then such Assets Accounts are debited against Profit and Loss Adjustment Accounts. When there is a reduction in the amount of the liabilities, such liability accounts are debited against Profit and Loss Adjustment Account. In case of increase those Liabilities, Profit and Loss Adjustment Account is debited as against those Liability Accounts. The difference in Profit and Loss Adjustment Account represents net profit or loss on revaluation which is transferred to partners, Capital Accounts in the old profit sharing ration. Revaluation brings about changes in the value of assets and liabilities in the books. Memorandum Revaluation A/c is used where values are not to be altered in the books.

NOTES

Profits & Loss Adjustment Account	is debited with the amount of reduction in the amount of the assets or increase in the amount of liabilities of the old firm

P&L Adjt, A/c Dr.

To Asset A/c

To Liability A/c

[ ]

[The corresponding, credit goes to the asset or (concerned account as the case may be]

Profits & Loss Adjustment Account	is credited with the amount of appreciation in the] value of the assets of reduction in the amount of the liabilities of the old firm.

Liability A/c Dr.

Asset A/c Dr.

To P&L Adjt. A/c

[ ]

[The corresponding debit goes to the asset for liability accounts as the case may be

Profits & Loss Adjustment Account	is finally closed and the balance profit or loss which is transferred to old partner's Capital Accounts in their old profit sharing ratio.

Illustration: 4

Sachin and Shewag are in partnership sharing profits and losses in proportion of 3/5 ad 2/5 respectively. Their Balance Sheet is as follows:

Liabilities		Rs.	Assets		Rs.
Bills Payable		8,000	Cash at bank		13,000
			Debtors	20,000	
Capitals :			Less : Reserve	800	
Sachin	36,000				19,200
Shewag	24,000	60,000	Stock		22,800
			Plans		13,000
		68,000			68,000

They decide to admit Dravid and given him 1/3rd share on the following terms and conditions:

1. That the Reserve for bad debts be reduced to Rs.200
2. The value of the plant be reduced by Rs.3,000
3. The stock be revalued at Rs.25,400
4. The outstanding expenses of Rs.200 to be brought into account.
5. There being a claim against the firm for damages liability to the extent of Rs.1000 be created.
6. It is further agreed that Sachin alone is to be charged with any loss arising from the revaluation, since he wants to become a sleeping partner.
7. Wheel is to bring Rs.5, 000 as his share of Goodwill and sufficient capital to give him a third share of the total capital of the new firm.

NOTES

Make Journal entries; prepare the Profit and Loss Adjustment A/c and Balance Sheet after Wheel's admission.

Solution: **Journal Entries**

S.No	Particulars	Dr.	Cr.
		Rs.	Rs.
	Reserve for Bad debts A/c Dr.	600	
	To Profit and Loss Adjustment A/c		600
	(being the reduction in the reserve for bad debts adjusted)		
	Profit and Loss Adjustment A/c Dr.	3,000	
	To Plant A/c		3,000
	(being the reduction in the value of stock brought in account)		
	Profit and Loss Adjustment A/c Dr.	1,200	
	To Outstanding Expense A/c		200
	To Provision against Contingent Liability A/c		1,000
	(being the outstanding expenses and expected liability in respect of damages now brought into account)		

NOTES

	Sachin Capital A/c Dr. * To Profit and Loss Adjustment A/c (being the loss transferred to Sachin Capital A/c as per agreement)	1,000	1,000
	Cash A/c Dr. To Goodwill A/c (being the goodwill received from David)	5,000	5,000
	Goodwill A/c Dr. To Sachin Capital A/c To Shewag Capital A/c (being the allocation of goodwill between Sachin and Shewag in the ratio of 3:2)	5,000	3,000 2,000
	Cash A/c Dr. # To Dravid Capital A/c (being the proportionate capital received from Dravid)	32,000	32,000

* This entry can be passed only after preparing the Profit and Loss Adjustment A/c

\# This entry will passed only after preparing the Capital account of Sachin and determining the proportionate amount to be brought in by Dravid.

NOTES

Profit and Loss Adjustment A/c

Dr. Cr.

	Rs.		Rs.
To Plant A/c	3,000	By Reserve for Bad Debts A/c	600
To Outstanding Expenses A/c	200	By Stock A/c	2,600
To Provision against Contingent Liability	1,000	By sachin Capital A/c	1,000
	4,200		4,200

* Balance Sheet As on

Liabilities		Rs.	Assets		Rs
Bills Payable		8,000			
Outstanding Expenses		200	Cash		37,000
Provision against Contingent			Cash at bank		13,000
Liability		1,000	Debtors	20,000	
			Less :R.B.D	200	
Capital Accounts:					19,800
Sachin	38,000				
Shewag	26,000		Stock		25,400
Dravid	32,000		Plant		10,000
		96,000			
		1,05,200			1,05,200

NOTES

Capital of Dravid is Determined like this

Wheel has been given 1/3 share so Sachin & Shewag combined share is 2/3 (i.e).1 – 1/3Sachin Capital

Loss Rs 1,000	opening capital. Rs 36,000 goodwill Rs 2,000
	Rs 38,000

Shewag Capital

	opening capital Rs. 24,000 goodwill Rs. 2,000
	Rs 26,000

	Rs.
Sachin Capital after adjustment	38,000
Shewag Capital after adjustment	26,000
	64,000

Therefore this figure of Rs. 64,000 represents 2/3 rd of the capital.

---

* Revalued Assets are (as per agreement) Shown in the Balance Sheet. This figure is arrived at after preparing Cash Account in a rough Sheet.

If so 1/3 of the total capital = 1/3 x 64,000 x 3/2

= Rs. 32,000

Hence, Dravid should bring Rs. 32,000 as his capital.

NOTES

What is surplus?

A quantity much larger than is needed

1.2.7 TRANSFER OF UNDISTRIBUTED RESERVES & SURPLUS

Reserve in a firm's; Balance Sheet represents the amount of accumulated profit and such reserve is created by existing partners. Therefore, it is essential to close all such accumulated profits by transferring them to capital accounts of old partners in their old profit sharing ratio. Similarly, the profit or loss in Profit and Loss Account in a firm's Balance Sheet it any should be distributed among the old partners in their old profit sharing ratio.

Journal Entry for transferring such profits is

Debit General Reserve A/c

Debit Reserve Fund A/c

Debit Profit & Loss A/c (Credit Balance)

Debit any other accumulated Reserve A/c*

Credit Old Partners' Capital Accounts

(Being the accumulated profit distributed amongst the old partners in their old profit sharing ratio)

(In examination student should remember to make its entry without being asked to do so)

* Investment Fluctuation Fund

Or Current Accounts as directed.

1.2.8 PREPARATION OF REVALUATION ACCOUNT, CAPITAL ACCOUNTS AND BALANCE SHEET AFTER

ADMISSION OF PARTNER.

Illustration: 7

Lakshmi and Sarawathi are partners of a firm sharing profits and losses in proportion to capital. Their balance sheet as on 31st March 2010 is as under:

LIABILITIES		Rs.	ASSETS	Rs.
Sundry Creditors		60,000	Bank	12,000
Bills Payable		40,000	Sundry Debtors	40,000
Capital Accounts:			Stock	40,000
Lakshmi	60,000		Plant	90,000
Saraswathi	40,000	1,00,000	Furniture	18,000
		2,00,000		2,00,000

They decided to admit Sulochana into the partnership with effect from 1st April, 2010 on the following terms:

(a) Sulochana shall bring in a capital of Rs.50, 000 for 1/5th share of profits

(b) Goodwill is to be valued at Rs.40, 000

(c) Plant and furniture was to depreciated by 5 %

(d) Provision for doubtful debts be created at 1 ½% on Sundry debtors.

Show Revaluation Account, Capital Accounts, Bank Account and Balance Sheet of the reconstituted partnership.

NOTES

Solution: **Revaluation Account**

Dr. **Cr.**

Date	Particulars	Rs.	Rs.	Date	Particulars	Rs.	Rs.
	To Plant To Furniture To Provn. for D.D.		4,500 900 600		By Loss Trans. to Capital A/cs: Lakshmi Saraswathi	3,600 2,400	6,000
			6,000				6,000

CAPITAL ACCOUNTS

Dr. **Cr.**

Particulars	Lakshmi Rs.	Saraswathi Rs.	Sulochana	Particulars	Lakshmi Rs.	Saraswathi Rs.	Sulochana
To Revaluation A/c	3,600	2,400	-	By Balance b/d	60,000	40,000	
					---	---	
To Balance c/d	80,400	53,600	50,000	By Bank A/c	24,000	16,000	50,000
				By Goodwill A/c			---
	84,000	56,000	50,000		84,000	56,000	50,000
				By Balance b/d	80,400	53,600	50,000

NOTES

Bank Account

Date	Particulars	Rs.	Rs.	Date	Particulars	Rs.	Rs.
	To Balance b/d		12,000		By Balance c/d		62,000
	To Sulochana's Capital A/c		50,000				
			62,000				62,000
	To Balance b/d		62,000				

Balance Sheet of M/s. Lakshmi, Saraswathi and Sulochana as on 1st April 2010

LIABILITIES	Rs.	ASSETS		Rs.
Sundry Creditors	60,000	Bank		62,000
Bills Payable	40,000	Sundry Debtors	40,000	
Capital Accounts:		Less: Provision	600	39,400
Lakshmi 80,400		Stock		40,000
Saraswathi 53,600		Plant		85,500
Sulochana 50,000	1,84,000	Furniture		17,100
		Goodwill		40,000
	2,84,000			2,84.000

Illustration: 8

Platinum and Bronze are partners in a firm sharing profits and losses in the ratio of 3:1. On 31st December 2009, their position was as follows:

Liabilities		Rs.	Assets		Rs.
Sundry		15,000	Cash at Bank		18,500
Capital Accounts :			Bills Receivable		2,500
Platinum	45,000		Sundry Debtors	9,500	
Bronze	15,000		Less: Provision	300	
		60,000		-----	9,200
			Stock		15,800
			Furniture & Fittings		6,000
			Land and Buildings		23,000
		75,000			75,000

On 1st January 2009 they admit Ruby in partnership on the following conditions:1) That 'Ruby' Brings Rs.40,000 as his capital for a third share in the future profits.

2) That a provision for Doubtful Debts be increased to Rs.50.

3) That the value of stock be appreciated by 20%.

4) That 'Ruby' Brings Goodwill to the tune of Rs.12,000.

5) That one half of the goodwill be withdrawn by the old partners.

6) That value of Furniture and Fittings be reduced by Rs.50.

7) That the Capital Accounts of the partners be readjusted on the basis of their profit sharing arrangement and any additional amount be debited or credited to the Current Accounts. Draft the Profit and Loss Adjustment Account, the Capital Accounts and the Balance Sheet of the new firm.

Solution: **Profit and Loss Adjustment A/c**

Dr. Cr.

		Rs.			Rs.
2009			2009		
Jan 1	To Provision for Doubtful Debts	200	Jan 1	By Stock	3,160
	Furniture and Fittings	600			
	Profit transferred to				
	Platinum ¾ 1,770				
	Bronze ¼ 590	2,360			
		3,160			3,160

Calculation of New Sharing Ratio

Assume the profit sharing ratio of the entire firm (including the new partner) is 1.

From that deduct the new partner's share

$1 - \frac{2}{3}$ (New Partner's Share) = $\frac{2}{3}$ (Balance)

Thus, new profit sharing ratio is arrived at by using the formula given below :

Old Ratio x Balance = New Ratio

Platinum $= \frac{3}{4} \times \frac{2}{3} = \frac{6}{12}$

Bronze $= \frac{1}{4} \times \frac{2}{3} = \frac{2}{12}$

Ruby $1 = \frac{6}{12} + \frac{2}{12} = \frac{8}{12} = \frac{4}{12}$ or $\frac{1}{3}$

New Ratio = 6 : 2 : 4 (or) 3 : 1 : 2

Platinum's Capital Account

Dr. Cr.

		Rs.			Rs.
2009			2009		
Jan 1	To Cash a/c	4,500	Jan 1	By Balance c/d	45,000
	To Balance c/d	60,000		By Goodwill A/c	9,000
				By P & L Adjustment a/c	1,770
				By Transfer to Platinum's Current A/c	8,730
		64,500			64,500
				By Balance b/d	60,000

Platinum's Current Account

Dr. Cr.

		Rs.			Rs.
2009			2009		
Jan 1	To Platinum's Capital A/c	8,730	Jan 1	By Balance c/d	8,730
		8,730			8,730
				By Balance b/d	8,730

NOTES

Platinum's Capital Account

Dr. Cr.

		Rs.			Rs.
2009			2009		
Jan 1	To Cash a/c	1,500	Jan 1	By Balance c/d	15,000
	To Balance c/d	20,000		By Goodwill A/c	3,000
				By P & L Adjustment a/c	590
				By Transfer to Bronze's Current A/c	2,910
		21,500			21,500
				By Balance b/d	20,000

Platinum's Current Account

Dr. Cr.

		Rs.			Rs.
2009			2009		
Jan 1	To Bronze's Capital A/c	2,910	Jan 1	By Balance c/d	2,910
		2,910			2,910
	To Balance b/d	2,910			

NOTES

Ruby's Capital Account

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2009			2009		
Jan 1	To Balance c/d	40,000	Jan 1	By Cash A/c	40,000
		40,000			40,000
				By Balance b/d	40,000

NOTES

Balance Sheet of Platinum, Bronze & Ruby

As at 1st January 2010

Liabilities		Rs.	**Assets**		Rs.
Sundry Creditors		15,000	Cash at Bank		64,500
Capital Accounts :			Bills Receivable		2,500
Platinum	60,000		Sundry Debtors	9,500	
Bronze	20,000		**Less :** Provision	500	
Ruby	40,000			--------	9,000
			Stock	15,800	
		1,20,000	**Add :**		
			Increase in value	3,160	
				-------	18,960
			Furniture & Fittings	6,000	
			Less : Written off	600	5,400
			Land and Buildings		23,000
			Current Accounts :		
			Platinum	8,730	
			Bronze	2,910	
					11,640
		1,35,000			1,35,000

NOTES

1.3. RETIREMENT AND DEATH OF PARTNER

1.3.1. INTRODUCTION

We know how a person can be introduced into a firm as a new Partner with the consent of all the existing partners. Such a new partner is known as an incoming partner. We have learned accounting problem relating to the admission of a partner. In this lesson, it is proposed to discuss the accounting problems arising out of the retirement of a partner.

A partner may decide to retire if he becomes too old or he has a better business opportunity in some other line or he finds it difficult to get along with the other partner. Such and ex-partner is known as an outgoing partner or retiring partner.

1.3.2. ADJUSTMENTS IN ACCOUNTS

Adjustments in Accounts – When a partner retires, the following adjustments are need.

1. **What is the amount due to him?**
2. **In what form is to be paid out?**

Amount due to the Retiring Partner

Upon the retirement of a partner, it becomes necessary to ascertain the exact amount due and payable to him by the firm. This is likely to create differences among the partners. A well drafted Partnership Agreement will always contain suitable provisions, so that there may not be any scope for litigation.

NOTES

Generally a retiring partner is entitled to the following balance:

1. To begin with, credit balance in his (the retiring partner's) Capital A/c :

2. Any amount of interest or salary payable to his;

3. Share of profit or loss up to the date of retirement;

4. Share of goodwill belonging to him;

5. Result of the revaluation of assets and liabilities; and

6. If there be a Reserve Fund, his share thereof; any Accumulated balance of profit.

If any amount is to be recovered from him, that amount is deducted from the amount due to him. Thus, the amount due to him is arrived at.

Settlement of amount due to Outgoing Partner

The amount ascertained after making all the necessary adjustments will be paid to retiring partner. The method of payment should be clearly laid down in the Partnership Agreement.

The amount in question may be paid in any one of the following ways:

1. By Lump Sum

The retiring partner is paid the entire amount outright. For this the following entry will be made:

Retiring Partner's Capital a/c Dr.

To Cash A/c

(being the sum due paid)

NOTES

2. By Installments

If the amount is not payable immediately, then the retiring partner's Capital Account will be transferred to a Loan Account and shown in the Balance Sheet of the newly constituted firm until paid off. In this case, the retiring partner may not be paid in Lump sum but partly in cash and the remaining balance in a few installments.

Every year interest is credited to the Loan Account and the Amount paid is debited. The balance is shown in Balance sheet as a liability. So long as the amount is not paid fully the retiring partner's loan account will appear on the liabilities side of the Balance sheet. The following entries will be made.

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(being the transfer of the sum due to his loan account)

Interest A/c Dr.

To Retiring Partner's Loan A/c

(being the interest credited in loan account)

Retiring Partner's Loan A/c Dr.

To.Cash A/c

Being the sum due paid)

What is Annuity?

ncome from capital nvestment paid in a series of egular payments

3. By Annuity

Under this method a fixed annual sum will be paid to the retiring partner so lone as he remains alive. If the amount is paid by means of annuity, it is transferred to the credit of an account called Annuity Suspense Account. It is credited periodically with the interest and debited with the amount of annuity paid. If the annuitant (i.e. retiring partner) dies before the annuity is exhausted, the balance of the account is transferred as an exceptional profit to the continuing partner's. Capital Account in their new profit sharing ratio. If the annuitant lives even after the Annuity suspense account is exhausted, the annuities are debited to Profit and Loss Account of the firm.

The New Profit-sharing Ratio and Gaining Ratio

On the retirement of the partner, his share will be taken by the remaining partners. The new profit sharing ratio can be easily ascertained by putting down the ratio of all partners and then the share of the outgoing partner is removed.

The gains made by the remaining partners can be ascertained by comparing the old ratio and the new ratio of the remaining partners.

Case 1 : Suppose X, Y and Z share profits in the ratio of 4:3:1. Y retires Let the ratio be stated without Y's share (i.e.) 4:1. This is the new sharing ratio X will get 4/5 and z will get 1/5

X : Y : Z

4 : 3 : 1

New Ratio – 4 : 1

The gaining ratio can be ascertained as follows:

Remaining Partner's gaining Ratio = Remaining Partner's New Ratio – Remaining Partner's Old Ratio

$$\text{Gains made by X} = \frac{4}{5} - \frac{4}{8}$$

$$\frac{32-20}{40} = \frac{12}{40}$$

NOTES

$$\text{Gains made by X} = \frac{1}{5} - \frac{1}{8}$$

$$\frac{8-5}{40} = \frac{3}{40}$$

$$\text{Gaining Ratio} = \frac{12}{40} : \frac{3}{40} \quad \text{or } 4:1$$

Here the gaining ratio (4:1) is equal to New ratio (4:1) because the ratio (4:1) between the remaining partners (X and Z) is not changing even after the retirement of Y.

Case 2 : Suppose, A, B and C are partners sharing profits and losses in the ratio of ½, 1/3 and 1/6 B retires and the new profit sharing ratio is 3/5 and 2/5 respectively between A and C. How much gain is made by them?

	A	:	B	:	C
Old Ratio	1/2	:	1/3	:	1/6
		Or			
	3	:	2	:	1
New Ratio	3	:	-	:	2

Multiply the old Ratio by 5 to make it 30 = 15 : 10 : 5 = 30

Multiply the new Ratio by 6 to make it 30 = 18 : - : 12 = 30

NOTES

Gain made by A and C +3 + 7

OR

The gain made by A $\frac{3}{5} - \frac{3}{6} = \frac{18-15}{30} = \frac{3}{30}$

The gain made by C $\frac{2}{5} - \frac{1}{6} = \frac{12-5}{30} = \frac{7}{30}$

Gaining Ratio = 3 : 7

Here the gaining ratio is not equal to New Ratio because the ratio between the remaining partners (A and C) is changing after the retirement of B.

The following table may used to ascertain the New ratio and the gaining ratio.

	As between Remaining Partners	
	New Ratio	Gaining Ratio
1. When the New Ratio is given in the question	As given in the question	New Ratio minus Old Ratio
2. When the New Ratio is not given in the questions	Same Old Ratio	Same Old Ratio
3. When the Gaining Ratio is not given in the question	Old Ratio plus gaining ratio	As given in the question

NOTES

Retiring partner's share of profit

The retiring partner's share of profit or loss from the date of the last Balance Sheet to the date of retirement will have to be found out and his capital account is credited or debited respectively.

Suppose A, B and C are partner's sharing profit 3 : 4 : 3 C wants to retire from the business on 1-1-2005 and his capital account stood at Rs. 30,000, Rs. 3,000 in the Drawings Account. Profit the date of retirement is to be considered on the basis that profit accrues evenly over the year. Profit for the year ending 31st March 2005 is Rs. 20,000.

The Amount Payable to C can be determined like this:

	Rs.
Balance in his capital A/c	30,000
Less: Drawings in his Drawings A/c	3,000

	27,000
Add profit for 9 months from	
01-04-2005 to 31-12-2005	
Rs. 20,000 x 9/12 = Rs. 15,000	
Out of this Rs. 15,000 C is entitled to 3/10th share	
Rs. 15,000 x 3/10	4,500

Amount payable to C	Rs. 31,500

1.3.3. Transfer of reserves & surplus

All accumulated profits (Like General Reserve etc. or losses (P&L A/c Debit Balance) are written off among all partner's (including retiring) in the old profit – sharing ratio. Alternatively, only retiring partner's share may be transferred from Reserve and Profits to his Capital Account. But this should be done only when the remaining partner's new and old profit sharing ratio inter-se remains unchanged.

1.3.4 Revaluation of Assets & Liabilities

If it is agreed to revalue the assets and liabilities on the retirement of a partner, a Profit & Loss Adjustment or Revaluation A/c is prepared. The profit or loss arising out of this Account is transferred to the capital accounts of the partner's including the retiring partner. This has already been explained in connection with the Admission of a partner.

1.3.5 Treatment of Goodwill

We have already discussed the problem of goodwill in connection with the admission. When a partner retires from a firm. He is entitled to his share of goodwill. Therefore, it becomes necessary to estimate the goodwill of the firm. The value of goodwill of the firm is estimated according to the Partnership Agreement.

Let A, B and C share profits and losses in the proportion of 3:4:3. C retires from the firm on 01-01-2010. on retirement goodwill is to be valued at 1 year's purchased of average profit for the last three completed years and the period up to the date of retirement.

NOTES

Profits for 4 years ending on 31st March 2010 are as follows:

1-4-06 to 31-3-07	12,000
1-4-07 to 31-3-08	15,000
1-4-08 to 31-3-09	18,000
1-4-09 to 31-3-10	20,000

The share of goodwill payable to C can be determined as follows:

		Rs.	
Profit for the year	2006-07	12,000	
	2007-08	15,000	
	2008-09	18,000	
Profit for 9 months from 1-4-09 to 31-12-09		15,000	i.e. Rs.20,000 x $\frac{9}{12}$
Profits for 3 ¾ years		60,000	

Annual Average profit = 60,000 ÷ 3 ¾ $= 60,000 + \dfrac{4}{15}$

$= \text{Rs.}16,000$

Value of goodwill at Year's purchases $= 1 \times 16,000$

$= \text{Rs.}16,000$

C's share of thereof $= \dfrac{3}{10} \times 16,000$

$= \text{Rs.}4,800$

When the goodwill of the firm has been estimated, a Goodwill Accounts is created. It may be created at full value or at the amount due to the retiring partner.

(A) When Goodwill Account is only raised at full value in the books of the firm and is allowed to stand in the books – the entry will be

Goodwill A/c Dr.

To Capital Accounts of all Partners A/c

(being the value of goodwill raised on partner's retirement)

In this case Goodwill Account will appear on the Assets side of the Balance Sheet. It is credited to all the partners capital accounts in the old profit sharing ratio.

(B) When Goodwill Account is first raised and then written back to the capital accounts of the remaining partners in the NEW profit – sharing ratio – The entries will be:

NOTES

Goodwill A/c Dr.

To Capital Accounts of all Partners A/c

(Being the value of goodwill rose on partner's retirement)

Capital Accounts of Continuing Partner's A/c Dr.

To Goodwill A/c

(Being the goodwill now written off to remaining partners)

(C) When goodwill account is raised equal to the retiring partner's share and is allowed to stand in the books of the firm the entry will be

Goodwill A/c Dr.

To Retiring Partner's Capital A/c

(Being the retiring partner's share of goodwill raised)

(D) If it is case (C), it is better to write off goodwill to the remaining partners in the ratio in which they gain on the retirement – The additional entry will be:

Capital Account of Remaining Partners A/c Dr.

To Goodwill A/c

(Being the retiring partners share of goodwill raised now written off to remaining partners in the gaining ratio)

(E) When Goodwill Accounts is not opened – The entries will be

Remaining Partners Capital Accounts A/c Dr.

To Retiring Partner's Capital A/c

(Being the retiring partner's share of goodwill credited to him and debited to remaining partners in the gaining ratio)

N.B.: If goodwill appears in the books already, entries for raising goodwill should be made only for the difference.

Illustration: 1

X, Y and Z are partners sharing profits in the ratio of 3 : 2 : 1. Y retires and the goodwill of firm is valued at Rs.24,000. Pass entries for goodwill if.

(a) Goodwill Account raised

(b) Goodwill raised but written off

(c) Only Y's share of goodwill is raised

(d) Only Y's share of a goodwill is raised and written off

(e) Y's share of goodwill be adjusted to that x and z.

Hint

Ratio	X: Y: Z
Old	3: 2: 1
New	X: Z
Ratio	3: 1

NOTES

NOTES

Solution

Journal

S.No	Particulars			Dr.	Cr.
Case (a)	**Goodwill A/c raised :**				
	Goodwill A/c	Dr.		24,000	
	To X's Capital A/c				12,000
	To Y's Capital A/c				8,000
	To Z's Capital A/c				4,000
	(being the value of goodwill raised on Y's retirement in the old ratio 3 : 2 : 1)				
Case (b)	**Goodwill A/c raised and Written off :**				
(i)	Goodwill A/c	Dr.		24,000	
	To X's Capital A/c				12,000
	To Y's Capital A/c				8,000
	To Z's Capital A/c				4,000
	(being the value of goodwill raised on, Y's retirement in the ratio of ½ : 1/3 : 1/6)				
(ii)	X's Capital A/c	Dr.		18,000	
	Y's Capital A/c	Dr.		6,000	
	To Goodwill A/c				24,000
	(being goodwill raised on Y's retirement now written off to X and Z in the new ratio of 3 : 1)				

Case (c)	**Only Y's share of goodwill raised :** Goodwill A/c Dr. To Y's Capital A/c (being the 1/3rd share of Y's goodwill raised)		8,000	 8,000
Case (d)	**Only Y's share of goodwill raised but written off :** Goodwill A/c Dr. To Y's Capital A/c (being the 1/3rd share of Y's goodwill raised)		8,000	 8,000
(i)	X's Capital A/c Dr. Z's Capital A/c Dr. To Goodwill A/c (being the goodwill raised on Y's retirement written of against X and Z in the new ratio 3:1)		6,000 2,000	 8,000
Case (e)	X's Capital A/c Dr. Z's Capital A/c Dr. To Y's Capital A/c (being the share of goodwill credited to Y and debited to remaining partners in the gaining ratio i.e. 3:1 which is the same as new ratio)		6,000 2,000	 8,000

NOTES

N.B. The net effect on these entries, in general that X has been debited with Rs.3,000 and Z had been debited with Rs.1000

X Y Z Total

* Put old ratio	3: 2: 1 =	6	
* Put new ratio	3: - : 1	=	4
Multiply the old ratio by 4 to make it 24	12: 8: 4	=	24
Multiply the new ratio by 6 to make it 24	18: - : 6	=	24
Gaining Ratio	+6 +2		

Illustration: 2

Arjun and Babu are Partners in a business sharing Profits and Losses as Arjun, 2/5; Babu, 3/5. Their Balance Sheet as on 1st January 2009 is given below :

Liabilities	Rs.	Assets	Rs.
Capital Accounts :			
Arjun 20,000		Plant and Machinery	19,500
Babu 15,000		Stock	16,000
---------		Debtors	5,000
Reserve Account	35,000	Bank Balance	16,000
Sundry Creditors	15,000	Cash in hand	1,000
	7,500		
	57,500		57,500

Arjun retire from the firm owing to illness on 1-1-09 and Babu takes it over. The following revaluations are made.

1. The goodwill of firm valued at Rs.15,000

2. Depreciation Plant and Machinery by 7 ½ % and stock by 15%

3. Create a Bad Debts Provision for 15% and a Discount Reserve against creditors at 2 ½ %.

(a) *You are asked to prepare the Journal Entries, show the Profit and Loss* Adjustment A/c and the Partner's Capital Account and prepare the Balance Sheet of Babu.

(b) It is agreed that Arjun will be paid Rs.5,345 by cheque and the balance of dues to be transferred to his Loan Account. The Loan is to be paid in four annual installments together with interest at 10% p.a.

Solution: **Journal**

Date	Particulars	L.F	**Dr.**	**Cr.**
			Rs.	**Rs.**
2009	Goodwill A/c Dr.		15,000	
Jan 1	To Arjun Capital A/c			9,000
	To Babu Capital A/c			6,000
	(being the value of Goodwill raised on A's retirement)			
	Profit and Loss Adjustment A/c Dr.		4,612	
	To Plant and Machinery A/c			1,462
	To Stock A/c			2,400
	To Provision for Bad Debts A/c			750
	(being the reduction in the value of the)			

NOTES

	Provision for Discount on Crs A/c Dr. To Profit and Loss Adjustment A/c (being the provision on creditors brought into account)		187	 187
	Arjun Capital A/c Dr. Babu Capital A/c Dr. To Profit and Loss Adjustment A/c (being the loss transferred to A and B in their old profit sharing ratio)		2,655 1,770	 4,425
	Reserve A/c Dr. To Arjun Capital A/c To Babu Capital A/c (being the reserve distributed to Arjun & Babu in their old profit sharing ratio).		15,000	 9,000 6,000
	Arjun Capital A/c Dr. To Arjun Loan A/c (being Arjun capital account transferred to his loan account)		35,345	 35,345

Profit and Loss Adjustment A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Jan 1	To Plant and Machinery A/c	1,462	2009 Jan 1	By Provision for Discount on Creditors A/c	187
	To Stock A/c	2,400		By A's Capital A/c	2,655
	To Provision for Bad Debts A/c	750		By B's Capital A/c	1,770
		4,612			4,612

Arjun Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Jan 1	To Profit and Loss Adjustment A/c	2,655	2009 Jan 1	By Balance b/d	20,000
	To A's loan A/c – Transferred	35,345		By Goodwill A/c	9,000
				By Reserve A/c	9,000
		38,000			38,000

Babu Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Jan 1	To Profit and Loss Adjustment A/c	1,770	2009 Jan 1	By Balance b/d	15,000
	To Balance c/d	25,230		By Goodwill A/c	6,000
				By Reserve A/c	6,000
		27,000			27,000
				By Balance b/d	2,230

Balance Sheet of Babu

As at 1st January 2009

Liabilities	Rs.	**Assets**	Rs.
		Cash in hand	1,000
Sundry Creditors 7,500		Bank Balance	16,000
Less Provisions 187		Debtor 5,000	
-----	7,313	Less Provision 750	
--			
	35,345	------	4,250
Arjun Loan Account		--	
	25,230		13,600
Babu Capital Account		Stock	
			18,038
		Plant and Machinery	
			15,000
		Goodwill	
	67,888		67,888

Arjun Capital A/c

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Bank A/c	5,345	By Balance b/d	35,345
To Arjun Loan A/c transferred	30,000		
	35,345		35,345

NOTES

Arjun Loan A/c

Dr. **Cr.**

		Rs.			Rs.
I Yr.	To Bank A/c (Rs. 7,500 + 3,000)	10,500	I Yr.	By A's Capital A/c	30,000
	Balance c/d	22,500		By Interest A/c	3,000
		33,000			33,000
II Yr.	To Bank A/c II Yr. (Rs. 7,500 + 2,500)	9,750	II Yr.	By Balance b/d	22,500
	Balance c/d	15,000		By Interest A/c	2,250
		24,750			24,750
III Yr.	To Bank A/c (Rs. 7,500 + 1,500)	9,000	III Yr.	By Balance b/d	15,000
	To Balance c/d	7,500		By Interest A/c	1,500
		16,500			16,500
IV Yr.	To Bank A/c	8,250	IV Yr.	By Balance b/d	7,500
				By Interest A/c	750
		8,250			8,250

However if it is desired that the loan is to be paid off in absolutely equal instalments, that is to say the instalment plus the interest to be paid every year should

NOTES

be equal. The Loan Account of Arjun in the above illustration no. (b) Will appear as follows, in case the loan has to be paid of in 4 equal annual installments of

Rs. 9,464 -12 P.

Arjun Loan A/c

Dr. Cr.

I Yr	To Cash A/c	9,464	12	I Yr	By A's Capital A/c transfer	30,000	00
	To Balance c/d	23,535	88		By Interest A/c (30000x10/100)	3,000	00
		33,000	00	II Yr		33,000	00
II Yr	To Cash A/c				By Balance c/d	23,535	88
		9,464	12		By Interest A/c (22535.88 x10/100)	2,353	58
	To Balance c/d	16,425	24			25,889	46
III Yr						16,425	34
	To Cash A/c	25,889	46	III Yr		1,642	53
	To Balance c/d	9,464	12		By Balance c/d	18,067	87
					By Interest A/c (16425.34 x10/100)	8,602	75
IV Yr		8,603	75	IV Yr		860	37
	To Cash A/c	18,067	87		By Balance c/d	9,464	12
	To Balance c/d	9,464	12		By Interest A/c (8603.75 x10/100)		
		9,464	12				

In the first case, installment amounts are not equal. In the second case the installment amounts are equal.

1.3.7 Retirement and admission

Illustration: 3

A, B and C are partners sharing profits and losses in the proportion of 3:2:1. Following is their Balance Sheet as at 31-12-2009

		Rs.		Rs.
Capital:			Goodwill	10,000
A	65,000		Sundry Debtors	61,400
B	38,000		Sundry Assets	1, 48,000
C	28,000			
	--------	1, 31,000		
General Reserve		38,400		
Sundry Debtors		50,000		
		-----------		----------
		2, 19,400		2, 19,400
		-----------		----------

C desires to retire from the firm on 1-1-2010. In terms of agreement, Goodwill is to be revalued at Rs. 50,000. Sundry Debtors at Rs. 41,400 and other Sundry Assets of Rs. 50,000. The amount payable to the retired partner is for the present to be treated as loan with 5 % interest. On the same day, i.e. 1-1-2010, D is admitted as a partner on payment of Rs. 32,000. Profits and Losses are henceforth to be shared as 4:3:2 between A, B and D. No alteration is to be made in the book value of the assets(other than cash brought in the D and the general reserve). Draw up the final Balance Sheet as at 1-1-2010 on the above basis after the admission of D Showing in detail, necessary Journal entries in the books.

NOTES

Solution: **Journal**

DATE	PARTICULARS	l/f	Dr.	Cr.
			Rs.	Rs.
	Goodwill A/c Dr.		40,000	
2010 Jan	To A Capital A/c			20,000
	To B Capital A/c			13,333
	To C Capital A/c			6,667
	(being excess goodwill (50,000 - 10,000) transferred to the Capital Accounts in the old ratio)			
	Memorandum Revaluation A/c Dr.		20,000	
	To Sundry Debtors A/c			20,000
	(being reduction in debtors transferred			
	Sundry Assets A/c Dr.		2,000	
	To Memorandum Revaluation A/c			2,000
	(being increase in value transferred)			
	A Capital A/c Dr.		9,000	
	B Capital A/c Dr.		6,000	
	C Capital A/c Dr.		3,000	
	To Memorandum Revaluation A/c			18,000
	(being the loss transferred to Capital Accounts in the old ratio)			

	General Reserve A/c Dr.		38,400	
	To A Capital A/c			19,200
	To B Capital A/c			12,800
	To C Capital A/c			6,400
	(being the general reserve transferred to Capital Account)			
	C Capital A/c Dr.		38,067	
	To C Loan A/c			38,067
	(being the balance of capital transferred to Loan A/c)			
	Cash A/c Dr.		32,000	
	To D Capital A/c			32,000
	(being the capital received from D)			
	A Capital A/c Dr.		17,778	
	B Capital A/c Dr.		13,333	
	D Capital A/c Dr.		8,889	
	To Goodwill A/c			40,000
	(being the excess goodwill written off in the books in the new ratio 4:3:2)			
	Memorandum Revaluation A/c Dr.		18,000	
	To A Capital A/c			8,000
	To B Capital A/c			6,000
	To D Capital A/c			4,000
	(being the lose cancelled in the new ratio 4:3:2)			

This entry can be entered after preparing the ledger account.

NOTES

Memorandum Revaluation a/c

Dr. **Cr.**

		Rs.		Rs.
2010				
Jan 1	To Sundry Debtors a/c	20,000	By Sundry Assets A/c	2,000
			By A Capital A/c	9,000
			By B Capital A/c	6,000
			By C Capital A/c	3,000
			(3:2:1)	
		20,000		20,000
	To Reversal of entry of		By Reversal of entry for	
	increase in value	2,000	decrease in value	20,000
	To A Capital A/c	8,000		
	To B Capital	6,000		
	To D Capital	4,000		
	(4:3:2)			
		20,000		20,000

A's Capital a/c

Dr. **Cr.**

		Rs.			Rs.
2010	To Memorandum		2006	By Balance b/d	65,000
Jan 1	Revaluation A/c	9,000	Dec 31		
	To Balance c/d	95,200		By Goodwill A/c	20,000
				By General Reserve A/c	19,200
		104,200			104,200
	To Goodwill A/c	17,778		By Balance b/d	95,200
	To Balance c/d	85,422		By Memorandum Revaluation	
				A/c	8,000
		103,200			103,200
				By Balance b/d	85,422

C's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2010	To Memorandum Revaluation		2010	By Balance b/d	28,000
Jan 1	A/c	3,000	Dec 1		
	To Loan A/c	38,067		By Goodwill A/c	6,667
				By General Reserve A/c	6,400
		41,067			41,067

NOTES

B's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2010	To Memorandum Revaluation			By Balance b/d	38,000
Jan 1	A/c	6,000		By Goodwill A/c	13,333
	To Balance c/d	58,133		By General Reserve A/c	12,800
		64,133			64,133
	To Goodwill A/c	13,333		By Balance b/d	58,133
	To Balance c/d	50,800	2010	By Revaluation A/c	6,000
		64,133	Jan 1		64,133
				By Balance b/d	50,800

D's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2010	To Goodwill A/c	8,889	2010	By Cash A/c	32,000
Jan 1	To Balance c/d	27,111	Jan	By Memorandum Revaluation A/c	4,000
		36,000			36,000
				By Balance	27,111

NOTES

Balance Sheet as on 1-1-2010

Liabilities		Rs.	Assets	Rs.
Sundry Creditors				
Charu's Loan		50,000	Cash	32,000
A	85,422	38,067	Goodwill	10,000
B	50,000		Sundry Debtors	61,400
D	27,111	163,333	Sundry Assets	148,000
		251,400		251,400

Illustration: 4

Rakesh and Roshan were working in partnership Profits equally. On 31-12-2009. Rakesh decided to retire and in his place it was decided that Dinesh, his son, would be admitted as partner from 1-1-2010 and his share in profits will be one third. The balance sheet of the firm as on 31-12-2009 was as follows.

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	14,700	Goodwill	15,000
Capitals:		Land and Buildings	40,050
Rakesh	54,300	Motor Car	12,000
Roshan	48,000	Furniture	9,300
		Sundry Debtors	24,150
		Cash	16,500
	1, 17,000		1, 17,000

NOTES

It was further decided as under (a) The goodwill should be raised to Rs. 20,000; (b) the motor car would be taken by Rakesh at its book value; (c) The value of land and building would be increased by Rs. 8,780; (d) Roshan and Dinesh would introduce sufficient capital to pay off Rakesh, to leave thereafter Rs. 7,350 as working capital in a manner, that the capitals of the new partners will be in profit sharing ratio; (e) the capital payable by Dinesh was to be gifted to him by his father; (f) the new partners introduced the capital on 10-1-2010. Pass Journal entries and prepare partner's capital A/cs. Cash A/c and the Balance Sheet of the firm as on 10-1-2010.

Solution: Capital of the new firm after the retirement of Rakesh

Assets	Rs.
Goodwill (15,000 + 5,000)	20,000
Land and Building (40,050 + 8,020)	48,330
Furniture	9,300
Sundry Debtors	24,150
Cash (Working Capital Required)	7,350

	1,09,130
Less Sundry Creditors	14,700

Total Capital of the firm =	94,430
	-----------

(2) Dinesh's Capital 1/3 x 94,430 = Rs. 31,477

(3) Roshan's Capital 2/3 x 94,430 = Rs. 62,953

Roshan is to bring Rs. 8,313 (62,953 – (48,000 + 2,500 + 4,140) = 62,953 – 54,640 =8,313

Solution: **Journal**

			Dr. Rs.	Cr. Rs.
2009 Dec 31	Goodwill A/c	Dr.	5,000	
	To Rakesh Capital A/c			2,500
	To Roshan's Capital A/c			2,500
	(being the excess goodwill transferred to capital accounts equally)			
	Rakesh's Capital A/c	Dr.	12,000	
	To Motor Car A/c			12,000
	(being the Motor Car taken by Rakesh)			
	Land and building A/c	Dr.	8,280	
	To Rakesh's Capital A/c			4,140
	To Roshan's Capital A/c			4,140
	(being the increase in value transferred to partners Capital accounts equally)			
	Rakesh's Capital A/c	Dr.	31,477	
	To Dinesh's A/c			31,477
	(being Rakesh's Capital A/c transferred to Dinesh's Capital account as gift)			
	Cash A/c	Dr.	8,313	
	To Roshan's Capital A/c			8,313
	(being the balance Capital introduced by Roshan)			

NOTES

Rakesh's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2009	To Motor Car A/c	12,000	2009	By Balance b/d	54,300
Dec 31	To Balance c/d	48,940	Dec 31	By Goodwill A/c	2,500
				By Land & Building A/c	4,140
		60,940			60,940
2010	To Dinesh's Capital A/c	31,477	2010		
Jan 1	To Cash A/c	17,463	Jan 1	By Balance b/d	48,940
		48,940			48,940

Roshan's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2009	To Balance c/d	54,640	2009	By Balance b/d	48,000
Dec 31			Dec 31	By Goodwill A/c	2,500
				By Land & Buildings A/c	4,140
		54,640			54,640
2010	To Goodwill A/c	13,333	2010	By Balance b/d	54,640
Jan 11	To Balance c/d	49,620	Jan 1	By Cash	8,313
		62,953			62,953
				By Balance c/d	49,620

NOTES

Dinesh's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2010	To Goodwill A/c	6,667	2010	By Rakesh's Capital A/c	31,477
Jan 10	To Balance c/d	24,810	Jan 10		
		31,477			31,477
				By Balance b/d	24,810

Cash A/c

Dr. **Cr.**

		Rs.			Rs.
2009			2010		
Dec 31	To Balance b/d	16,500	Jan 10	By Rakesh's Capital A/c	17,463
	To Roshan's Capital a/c	8,313		By Balance b/d	7,350
		24,813			24,813
2010					
Jan 10	To Balance b/d	7,350			

NOTES

Balance Sheet of the Firm(Roshan and Dinesh) as on 10-1-10

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	14,700	Cash	7,350
Capital:		Sundry Debtors	24,150
Roshan	49,620	Furniture	9,300
Dinesh	24,810	Land & Buildings	48,330
	89,130		89,130

1.4. DEATH OF A PARTNER

1.4.1 INTRODUCTIONS

When a partner dies, the partnership is dissolved. The surviving partners have to settle the deceased partner's account with his legal representatives. This right of the representatives of the deceased partners would depend upon the provisions of the partnership agreement.

From the accountancy point of view, the only difference between the retirement and death of a partner is that, in the former event the retirement partner's due if not paid at once credited to a Loan A/c in his name, whereas in the case of partner's death, his capital and current accounts are transferred to an account called Legal Representatives A/c or his Executor's A/c pending payment.

1.4.2. ACCOUNTING TREATMENT

The problems arising on the death of a partner are similar to those arising on retirement. The only additional point is that as death may occur on any day. This would mean the executors of the deceased partner would be entitled to the partner's share of profits from the beginning of the year to the date of death. Treatment of Joint Life Policy has been given below. Apart from this additional point, the treatment of account is not different from that in case retirement.

After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account; the executors may be paid either in lump sum or by installments. If it is paid in several installments the executors are allowed a certain rate of interest on the unpaid portion. On Payment, the Executor's Account will be debited a Cash A/c or Bank A/c will be credited.

It should be remembered that under Section 37 of the Partnership Act, the executors would be entitled, at their option:

1) to that portion of the profit that is earned by the firm with the help of the amount due to the deceased partner or

2) To interest at 6% p.a. on the amount due from the date of death to the date of payment. Usually, the surviving partners carry on the business, purchasing the share of the deceased partners after determining the amount due to him and then treating it as a loan to the firm.

NOTES

Illustration: 1 **(Executors A/c)**

P, Q and R are partners. The partnership Deed provides inter aria:

1. That the Accounts be balanced on 31^{st} December each year.

2. That the Accounts be divided as follows:

   P ½; Q 1/3; R 1/6;

3. That in the event of death of a partner his executors are entitled to be paid out immediately:

   a) The Capital to his credit at the date of death.

   b) Interest on capital at 5% p... the date of death.

   c) His Proportion to reserve.

   d) His share of goodwill (Goodwill is to be raised on the basis of 2 year's purchase of the average profits of the last 3 years)

   e) His proportion of profits to the date of death based on the average profits of the last 3 completed years.

Q dies on 31^{st} March 2009. His capital account as per last Balance Sheet showed a credit balance of Rs.8, 000. The net profits for 2006, 2007, and 2008 were Rs.5, 000, Rs.6, 000 and Rs.7, 000 respectively. They have a Joint Life Policy for Rs.15, 000 at an annual premium of Rs.500 which is charged to Profit and Loss Account. There was a reserve to the extent of Rs.3, 000 on 31-3-2009.

Solution

1. Calculation of Goodwill

	Rs.
Profit for 2006	5,000
Profit for 2007	6,000
Profit for 2008	7,000
Total Profit	18,000

$$\text{Average Profit} = \text{Rs.} \frac{18,000}{3} = \text{Rs.}6,000$$

2 year's purchase = Rs.12, 000

2. Q's share of goodwill: 1/3rd of Rs.12, 000 = Rs.4, 000

3. Q's share of Profit:

Average Profit is Rs.6, 000

As Q died 31-3-2009, average profit for 3 months =

$$= 6,000 \times \frac{3}{12} \quad \text{Rs.}1,500$$

1/3rd of Rs.1, 500 = Rs.500

NOTES

4. Interest on Q's Capital

Interest 5% for 3 months on Rs.8,000

$$\text{Opening Balance} = 8{,}000 \times \frac{5}{100} \times \frac{3}{12}$$

Rs.100

5. Q's share of Reserve : 1/3rd of Rs.3,000 = Rs.1,000

6. Q's share of Joint Life Policy : 1/3rd of Rs.15,000 = Rs.5,000

Q's Executors A/c

Dr. **Cr.**

		Rs.			**Rs.**
2009	To Cash A/c	18,600	2009	By Balance b/d	8,000
			Jan 1	By Interest A/c	100
				By Reserve A/c	1,000
				By Goodwill A/c	4,000
				By P & L A/c	500
				By Joint Life Policy A/c	5,000
		18,600			18,600

Joint Life Policy

Often, partners take out a life insurance policy on their lives jointly, a small, amount known as premium is paid annually to the insurance company, (LIC). On the death of any one of the partners the insurance company will pay the full amount of the policy. On death, the payment of premium also stops. The object of this is to provide funds to pay out the amount due to the executors of a deceased partner. The arrangement will not upset the working capital of the firm.

The accounting treatment of a Joint Life Policy can taken anyone of the following three ways:

1. When Premium paid is treated as an Expense

Here, premium is treated as an expense. Hence, it is closed by transferring and debiting to Profit and Loss Account. There will be no Joint Life Policy A/c in the books of the firm and naturally nothing will appear in the Balance Sheet.

When the firm receives the full amount of the policy, it is credited to all partners in the profit sharing ratio.

2. When Premium paid is treated as an Asset

In this case, premium is first debited to Joint Life Policy a/c and credited to Cash or Bank A/c. At the end of the year the amount in excess of the surrender value is treated as a loss and is transferred to Profit and Loss A/c. Here the amount received in excess of the surrender value represents gain and is credited to all partners in the profit sharing ratio by debiting the joint A/c.

NOTES

3. **When Premium paid treated as an Asset and reserve is maintained?**

1) In this case also the premium is first debited to Joint Life Policy A/c and credited to Cash or Bank Account. However, it is not proper to show the whole amount paid as an asset, since the insurance company will pay only surrender value, if default in payment of premium is made.

2) At the close of year; in order to reduce the divisible profit among the partners, an amount equal to the premium is debited to Profit and Loss Account and credited to Joint Life Policy Reserve Account.

3) The Joint Life Policy Account the Joint Life Policy Reserve Account are mutually adjusted so as to leave a balance in each account equal to the surrender value of the policy. This will be done by debiting the Joint Life Policy Reserve Account and crediting the Joint Life Policy Account for an amount equal to the excess of the surrender value. The Joint Life Policy Account is shown on the assets side of the Balance Sheet and the Joint Life Policy Reserve Account is shown on the Liabilities side of the Balance Sheet.

4) When partner dies, the amount received is credited to Joint Life Policy Account by debiting Cash or Bank Account.

5) The amount standing to the credit the Joint Life Policy Reserve Account is transferred to the Joint Policy Account by debiting the former and crediting the latter.

6) Finally, the Joint Policy Account too is closed by transfer to the capital account of all partners (including the deceased partner) in the profit sharing ratio.

Date	Particulars		Rs.
Year (1) Beginning	Joint.Life.Policy A/c To Cash A/c (being the premium paid)	Dr.	

NOTES

Year (2) end	Profit & Loss A/c Dr To Joint.Life.Policy A/c (being the reserve made equal to the amount after year of premium paid out)	Repeat year
(3)	Joint.Life.Policy Reserve A/c Dr. To Join.Life.Policy A/c (being the excess of J.L.P A/c over surrender values written off to J.L.P. Reserve A/c)	
(4)	Cash A/c Dr. To Join.Life.Policy A/c (being the entry to close the former A/c)	When a partner DIES
(5)	Joint.Life.Policy A/c Dr. To Capital accounts of all partner (being the amount divided in the profit sharing proportions)	

* J.L.P. – Joint Life Policy; **J.L.P.R – Joint Life Policy Reserve

Illustration: 2

A firm having 3 partner E, F and G, took a Joint Life Policy on 2nd January 2006 Rs.30,000 in order to make provision for funds for repayment of a deceased partner's share. The premium of Rs.800 was paid every year on 2nd January. The last premium was paid on 2nd January 2009. F died on 3rd March 2009.

NOTES

The surrender value of the policy was as under:

		Rs.		Rs.		Rs.
2006	-	Nil,	2007	-600,	2008	-900
2009	-	Rs. 1,175				

When F died, the policy amount was realized in full from L.I.C. Prepare Journal Entries. Joint Life Policy Account and Joint Life Policy Reserve Account for three years. The books were closed on 31st December each year.

Solution **Journal**

Date	Particular	Dr.	Cr.
		Rs.	**Rs.**
2006	Joint Life Policy A/c Dr.	800	
Jan 2	To Cash A/c		800
	(being the premium paid)		
Dec 31	Profit & Loss A/c Dr.	800	
	To J.L.P Reserve A/c		800
	(being the reserve made equal to the amount of premium paid out)		
	J.L.P Reserve A/c Dr.	800	
	To Joint Life Policy A/c		800
	(being the entry for surrender value)		
2007	Joint Life Policy A/c Dr.	800	
Jan 2	To Cash A/c		800
	(being the premium paid)		

NOTES

Dec 31	Profit & Loss A/c Dr.	800	
	To J.L.P Reserve A/c	217	800
	(being the reserve made equal to the amount of premium paid)		
	J.L.P Reserve A/c Dr.	200	
	To Joint Life Policy A/c		200
	(being the excess of J.L.P A/c over surrender value written off to J.L.P Reserve A/c)		
2008 Jan 2	Joint Life Policy A/c Dr.	800	
	To Cash A/c		800
	(being the premium paid)		
Dec 31	Profit & Loss A/c Dr.	800	
	To J.L.P Reserve A/c		800
	(being the reserve made equal to the amount of premium paid)		
Dec 31	J.L.P Reserve A/c Dr.	500	
	To Joint Life Policy A/c		500
	(being the excess of J.L.P A/c over surrender value written off to J.L.P Reserve A/c)		
2009 Jan 2	Joint Life Policy A/c Dr.	800	
	To Cash A/c		800
	(being the premium paid)		
Mar 3	Cash A/c	30,000	
	To Joint Life Policy A/c		30,000
	(being the full policy amount realised on the		

NOTES

	J.L.P Reserve A/c Dr.	900	
	To Joint Life Policy A/c		900
	(being the fully entry to close the former account)		
	Joint Life Policy A/c Dr.	29,200	
	To E's Capital A/c		9,733
	To F's Capital A/c		9,734
	To G's Capital A/c		9,733

Joint Life Policy A/c

Dr. **Cr.**

Date	Details	Rs.	Date	Details	Rs.
2006 Jan 2	To Cash A/c	800	2006 Dec 14	By Joint Life Policy reserve A/c	800
		800			800
2007 Jan	To Cash A/c	800	2007 Dec 14	By Joint Life Policy Reserve A/c	200
				By Balance c/d	600
		800			800
2008 Jan 1	To Balance b/d	600	2008 Dec 14	By Joint Life Policy Reserve A/c	500
Jan 2	To Cash A/c	800		By Balance c/d	900
		1,400			1,400
2009	To Balance b/d	900	2009		
					30,000

Jan 1			Mar 31	By Cash A/c	
Jan 2	To Cash A/c	800		By Joint Life Policy Reserve A/c Transfer	900
Mar 3	To E's Capital A/c	9,733			
	To F's Capital A/c	9,734			
	To G's Capital A/c	9,733			
		30,900			30,900

Joint Life Policy Reserve A/c

Dr.				Cr.	
		Rs.			Rs.
2006 Dec 31	To Joint Life Policy A/c (2)	800	2006 Dec 31	By Profit & Loss a/c (1)	800
		800			800
2007 Dec 31	To Joint Life Policy A/c	200	2007 Dec 31	By Profit & Loss A/c	800
	Balance c/d	600			
		800			800
2008 Dec 31	To Joint Life Policy A/c	500	2008 Jan 1	By Balance b/d	600
	To Balance A/c	900	Dec 31	By Profit & Loss A/c	800
		1,400			1,400
2009	To Joint Life Policy A/c Transferred	900	2009 Jan 1	By Balance b/d	900

NOTES

Illustration: 3 [Executors paid off with the help of Bank O/D]

X, Y and Z were partners sharing profits sin in the proportion of ½, ¼, and ¼ respectively. Their Balance Sheet on 31st December 2008 was follows:

	Rs.		Rs.
Trade Creditors	4,000	Cash	1,000
X's Capital	10,000	Sundry Asset	
Y's Capital	6,000	(Excluding Goodwill)	20,000
Z's Capital	4,000	Loan to X	3,000
	24,000		24,000

1. A died on 1st April 2009. The firm had affected insurance for Rs.10, 000 on the joint lives of three partners. The amount of the policy was realized on 10th May 2009.

2. According to the Partnership Deed, goodwill was to be calculated at 2 year's purchase of the average profits for the preceding completed years.

The trading results were:

2006	Profit	Rs.12, 000
2007	Loss	Rs.4, 000
2008	Profit	Rs.8, 800

NOTES

3. The deceased partner's share of Capital, Goodwill etc. was paid out in Cash on 1st June 2009, the available Cash balance being supplemented by a loan from the firm's bankers on the security of some sundry assets.

You are required to journalize the above transaction and show the important ledger accounts of the partners and the Balance Sheet of the Y and Z on 1st June 2009 as it would stand after X's share is paid off assuming the on goodwill Account is retainer in the books of Y and Z.

Division of J.L.P:

		Rs.
X ½ x 10,000	=	5,000
Y ¼ x 10,000	=	2,500
Z ¼ x 10,000	=	2,500

Calculation of Goodwill:

Profit 2004	12,000
Profit 2008	8,800
	20,800
Less Loss 2007	4,000
	16,800

Average Profits $\dfrac{16{,}800}{3}$ = Rs.5, 600

2 Years Average = 2 x 5,600 = Rs.11, 200

X's Share = ½ x 11,200 = Rs.5, 600

To write off this Rs.5, 600 between Yand Z

Debit Y and Z equally since they are equal partners

NOTES

Solution

Journal

Date	Particulars		Dr.	Cr.
2009	X's Capital A/c Dr.		10,000	
Apr 1	To X's Executors A/c			10,000
	(being the capital accounts transferred to the later)			
	X's Executors A/c Dr		3,000	
	To X's Loan A/c			3,000
	(being the loan account transferred to the former)			
	Goodwill A/c Dr.		5,600	
	To X's Executors A/c			5,600
	(being X's share of goodwill raised)			
	Y's Capital A/c Dr.		2,800	
	Z's Capital A/c Dr.		2,800	
	To Goodwill A/c			5,600
	(being X's share of goodwill raised now written off to Y & Z equally)			
	Cash A/c Dr.		10,000	
	To Joint Life Policy A/c			10,000
May 10	(being the full policy amount realized on X's death)			
	Joint Life Policy A/c Dr.		10,000	

NOTES

	To X's Executors A/c			5,000
	To Y's Capital A/c			2,500
	To Z's Capital A/c			2,500
	(being the amount of J.L.P credited between X, Y and Z in the ratio of ½, ¼ and ¼)			
June 1*	Cash A/c Dr.		6,600	
	To Bank Overdraft A/c			6,600
	(being the O/D arranged)			
	X's Executors A/c Dr.		17,600	
	To Cash A/c			17,600
	(being the executors of X paid of in full)			

* After preparing Executors A/c and Cash A/c these entries are passed.

X's Executors A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2009 Apr 1	To X's Loan A/c	3,000	2009 Apr 1	By X's Capital A/c transferred	10,000
Jun 1	To Cash A/c	17,600	May 10	By Goodwill A/c	5,600
				By Joint Life Policy A/c	5,000
		20,600			20,600

NOTES

B's Capital A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2009 Apr 1	To Goodwill A/c	2,800	2009 Apr 1	By Balance b/d	6,000
May 31	To Balance c/d	5,700	May 16	By Joint Life Policy A/c	2,500
		8,500			8,500
				By Balance b/d	5,700

Z's Capital A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Apr 1	To Goodwill A/c	2,800	2009 Apr 1	By Balance b/d	4,000
May 31	To Balance c/d	3,700	May 1	By Joint Life Policy A/c	2,500
		6,500			6,500
				By Balance b/d	3,700

NOTES

Goodwill A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Apr 1	To A's Executors A/c	5,600	2009 Apr 1	By B's Capital A/c	2,800
				By C's Capital A/c	2,800
		5,600			5,600

Joint Life Policy A/c

Dr. **Cr.**

		Rs.			Rs.
2009 May 10	To X's Executors A/c	5,000	2009 May 10	By Cash A/c	10,000
	To Y's Capital A/c	2,500			
	To Z's Capital A/c	2,500			
		10,000			10,000

NOTES

Cash A/c

Dr. **Cr.**

		Rs.			**Rs.**
2009 Apr 1	To Balance b/d	1,000	2009 May 10	By X's Executors A/c	17,600
May 10	To Joint Life Policy A/c	10,000			
	To Bank O/D A/c	6,600			
		17,600			17,600

Bank O/D A/c

Dr. **Cr.**

		Rs.			**Rs.**
2009 May 31	To Balance c/d	6,600	2009 May 10	By Cash A/c	6,600
		6,600			6,600
			2009 June 1	By Balance b/d	6,600

NOTES

Cash A/c

Dr. Cr.

		Rs.			Rs.
2009 Apr 1	To Balance b/d	1,000	2009 May 10	By X's Executors A/c	17,600
May 10	To Joint Life Policy A/c	10,000			
	To Bank O/D A/c	6,600			
		17,600			17,600

Bank O/D A/c

Dr. Cr.

		Rs.			Rs.
2009 May 31	To Balance c/d	6,600	2009 May 10	By Cash A/c	6,600
		6,600			6,600
			2009 June 1	By Balance b/d	6,600

NOTES

1.5. DISSOLUTION OF FIRM

1.5.1. INTRODUCTION

In our previous lesson, it has been pointed out when a partner retires or dies the partnership will come to an end. The other partner may continue to do the business. In such case there will be a new partnership but the firm will continue in reconstituted form. In other words, dissolution of a Partnership involves a change in the relations of partners.

1. When the object with which it was started is fulfilled;
2. When the fixed period for which it was started is ended;
3. When a partner retires;
4. When a partner dies; and
5. When a partner becomes insolvent.

When a firm decided to close down its business so that it ceases to exist it is said that the firm is dissolved; if the business also comes to an end, then only it will be said, that the firm has been dissolved. Dissolution of a firm thus, means the closing down of the business.

A firm will be dissolved on the happening of the above contingencies, in the absence of any contract of the contrary.

A Firm stands dissolved

1. When the partners agree that the firm should be dissolved.
2. When all the partners except one become insolvent;
3. When the business becomes illegal;
4. When a partner given notice of dissolution; and
5. When the court orders dissolution.

The dissolution of partners may or may not result in the dissolution of the firm, but the dissolution of a firm will necessarily result in the dissolution of the partnership.

When a firm is dissolved a public notice must be given, otherwise, the partners continue to be liable to outsiders for any act done on behalf of the firm thereafteı, as if the firm is not dissolved.

Settlement of Accounts

As soon as a firm is dissolved, it ceases to transact normal business. It proceeds to

1. Realize all its assets.
2. Apply the realized sums for meeting all its liabilities.
3. Distribute the remaining sums among partners.

The above means that the amount realized by sale of the firm's assets should be used;

First to pay outsiders and then only to repay the loans of the partners.

The losses of the firm on dissolution have to be made up

i) First out of past accumulated profits.

NOTES

ii) Next out of capitals of the partners.

iii) Lastly, if necessary (if the loss is still not recovered fully) out of contributions from the private estates of the partners in the profit-sharing ratio.

In the absence of any specific agreement between the partners as to the made of settlement of accounts after the dissolution of the firm, the provision of the Partnership Act as described above shall apply.

Firm's Debt & Private Debts

The private property of a partner is to be used first to pay his private debts and only the surplus, if any, can be used to pay firm's debts.

Similarly, firm's assets are first used to pay firm's debts. A partner can use only his share of the surplus to pay his private debts.

1.5.2. Settlement of Accounts

For the purpose of dissolution the partnership assets have to realize and the liabilities have to be paid off. Then the partner's accounts are finally adjusted inter se. In other words, the accounting work that has to be done can be divided into 2 parts:

1. # Realization of Assets and Payment of Liabilities.

2. Settlement of the Accounts of Partners inters se. We will, discuss the two steps below; we have learnt that when the business is discontinued, the firm is said to be dissolved. As a result all the accounts including Cash A/c or Bank and Capital Accounts will be closed. How can you close them until all the assets have been disposed off and all the liabilities are paid off? If we transfer all the assets and liabilities to a special account known as Realization Account these accounts will then stand closed.

In this Realization Account all transaction, relating to realization of assets and payment of liabilities are recorded. During the course of realization, some expenses may be incurred. They are known as realization expenses. At this stage, the Realization Account will show profit or loss; on dissolution. If the debit side is more there is a loss; if the credit side is more there is a profit. This profit or loss transferred to the capital accounts of partners in their profit-sharing ratio. Realization means conversion of business assets into cash

1. Transfer all the Assets of the firm at Books values. (Don't transfer accumulated losses like P & L A/c Debit Balance & Debit Balance on Advertisement Suspense A/c) (Similarly don't transfer Cash A/c and Bank A/c since they are already in the most liquid from) But if there is dissolution of a form due to sale of the business then Cash A/c and Bank A/c will also be transferred to Realization A/c unless specifically mentioned otherwise. N.B.: (A) It should be remembered that Sundry Debtors Account and Reserve for Bad Accounts and the Gross Amount of Sundry Debtors should be transferred to Realisation A/c. (B) If Goodwill appears in the Balance Sheet, it is treated like any other assets and is closed by transferring it to Realisation A/c at books value. If it does not so appear, there is no question of transfer, If a partner takes up the business and agrees to pay a sum for goodwill his	Realization A/c Dr. To individual Assets A/c [being the assets transferred to Realisation A/c]

NOTES

capital account will be debited and the Realisation Account Credited with the agreed sum. (C) The Reserve for Discount on Creditors is to be transferred to Realisation A/c.	
2. Transfer all the Liabilities of the firm at books values (Don't transfer accumulated balances of profits like Reserve Fund and P & L A/c Credit Balance Similarly, don't transfer the loan accounts of partner) (The Reserve for bad and Doubtful Debts A/c and Reserve for Discount on Debtors A/c are to be transferred to the Realisation A/c)	
N.B.: Transfer Joint Life Policy Reserve and other Specific provisions like Fluction Fund, Dividend Equalization Fund, etc.	Individual Liabilities A/c Dr. To Realisation A/c (being the liabilities transferred to Realisation A/c)
3. (a) Record the assets that are sold for cash. N.B.: (A) If something is realized for goodwill then, debit Cash A/c and Credit Realization A/c. (B) If an unrecorded asset is sold for cash then debit Cash or bank A/c and credit Realization A/c). It is a gain.	

(C) If a partner receive remuneration for realizing asset, then, debit Realisation A/c and credit his Capital A/c	
3. (b) Record the asset that are taken over by a partner. N.B.: If goodwill is purchased by a partner, then debit partners Capital A/c and credit Realisation A/c	CashA/c Dr. To Realisation A/c (being the amount realized on sale of the assets)
4. Record the realisation expenses in connection with the dissolution: N.B.: If partner agree to defray the realisation expenses debit his Capital Account end credit Cash A/c.	
5. Pay off the liabilities N.B.: For the payment of unrecorded liability; debit Realisation A/c and credit Cash A/c. It is a loss.	Partner's Capital A/c Dr. To Realisation A/c. (being the asset taken over by)
6. a) Liabilities that are under taken by a partner 7. Transfer the Profit or Loss on Realisation	Realisation A/c Dr. To Cash A/c (being the payment of realisation expenses)

NOTES

NOTES

8. Pay off Partner's Loan if any:	Realisation A/c Dr. To Cash A/c (being the settlement of liabilities)
9. Distribute accumulated profits like Reserve Fund etc.: N.B.: Similarly transfer all accumulated losses like P&L A/c (Debit Balance) in the Balance Sheet.	Realisation A/c Dr. To Partner's Capital A/c (being the liability undertaken by)
10. Close the Capital Accounts of Partners: N.B.: The Capital Account will show how much money is due for each partner. Now, the Cash A/c or Bank A/c shows them to which is just sufficient balance pay off the amount due to each partner. Money will be paid to them. This will close the Capital Accounts as well as Cash or Bank A/c.	Realisation A/c Dr. To Partner's Capital A/c (being the profit on realisation dividend according to the profit sharing ratio) N.B.: If there is loss, reserve the above entry and suitably amend the narration.
11. Should the Capital Accounts of partner's show a debit balance after adjustments of the loss on Realisation, it means, such a partner is a debtor to the firm. Then, the is required to bring the cash to clear off his debit balance in his Capital A/c. (1) If he is unable to bring cash to	Partner's Loan A/c Dr. To Cash A/c (being the Loan pad off) Reserve Fund A/c Dr.

NOTES

clear off his debit balance.	To Partner's Capital A/c (being the reserve distribute according to profit sharing ration) N.B.: For this, reserve the above entry and suitably amend the narration. Partner's Capital A/c Dr. To Cash A/c (being the payment made to partner's what is due to each of them) Cash A/c Dr. To Partner's Capital A/c (being the amount brought in by to make up his deficiency) Then his debit balance will be written off against other solvent partners in their last agreed ratios. (Garner Vs. Murray, See Lesson No.7)

Note: If Capital's are fixed all the adjustment with regard to dissolution are made through Current Accounts. Finally, the Current Account a balance will be transferred to the respective Capital Account.

Illustration: 1

Sasi, Sampath and Saran were in partnership sharing profit and losses in the proportion of 5:3:2. The decided to dissolve their partnership when their Balance Sheet as on 31st December 2009 was as follows:

Liabilities	Rs	Rs	Assets	Rs
Capital :				
Sasi	10,000		Goodwill	2,000
Siva	5,000		Stock	12,500
Saran	2,500		Debtors	10,000
		17,500	Cash	500
		7,500		
Sundry Creditors				
		25,000		
				25,000

On Dissolution, debtors realized Rs.8, 000 and Stock Rs.10, 000. The dissolution expenses amounted to Rs.500. The Sundry Creditors were paid off less 10%. There was an old Typewriter in the firm which had been written off completely from the books. It is now estimate to realize Rs.750. It was taken over by Gopalan at the estimated price. Prepare Journal Entries and the Ledger Accounts to close the books of the firm.

NOTES

Solution **Journal**

Date	Particulars	Dr.	Cr.
2009	Realisation A/c Dr.	24,500	
Dec 31	To Goodwill A/c		2,000
	To Stock A/c		12,500
	To Debtors A/c		10,000
	(being assets transferred to Realisation A/c)		
	Sundry Creditors A/c Dr.	7,500	
	To Realisation A/c		7,500
	(being the liability transferred to Realisation A/c)		
	Cash A/c Dr.	18,000	
	To Realisation A/c		18,000
	(being the amount realized on sale of assets : Stock Rs.10,000 + Dis. Rs.8,000)		
	Realisation A/c Dr.	500	
	To Cash A/c		500
	(being the payment of realisation expenses)		
	Realisation A/c Dr.	6,750	
	To Cash A/c		6,750
	(being the settlement of sundry creditors at a discount of 10%)		
	Saran's Capital A/c Dr.	750	
	To Realisation A/c		750
	(being the old unrecorded typewriter taken over by Gopalan at the estimated price)		

NOTES

	Sasi's Capital A/c	Dr.	2,750	
	Siva's Capital A/c	Dr.	1,650	
	Saran's Capital A/c	Dr.	1,100	
	To Realisation A/c			5,500
	(being the loss on realisation dividend according to the profit sharing ratio of 5:3:2)			
	Sasi's Capital A/c	Dr.	7,250	
	Siva's Capital A/c	Dr.	3,350	
	Saran's Capital A/c	Dr.	650	
	To Cash A/c			11,250
	(being the payment to partners what is due to each of them)			

Goodwill A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Dec 31	To Balance b/d	2,000	2009 Dec 31	By Realisation A/c Transfer	2,000
		2,000			2,000

NOTES

Stock A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Dec 31	To Balance b/d	12,500	2009 Dec 31	By Realisation A/c Transfer	12,500
		12,500			12,500

Realisation A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Dec 31	To Balance b/d	10,000	2009 Dec 31	By Realisation A/c Transfer	10,000
		10,000			10,000

Sundry Creditors A/c

Dr. **Cr.**

		Rs.			Rs.
2009 Dec 31	To Realisation A/c Transfer	7,500	2009 Dec 31	By Balance b/d	7,500
		7,500			7,500

NOTES

Realisation A/c

Dr. Cr.

		Rs.			Rs.
2009	To Goodwill A/c	2,000	2009	By Sundry Creditors A/c	7,500
Dec 31	To Stock A/c	12,500	Dec 31	By Cash A/c	18,000
	To Debtors A/c	10,000		BySaran's Capital A/c	750
	To Cash A/c Exp.	500		By Loss transferred to:	
	To Cash A/c Creditors	6,750		Sasi's Capital A/c	2,750
				Siva's Capital A/c	1,650
				Saran's Capital A/c	1,100
				[5:3:2]	
		31,750			31,750

Sasi's Capital A/c

Dr. Cr.

		Rs.			Rs.
2009	To Realisation A/c	2,750	2009	By Balance b/d	10,000
Dec 31	Loss		Dec 31		
	To Cash A/c	7,250			
		10,000			10,000

NOTES

Siva's Capital A/c

Dr.					Cr.
		Rs.			Rs.
2009	To Realisation A/c	1,650	2009	By Balance b/d	5,000
Dec 31	Loss		Dec 31		
	To Cash A/c	3,350			
		5,000			5,000

Saran's Capital A/c

Dr.					Cr.
		Rs.			Rs.
2009	To Realisation A/c	750	2009	By Balance b/d	2,500
Dec 31	Typewriter		Dec 31		
	To Realisation A/c				
	Loss	1,100			
	To Cash A/c	650			
		2,500			2,500

Cash (Capital A/c) 21+

Dr. **Cr.**

		Rs.			Rs.
2009	To Balance c/d	500	2009	By Realisation A/c	500
Dec 31	To Realisation A/c	18,00C	Dec 31	By Realisation A/c	6,750
				By Raman's Capital A/c	7,250
				By Krishnan's Capital A/c	3,350
				By Gopalan's Capital A/c	650
		18,500			18,500

Illustration: 2

Red, White and Green sharing profits in the proportions of 3:2:1 agreed upon dissolution of their partnership on 31st December on which date their Balance Sheet was as under :

Liabilities	Rs	Assets	Rs
		Goodwill	11,500
Capital Accounts :		Machinery	40,500
Red 40,000		Stock	7,550
White 20,000		Investments	20,830
Green 11,500		Joint Life Policy	14,000
---------	71,500	Debtors 9,300	
Mrs. Blue's Loan	10,000	Less Reserve 600	
Creditors	18,500	--------	
Joint Life Policy Reserve	14,000	Cash at Bank	8,700
Investments Fluctuation Fund	3,000		16,920
Reserve Fund			
	3,000		
	1,20,000		1,20,000

The Life Policy is surrendered for Rs.12, 000. The investments are taken over by Blue for Rs.17, 500. Black takes over all the Stock at Rs.7, 000. Brown takes over Debtors amounting Rs.5, 000 at Rs.4, 500. The remaining Debtors realize 50% of book value. Machinery is sold for Rs.55, 000. The expenses of realisation amounted to Rs.600 is allowed to carry on the trade in the firm's name on his taking over the Goodwill at Rs.5, 000. Show the journal entries and prepare important ledger accounts on completion of the dissolution of the firm.

NOTES

Solution **Journal**

Date	Particular	Dr.	Cr.
	Realisation A/c Dr.	1,03,68 0	
	To Goodwill A/c		11,500
	To Machinery A/c		40,500
	To Stock A/c		7,550
	To Investment A/c		20,830
	To Joint Life Policy A/c		14,000
	To Debtors A/c		9,300
	(being the assets transferred to Realisation A/c)		
	Mrs. Red's Loan A/c Dr.	10,000	
	Creditors A/c Dr.	18,500	
	Investment Fluctuation Fund A/c Dr.	3,000	
	Joint Life Policy Reserve A/c Dr.	14,000	
	Reserve for Doubtful Debts A/c Dr.	600	
	To Realisation A/c		46,100
	(being the liabilities and specific provision transferred to Realisation A/c)		
	Reserve Fund A/c Dr.	3,000	
	To Red's Capital A/c		1,500
	To White's Capital A/c		1,000
	To Green's Capital A/c		500
	(being the reserve distributed according to		

NOTES

	profit sharing ratio of 3:2:1)		
	Bank A/c Dr. To Realisation A/c (being the life policy surrendered for Rs.12,000)	12,000	 12,000
	Red's Capital A/c Dr. To Realisation A/c (being the investment taken over by Blue's at the agreed value)	17,500	 17,500
	Red's Capital A/c Dr. To Realisation A/c (being the stock taken over by Balance at the agreed value)	7,000	 7,000
	Green's Capital A/c Dr. To Realisation A/c (being the debtors of Rs.5,000 taken over by Green at the agreed value of Rs.4,500)	4,500	 4,500
	Bank A/c Dr. To Realisation A/c (being the remaining debtors of Rs.4,500 (Rs.9,300 – Rs.5,000) 50%	2,150	 2,150
	Bank A/c Dr. To Realisation A/c (being the machinery realized)	35,000	 35,000
	Red's Capital A/c Dr.	5,000	

	To Realisation A/c (being the goodwill taken over by Red at the agreed value)	217	5,000
	Realisation A/c Dr. To Bank A/c (being the payment of Realisation expenses)	600	600

NOTES

Realisation A/c

Liabilities	Rs	Assets	Rs
To Goodwill	11,500	By Mrs. Red's Loan	10,000
To Machinery	40,500	By Creditors	18,500
To Stock	7,550	By Investment Fluctuation Fund	
To Investment	20,830		3,000
To Joint Life Policy	14,000	By Joint Life Policy Reserve	
To Debtors	9,300	By Reserve for Doubtful Debts	14,000
To BankRed's (Expenses)	600		600
		By Bank	
To Bank		By Joint Life Policy 12,000	600
To Mrs.Red's Loan 10,000	28,500	By Debtors 2,150	
		By Machinery 55,000	
To Creditors 18,500		--------	
To Profit transferred to		ByRed's Capital Investment	69,150
Red A/c 8,235			
White A/c 5,490		By White's Capital A/c (Stock)	17,500
Green A/c 2,745		By Green's Capital A/c	7,000

NOTES

--------		(Debtors)	
		By Red's Capital A/c (Goodwill)	4,500
	16,470		5,000
	1,49,250		1,49,250

Red's Capital Account

Dr. Cr.

	Rs.		Rs.
To Realisation A/c (Investment)	17,500	By Balance b/d	40,000
To Realisation A/c (goodwill)	5,000	By Reserve Fund	1,500
		By Realisation A/c (Profit)	8,235
To Bank A/c (Balancing Figure)	27,235		
	49,735		49,735

NOTES

White's Capital Account

Dr. Cr.

	Rs.		Rs.
To Realisation A/c (Stock)	7,000	By Balance b/d	20,000
To Bank A/c (Balancing Figure)	19,490	By Reserve Fund	1,000
		By Realisation A/c (Profit)	5,490
	26,490		26,490

Green's Capital Account

Dr. Cr.

	Rs.		Rs.
To Realisation A/c (Debtors)	4,500	By Balance b/d	11,500
To Bank A/c (Balancing Figure)	10,245	By Reserve Fund	500
		By Realisation A/c (Profit)	2,745
	14,745		14,745

Bank Account

Dr. **Cr.**

	Rs.		Rs.
To Balance b/d	16,920	By Realisation A/c	600
To Realisation A/c (Sundry		By Red's A/c	28,500
assets realized)	69,150	By Red's A/c	27,235
		By White's A/c	19,490
		By Green's A/c	10,245
	86,070		86,070

1.6. INSOLVENCY OF A PARTNER INCLUDING PIECEMEAL DISTRIBUTION

1.6.1 INTRODUCTION

We have already learned how; at the time of dissolution any loss arising from the realization of assets, was borne by the partners in the same proportion as they had shared profits and losses of the business.

Trading Loss and Insolvency Loss

When a partner is unable to pay his debt due to the fir, he is said to be insolvent. As the liability of partners is unlimited the solvent partners will be required to make up the deficiency of the insolvent partner. Now, the question arises as to whether this loss is like the other losses to be born in the profit sharing ratio or whether it is a special case to be dealt with differently. But after the decision of Justice Joyce in the case of Garner vs. Murray, the loss caused by the insolvency of partner was distinguished from the ordinary loss.

1.6.2 ACCOUNTING TREATMENT: Garner vs. Murray

The judgment laid down the following rules:

a) Solvent partners should bring further cash equal to their share of the loss on realization

b) The loss on account of the insolvent partners should be borne in their ratio capitals after (a)

The determination capital ratio for this purpose is described below. Partners are free to have either fixed or fluctuating capital in the firm:

1. If the capitals are fixed (all adjustment will be made through current accounts), solvency loss is distributed in the ratio of fixed capital.

2. If the capitals are fluctuating, insolvency loss is distributed according to the actual capital.

(i.e., after adjusting all the reserves and accumulated profits to date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on realization.

Treat this loss as fictitious asset and divide in the last agreed capital ratio. If there is any provision in the partnership. Deed as to the ratio in which losses arising from capital deficiency of an insolvent partner shall be borne, then this ratio will be applicable. In the absence of such provision, the ruling in Garner Vs. Murray will be applicable. Some people think that this English decision is not applicable to India. We can say that the decision can be followed till an Indian Court decides otherwise.

The above paragraph is explained with example. For example X's Capital is Rs. 5,000 and Y's Capital is Rs.3, 000, Z's Capital A/c shows a debit balance of Rs.3, 000. Further, there is Reserve Fund of Rs.3, 000, Z is an insolvent.

If the capitals are fixed, the loss on Z's Capital Account will be borne by x and y in their fixed capital ratio is 5:3

NOTES

If the capitals are fluctuating the loss on Z's capital account will be borned X and Y. in their actual ratio 6: 4 (i.e., capital after adjustments for Reserve Fund X's Capital will be Rs.5,000 + ½ of Reserve Fund Rs.1,000 = Rs.6,000 and Y's Capital will be 3,000 = 1/3rd of Reserve Fund Rs.1,000 = Rs.4,000

The decision in Garner vs. Murray does not always work equitable. For instance, in the example described above it might be possible, if Y having debit balance on his Capital Account and was not insolved, then he could not be called upon to bear the loss on account for the insolvency of Z. The position will be very peculiar, if a solvent partner does not have any capital, he will not be called upon to share any deficiency of insolvent partner, if Garner vs. Murray decision is followed. Therefore, the application of the ruling in Garner vs. Murray may be excluded by an express agreement (in the Partnership Deed) among partners.

1.6.3 FIXED CAPITAL METHOD:

Illustration: 1

P, Q and R dissolve partnership and their Balance sheet stood at

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	4,000	Cash	500
Bills Payable	640	Debtors	3,800
P's Capital	6,000	Building	7,000
Q's Capital	5,000	R's Capital over-drawn	4,340
	15,640		15,640

The partners share profits and losses as follows:

P ½, Q 3/10, R 1/5

The assets on being sold realize the following sum:

Debtors	Rs 2,000,	Building	Rs 14,000

R is unable to contribute anything. He is insolvent Draw up the Realisation A/c, Cash A/c and the Partner's Capital Accounts. Assume that the Capital are fixed.

Hints

The whole position, when a partner becomes insolvent, may be summed like up this:

1. Open a Realisation A/c and record therein entries as usual.
2. Distribute the accumulated profits, if any, among all the partners according to their profit sharing ratio.
3. Profit or loss on realisation should be distributed among all the partners according to their profit sharing ratio.
4. Solvent partners should bring further cash equal to their share of loss realisation.
5. The debit balance in the capital account of the insolvent partner should be borne by the solvent partners either.

    a) In the ratio of fixed capitals if capital are fixed.

    or

    c) In the ratio of actual capitals, if capitals are not fixed.

NOTES

Solution **Realization A/c**

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Debtors A/c	3,800	By Sundry Creditors	4,000
To Building A/c	7,000	By Bills Payable	640
To Cash A/c		By Cash A/c	
Crs. 4,000		Debtors. 2,000	
B/P 640		Building 14,000	
---------	4,640	---------	
To Profit transferred to:			16,000
P 2,600			
Q 1,560			
R 1,040			
(5:3:2) --------	5,200		
	20,640		20,460

P's Capital Account

Dr. **Cr.**

	Rs.		**Rs.**
To R's Capital A/c 6/11	1,800	By Balance b/d	6,000
To Cash A/c	6,800	By Realization A/c	2,600
	8,600		8,600

Q's Capital Account

Dr. **Cr.**

	Rs.		Rs.
To R's Capital A/c 5/11	1,500	By Balance b/d	5,000
To Cash A/c	5,060	By Realization A/c	1,560
	6,560		6,560

R's Capital Account

Dr. **Cr.**

	Rs.		Rs.
To Balance b/d	4,340	By Realization A/c	1,040
		By P's Capital A/c	
		(3,300 x 6/11)	1,800
		By Q's Capital A/c	
		(3,000 x 5/11)	1,500
	4,340		4,340

N.B.R's Capital Debit Balance Rs.3, 300 [Rs.4, 340 – Rs.1, 040] should be borne by Pand Q in the ratio of Capitals just before dissolution i.e., Rs.6, 000; Rs.5, 000 or 6:5 i.e.

NOTES

$$\frac{6}{11} \text{ And } \frac{5}{11}$$

1.6.4. FLUCTUATING CAPITAL METHOD

Illustration: 2

Mani, Sathish and Lakshmi were equal partners in a firm. At the time of dissolution of the firm their Balance Sheet was as follows:

Liabilities		Rs	Assets	Rs
Creditors		2,500	Cash	500
Capital Accounts			Sundry Assets	15,000
Mani	5,500			
Sathish	4,500			
Lakshmi	1,500			
	-------	11,500		
Profit and Loss A/c		1,500		
		15,500		15,500

The Sundry Assets realized Rs.8, 900 only and the expenses on realisation amounted to Rs.560. Lakshmi is insolvent. Assume the capitals are not fixed. Give important ledger accounts along with journal entries.

NOTES

Solution

Journal

Date	Particulars	L.F	Dr.	Cr.
	Realisation A/c Dr. To Sundry Assets A/c (being the sundry assets transferred to Realisation A/c)		15,000	 15,000
	Creditors A/c Dr. To Realisation A/c (being the liability transferred to Realisation A/c)		2,500	 2,500
	Profit and Loss A/c Dr. To Mani's Capital A/c To Sathish's Capital A/c To Lakshmi's Capital A/c (being the accumulated profit distributed in the profit sharing ratio ie., equally)		1,500	 500 500 500
	Cash A/c Dr. To Cash A/c (being the payment of realisation)		8,900	 8,900
	Realisation A/c Dr. To Cash A/c (being the payment of realisation expenses)		560	 560
	Realisation A/c Dr. To Cash A/c		2,500	 2,500
	(being the settlement of liabilities)			

NOTES

	Mani's Capital A/c Dr. Sathish's Capital A/c Dr. Lakshmi's Capital A/c Dr. To Realisation A/c (being the loss on realization divided equally)		2,220 2,220 2,220	6,660
	Cash A/c Dr. To Mani's Capital A/c To Sathish's Capital A/c (being the solvent partners brought cash for their share of loss on realisation)		4,440	2,220 2,220
	Mani's Capital A/c Dr. Sathish's Capital A/c Dr. To Lakshmi's Capital A/c (being the deficiency in Lakshmi's Capital A/c borne by other solvent partners in the ratio of 6,000 : 5,000 i.e., capital plus their share of accumulated profit)		120 100	220
	Mani's Capital A/c Dr. Sathish's Capital A/c Dr. To Cash A/c (being the payment due to partners what is due to each of them)		5,880 4,900	10,780

The solvent partners should bring in cash equal to their share of the loss on realisation.

The loss due to insolvency of Lakshmi should be borne by the other partners in the ratio of capitals then standing.

NOTES

Realisation A/c

Dr. **Cr.**

	Rs.		Rs.
To Sundry Assets A/c	15,000	By Creditor A/c	2,500
To Cash A/c	560	By Cash A/c	8,900
To Cash A/c	2,500	By Loss Transferred to :	
		Mani's Capital A/c 1/3	2,220
		Sathish's Capital A/c 1/3	2,220
		Lakshmi's Capital A/c 1/3	2,220
	18,060		18,060

Mani's Capital A/c

Dr. **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Realisation A/c Loss 1/3	2,220	By Balance b/d	5,500
To Lakshmi's Capital A/c	120	By Profit & Loss A/c	500
To Cash A/c	5,880	By Cash A/c	2,220
	8,220		8,220

NOTES

Sathish's Capital A/c

Dr. Cr.

	Rs.		Rs.
To Realisation A/c Loss 1/3	2,220	By Balance b/d	4,500
To Lakshmi's Capital A/c	100	By Profit & Loss A/c	500
To Cash A/c	4,900	By Cash A/c	2,220
	7,220		7,220

Lakshmi's Capital A/c

Dr. Cr.

	Rs.		Rs.
To Realisation A/c Loss 1/3	2,220	By Balance b/d	1,500
		By Profit & Loss A/c	500
		By Mani's Capital A/c $220 \times \frac{6,000}{11,000}$	120
		By Sathish's Capital A/c $220 \times \frac{5,000}{11,000}$	100
	2,220		2,220

Illustration: 3

NOTES

Arivu, Beema and Charles were partners in firm. They shared profits and losses, Arivu 40% Beema 30% and Charles 30%. The firm was dissolved and Beema was appointed to realize the assets and distribute the proceeds. Beema is to receive 5% commission on the amount realized from sale of assets and to bear all expenses of realisation.

The Balance Sheet on the date of dissolution was as under

Dr. **Cr.**

Liabilities	**Rs**	**Assets**		**Rs**
Creditors	59,000	Cash		1,500
Arivu's Capital	30,000	Debtors	45,500	
Beema's Capital	20,000	Less Provision	2,500	
			----------	43,000
		Stock		60,000
		Charles's Capital over drawn		4,500
	1,09,000			1,09,000

Debtors realized Rs.35, 000; Stock Rs.45, 000; Goodwill Rs.2, 000. Creditors were paid Rs.57, 500 in full settlement. In addition Outstanding Creditors, Rs.500 were also paid. The expenses amounted to Rs.600. Arivu and Beema agreed to reserve Rs.3, 000 in full settlement. Show Realisation A/c, Cash A/c and Capital Accounts of the partners.

NOTES

Realisation A/c

Dr. **Cr.**

	Rs.			Rs.
To Debtors	45,500	By Provision for Bad Debts		2,500
To Stock	60,000	By Creditors		59,000
To Cash A/c (Charles's)	57,500	By Cash Account:		
To Cash (Outstanding Crs)	500	Debtors	35,000	
To Beema's A/c (Commission @ 5% on 82,000	4,100	Stock	45,000	
		By Goodwill	2,000	82,000

		By Loss Transferred to:		
		Arivu	9,640	
		Beema	7,230	
		Charles	7,230	24,100
	1,67,000			1,67,000

Charles's Capital A/c

Dr. **Cr.**

	Rs.			Rs.
To Balance b/d	4,500	By Cash		3,000
To Loss on Realisation	7,230	By Arivu's Capital A/c 3/5	5,238	
		Beema's Capital A/c 2/5	3,492	
			--------	8,730
	11,730			11,730

NOTES

Arivu's Capital A/c

Dr. **Cr.**

	Rs.		Rs.
To Loss on Realisation	9,640	By Balance b/d	30,000
To Charles's Capital A/c	5,238	By Cash (Realisation)	9,640
(Rs.8,740 in the ratio of (3:2)			
To Cash (B.F)	24,762		
	39,640		39,640

Beema's Capital A/c

Dr. **Cr.**

	Rs.		Rs.
To Loss on Realisation	7,230	By Balance b/d	20,000
To Charles's Capital A/c	3,492	By Cash (Realisation Loss)	7,230
To Cash (Realisation Exps).	600	By Realisation A/c (Commission)	4,100
To Cash (B.F)	20,008		
	31,330		31,330

NOTES

Cash A/c

Dr. Cr.

Particulars		Rs.	Particulars		Rs.
To Balance b/d		1,500	By Realisation A/c		
To Realisation			By Creditors	57,500	
Debtors	35,000		Outstanding Crs.	500	58,000
Stock.	45,000		By Arivu's Capital A/c	------	24,762
Goodwill	2,000	82,000	By Arivu's Capital A/c (Expenses)		600

To Charles's Capital A/c		3,000	By Beema's Capital A/c		20,008
To Arivu's Capital A/c (R Loss)		9,640			
To Beema's Capital A/c (R Loss)		7,230			
		1,03,370			1,03,370

NOTES

Illustration: 4 **[All partners become insolvent]**

Kishore and John are partners sharing profits and losses in the ratio of.3:1. Their Balance Sheet was follows when they dissolved the firm.

		Rs.		Rs.
Sundry Creditors		10,000	Cash	500
Capitals :			Sundry Assets	18,500
Kishore	7,500			
John	1,500			
	------	9,000		
		19,000		19,000

The Sundry Assets realized Rs.6, 000 only. The estate of John could not contribute anything but Kishore contributed Rs.1, 000. The expenses of realization were Rs.300. Both are declared insolvent. Close the books of the firm by giving ledger accounts.

Solution **Realization A/c**

Dr. Cr.

	Rs.		Rs.
To Sundry Assets	18,500	By Cash A/c	6,000
To Cash A/c Exp.	300	By Loss transferred to :	
		Kishore's Capital A/c ¾	9,600
		John's Capital A/c ¼	3,200
	18,800		18,800

NOTES

Cash A/c

Dr. Cr.

	Rs.		Rs.
To Balance b/d	500	By Realisation A/c	300
To Realisation A/c	6,000	By Sundry Creditors A/c Exp.	7,200
To Kishore's Capital A/c (Contribution)	1,000		
	7,500		7,500

Sundry Assets A/c

Dr. Cr.

	Rs.		Rs.
To Balance b/d	18,500	By Realisation A/c Transfer	18,500
	18,500		18,500

Sundry Creditors A/c

Dr. Cr.

	Rs.		Rs.
To Cash A/c	7,200	By Balance b/d	10,000
To Deficiency A/c amount unpaid	2,800		
	10,000		10,000

Kishore's Capital A/c

Dr. Cr.

	Rs.		Rs.
To Realisation A/c Loss	9,600	By Balance b/d	7,500
		By Cash A/c	1,000
		By Deficiency A/c Transfer	1,100
	9,600		9,600

NOTES

John's Capital A/c

Dr. Cr.

	Rs.		Rs.
To Realisation A/c Loss	3,200	By Balance b/d	1,500
		By Deficiency A/c Transfer	1,700
	3,200		3,200

Deficiency A/c

Dr. Cr.

	Rs.		Rs.
To Kishore's Capital A/c	1,100	By Sundry Creditors A/c	2,800
To Kishore's Capital A/c	1,700		
	2,800		2,800

NOTES

1.6.5 Piecemeal Distribution

In all the previous illustration worked out in this lesson, it was assumed that all assets were realized on the date of dissolution and all the liabilities and realization expenses were met on that day itself. These assumptions are to some extent imaginary. Usually, the assets are put to sale conveniently over a period of time and the cash realized there on is distributed at periodical intervals in the following order:

1. Amount available in hand and the amount of assets realized is first paid to the creditors of the firm.

2. After the payment to the creditors in full, the loan accounts of partners are paid in full.

3. New amount left unpaid is that due to partners only.

When payments are to be made to partners, care should be taken to see that the chance of over payment is avoided, as possibilities of realization are not definitely known. Payments in the Capital Ratio or in the Profit Sharing Ratio will not give the desired objective.

Methods of piecemeal distribution:

1. Surplus capital basis
2. Maximum Loss basis.

This can be achieved if payments are made on either of the two bases:

1.Surplus Capital Basis

2. Maximum Loss Basis

SURPLUS CAPITAL BASIS

If the capitals of partner correspond to the profit-sharing proportions, then each partner is paid in proportion to his capital : otherwise, cash available for distribution amongst, the partners should be paid to such partners whose capitals are in excess of their profit sharing proportions and then each partner is paid in proportion to his capital.

NOTES

MAXIMUM LOSS BASIS

At every stage, it is assumed that there will be no further realizations, and the assumed loss is deducted from the total to capital. Suppose X, Y and Z share profits and losses in the ratio of 2:2:1 and their capitals stood at Rs.4, 000 Rs.8, 000 and Rs.3,000. Suppose, Rs.5, 000 is available for distribution. There may be further realizations. Under these methods, an assumption will be made to the effect that there will be no further realization. Hence the maximum loss is = (Total capitals Rs.15, 000; Available cash Rs.5,000) Rs.10,000.

Thus the installment of cash received is compared with total capitals to be paid to partners and thinking, that in future, assets will not fetch anything. By deducting the cash received from totals from capitals we get, maximum loss. This loss is divided between partners in the ratio of their profit-sharing. Then find out the balance of the partner's capital accounts which may be paid to them. This procedure will be repeated instalment after instalment. But sometimes, the balance so calculated may be a negative balance (See Illustration 2). This negative balance must be transferred to other partner's capital accounts in the ratio of capitals just before dissolution. When all final balances are left only in plus signs then they are paid out and again balance is struck by deducting the amount paid from the total amount to be paid. The total of capital now available is again compared with the installment realized and the same procedure is repeated..

Illustration: 5 Kamali, Leela and Mala share profits of a firm in the proportion of ½, ¼ and ¼ respectively. On the date of dissolution their Balance Sheet showed as follows:

NOTES

Liabilities	Rs	Assets	Rs
Creditors	14,000	Sundry Assets	39,000
Kamali's Capital	10,000	Cash in hand	1,000
Leela's Capital	10,000		
Mala's Capital	6,000		
	40,000		40,000

The assets realized as follows: I Realisation Rs. 13,000,II RealisationRs. 10, 000,III RealisationRs. 10,000.Show how proceeds should be distributed as and when received. Statement of Distribution of Cash (Maximum Loss Method)

Solution: ½ 1/4 1/4

Particulars	Creditors	Kamali	Leela	Mala
	Rs.	**Rs.**	**Rs.**	**Rs.**
Balances	14,000	3,000	5,000	5,000
Cash in hand Paid to Crs.	1,000			
Balances unpaid	13,000	10,000	10,000	6,000
I Realisation of Rs.13,000				
Cash Rs.13,000 – Paid to Crs.	13,000			
Balance of Capital left unpaid		10,000	10,000	6,000
(total of Capital unpaid Rs.26,000 minus II Realisation of Rs.10,000 Rs.16,000 allocated in the ration ½, ¼ & ¼)		-8,000	-4,000	-4,000

NOTES

Cash Paid		2,000	6,000	2,000
Balances of capital left unpaid		8,000	4,000	4,000
II Realisation of Rs.10,000) 6000 allocated ration of ½, ¼, & ¼				
Cash paid		-3,000	-1,500	-1,500
		5,000	2,500	2,500
Balances of capital left unpaid		3,000	1,500	1,500

ILLUSTRATION: 6

A partnership firm has three partners X, Y, and Z with capitals as X Rs.20,000 Y Rs.10,000 and Z Rs.10,000. The creditors amounted to Rs.20, 000 and sundry assets to Rs.60,000. On dissolution, the assets realized as follows: 1st Instalment Rs.20,000; 2nd Instalment Rs.20,000 and final realization Rs.10,000. The partners share profits and losses in the ratio of 3:2:1.Show the piecemeal distribution of the realisation on (i) Proportionate capital method (ii) Maximum loss method.

Solution: **(i) Proportionate capital method**

		Creditors Rs.	X Rs.	Y Rs.	Z Rs.
		20,000	20,000	10,000	10,000
1st Instalment					
Rs.20,000 paid		20,000	----	----	----
Balance due		Nil	20,000	10,000	10,000
Second Instalment Rs.20,000					
Less: Paid to Z	3,334		----	----	3,334
	16,666		20,000	10,000	6,666
Less: Paid to X	6,666		5,000	----	1,666
	10,000		15,000	10,000	5,000
Less: Paid to X, Y, Z	10,000		5,000	3,334	1,666
Balance Due			10,000	6,666	3,334
Final Instalment	10,000				
Less: Paid to X, Y, Z	10,000		5,000	3,334	1,666
Loss to be borne by X, Y and Z			**5,000**	**3,332**	**1,668**

NOTES

(ii) Maximum loss method:

	Creditors Rs.	X Rs.	Y Rs.	Z Rs.
	20,000	20,000	10,000	10,000
1st Instalment				
Rs.20,000 paid	20,000	----	----	----
Balance due	Nil	20,000	10,000	10,000
Second Instalment Rs.20,000				
Maximum loss Rs.20,000 shared				
by X, Y, Z in Profit sharing ratio		10,000	6,666	3,334
		10,000	3,334	6,666
Second Instalment Rs.20,000 paid		10,000	3,334	6,666
Balance Due		10,000	6,666	3,334
Final Instalment Rs.10,000				
Maximum loss Rs.10,000 shared by				
Partners in 3:2:1		5,000	3,334	1,666
Rs.10,000 paid		5,000	3,334	1,666
Amount unpaid i.e., loss on realization				
to be borne by partners		**5,000**	**3,332**	**1,668**

1.7. AMALGAMATION AND SALE OF FIRMS

1.7.1. INTRODUCTION

What is Amalgamation?

The combination of two or more commercial companies

With a view to secure the economies of large scale business and reduce the establishment charges, firms amalgamate their businesses and form a new partnership. For this purpose, the assets & liabilities of the individual firms are readjusted according to their agreement. The net result of reduction or appreciation is adjusted in the capital accounts of the partners of respective firms. A partner will be asked to bring in cash to make his deficiency, if his capital is more, the surplus is either paid back to him or transferred to his current account. Then, the accounts of individual firms are closed by transferring the same to the newly constituted firm. The new firm will make a record for the assets and liabilities taken over in its books of accounts by passing Opening entries.

The following is the procedure for recording transactions relating to amalgamation of firms:

1. In almost all the cases, the new firm takes over some assets and liabilities at book values while others at revised values. To solve this, each firm will open a Revaluation A/c or Profits and Loss Adjustment A/c which will be closed by transferring the result to the capital accounts of the partners in each firm separately.

2. In some cases Goodwill will be valued and raised separately in the books of each firm. The capital accounts of the partners of each firm will be credited for this.

3. If the new firm does not take over some assets, it should either be realized in cash or it should be taken over by any of the partners concerned. Similarly, if any liability is not to be taken over by the new firm, it will be paid off. In case a

NOTES

partner agrees to undertake the liability, his account will be credited and the liability account will be debited.

4. All accumulated profits and losses are transferred to the capital accounts of the partners in their profit – sharing ratio.

1.7.2 ACCOUNTING TREATMFNT AMALGAMATION OF FIRMS

Illustration: 1

Following were the Balance sheet as on 31.03.2009 of two firms A&B and C & D

Liabilities	A & B	C & D	Assets	A & B	C & D
Sundry Creditor	Rs.	Rs.		Rs.	Rs.
Bills Payable	20,000	10,000	Cash at Bank	15,000	8,000
Bank O/D	5,000	-	Investment	10,000	8,000
A's Loan	2,000	10,000	Debtor's 10,000		
Capital :	6000	-	Less		
A	35,000		Provision 1000	9000	8000
B	22,000		Furniture	12,000	6,000
C		36,000	Land	-	50,000
D		20,000	Premises	30,000	-
General Reserve		3000	Machinery	15,000	-
Investment Fund	8000	1000	Good will	9000	-
	2000	80,000		1,00,000	80,000
	1,00,000				

The two firms decided to amalgamate their business on 1 st April 2002. For this purpose it was decided that the new firm shall not take furniture of both the firms and shall take over investments at 10 % less, land at Rs, 80,000, premises at Rs. 45,000, machinery at Rs. 9000. New firm agreed to take over only trade liabilities of both the firms and to pay Rs. 12,000 to each firm for goodwill. Unrecorded typewriter with C and D, valued at Rs.800, was not taken over by the new firm.

Liabilities	Rs.	Assets		Rs
Sundry creditors	30,000	Bank		15,000
Bills payable	5000	Investments		16,200
Capitals :		Debtors	18,000	
A	40,000	Less: Provision	1,000	
B	40,000			17,000
C	40,000	Machinery		9,000
D	40,000	Premises		45,000
Current accounts :		Land		80,0000
C	20,600	Goodwill		24,000
D	4,600	Current accounts :		
		A	5,00	
		B	13,500	14,000
	2,20,200			2,20,200

NOTES

Illustration: 2(Sale Of firms)

Prem,Ram,Lokesh were partners in M.s Lok Pran & co. Sharing profits and losses in the ratio of 2:1:2 They decided to convert their business into a private limited company with effect from September 1,2003 on which date their balance sheet stood as under.

BALANCE SHEET

Liabilities	Rs.	Assets	Rs
Partners Capital accounts:		Goodwill	8,000
Prem 2,500		Motor Car	5,000
Lokesh 8,500		Commission Receivable	1,000
	11,000	Stock	4,000
Loan from Lokesh	5,000	Debtors	8,000
Bank overdraft	3,000	Cash	1,000
Creditors	6,000	Ram's account	3,000
Bills payable	5,000		
	30,000		30,000

All assets and all outside liabilities are taken over by the company for a consideration of Rs.20, 000 to be charged through allotment of 2,000 equity shares of Rs .10 each, Treated as fully paid in limited company. Show ledger accounts to close the books of the firm..

NOTES

Ledger of M/s Lokesh pran & Co

REALISATION ACCOUNT

Particulars		Rs.	Particulars	
To sundry assets :			By Sundry liabilities:	
Goodwill		8,000	Bank overdraft	3,000
Motor Car		5,000	Creditors	6,000
Stock		4,000	Bills payable	5,000
Debtors		8,000		
To Partners capitals :			By Purchasing Co's account	20,000
Prem :	3,600			
Ram :	1,800			
Lokesh :	3,600	9,000		
		34,000		34,000

NOTES

PARTNERS' CAPITAL ACCOUNT

Particulars	Prem	Ram	Lokesh	Particulars	Prem	Ram	Lokesh
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Balance b/d	-	3,000	-	By Balance b/d	2,500	-	8,500
To Commission				By Realization			
Receivable	400	200	400	Account	3,600	1,800	3,600
To shares in				By Cash	2,300	5,400	-
Purchasing Co	8,000	4,000	8,000				
To Cash	-	-	3,700				
	8,400	7,200	12,100		8,400	7,200	12,100

CASH ACCOUNT

Particulars		Rs.	Particulars	Rs.
To Balance b/d		1,000	By Lokesh loan account	5,000
To Partners' Capital accounts :			By Lokesh capital account	3,700
Prem	2,300			
Ram	5,400	7,700		
		8,700		8,700

Exercise

1. Nirmala and Shanthi were partners in a firm sharing profit or loss in the ration of 2:1. Their capitals on 1.4.2009 were Rs.1, 60,000 and Rs.80, 000 respectively. Their partnership deed provided for the following:

(a) Interest on capital @ 8%

(b) Interest on drawings @ 6 %

(c) Shanthi to get a salary of Rs.1, 000 p.m.

(d) Shanthi to get a commission of 10% on the net profit after charging such commission.

The profit of the firm for the year ended 31.3.2010 before making the above adjustments was Rs.75, 000. Drawings of the partners during the year were Nirmala Rs.15, 000 and Shanthi Rs.10, 000.

Show the profit and Loss Appropriation account and capital accounts of the partners assuring that their capitals are fluctuating.

Ans: Profit Rs.40, 500; Capital A/c Rs.1, 84,350; Balance C/D Rs.1, 05,650.

2. A partner makes drawings of Rs.2000 P.M. under the partnership deed. Interest is to be charged at 12% p.a. what is the interest that should be charged to the partner if the amount was drawn (i) in the beginning of the month (ii) in the middle of the month and (iii) at the end of the month

Ans: Beginning of the month Rs.1, 560.00; Middle of the month Rs.1, 440.00
End of the month Rs.1, 320.00

NOTES

3. John and Daniel are partners in a partnership firm sharing profits and losses in the ratio of 5: 3. They agree to admit "Rajesh" for a fifth share of the future profits of the firm. Find out the new Profit Sharing Ratio.

(Ans.: New Profit sharing ratio 5: 3: 2)

Hints: Sacrifice ratio can be found out by applying the formula given

4. R and S share profits and losses in the ratio of 2: 1. T is admitted into the partnership and he is given 3/10 of the profits (which he acquires 2/20 form R and 4/20 from S). He also brings Rs. 6,000 by way of Goodwill. From the above particulars calculate the following:

a) New Profit Sharing Ratio.

b) Sacrifice Ratio.

c) The amount of goodwill is credited.

(Ans.: a)17: 4 :9,b)1 : 2,c)R : Rs. 2,000 : S : 4,000)

Hints: In this problem, sacrifice ratio is given i.e. $\frac{2}{10}$ $\frac{4}{10}$

Hence new ratio can be ascertained by using the formula given below.

Old Ratio – Sacrifice Ratio = New Ratio

5. Tube and Tyre are partners in a firm sharing profits and losses in the ratio of 7:3. On 1st July, 2009 position of the business was as follows:

Balance Sheet

Liabilities		Rs.	Assets		Rs.
Sundry Creditors		4,000	Cash in hand		400
Capital Accounts :			Cash at Bank		2,600
Table	30,000		Debtors	5000	
Ruby	14,000		**Less :** Provision	200	
	---------	44,000		----	4,800
			Stock	9,500	
			Plant	12,000	
			Building	18,700	40,200
		48,000			48,000

Wheel is admitted into the partnership. He agrees to introduce Rs. 5,000 for goodwill for a fourth share in the profits and Rs. 12,000 as Capital. The provision for doubtful Debts be raised to 6% and that the value of plant be appreciated by 20%. Pass Journal entries and show the necessary ledger accounts after depreciating building by 10% p.a.

(Ans: New ratio: 21: 9: 10: P & L A/c (profit Rs. 430)

Tyre Capital Rs. 33,801; Tube Capital Rs. 15,629; Balance SheetRs. 55,430)

NOTES

6. X, Y and Z were partners of a firm sharing profit and losses in proportion of their capital. Their Balance Sheet as on 31.12.2009 stood as under:

Balance Sheet

LIABILITIES	Rs.	ASSETS	Rs.
Sundry Creditors	10,500	Cash at Bank	8,000
Reserve Fund	24,000	Sundry Debtors	
Capital Accounts:		10,000	9,500
X		Less: Provision	9,000
45,000		500	24,000
Y	90,000	Stock	38,000
30,000		Machinery	24,000
Z		Land and Buildings	12,000
15,000	1,24,500	Goodwill	1,24,50
		Profit and Loss Account	0

On 1st January, 2010, Z retired from the firm on the following terms:

(a) That Goodwill of the firm was estimated at Rs.18, 000.

(b) That the land and building be appreciated by 20%

(c) That provisions for doubtful debts reduced by Rs.300

(d) That out of the amount of Insurance which was debited entirely to profit and Loss Account, Rs.1, 000 be carried forward for unexpired Insurance.

(e) That machinery be depreciated by 5%.

(f) That a provision of Rs.1, 100 be made in respect of an outstanding bill for repairs.

(g) That Z be paid Rs.5, 000 cash and the balance be transferred to his loan account.

Pass the journal entries to give effect of the terms of retirement. Show also Revaluation account, Capital account and the Balance sheet of the reconstituted partnership.

(Ans: Revaluation Profit Rs.6,600, capital A/c X – Rs.51,300, Y – Rs.34,200, Z - Rs.12,100, Balance Sheet Total Rs.1,09,200.)

7. Blue, Green and White are general merchants, Blue wishes to retire on 31st January 2010 on which date the Balance Sheet is as follows:

Liabilities		Rs	Assets	Rs
Sundry Creditors		20,000	Machinery	16,000
Reserve		50,000	Furniture	18,000
Employee's Provident Fund		2,000	Stock	120,000
Capital:			Debtors	108,000
Blue	100,000		Bank	10,000
Green	60,000			
White	40,000			
		200,000		
		272,000		272,000

1. They share profits and losses in the proportion of 3: 4: 5 respectively.
2. Machinery has been over-depreciated in the past of Rs.4, 000.
3. Debtors amounting to Rs.6, 000 are bad.

Prepare Profit and Loss Adjustment A/c to adjust the value of assets and ascertain in the amount payable to blue in respect of his capital etc. on retirement. Show the opening Balance Sheet of Green and White after Blue's retirement. To pay the amount due to Blue, the fir borrowed an equal sum from their bankers.

[Ans.: Loss Rs.2, 000; Blue Rs.1, 12,000; Balance Sheet Total Rs.2, 70,000]

NOTES

8. Jài retired from a firm on December 31, 2009. The amount due to him was Rs.40, 400. The terms of the retirement provided payment of Rs.10, 400 immediately and thereafter the doubtful was to be extinguished by payment of Rs.10, 000 together with interest every year on 31st December. The outstanding balance was to carry interest at the rate of 5 per cent. Show the Loan A/c.

[2009 Rs.10, 400; 2010 Rs.11, 500; 2011 Rs.11, 000; 2012 Rs.10, 500]

9. A, B, and C were in Partnership sharing profits and losses equally. C died on 31st March 2008. The Balance sheet of the firm as at 31st December 2007 was as under:

LIABILITIES	Rs.	ASSETS	Rs.
Sundry Creditors	15,600	Cash in hand and Bank	4,000
General Reserve	6,000	Debtors	18,000
Investment Fluctuation	2,100	Stock	28,000
Fund	1,800	Investments (at cost)	8,000
Provision for doubtful		Freehold property	30,000
debts		Goodwill	13,500
Capitals:			
A	76,000		
30,000			
B			
25,000			
C			
21,000			
	1,01,500		56,200

On the date of death it was found that:

(a) Freehold property was worth Rs.57, 000. (b) Debtors were all good. (c) Stocks were valued at Rs.25, 000. (d) Investments were valued at Rs.7, 500 and were taken over by A at that value. (e) A liability for Workmen's Compensation for Rs.3, 000 was to be provided for. (f) Goodwill was to be valued at one year purchase of average profits of last 5 years. (g) C's share of profit up to the date of death was to be calculated on the basis of last year's profit. The profits of the last years were as under: 2003- Rs.11, 500; 2004 – Rs. 12,500; 2005 – Rs.8, 000; 2006 – Rs. 10,000; 2007 – Rs.12, 000. Prepare Revaluation account, capital account of C, balance sheet of the remaining partners.

Ans: Revaluation profit Rs.24, 400, Capital account Rs.31, 733, Rs.34, 233, Rs.31, 234 Balance Sheet Total Rs.1, 15,800.

10. X, Y and Z who were carrying on business in partnership and sharing profits and losses equally decide to dissolve on 3rd December 2009. Their Balance Sheet on that date was as under:

Liabilities		Assets	
	Rs.		Rs.
Sundry Creditors	2,050	Bank	2,050
X's Capital	20,000	Sundry Debtors	3,500
Y's Capital	10,000	Stock	20,000
Z's Capital	9,000	Furniture	500
		Plant	5,000
		Building	10,000
	41,050		41,050

NOTES

The assets realized as follows:

Building	8,000
Plant	5,500
Furniture	375
Stock	21,000
Sundry	3,000

The expenses of realization amounted to Rs.500. Sundry Creditors were paid in full. Pass the necessary journal Entries to close the books and show the Realization Account, Capital Accounts and Bank Account.

Ans: (Loss Rs.2, 625; Due to X Rs.19, 125: Y Rs.9, 125 and X Rs.8, 125)

11. A and B carries on a business in Chennai and Vellore sharing profits and losses in proportion to their capitals and their Balance Sheet on 31st March 2009 was as follows:

Liabilities	Rs	Assets	Rs
		Furniture :	
Sundry Creditors : Chennai		Chennai	7,000
Vellore	7,630	Vellore	3,000
Capital : A	3,420	Book Debts :	
B	50,000	Chennai	42,000
	40,000	Vellore	28,950
		Cash	
		Chennai	14,370
		Vellore	5,730
	1,01,050		1,01,050

The partnership was dissolved by mutual consent on that date, and it was agreed that A should take over the business in Delhi, including the assets and liabilities there, for Rs.72,000 and B should similarly take over the business in Agra for Rs.45,000. Prepare accounts of the dissolution, showing the adjustment necessary between partners.

[Ans : Profit on Realization Rs.27,000

A pay cash Rs.7,000 and B receive Rs.7,000]

NOTES

12. Mani, Nagu and Kamal were the partners sharing the profit in the ratio of 3:2:1.

Their Balance Sheet as on 31st December, 2010 was as under:

LIABILITIES		Rs.	ASSETS		Rs.
Sundry Creditors		15,000	Plant and Machinery		16,000
Sasi's Loan		13,000	Stock		15,000
Reserve		1,200	Sundry	Debtors	
Capitals:			20,000		19,000
Mani	10,000		Less:	Provision	400
Nag	15,000		1,000		3,000
Kamal	2,000	27,000	Prepaid Insurance		2,800
			Investments		
			Cash		
		56,200			56,200

On this date the firm was dissolved. The assets realized as under: Plant and Machinery Rs.10, 000; Stock Rs.12, 000; Sundry Debtors Rs16, 000. The investments were taken over by Mani at a value of Rs.2, 000. He also agreed to pay Sasi's loan. During the course of realization it was found that a bill for Rs.5, 000 previously discounted by the firm was dishonored and had to be paid. Expenses came to Rs.800. Give ledger accounts in the books of the firm.

Ans: Realization Loss: 19,200; Capital A/c Balance: 11,400, 8,600, -1,200; Cash / Bank A/c Total Rs.42, 000

13. The Balance Sheet as at 30-02-2010 was as under:

Liabilities	Rs	Assets	Rs
Surya Capital	3,000	Fixed & Current Assets	20,000
Vikram Capital	5,000		
Ranjith Capital	3,000		
Creditors	7,000		
	20,000		20,000

The partnership is dissolved and the assets realized as follows. First Realization is Rs.5, 000; Second Realization Rs.3, 000 and Third Realization Rs.9, 000. Prepare a statement of piecemeal distribution of cash.

Ans (Balance of capital left unpaid Surya Rs.1, 500, vikaram Rs.1000 & Ranjith Rs 500)

NOTES

LESSON – 2

HIRE PURCHASE ACCOUNTS

Hire purchase and installment system 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.

2.1. Hire Purchase System

Definition:

According to the Hire Purchase Act 1972 Section 2 © " 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:

a) The hire purchase price of the goods to which the agreement relates.

b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash.

c) The date on which the agreement shall be deemed to have commenced.

d) 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 determine the date, upon which it is payable and the person to whom and the place where it is payable.

e) 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:** This 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.

NOTES

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.

2.2. Main features of Hire Purchase system

1. The hirer or buyer gets possession of the goods on signing the hire purchase agreement and he has the right to use them.
2. The ownership of the goods continues to be with the seller or hire vendor. The buyer gets ownership of the goods on the payment of the last installment.
3. The hirer has the duty to keep the goods in good condition and take reasonable precaution for their safety till the last installment is paid.
4. Each installment is treated as hire charges
5. The hirer has the option to return the goods before the last installment is paid
6. 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 installment
7. If foods are repossessed, the value of goods on that date and the installment paid are added and the total hire purchase price is reduced. The balance is payable by the hire vendor to the hirer.

NOTES

2.3. HIRE PURCHASE AGREEMENT, AS DISTINGUISHED FROM CREDIT SALE:

There are some vital points of difference between a hire purchase agreement and an ordinary contract of sale:

1. Under a sale, the title in the property passes to the buyer as soon as the transaction is complete, while the title in the case of hire purchase agreement passes to buyer only after the last payment is made.
2. In case a sale , the buyers position is like that of an owner while the position of hire purchaser is like that of a bailee in respect of the property so long as the title does not pass to him.
3. In case of sale, the buyer can dispose of the property in any way as he likes after sale transaction is complete, while the hire-purchase does not acquire the right before he acquires the title by making the last payment.
4. In case of sale, the seller can sue the buyer for the payment of the price outstanding, while the vendor under hire-purchase agreement can repossess the property sold in case of default by the hire purchaser in payment of the installments'.
5. In case of sale once the goods are sold they cannot be returned by the buyer normally, while under hire purchase agreement, the property may be either returned or retained at the option of the hire-purchase.

6. In case of sale, only the "Cash price" of the property will be charged while in case of hire-purchase agreement the total price of the goods will be somewhat higher than the cash price as interested on the outstanding balance will be added to it.

In a hire purchase transaction, the four essential figures are 1) cash price, 2) Rate of interest, 3) Number of installments and 4) Amount of each installment.

When cash price is not given, it can be ascertained by "Back calculation method; taking the last year as the 'first' and so out it can be ascertained by using the following formula

$$\frac{\left[\dfrac{100}{100+r}\right]^{n \times 1}}{\dfrac{r}{100}}$$

Where

r = rate of interest

n = number of years

i = installment amount

if cash price is not directly given, it can be determined by using the Annuity Table If Rate of interest is not supplied in the problem then, the total interest will be allocated in the ratio of Hire Purchase outstanding during each year. When the amount of installment is missing it can be found out.

DEPRECIATION ON ASSETS UNDER THE HIRE-PURCHASE SYSTEM

Depreciation on the asset acquired under hire-purchase system should always be provided at the given rate on the full cash value of the asset. Fixed installment method or Reducing balance method, as instructed in problem should be employed. The argument for providing depreciation on the cash value of the asset acquired under hire-purchase system is that since it is the intention of the purchaser to be the owner of the asset by making regular payment, depreciation should be provided in the same way as in case of assets acquired with ownership on acquisition. Where no depreciation is charged, it will be found at the time when the ownership will be actually acquired that the asset so long used for purpose of the business is not depreciated at all. In such a case, the accumulated depreciation will have to be charged against the profits of the period after acquisition of the title. This is unfair. Therefore, depreciation must be charged on the full cash value of the asset so that by the time the last payment is made, the book value of the asset appears at its true value on the date (i.e.) its cash price value less depreciation.

2.4. EXHIBITION OF ASSETS ACQUIRED UNDER HIRE-PURCHASE SYSTEM IN THE BALANCE SHEET OF THE HIRE-PURCHASERS

Shall we accept the argument, that unless the ownership of any asset is acquired it should not be shown in the Balance sheet? In practice, this argument is ignored and the asset is shown in the Balance sheet before the ownership is acquired on the contention that acquiring the ownership ultimately is the intention of the hire-purchase and hence there is least

NOTES

possibility of defaulting in payment. The hole property which can be undoubtedly shown in the Balance sheet because in the latter case, the right of using the property for a definite period is acquired but in the former case, the right depends upon the continuity of payment till the last installment.

ACCOUNTING TREATMENT

Hire-purchasers and vendors maintain accounts in a slightly different fashion from usual outright sales. The method of recording the hire-purchase transactions in the books of the hire-purchase and the vendor depends upon the nature of good-whether they are of considerable value or of comparatively small value. There are three methods recording the hire purchase transactions in the book of the hire-purchase.

(A) GOODS OF CONSIDERABLE VALUE

1. IN THE BOOKS OF THE HIRE-PURCHASER

First method (known as Asset Accrual Method)

As the goods do not become the property of the hirer until the purchase is fully completed no entry is passed until a payment is actually made. Under this method, the Asset account is debited with the amount of interest paid and the vendor's account is credited with the full amount of the installment due. When actual payment is made, the vendors account is debited against cash or bank account. The interest account will be closed by transfer to profit and loss account.

Any expenditure on repairs is debited to profit and loss account of the year in which the repairs are carried out. But depreciation must be charged on the cash down price of the asset by debiting depreciation account and crediting the asset account. The depreciation account will be closed by transfer to the profit and loss account. The asset account will appear in the Balance sheet say "Machinery (on hire-purchase) at cost less depreciation."

First year (journal Entries without Narration)

1. On the date of contract, if any down payment is to be made ....

   (a) Asset A/c Dr.

   To Vendor's A/c — amount of down payment

   (b) Vendor's A/c Dr.

   To Bank — amount of down payment

2. At the end of the period (year) when the next installment fall due ....

   Asset A/c Dr — Capital value of the installment

   Interest A/c Dr — Interest portion in the installment

   To vendors' A/c

3. For payment of the above installment

   Vendors' A/c Dr

   To Bank A/c

4. For providing depreciation for the year

   Depreciation A/c Dr

   To Asset A/c

NOTES

5. For closing the interest A/c..........

Profit and loss A/c Dr

To interest A/c

6. For closing the depreciation A/c

Profit and loss A/c Dr

To Depreciation A/c

In any subsequent year

Repeat entries 2,3,4,5 and 6 with respective figures for the year concerned.

Second Method (known as credit purchase with interest method)

Under this method, the full cash price i.e. cash value of the asset is debited to the Asset account and credited to the vendors account, as if it were an outright purchase. The periodical interest is debited to interest account and credited to vendors account. The vendors account is debited with all cash payments against cash or Bank account. The interest account is closed by transfer to profit and loss account. Depreciation and repairs will be treated in the same manner as per first method.

In the Balance sheet , the asset account is shown by deducting the outstanding credit balance on the vendors account from the depreciated book value of the asset.

Exception is taken to the use of this method on the ground that the asset does not belong to the hire-purchase and therefore is should not be debited with the full cash price, but we can argue since it is intended that the asset shall eventually belong to him, there is nothing in this method.

NOTES

First year (journal entries without narration)

On delivery ....

1. Asset A/c Dr.

   To Vendors A/c — Full cash price

2. On the same date if any deposit is made ....

   Vendors A/c Dr.

   To Bank A/c amount of deposit

3. At the end of the year when the interest falls ....

   Interest A/c Dr.

   To Vendors A/c — Interest for the year

4. For payment of the installment including interest at the end of the year ....

   Vendors A/c Dr

   To Bank A/c

5. For changing depreciation for the year ....

   Depreciation A/c Dr

   To Asset A/c

6. For closing the interest account...............

   Profit and loss A/c Dr

   To interest A/c

7. For closing the depreciation account.............

   Profit and loss A/c Dr

   To Depreciation A/c

In any subsequent year

Repeat entries 3, 4, 5, 6, and 7 with respective figures for the year concerned.

Third Method (known as interest suspense method)

Under this method, the asset account is debited with the full cash price of the asset and the total interest i.e. (the difference between total of installments payable and cash price) is debited to interest suspense account against vendors account. At the end of year when the year's interest becomes due, the interest account is debited against suspense account. The interest account is closed by transfer to profit and loss account for charging depreciation. Depreciation account is debited against asset account. The depreciation account is closed by transfer to the profit and loss account. The vendors account is debited for all cash payment-against cash or Bank account.

The depreciation book value of the asset will be shown in the balance sheet.

Sometimes, instead of separating the year's interest from interest suspense A/c, it is straightly written off to profit and loss A/c from interest suspense A/c by debiting profit and loss a/c and crediting interest suspense A/c.

This method is more or less the same as the second method with the difference that, in this, interest suspense account is prepared.

First year (journal entries without narration)

1. On delivery ....

Asset A/c Dr	full cash price
Interest suspense A/c Dr	total interest for all the year
Vendors A/c	

NOTES

2. On the same date if any deposit is made

    Vendors A/c Dr

        To Bank

3. At the end of the year, when the year's interest becomes due, it has to be separated from the interest suspense account by the following entry ....

    Interest A/c Dr (for the year's interest)

        To interest suspense A/c

4. At the end of the year, when any installment including interest is paid ....

    Vendors A/c Dr

        To Bank

5. For charging the year's depreciation

    Depreciation A/c Dr

        To Asset A/c

6. For closing the interest A/c ....

    Profit and loss A/c Dr

        To interest

NOTES

7. For closing the depreciation A/c...........

Profit and loss A/c Dr

To Depreciation A/c

In any subsequent year

Repeat entries 3,4,5,6 and 7 with the respective figures for the year concerned.

Note: For examination purpose, we recommend the first method

Illustration: 1

Mohan Color Company purchased one Tempo Delivery van under hire purchase agreement from Tempo co. on 2nd January, 1980, payment to be made of Rs.2, 000 on that date and the balance in three equal installments of Rs. 4,000 each on 29th December 1980, 1981 and 1982. The cash price of the van was Rs. 12,900. Interest was charged at 5% per annum on the yearly balances. The purchasers decided to charge 20% on the written down value as depreciation each year. Show the journal entries in the books of Mohan Color Company for the three years ending 31st December 1982.

Show the Balance sheet of this company for 3 years.

Solution:	**Rs**
H.P price (2,000 + 4,000 x 3)	= 14,000
Less cash price	= 12,900

Total interest	1,100

	Interest @ 5%		Capital Value
	Rs	Rs	Rs
Cash price	12,900	-	2,000
Less Down payment	2,000	-	
	10,900		
Add Int. for 1 year up to 31st Dec 1980	545		
	11,445		
Less Installment	4,000		
C/F		545	3,455
B/F	7,445	545	5,455
Add int, for 1 year up to 31st Dec 1981	372		
	7,817		
Less Installment	4,000	372	3,628
	3,817		
Add Int. for 1 year upto 31st Dec 82	183		
	4,000		
Less Installment	4,000	183	3,817
	Nil	1,100	12,900

NOTES

Books of Mohan Color Company

Journal

Date	Particulars	L.F	Dr	Cr
1980 Jan 2	Delivery Van A/c Dr To Tempo co's A/c (Being the amount payable to vendors as down payment for purchase of one tempo delivery van on hire-purchase)		2,000	 2,000
Jan -2	Tempo Co's A/c Dr To Bank A/c (Being the down payment paid)		2,000	 2,000
December-29	Delivery van A/c Dr Interest/c Dr To Tempo Co's (Being the first installment due to vendors of which Rs.545 towards interest and the balance towards Van)		3,455 545	 4,000
December-29	Tempo Co's A/c Dr To Bank A/c (Being the first installment paid)		4,000	 4,000
1980 Dec.31	Depreciation A/c Dr To Delivery Van A/c (Being the 20% dep.on Rs. 12,900)		2,580	 2,580
1980 Dec.31	Profit and loss A/c Dr To Interest A/c To Depreciation A/c (Being the interest and depreciation transferred P & L A/c)		3,125	 545 2,580
1981 Dec	Delivery van A/c Dr Interest A/c Dr To Tempo Co's A/c (Being the second installment due of which Rs.372 towards interest and the balance towards van)		3,628 372	 4,000
1981 Dec	Tempo Co's A/c Dr To Bank A/c		4,000	 4,000

NOTES

Date	Particulars	LF	Dr	Cr
Dec-31	Depreciation A/c Dr To Delivery Van A/c (Being the depreciation at 20% on Rs.10320 provided for)		2,064	2,064
1981 Dec-31	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the interest and Depreciation transferred to P&L A/c)		2436	372 2064
1982 Dec.29	Delivery Van A/c Dr Interest A/c Dr To Tempo Co's A/c (Being the final installments due of which Rs.183 towards interest and the balance towards van)		3817 183	4000
Dec.29	Tempo Co's A/c Dr To Bank A/c (Being the final installment paid)		4000	4000
Dec-31	Depreciation A/c Dr To Delivery Van A/c (Being the depreciation at 20% on Rs. 8256)		1651	1651
Dec-31	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the interest and depreciation transferred to Profit and loss account		1834	183 1651

NOTES

DELIVERY VAN A/C

Date	Particulars	Rs	Date	Particulars	Rs
Jan 2	To Tempo Co A/c	2,000	1980	By Depreciation	2,580
Dec. 29	To Tempo Co A/c	3,455	Dec.31	By Balance c/d	2,875
		5,455			5,455
1981			1981	By Depreciation	2064
Jan-1	To Balance c/d	2875	Dec.31	By Balance c/d	4439
Dec-29	To Tempo Co.A/c	3628			6503
		6503			
1983		4439	1981		1651
Jan-1	To Balance b/d	3817	Dec.31	By Depreciation	6605
Dec.29	To Tempo Co.	8256		By Balance c/d	8256

2. **In the books of vendor:**

First Method (without interest suspense A/c)

Debit the Hire purchase and credit hire-purchase sales account with the cash price of the goods. As each installment falls due-debit. Hire purchase and credit interest account with the amount of interest on the unpaid portion of the cash price. On receipt of payment, debit cash or Bank account and credit the Hire-purchase. The interest account will be closed by transfer to profit and loss account.

First year (Journal entries without narration)

1. On the date of delivery ....

   Hire purchaser A/c Dr

   To H.P. sale A/c (cash price of the asset)

2. For any deposit received on the date of delivery..............

   Bank A/c Dr

   To Hire purchaser A/c

3. For charging the years interest at the end of the year ....

   Hire-purchasers A/c Dr

   To Interest A/c

4. For the installment, including interest received at the end of the year ....

   Bank A/c Dr

   To Hire-purchaser A/c

5. For closing the interest

   Interest A/c Dr

   To Profit and loss a/c

Second Method (with interest suspense: A/c)

Under this method, the H.P. sales account is credited with cash price and the interest suspense account is credited with interest of all the years and Hire-purchasers account is debited for the total. At the end of the year, when the year's interest becomes receivable, the interest suspense account is debited and the interest account is credited. The interest account is closed by transfer to the profit and loss account for all cash receipts, cash or Bank account is debited against Hire-Purchaser's Account.

First year (Journal entries without Narration)

1. On the date of deliver ....

   Hire purchaser's A/c Dr (cash price plus interest for all years)

   To H.P sales A/c (full cash price)

   To Interest suspense A/c Interest for all the years.

2. For any deposit received on the date of delivery

   Bank A/c Dr

   To Hire-purchaser's A/c

3. For separating the years interest from interest suspense A/c

   Interest suspense A/c Dr

   To Interest A/c

4. For the installment including interest received at the end of the year................

   Bank A/c Dr

   To Hire purchaser's A/c

5. For closing interest account ....

   Interest A/c Dr

   To profit and loss A/c

Illustration-2

A machine whose cash price is Rs. 20,000 is sold on hire purchase basis for 6 yearly installments of Rs.4, 000 each. The first payment is to be made at the end of first year by sangam printers to kalaimani, machinery Co. show the amount of interest for each year.

Solution:

H.P price (6x4000)	= 24,000
Less cash price	= 20,000
Total Interest	4,000

Rate of interest has not been given. To find out the amount of interest for each year, the total intrest Rs. 4,000/- will be allocated in the ratio of Hire-purchase price outstanding during each year, in the manner given below:

NOTES

Year	Outstanding Hire purchase price	Ratio	Interest	Capital value or principal or cash price
1^{st}	24000	6	6/21 x 400=1143	2857
2^{nd}	20000	5	5/21 x 4000=952	3048
3^{rd}	16000	4	4/21 x 4000=762	3238
4^{th}	12000	3	3/21 x 4000=571	3429
5^{th}	8000	2	2/21 x 4000= 381	3619
6^{th}	4000	1	1/21 x 4000= 191	3809
			4000	20000

Illustration: 3

Madurai Taxi service co, purchased two baby taxis on hire purchase terms, payments were to be made for the two taxis as under.

On signing the agreement Rs.10000

At the end of first year Rs. 15000

At the end of the second year Rs. 15000

At the end of the third year Rs. 10000

Nothing more was payable

An interest was reckoned at 10% p.a and Depreciation at 20% on the diminishing balance. Find out the cash price.

Solution:

NOTES

Cash price is not given. To find out the cash price we can use "Back calculation method". So that, we can find out each year's interest, total interest and capital value included in each installment.

		Interest Rs	Capital value Rs
	Rs		
III instalment 10000	10000		
Less Interest included	909		
	-----------	909	9091
	9091		
Add II instalment	15,000		

	24,091		
Less interest included	2190		

	21901	2190	12810
Add I instalment	15000		

	36901		
Less interest included	3355		

	33,546	3355	11645
	------------	---	
		-------	----------
Add: Amount paid on signing the agreement		6454	33,546
		--	

			10,000

			43,546

NOTES

Illustration-4

Ashok ice factory purchases a machine on the hire-purchase system over period of 5years, payable by annual installments of Rs.6000. The machine company charges, interest at the rate of 5%p.a.on the yearly balances. The cash value of the asset may be taken at the present value of annuity of Rs.6000 for 5 years at 5% interest. Reference to the annuity table shows that the present value of an annuity of Re.1 for 5 years at 5% p.a is Rs. 4329477. Depreciation to be at 10% under straight line method.

Write up the journal entries in the books of Ashok ice Factory under credit purchase with interest method.

Solution:

H.P price	(5 x 6000)	= 30000
Less cash price		= ?

Total interest		?

Cash price is not directly given. The present value (in other words cash price) of the annuity is Rs.1 for 5 years Rs. 4.329477. It means that a buyer has a choice of paying the Re.1 for 5 years (i.e. Rs. 5 in total) or Rs. 4.329477 in all at the time of purchase thus, Rs. 4.329477in be a easily interpreted as the cash price of the installments of Rs.5. On the basis of this, the cash price of a total installment of Rs.30000 can be calculated in this case, it will be:

$$\frac{4.329477}{5} \times 30,000$$

Cash price = Rs.25, 980

H.P price = Rs.30, 000

NOTES

Less cash price		= Rs. 25,980
	Total Interest	4020

	Rs	Interest	Capital value
Cash price	25,980		
Less Down payment	Nil		
	25,980		
Add Int. for 1 year at 5% p.a.	1,299		
	27,279		
Less I Installment	6,000	1,299	
			4,701
	21,279		
Add: interest for 2^{nd} year	1,064		
	22,343		
Less: II instalment	6,000	1,064	
			4,936
	16,343		
Add: Interest for 3^{nd} year	817		
	17,160		
Less: III instalment	6,000	817	
			5,183
	11,160		
Add: interest for 4^{th} year	558		
	11,718		
Less: IV instalment	6,000	558	
			5,442
	5,718		
Add: Interest 5^{th} year(adjusted)	282		
	6,000		
Less: V instalment	6,000	282	
			5,718
	Nil	4,020	25,980

NOTES

IN THE BOOKS OF ASHOK ICE FACTORY

JOURNAL

Date	Particulars	L.F	Dr	Cr
I year beginning	Machinery A/c Dr To Vendors A/c (Being the machine purchased on hire purchase)		25,980	 25,980
I year end	Interest A/c Dr To Vendors A/c (Being the interest at 8% on Rs.25,980 due for the year		6,000	 6,000
	Vendors A/c Dr To Bank A/c (Being the first installment paid)		6,000	 6,000
	Depreciation A/c Dr To Machine A/c (Being the depreciation at 10%provided under straight line method)		2,598	 2,598
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the transfer of interest and depreciation account to P&L A/c)		3,897	 1,299 2,598
2nd year end	Interest A/c Dr To Vendors A/c (Being the interest due for the year)		1,064	 1,064
	Vendors A/c Dr To Bank A/c (Being the second installment paid)		6,000	 6,000
	Depreciation A/c Dr To Machine A/c (Being the depreciation at 10%provided under straight line method)		2,598	 2,598
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the transfer of interest and depreciation account to P&L A/c)		3,662	 1,064 2,598

NOTES

Date	Particulars	L.F	Dr	Cr
3rd year end	Interest A/c Dr To Vendors A/c (Being the interest due for the year)		817	817
	Vendors A/c Dr To Bank A/c (Being the third installment paid)		6,000	6,000
	Depreciation A/c Dr To Machinery A/c (Being the depreciation at 10%provided under straight line method)		2,598	2,598
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the transfer of interest and depreciation account to P&L A/c)		3,415	817 2,598
4th year end	Interest A/c Dr To Vendors A/c (Being the interest due for the year)		558	558
	Vendors A/c Dr To Bank A/c (Being the second installment paid)		6,000	6,000
	Depreciation A/c Dr To Machine A/c (Being the depreciation at 10%provided under straight line method)		2,598	2,598
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the transfer of interest and depreciation account to P&L A/c)		3,156	558 2,598

NOTES

5^{th} year end	Interest A/c Dr To Vendors A/c (Being the interest due for the year)		282	 282
	Vendors A/c Dr To Bank A/c (Being the final installment paid)		6,000	 6,000
	Depreciation A/c Dr To Machine A/c (Being the depreciation at 10%provided under straight line method)		2,598	 2,598
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c (Being the transfer of interest and depreciation account to P&L A/c)		2,880	 282 2,598

'hat is Re-ossession?

he action of :gaining possession :specially the seizure f collateral securing loan that is in efault)

RE-POSSESSION

Under the hire-purchase system, the vendor can repossess the goods sold, if the hire-purchase fails to pay the installment. The vendor may at his option; either re-possesses all the goods or a part thereof in case of default in payment or installments by the hire purchaser. Thus, we have two distinct cases of re-possession.................

1. Complete Re-possession and
2. Partial Re-possession

1. COMPLETE RE-POSSESSION

When the seller re-possesses all the goods sold under hire-purchase system, the hire-purchase has to write off Asset against the profit and loss account. In case if vendors account was credited with the cash price at the very beginning the balance standing to his credit at the date of re-possession should be set-off against the

NOTES

asset account and the balance of the asset account should be written off against the profit and loss account. These adjustments are to be made in the books of hire-purchase.

In the books of the vendor, debit is given to Re-possessed stock account and Hire-purchaser's account is credited with the balance standing in the books of the hire-purchase on the date of re-possession.

2. PARTIAL RE-POSSESSION

Where the vendor does not re-possess all the goods sold under hire-purchase system, but leaves a portion with the hire-purchase, there is always an agreement the hire purchaser and the vendor regarding the valuation of the goods re-possessed. In the books of the hire purchaser the vendors account is debit and the asset account is credited with the agreed value. (Alternatively, debit asset surrendered account and credit asset account with the book value of the asset 0on the date of surrender. Then, debit vendors account and credit asset surrendered account will now represent loss on surrender to be transferred to profit and loss account. The asset account will naturally leave a balance after re-possession equal to the depreciated value of the asset not re-possessed. The vendors account will show a balance representing the money due to him.

In the books of the vendor, Re-possessed stock account is debited and Hire-purchaser account is credited with the agreed value of repossessed goods. The hire-purchasers account leaves a balance representing the money due from him.

3. TERMINATION OF HIRE-PURCHASE AGREEMENT

Meaning of Agreement:

The statement (oral or written) of an exchange of promises

Under the Hire-purchase system the hire-purchase does not possess any right to dispose of the goods bought before his acquires the title in the goods by paying the last installment. However, the vendor, sometimes, permits the hire-purchase to dispose of the goods and pay him fixed amount to terminate the agreement. This may

NOTES

happen when the hire-purchase is incapable of making regular payments and at the same time, the vendor is not interested in re-possessing the goods.

1. Debit Bank A/c
   for the exact selling price.
   Credit Asset A/c
2. Debit vendor's A/c
   for the termination payment
   Credit Bank A/c
3. Debit Vendor's A/c
   For the credit balance in Vendor's A/c
   Credit Asset A/c
4. Now, the Asset A/c will show profit or loss on disposal to be transferred to the appropriate account.

Note: If there is any interest suspense account, the credit balance in vendors account may be set off against the interest suspense account balance (Dt): if and in which case the balance of interest suspense account still surviving after the above set off may be written off to profit and loss account

The vendor will make the following treatment in the above circumstances:

1. Debit Bank A/c
   For the termination
   Credit Hire-Purchaser's A/c
2. Write off the balance in Hire-purchaser's Account, against profit and loss account.

Note: if there is any interest suspense account, transfer the balance of interest suspense account. If any, transfer to Hire-purchaser's account. Write off balance in the Hire-purchaser's account. Then write off the balance in the Hire-purchaser's account against profit and loss account.

Complete Repossession

Illustration-5

Knight purchased a truck for Rs.1,60,000 from S.Waugh on 1-1-93 payment to be made Rs.40,000 down and Rs. 46,000 at end of the first year, Rs.44,000 at the end of second year and Rs.42,000 at the of third year. Interest was charged at 5%. Knight depreciates the truck at 10% per annum on written down value method. Knight, after having paid down payment and first installment at the end of the first year, could not pay second installment. The seller took possession of the truck, and after spending Rs.4, 000 on repairs of the asset, sold it away for Rs.91, 500.

Give the journal entries and ledger accounts in the books of the both parties.

Solution:

Calculation of interest

No. of. Installment	Total cash price paid Rs.	Inst. Paid	Interest Paid Rs.	Net cash price paid Rs.
Down	1,60,000			
	40,000	40,000	-	40,000
	1,20,000			
1st installment	40,000	46,000	1,20,000X 5%) 6000	40,000
	80,000			
2nd installment	40,000	44,000	(80,000X5%) 4,000	40,000
	40,000			
3rd installment	40,000	42,000	(42,000-40,000) 2,000	40,000
	Nil	1,72,000	12,000	1,60,000

NOTES

217

Journal entries in the books of knight (Hire Purchaser)

Date		1993		1994	
		Dr. Rs.	Cr. Rs.	Dr. Rs.	Cr. Rs.
Jan 1	Truck A/c Dr To S.Waugh A/c (Being Purchase of truck on H.P)	1,60,000	1,60,000	-	-
Jan 1	S.Waugh A/c Dr To Bank A/c (Being Cash down Payment)	40,000	40,000	-	-
Jan 31	Interest A/c Dr. To S. Waugh A/c (Interest credited to Hire Vendor A/c)	6,000	6,000	4,000	4,000
Dec 31	S. Waugh A/c Dr. To Bank A/C (Being 1st installment paid)	46,000	46,000	-	
Dec 31	Depreciation A/c Dr. To Trunk A/c (Being depreciation charged)	16,000	16,000	14,400	14,400
Dec 31	P& L A/c Dr. To Interest A/c To Depreciation A/c (Being Charge to interest & Depreciation to P & L A/c)	22,000	6,000 16,000	18,400	4,000 14,400
Dec 31	S. Waugh A/c Dr. To Truck A/c (Being truck taken over by vendor on default)	-	-	84,000	84,000
Dec 31	P & L A/c Dr. To Truck A/c (Loss on Surrender)	-	-	45,600	45,600

NOTES

Ledger Accounts in the Books of S. Waugh Knight A/c

		Rs.			Rs.
1-1-93	To Hire Sale	1,60,000	1-1-93	By Bank (Down Payment)	40,000
31-12-93	To Interest	6,000	31-12-93	By Bank (1st)	46,000
		1,66,000			1,66,000
1-1-94 31-12-94	To Balance b/d To Interest	80,000 4,000	31-12-94	By Repossessed Stock A/c (Bal.fig) (transfer)	84,000
		84,000			84,000

Repossessed Stock A/c

		Rs.			Rs.
31-12-94 31-12-94	To Cash A/c To Knight A/c To P & L A/c (Bal. fig) (Profit on Sale	4,000 84,000 3,500	31-12-94	By Cash	91,500
		91,500			91,500

Ledger A/c's in the books of Knight

		Rs.			Rs.
1-1-93	To Hire Vendor A/c	1,60,000	31-12-93	By Depreciation A/c By Balance C/d	16,000 1,44,000
			1,60,000		1,60,000
1-1-94	To Balance C/d	1,44,000	31-12-93	By Depreciation A/c By S. Waugh A/c By P & L A/c (Bal.fig)	14,400 84,000 45,600
		1,44,000			1,44,000

S.Waugh A/c

		Rs.			Rs.
1-1-93 31-12-93	To Bank A/c To Bank A/c (1^{st}) To Balance c/d	40,000 46,000 80,000	1-1-93 31-12-93	By Truck A/c By Interest A/c	1,60,000 6,000
		1,66,000			1.66,000
31-12-94	To Truck A/c (Bal.fig) (transfer)	84,000	1-1-94	By Balance b/d By Interest A/c	80,000 4,000
		84,0000			84,000

NOTES

Journal Entries in the books of S.Waugh (Hire Vendor)

Date		1993		1994	
		Dr. Rs.	Cr. Rs.	Dr. Rs.	Cr. Rs.
Jan 1	Knight A/c Dr To Hire sale A/c (Being truck sold on H.P)	1,60,000	1,60,000	-	-
Jan 1	Bank A/c Dr. To Knight A/c (Being down payment received)	40,000	40,000	-	-
Dec 31	Knight A/c Dr. To Interest A/c (Being interest charged to Knight)	6,000	6,000	4,000	4,000
Dec 31	Bank A/c Dr. To Knight A/c (Being 1st installment received)	46,000	46,000	-	-
Dec 31	Interest A/c Dr. To P & L A/c (Being interest transferred to P & L A/c)	6,000	6,000	4,000	4,000
Dec 31	Repossessed stock A/c Dr. To Knight A/c (Truck seized from buyer on default)	-	-	84,000	84,000
Dec 31	Repossessed Stock A/cDr. To Cash A/c (Being amount spent on repair)	-	-	4,000	4,000
Dec 31	Cash A/c Dr. To Repossessed Stock A/c (Being repossessed truck sold away)	-	-	91,500	91,500
Dec 31	Repossessed stock A/c Dr. To P&L A/c (Profit on sale)	-	-	3,500	3,500

NOTES

Illustration-6

Malan purchased a machine on hire purchase system on 1st January 1993. The terms of payment are four annual installments Rs. 12,690 at the end of each year. Interest is charged @ 5% and is included in the annual payment of Rs. 12,690.

Show machinery account and Hire vendor account in the books of Malan who defaulted in the payment of the third yearly payment whereupon the vendor repossessed the machinery. Malan provides depreciation on the machinery at 10% p.a. on the reducing balance.

Solution

Calculation of cash price and interest

No. of installments	Amount of inst. (Rs.)	Interest		Net Cash Price (Rs.)
4th	12,690	12,690 x 5/105	= 604	12,086
3rd	12,690	(12,690+12,086)x 5/105	= 1,180	11,510
2nd	12,690	(12,690+11,510+12,086)x5/10	1,728	10,962
1st	12,690	(12,690+10,962+11,510 + 12,086)		
	50,760		2,250	10,440
			5,762	

NOTES

In the books of Malan (Buyer)
Machinery A/c

		Rs.			Rs.
1-1-93	To Hire Vendor A/c	44,998	31-12-93	By Depreciation	4,500
				By Balance C/d	40,498
		44,998			44,998
1-1-94	To Balance b/d	40,498	31-12-94	By Depreciation	4,050
				By Balance c/d	36,448
		40,498			40,498
1-1-95	To Balance b/d	36,448	31-12-95	By Depreciation	3,645
				By Hire vendor	24,776
				By P & L A/c- Loss Surrender (Bal.fig)	8,027
		36,448			36,448

Hire Vendor A/c

		Rs.			Rs.
1-1-93	To Bank (1st)	12,690	1-1-93	By Machinery	44,998
	To Balance c/d	34,558	31-12-93	By Interest	2,250
		47,248			47,248
31-12-94	To Bank (2nd)	12,690	1-1-94	By Balance b/d	34,558
	To Balance c/d	23,596	31-12-94	By Interest	1,728
		36,286			36,286
31-12-95	To Machinery A/c Transfer due to Surrender	24,776	1-1-95	By Balance c/d	23,596
				By Interest	1,180
		24,776			24,776

NOTES

B.PARTIAL REPOSSESSION

Illustration 10

On 1.1.90 National Transport Company purchased from Metro Motors five trucks costing

Rs.40, 000 each on the hire purchase system. It was agreed that Rs. 50,000 should be paid immediately and the balance in three installments of Rs.60, 000 each at the end of each year. The Metro Motors charges interest @ 10% p.a. The buyer depreciates trucks at 20% p.a. On the diminishing balance Method. The buyer paid cash down and two installments but failed to pay the last installment. Consequently, the Metro Motors repossessed three trucks leaving tow trucks with the buyer and adjusting the value of 3 trucks against the amount due. The trucks repossessed were valued on the basis of 30% depreciation p.a. on the written down value. The trucks repossessed were sold by Metro Motors for Rs.60,000 after necessary repairs amounting to Rs.10,000. Open the necessary ledger accounts in the books of both the parties.

Solution: Working Notes W.N.1

Table Showing Calculation of Interest

Payment	Total Cash Price Rs.	Installment Rs.	Interest Rs.	Net cash Price Rs.
Down Payment	2,00,000 50,000	50,000	-	50,000
	1,50,000 45,000	60,000	(1,50,000x10%)=15,000	45,000
1st Installment	1,05,000 49,500	60,000	(1,05,000x10%)=10,500	49,500
2nd	55,500	60,000	(60,000-55,500)=4,500	55,500

Installment .	55,500	2,30,000	----------	
3rd Installment	Nil		30,000	2,00,000

W.N.2 & 3

Calculation of value of 3 trucks Repossessed	Rs.	Calculation of value of 2 trucks left with buyer	Rs.
Cost: Rs.40,000x3 trucks:	1,20,000	Cost: Rs.	80,000
Less: 1st Year Depreciation (i.e.,1990) 1,20,000x30%	36,000	Less: Depreciation for 1990 80,000x20%	16,000
	84,000		64,000
Less: Depreciation for 1991 84,000x30%	25,200	Less: Depreciation for 1991 64,000x20%	12,800
	58,800		51,200
	17,640	Less: Depreciation for 1992 51,200x20%	10,240
	41,160	Value of two trucks left With the buyer	40,960

In the books of National Transport Company (Buyer)

Trucks A/c

		Rs.			Rs.
1.1.90	To Metro Motors	2,00,000	31.12.90	By Depreciation	40,000
				By Balance c/d	1,60,000
		2,00,000			2,00,000
1.1.91	To Balance b/d	1,60,000	31.12.91	By Depreciation	32,000
				By Balance c/d	1,28,000
		1,60,000			1,60,000
1.1.92	To Balance b/d	1,28,000	31.12.92	By depreciation	25,600
				By Metro Motors (3 trucks repossessed)	41,160
				By P & L A/c (Loss on repossession) (Bal.fig)	20,280
				By Balance c/d (Book value of 2 tucks left)	40,960
		1,28,000			1,28,000

NOTES

Metro Motors A/c

		Rs.			Rs.
1.1.90	To Bank (down payment)	50,000	1.1.90	By Trucks A/c	2,00,000
			31.12.90	By Interest A/c	15,000
31.12.90	To Bank (1st Installment)	60,000			
	To Balance c/d	1,05,000			
		2,15,000			2,15,000
31.12.91	To Bank (2nd Installment)	60,000	1.1.91	By Balance b/d	1,05,000
	To Balance c/d	55,000		By Interest A/c	10,500
		1,15,500			1,15,500
31.12.92	To Trucks A/c (3 trucks repossessed) (W.N.2)	41,160	1.1.92	By Balance b/d	55,500
			31.12.92	By Interest A/c	4,500
	To Balance c/d	18,840			
		60,000			60,000

NOTES

In the Books of Metro Motors

National Transport Company A/c

		Rs.			Rs.
1.1.90	To Hire Sales	2,00,000	1.1.90	By Bank (Down Payment)	50,000
31.12.90	To Interest	15,000	31.12.90	By Bank (1st Installment)	60,000
			31.12.90	By Balance c/d	1,05,000
		2,15,000			2,15,000
1.1.91	To Balance b/d	1,05,000	31.12.91	By Bank (2nd Installment)	60,000
31.12.91	To Interest	10,500		By Balance c/d	55,500
		1,15,500			1,15,500
1.1.92	To Balance b/d	55,500	31.12.92	By Repossessed Stock A/c (3 trucks seized)	41,160
31.12.92	To Interest	4,500		By Balance c/d	18,840
		60,000			60,000

Repossessed Stock A/c

		Rs.			
31.12.92	To National Transport Company A/c	41,160	1.1.93	By Bank (Sales)	60,000
	To Bank (repairs)	10,000			
1.1.93	To P & L A/c (Profit on Sale)	8,840			
		60,000			60,000

NOTES

Theory questions

1. Explain the main features of Hire purchase system in detail
2. What is complete repossession? Explain the procedure to account for it in the books of buyer and seller in such a case.
3. What is partial repossession? Describe the method of dealing with such repossession in the books of buyer and seller.

Exercise

4. "M" Ltd sold a lorry to Arun on Hire purchase system. The cash price was Rs.7, 45,000. Rs.2, 00,000 was to be paid on delivery and the balance in three installments of Rs.2, 00,000 each at the end of each year. "M" Ltd. Charged interest of 5% p.a. Arun depreciates the lorry at 10% p.a on reducing balance method.

   Prepare necessary ledger accounts in the books of Arun

   (Ans: Interest I: Rs.27, 250; Rs. 18,613; III: 9,137: Balance in Lorry A/c:5, 43,105)

5. Mr. Ram purchased a T.V on Hire purchase on the following terms:

   Rs. 1,200 to be paid on signing the agreement

   Rs. 1,700 at the end of the first year

   Rs. 1,600 at the end of the second year

   Rs. 5,500 at the end of third and last year

NOTES

The hire vendors charged interest at 10% p.a. on cash value of the T.V. Mr. Raman wished to provide depreciation at 10% p.a. on the diminishing balance method.

Write up the necessary ledger accounts in the books of both the parties.

(Ans: Total cash price: Rs.8,200; Interest: I year Rs.700; II year Rs.600; III year Rs.500)

Complete Repossession

6. Mr. A purchased a machine from B Ltd. for Rs.5, 60,000; payment to be made Rs.1, 50,000 down and three installments of Rs.1, 50,000 each at the end of each year. He depreciates the asset at 10% p.a on written down value method. Because of financial difficulties Mr. A after having paid down payment and first installment at the end of the first year, could not pay second installment and the seller took possession of the asset.

   Open a Ledger account in the books of both parties to record the transaction.

   (Ans: Transfer from Hire-Vendor A/c to Machinery A/c: Rs.2, 93,333; Loss due to Repossession; Rs. 1, 60,267)

7. Mr.Mukesh purchased on 1st October 1992, a machine on hire purchase system. The cash price was Rs.20, 000. Payment was to be made as to Rs.5, 000 down and Rs.4, 000 annually for five years. The machine was depreciated at 15% p.a. on the diminishing value. The third annual installment could not be paid and the vendor seized the machinery. Record the above transaction in the books of Mukesh assuming accounts are closed on 31st Dec.

   (Ans: Interest I year Rs.1, 667; II year Rs.1, 333; III year Rs.1, 000; Loss on Repossession: Rs. 1343, Transfer from Hire vendor A/c: Rs.11, 000)

   Hint: Depreciation in 1992 is for 3 months and in 1995 it is for 9 months.

NOTES

What is installment?

A payment of part of a debt; usually paid at regular intervals

LESSON – 3

INSTALLMENT SYSTEM

3.1. INTRODUCTION

Installment payment system indicates a system of sale under which the payment for the goods together with interest on the price is made by periodical installments, but the buyer acquires the title in the goods and the possession there of as soon as the transaction is complete .

This is actually a system of deferred payment of price of goods in installments. It involves a contract for the sale of goods, the title to which passes from the seller to the buyer is delayed as the sum is split up in certain agreed installments with additional interest on the outstanding balances.

It appears at first sight, that the Hire purchase system and the installment payment system are the same. But there are important differences between these two systems. They may be enumerated as follows.

1. Under the Hire purchases system, the parties involved are hire-purchase and vendor. When an asset is purchased under installment payment system, the parties involved are buyer and seller.
2. Under the Hire purchase system, installments are paid for hire with the ultimate object of acquiring the property on payment of final installment. But under the installment payment system, installments are paid for assets already bought. So, under the Hire purchase system, installments are paid before the property is acquired. While under the installment payment system, installments are paid after the contract of sale is finished and the property is acquired.
3. Under the Hire purchase system, the location of property changes but not the ownership, until the payment of final installment. The hire-purchasers in the meantime cannot sell, transfer or mortgage the property as the ownership remains with the vendor. Under the installment payment

system, the property moves to the buyer along with the title to it from the moment of purchase, and the latter being the ultimate owner, possess the legal right to sell, transfer or mortgage the property even before the price is fully paid.

NOTES

4. Under the Hire purchase system, if default is made in the payment of any of the installments, the vendor can take the possession of goods, but under the installment payment system, the seller cannot claim back the property once sold and transferred, though he has the legal right to sue the buyer for the non-payment of the balance price unpaid.
5. Sales under installment payment system, is complete in all respects. Legally, it is an Executed contract. But sales under Hire purchase system are only "an agreement to sell". Legally it is an Executor contract.
6. When the vendor becomes insolvent, the official assignee or Receiver can tack back the possession of the goods from the hirer, as the ownership of the goods remains with the vendor, under installment payment system, this cannot be done but only steps can be taken for the amount due from the buyer.

3.2. ACCOUNTING TREATMENT

First year (Journal Entries without narration)

1. On Delivery ....

Asset A/c Dr (Full cash price)

Interest suspense A/c Dr (Total Interest of all the years)

To Seller's A/c

2. On the same date if any deposit is made ....

Seller's A/c Dr

To Bank A/c

3. At the end of the year, when the year's interest becomes due it has to be separated from the interest suspense account by the following entry...............

   Interest A/c Dr

   To Interest suspense A/c

4. At the end of the year, when any installment including interest is paid..........

   Seller's A/c Dr

   To Bank A/c

5. For Charging the year's depreciation..................

   Depreciation A/c Dr

   To Asset A/c

6. For closing the interest A/c ....

   Profit and Loss A/c Dr

   To Interest A/c

7. For closing the Depreciation A/c

   Profit and Loss A/c Dr

   To Depreciation A/c

In any subsequent year:

Repeat entries 3,4,5,6, and 7 with respective figures for the year concerned.

The asset account is debited with the full cash price of the asset and the total interest (i.e., the difference between total of installments payable and cash price) is debited to interest suspense account against sellers account. At the end of the year, when the years interest becomes, due, the interest account is debited against interest suspense account. The interest account is closed by transfer to profit and loss account. For charging depreciation, Depreciation account is debited against asset account. The depreciation account is closed by transfer to the profit and loss account. The sellers account is debited for all cash payments against cash or bank account

The depreciated book value of the asset will be shown in the Balance sheet.

Sometimes instead of separating the year's interest from interest suspense account, it is straightly written off to profit and loss account from interest suspense account by debiting profit and loss account and crediting interest's suspense account.

3.3. SPECIMEN JOURNAL ENTRIES IN THE BOOKS OF SELLER

The sales account is credited with cash down price and the interest suspense account is credited with interest for all the years and the buyers account is debited for the total. At the end of the year, when the year's interest becomes receivable, the interest suspense account is debited and the interest account is credited. The interest account is closed by transfer to the profit and loss account and cash receipts. Cash or Bank account is debited against the buyer account.

First year (Journal entries without narration)

1. On the date of delivery ....

    Buyer's A/c Dr

    To Sales A/c

    To Interest suspense a/c

2. For any deposit received on the date of delivery............ ....

    Bank A/c Dr

    To Buyers' A/c

3. For separating the year's interest received from interest suspense A/c ....

    Interest suspense A/c Dr

    To Interest A/c

4. For the installment including interest received at the end of the year..............

    Bank A/c Dr

    To Buyer's A/c

Note

1. As the asset purchased under the installment payment system become the property of the buyer they will be shown on his Balance sheet at cost less depreciation and the amount due to the seller will appear as a liability and not as a deduction from the asset.
2. As the goods cannot be taken back by the seller in the event of the buyers default, it is not necessary to make a provision in the seller's books against any possible loss on the goods.

Illustration-1

On 1st January 1980, Star Transport Co., bought a heavy lorry from Loyal Lorry Co. on the installment system. The cash price of the lorry was Rs.71,000 and the payment was to made as follows:

Rs.20,000 was to be paid on signing the agreement on 1st January 1980, and the balance in 3 annual installments of Rs.20000each. 10% interest will be charged by Loyal Co., p.a, the reducing balance of the cash values.

Make necessary journal entries in the books of the buyer and seller.

Solution

1. TOTAL INTERST 3 YEARS	**Rs**
Down payment	20,000
3 Annual installment of Rs.20, 000 each	60,000
	80,000
Less cash price	71,000
Total Interest for 3 years	9,000

NOTES

2. INTERST FOR EACH YEAR

Cash price	71,000
Less: Down payment	20,000
	51,000
Add: Interest	5,100
	56,100
Less: Installment	20,000
	36,100
Add: Interest	3,610
	39,710
Less: Installment	20,000
	19,710

JOURNAL ENTRIES IN THE BOOKS OF STAR TRANSPORT CO

Date	Particulars	L.F	Dr	Cr
1980 Jan-1	Mini Lorry A/c Dr Interest suspense A/c Dr To Loyal Lorry Co.A/c (Being the purchase of Motor Lorry on installment and the total interest payable for 3 years)		71,100 9,000	80,000
	Loyal Lorry Co. A/c Dr To Bank A/c (Being the down payment on signing installment agreement)		20,000	20000
Dec-31	Interest A/c Dr To Interest suspense A/c (Being the interest debited)		5,100	5,100
	Loyal Lorry Co A/c Dr To Bank A/c (Being the payment of first installment)		20,000	20,000

NOTES

	Depreciation A/c Dr To Motor Lorry A/c (Being the depreciation provided)		14,200 217	14,200
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c		19,300	5,100 14,200
1981 Dec-31	Interest A/c Dr To Interest suspense A/c (Being the interest debited)		3,610	3,610
	Loyal Lorry A/c Dr To Bank A/c (Being the payment of second Installment)		20,000	20,000
	Depreciation A/c Dr To Motor Lorry A/c (Being the depreciation provided)		11,360	11,360
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c		14,970	3,610 11,360
1982 Deo-31	Interest A/c Dr To Interest suspense A/c (Being the interest debited)		290	290
	Loyal Lorry A/c Dr To Bank A/c (Being the payment of final Installment)		20,000	20,000
	Depreciation A/c Dr To Motor Lorry A/c (Being the depreciation provided)		9,088	9,088
	Profit and Loss A/c Dr To Interest A/c To Depreciation A/c		9,378	290 9,088

JOURNAL ENTRIES IN THE BOOKS OF LOYAL LORRY CO

Date	Particulars	L.F	Dr. Rs	Cr Rs
1980 Jan-1	Star Transport Co. A/c Dr To Sales A/c To Interest suspense A/c (Being the sale of motor lorry on installment and the total interest receivable for three years)		80,000	 71,000 9,000
	Bank A/c Dr To Star Transport Co. A/c (Being the down payment received)		20,000	 20,000
Dec-31	Interest suspense A/c Dr To Interest A/c (Being the depreciation provided)		5,100	 5,100
	Bank A/c Dr To Star Transport Co. A/c (Being the installment received)		20,000	 20,000
1981 Dec-31	Interest suspense A/c Dr To Interest A/c (Being the interest debited)		3,610	 3,610
	Bank A/c Dr To Star Transport Co. A/c (Being the second payment received)		20,000	 20,000
	Interest suspense A/c Dr To Interest A/c (Being the interest debited)		3,610	 3,610
	Bank A/c Dr To Star Transport Co. A/c (Being the installment received)		20,000	 20,000

Illustration-2

On 1.1.93, a firm purchased a Truck on installment system. The cash price of the Truck was Rs.11, 175 and payment was to be made as follows:

Rs.3, 000 was to be paid on signing of the agreement and the balance in three installments of Rs. 3,000 each at the end of each year. Interest at 5% is charged by the vendor. The firm has decided to write off 10% annually on the diminishing balance of the cash price.
Give journal entries and ledger accounts in the books of the purchaser and hire vendor.

Journal entries in the books of buyer

		1993		1994		1995	
		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
		Rs.		Rs.		Rs.	
Jan 1	Truck A/c Dr	11,175		-		-	
	Interest suspense A/c	825					
	To Seller A/c		12,000		-		-
	(purchase of truck under installment system)						
Jan 1	Seller A/c D.r	3,000					
	To Bank A/c		3,000				
	(Cash paid on delivery)						
Dec 31	Interest A/c D.r	409		279		137	
	To Int. suspense A/c		409		279		137
	(Adjustment of Interest)						
Dec 31	Seller A/c D.r	3,000		3,00		3,000	
	To Bank		3,000		3,000		3,000
	(Amount of installment paid)						
Dec 31	Depreciation A/c D.r	1,118		1,006		905	
	To Truck A/C		1,118		1,006		905
	(Depreciation charged at 10%)						
Dec 31	P& L A/C D.r	1,527		1,285		1,042	
	To Interest A/c		409		279		137
	To Depreciation A/c		1,118		1,006		905
	(Interest & Depreciation transferred)						

Journal entries in the books of seller

		1993 Dr. Rs.	1993 Cr. Rs.	1994 Dr. Rs.	1994 Cr. Rs.	1995 Dr. Rs.	1995 Cr. Rs.
Jan 1	Buyer A/c D.r	12,000		-		-	
	To Sales A/c		11,175				
	To Interest suspense/c		825		-		-
	(Truck sold on installment system)						
Jan 1	Bank A/c D.r	3,000					
	To Buyer A/c		3,000				
	(Cash received on delivery)						
Dec 31	Int. suspense A/c D.r	409		279		137	
	To Interest A/c				279		137
	(Amount of Interest		409				
Dec 31	due)			3,00		3,000	
	Bank A/c D.r	3,000		0	3,00		3,000
	To Buyer A/c		3,000		0		
	(Amount of installment						
Dec 31	received)					137	
	Interest A/c Dr.	409		279			137
	To P& L A/C		409		279		
	To Interest A/c						
	(Interest transferred)						

NOTES

Ledger Accounts in the books of the buyer

Interest suspense A/c

		Rs.			Rs.
1.1.93	To Seller A/c	825	31.12.93	By Interest	409
			"	By Balance C/d	416
		825			825
1.1.94	To balance b/d	416	31.12.94	By Interest A/c	279
				By Balance c/d	137
		416			416
1.1.95	To balance b/d	137	31.12.95	By Interest	137
		137			137

Truck A/c

		Rs.			Rs.
1.1.93	To Seller A/c	11,175	31.12.93	By Depreciation	1,118
				By Balance C/d	10,057
		11,175			11,175
1.1.94	To Balance b/d	10,057	31.12.94	By Depreciation	1,006
				By Balance c/d	9,051
		10,057			10,057
1.1.95	To Balance b/d	9,051	31.12.95	By Depreciation	905
				By Balance c/d	8,146
		9,051			9,051

NOTES

Seller A/c

		Rs.			Rs.
1.1.93	To Bank	3,000	1.1.93	By Truck A/c	11,175
31.12.93	To Bank	3,000	31.12.93	By Int. suspense A/c	825
"	To Balance C/d	6,000			12,000
		12,000			
31.12.94		3,000	1.1.94	By balance B/d	6,000
	To Bank	3,000			
	To balance c/d	6,000			6,000
31.12.95		3,000	1.1.95	By balance b/d	3,000
	To Bank	3,000			3,000

Interest Account

		Rs.			Rs.
31.12.93	To Int. suspense A/c	409	31.12.93	By P&L A/c	409
31.12.94	To Int. suspense A/c	279	31.12.94	By P&L A/c	279
31.12.95	To Int. suspense A/c	137	31.12.95	By P&L A/c	137

NOTES

Ledger Accounts in the books of Seller

Buyer A/c

		Rs.			Rs.
1.1.93.	To Sales	11,175	1.1.93	By Bank	3,000
31.12.93	To Int. Suspense A/c	825	31.12.93	By Bank	3,000
			"	By Balance c/d	6,000
		12,000			12,000
1.1.94	To Balance B/d	6,000	31.12.94	By Bank	3,000
				By Balance c/d	3,000
		6,000			6,000
1.1.95	To Balance B/d	3,000	31.12.95	By Bank	3,000
		3,000			3,000

NOTES

Interest suspense A/c

		Rs.			Rs.
31.12.93	To Interest	409	1.1.93	By buyer A/c	825
	To Balance c/d	416			
		825			825
31.12.94	To Interest A/c	279	1.1.94	By Balance b/d	416
	To Balance c/d	137			
		416			416
31.12.95	To Interest A/c	137	1.1.95	By Balance b/d	137
		137			137

Interest A/c

		Rs.			Rs.
31.12.93	To P&L A/c	409	31.12.93	By Int. suspense A/c	409
31.12.94	To P&L A/c	279	31.12.94	By Int. suspense A/c	279
31.12.95	To P&L A/c	137	31.12.95	By Int. suspense A/c	137

NOTES

Exercise

1. On 1-1-90 Velan bought a machine from Devi&Co on the installment system. The cost price of the machine was Rs.17,340 and the payment was to be made as follows:

   Rs.5, 000 to be paid on signing of the agreement and the balance in three installments of Rs.5,000 each at the end year. It is agreed to charge interest at the rate of 10% by Devi & Co., velan has decided to write off 15% annually on the diminishing balance on the value of the assets. Show the ledger accounts in the books of Velan.

   (Ans: Interest installments: 1st Rs.1, 243; 2nd Rs.867; 3rd 460; Total interest suspense A/c:Rs.2, 570; closing balance of machine: Rs.10, 704.20)

2. On 1.1.95 the colliery company purchased 5 wagons on the installment system. The cash price of the wagons was Rs.1,490 and Rs.400 was to be paid on signing the agreement and the balance in three installments of Rs.400 each at the end of each year. Interest is charged at 5%per annum by the wagons company. The colliery company has decided to write off 10% annually on the diminishing balance of the cash value. Make the entries and open necessary accounts in the books of both the parties.

   (Ans: Interest: 1year: Rs.54.50;II year: Rs.37.22; III year : Rs.18.28; Interest suspense A/c Rs.110)

3. On 1st January 1988 M/s Sangam printers purchased machinery on the installment payment system. The cash price of the machinery is Rs.40, 000 Rs.8, 000 is paid on delivery and four annual installments of Rs.8, 000 each are paid on 31st December. In addition, interest is to be charged at 12%per annum on yearly balances.

   Show the seller's account in the books of the buyer for the period of the agreement assuring that all payments were duly made by cash.

4. A manufacturer purchases a plant for Rs.20, 000 (cash price) on the installment payment system. The first payment is to be made at the end of first year i.e., 31-12-1977 and the entire on 31st December each. The seller charges interest at 5% per annum. Assuming that depreciation is to be charged at 10% per annum on the reducing installment plan draw up the plant account and the sellers account in the books of the manufacturer.

   Rs.1 can buy an annuity of Rs.0.2820 at 5% for 4 years.

5. Vasantham company purchased a motor car from Sivan on the installment system on Jan.1, 2000 paying cash Rs.20,000 and agreeing to pay three further installment of Rs.20,000 each on 31st Dec. of the coming years. The cash price of the car is Rs.74,500 and Sivan charges interest at 5% per annum. Vasantham writes off depreciation at 10% per annum on written down value method.

   Show the ledger accounts in the books of Vasantham and Sivan.

   (Ans: Interest: 2000: Rs.2, 725; 2001: Rs.1, 861; 2002: Rs.914; Balance in machinery account Rs.54, 310)

NOTES

6. On 1.1.1994 Hari purchased machinery under installment system. The down payment was Rs.10, 000 and the balance is payable in four annual installments of Rs.10, 000each. Interest is charged at 5% per annum. Hari writes off depreciation at 15% p.a. on straight line method. Calculate the cash price of the machine, interest and give journal entries in the books of Hari.

(Ans: Interest :I year Rs.1,773 ; II year Rs.1,362 ; III year Rs.930 ; IV year Rs.476; Total cash price Rs.45,459)

NOTES

LESSON-4

ROYALTY ACCOUNTS

4.1. INTRODUCTION

Meaning of Royalty

Payment to the holder of a patent, copyright or resource for the right to use their property

Royalty is a periodical payment in the nature of rent made to a person for the right to use certain property such as a mine, a quarry, a patent, a copy-right or any secret process or technical know-how. But why is this rent called "royalty"? The reason is this. In olden days, all mineral-bearing land belonged to the king, who gave the right of working the mines to others in consideration of a payment made by them. As this rent was paid to the king, it came to be known as "royalty", that is to say payment made to the king. Now, the term royalty is not confined to mineral bearing land but it is also used in other cases of property. The owner of such a property may sell the property outright or he may use it himself or he may transfer the right to use it to some-one else. When he transfers the right of its use, the consideration usually takes the form of royalty.

The agreement between the owner of the property and the transferee of its use contains the terms of transfer, mining companies and concerns dealing in raising of earth, clay, stone or collection of forest products as lac etc, may have to continue their activity on the basis of payment of royalty to landlord or Government from whom lease has been taken. Similarly, for production under license from the original patentee, royalty may be payable and for publishing a book royalty may payable to the author. It may be remembered that a lump sum payment for the outright purchase of a mine, patent or book is not treated as royalty but it is a capital expenditure and recorded as a fixed asset.

NOTES

1. MINING ROYALTIES

Actual Royalty: The Royalty is usually calculated at a given rate on the basis of output of sale during certain period. It is usually agreed at so much per ton (or other unit) of mineral raised, per 100 centimeters of earth taken out or stone. When royalty is payable on production, it is to be regarded as cost of production and as such should be considered in production section of profit and loss account. On the other hand, When royalty is payable on sales, it is better to be regarded as selling expense and as such it is considered in a profit & Loss Account proper.

Minimum Rent: Royalty agreements are usually associated with a Minimum rent or Dead Rent clause providing that whatever be the production or sale in a particular year, this much royalty must be paid. This minimum sum is known as Minimum rent or Dead rent or Fixed rent or Head rent or Annual rent or sleeping rent. Sometimes, there is a rider in the clause for proportionate reduction of the minimum rent on the basis of the period of dislocation by strike lockout etc. Or the actual royalty will discharge all rental obligations for that year. The minimum rent may be same for each year or are different for different years. Similarly, special arrangements may be provided for the recovery of short workings.

Short working: The difference between (i.e., excess of minimum rent over actual royalty) minimum rent and actual royalty in a particular period is known as short workings. For example, a mine is leased out at a royalty or Rs.1 per ton of mineral rose with a minimum rent to Rs.5, 000 per annum. In any year only 3,000 tons of minerals are raised, the shortfall or deficiency will be 2,000 tons of Rs.2, 000 which amount is called short workings.

Right to Recoup Short workings: The deed of agreement may provide that the short workings arising in any year may be allowed to be carried forward and deducted from future royalties. In such a case the lessees has the right to recoup short working within a fixed number of years either from the date of agreement or from the year of deficiency. This right is known as the Right to recoup short workings and the short working in this case is often termed as redeemable Dead Rent. If there is no provision for recoupment of short workings, it will be treated as a loss which is written off to the profit and Loss account (proper) in the very of short workings.

NOTES

Surface Rent: It refers to the fixed sum payable yearly, half yearly to the landlord by the leaseholder of mine or quarry as surface or ground rent in addition to minimum rent royalty.

4.2. ACCOUNTING ENTRIES IN THE BOOKS OF LEASES: (WITHOUT NARRATION)

For Royalty payable:

a) When Royalty is less Minimum Rent, the entry may be passed in either of the following two ways-

1) First Method: (without opening minimum rent)

Royalty A/C Dr	(……actual royalty)
Short workings A/C Dr	(……..deficit)
To Landlord A/C	(……… minimum rent)

Or

2. Second Method : (through minimum rent a/c)

Minimum Rent A/C Dr	
To Landlord A/c	(…. Minimum rent)

Royalty A/C Dr.	(……..actual royalty)
Short workings A/C Dr	(……. deficit)
To Minimum rent A/c	(……. minimum rent)

NOTES

b) When royalty is equal to more than Minimum rent

Royalty A/C Dr

To Landlord A/c

Note: Minimum rent account will be opened only in the year when actual royalty is less than the minimum rent.

3. For recoupment of past short workings from the year's surplus

Landlord A/C Dr.

To Short working A/c (......amount of recoupment)

4. For irrecoverable short workings (i.e. short workings which cannot be recouped due to expiry of their term of recoupment)

Profit and Loss A/C Dr (amount of irrecoverable short orkings)

To short workings

5. For payment to Landlord

Landlord A/C Dr

To Cash or Bank (amount paid)

6. For Closing the Royalty A/c

Profit and Loss A/c Dr.

Production A/c Dr.

To Royalty A/c (actual amount)

4.3. ACCOUNTING ENTRIES IN THE BOOKS OF LANDLORD: (WITHOUT NARRATION)

1. a) When Royalty is less than Minimum Rent

Lessee A/C Dr (.........minimum rent)

To Royalty receivables (........ actual royalty)

To short workings Reserve A/c (.......deficit)

2. For Recoupment of past short workings by the Lessee

Short working Reserve A/C Dr

To Lessee A/c

3. For irrecoverable short workings:

Short workings Reserve A/C Dr

Profit and Loss A/c

4. For Receipt of money from the Lessee.

Cash or Bank A/C Dr

To Lessee A/c

5. For closing Royalty Receivables A/c

Royalty Receivable A/C Dr

To profit and Loss A/c

1. PATENT AND COPY-RIGHT ROYALTIES

The accounting entries relating to patent and copy-right royalties are quite simple. In the user's books, the amount of royalty is debited to Royalty A/c and credited to the owners account (of the copyright of patent) The Royalty account is transferred to profit and loss account and the owner's account is settled by payment of cash. Royalty is calculated on each copy of book or article produced or sole.

NOTES

If the amount of Royalty payable is subject to a minimum, and if in any year the actual Royalty is less than the minimum the deficiency will be treated in the same way as short workings in connection with mining royalties.

2. FOREST LEASE

Lease of forest may also be taken for collection of forest products for processing them (taken). Similarly, lease of river bad is taken for collection of sand. So also, lease of water may be taken for culture of fish and collection of different water products. Annual Rent is usually payable rather than Royalty in such cases.

3. ROYALTIES UNDER FOREIGN COLLABORATION AGREEMENTS

During the post-independence period, may industries have been started in India with foreign collaboration? Indian industrialist has to pay the royalty for the use of technical know-how, processes trademarks, patents etc. The method of accounting for the payment of such royalties depends upon the exact terms of the collaboration agreement between the Indian concern and the foreign collaborator.

eaning of sub-lease

lease from one lessee another

SUB-LEASE: Sometimes, the lessee of property may sub-lease the whole or part of the property to another person. In this case, the lessee is the land lord to the sub-lessee and he will receive royalty from the sub-lessee in respect of the production/sale of the sub lessee. But original land-lord will get royalty from the lessee in respect of production/sale of not only the lessee but also the sub-lessee. Of course sub lease agreement may provide for royalty payment on the basis of sale, whereas original lease agreement provides royalty on the basis of production or vice-versa. Moreover, sub lease agreements may contain minimum rent and short working recoupment clause etc, in the lines discussed above.

Thus, two charts should be prepared:

1. To show the royalty receivable from the sub-lessee; and
2. To show the royalty payable by the lessee to the landlord.

In lessee's books two sets of entries are to be passed viz; one set in respect of royalty payable to the land-lord

It will be necessary for the lessee to keep two short workings account. One for short workings recoverable and the other for short workings reserve. The balance of the short workings recoverable account will appear in the Balance sheet as an asset while the balance of the Short workings Reserve A/c will be shown as a liability. When any short workings become irrecoverable, owning to other party of the time-limit, the balance of short workings account will be transferred to profit and loss account.

Illustration-1

A Colliery company acquired the lease of a mine at a minimum rent of Rs.10,000 per annum merging into a Royalty of 50 paisa per ton. Short workings could be recouped only within three years following the year in which the short workings occur.

The lease, however, stipulated that if any year normai proauction was not attained due to strike or any accident , the minimum rent was to be regarded as having been reduced proportionately having regard to the length of the stoppage.

NOTES

The output was as follows:

Year	Tons
31-12-1980	8,000
31-12-1981	12,500
31-12-1982	21,500
31-12-1983	26,000
31-12-1984	17,000
31-12-1985	30,000

During the year 1984, there was a stoppage due to strike lasting 3 months.

Show the journal Entries relating to the sea transactions in the books of the colliery company.

Solution:

Year	Output Tons	Royalty Rs	M.R Rs	S.W Rs	S.W. Recouped Rs	Payment Rs	S.W Lapsed Rs	S.W C/F Rs
1980	8000	4000	10000	6000	-	10000	-	6000
1981	12500	6250	10000	3570	-	10000	-	9750
1982	21500	10750	10000	-	750	10000	-	9000
1983	26000	13000	-	-	3000	10000	2250	3750
1984	17000	8500	7500	-	1000	7500	2750	-
1985	30000	15000	10000	-	-	15000	-	-

NOTES

JOURNAL ENTRIES IN THE BOOKS OF COLLIERY COMPANY

Date	Particulars	L.F	Dr	Cr
1980 Dec-31	Royalty A/c Dr Short workings A/c Dr To Land Lord .A/c (Being the royalty payable on 8,000 tons at 50 paisa per ton subject to a minimum rent of Rs.1,000)		4,000 6,000	 10,000
	Land Lord A/c Dr To Bank A/c (Being the amount due to Landlord paid off)		10,000	 10,000
	Production A/c Dr To Royalty A/c (Being the transfer of royalty account)		4,000	 4,000
1981 Dec-31	Royalty A/c Dr Short workings A/c Dr To Land Lord .A/c (Being the royalty payable on 12,500 tons at 50 paisa per ton subject to a minimum rent of Rs.1,0000)		6,250 3,750	 10,000
	Land Lord A/c Dr To Bank A/c (Being the amount due to Land lord paid off)		10,000	 10,000
	Production A/c Dr To Royalty A/c		6,250	 6,250
1982 Dec-31	Royalty A/c Dr To Land Lord A/c (Being the interest debited)		10,750	 10,750
	Land Lord A/c Dr To Short workings A/c (Being the short workings recouped from the landlord)		750	 750

NOTES

	Land Lord A/c Dr To Bank A/c (Being the amount due to Land lord paid off)		10,000 217	 10,000
	production A/c Dr To Royalty/c		10,750	 10750
1983 Dec-31	Royalty A/c Dr To Land Lord A/c (Being the royalty payable to Land lord at 50 paisa per ton on 26,000 tons)		13,000	 13,000
	Land Lord A/c Dr Profit and Loss A/c Dr To Short workings A/c (Being the short working recovered from landlord and irrecoverable short workings transferred to P&L A/c)		3,000 2,250	 5,250
1983 Dec-31	Land Lord A/c Dr To Bank A/c (Being the amount due to landlord paid off)		10,000	 10,000
1984 Dec-31	production A/c Dr To Royalty A/c Land Lord A/C Dr Profit and Loss A/C Dr To Short workings A/c (Being the short working recouped to landlord and irrecoverable shortcoming transferred to P&L a/c)		13,000 1,000 2,750	 13,000 3,750
	Landlord A/C Dr To Bank A/c (Being the amount due to Landlord paid off)		7500	 7,500
	Production A/C Dr To Royalty A/c (Being the Royalty A/c transferred)		8,500	 8,500
1985 Dec-31	Royalty A/c Dr To Land Lord A/c (Being the royalty payable to and		15,000	 15000

NOTES

	lord at 50 paisa per ton on 30,000 tons)			
	Landlord A/C Dr To Bank A/C (Being the amount due to Landlord paid off)		15,000 217	15,000
	Production A/C Dr To Royalty A/c (Being the Royalty account transferred to production A/c)		15,000	15,000

Illustration -2

Nanjil Tiles Co., Ltd., leased a land from Mr.Thanu on a royalty of 25 paisa per ton of clay raised with A Dead Rent of Rs.12,000 a year and power to recoup short workings during the first four years of the lease. The clay raised was as follows.

Year	TONS
1st year	16,000
2nd year	40,000
3rd year	48,000
4th year	72,000
5th year	76,000

Show the journal entries relating to these transactions in the books of Mr.Thanu.

Solution

ANALYSIS OF ROYALTY

Year	Output Tons	Royalty Rs	M.R Rs	S.W Rs	S.W. Recouped Rs	Payment Rs	S.W Lapsed Rs	S.W C/F Rs
1	16000	4000	12000	8000	-	12000	-	8000
2	40000	10000	12000	2000	-	12000	-	10000
3	48000	12000	12000	-	-	12000	-	10000
4	72000	18000	12000	-	6000	12000	4000	-
5	76000	19000	12000	-	-	19000	-	-

NOTES

JOURNAL ENTRIES IN THE BOOKS OF MR.THANU

Date	Particulars	L.F	Dr	Cr
1^{st} year	Nanjil Tiles Co.Ltd A/c Dr To Royalty Receivable .A/c To short workings Reserve A/c (Being the royalty receivable from the lease at 25 paisa per ton on 16,000 tons subject to minimum rent of Rs.12,000)		12,000	 4,000 8,000
	Bank A/c Dr To Nanjil Tiles Co.Ltd A/c (Being the amount due from lessee received)		12,000	 12000
	Royalty Receivable A/c Dr To Profit and Loss A/c (Being the transfer of royalty receivable)		4,000	 4,000
2^{nd} year	Nanjil Tiles Co.Ltd A/c Dr To Royalty Receivable .A/c To short workings A/C (Being the royalty receivable from the lessee at 25 paisa per ton on 40,000 tons subject to a minimum rent of Rs.12,000)		12000	 10,000 2,000
	Bank A/c Dr To Nanjil Tiles A/c (Being the amount due to from lessee received)		12,000	 12,000
	Royalty Receivable A/c Dr To Profit and Loss A/c (Being the transfer of Royalty Receivable)		10,000	 10,000
3^{rd} year	Nanjil Tiles Co. Ltd A/c Dr To Royalty Receivable A/c (Being the interest debited)		12,000	 12,000
	Bank A/c Dr To Nanjil Tiles Co.Ltd A/c (Being the transfer of Royalty receivable account)		12,000	 12,000

NOTES

4th Year	Nanjil Tiles Co. Ltd A/c Dr To Royalty Receivable A/c (Being the royalty receivable from the lessee at 25 paisa per ton on 72,000 tons)		18,000	18,000
	Short workings Reserve A/c Dr To Nanjil Tiles Co.Ltd. A/c To Profit and Loss A/c (Being the recoupment of past short workings by the lessee and irrecoverable shortworknjgs transferred to profit and loss account		10,000	6,000 4,000
1983 Dec-31	Bank A/c Dr To Nanjil Tiles Co. Ltd A/c (Being the amount due from lessee received)		12,000	12,000
	Royalty Receivable A/c Dr To Profit and Loss A/c Dr (Being the transfer of Royalty Receivable account)		18,000	18,000
5th year	Nanjil Tiles Co. Ltd A/c Dr To Royalty Receivable A/c (Being the royalty receivable from the lessee at 25 paisa per ton 76,000 tons)		19000	19,000
	Bank A/c Dr To Nanjil Tiles Co.Ltd A/c To Short workings A/c (Being the amount due from lessee received)		19,000	19,000
	Royalty Receivable A/C Dr To profit and loss A/c (Being the transfer of Royalty Receivable account)		19,000	19,000

NOTES

Illustration-3

Academic Co., have sole right to public the Academic Encycloy paid. They permitted Geetha publications to publish it. Royalty is Rs.10-on each published book, subject to minimum of Rs.40, 000-in the first year, Rs.42, 000-in the second year and Rs.45, 000 – thereafter. Short workings if any, can be recouped in the first 5 years only. In the event of strike, lock out etc., and the minimum sum not being reached, the agreement provided that the minimum sum would stand proportionately to the time actually worked.

Write up necessary accounts ledger to record the transactions in the books of Academic Co., assuming that the results of the workings were are follows.

Year	No. of copies published
1	1,000
2	3,000
3	4,500
4	5,500
5	2,700 (strike for 4 months)

Year	Copies Tons	Royalty Rs	M.R Rs	S.W Rs	S.W. Recouped Rs	Payment Rs	S.W Lapsed Rs	S.W C/F Rs
1	1,000	10,000	40,000	30,000	-	40,000	-	30,000
2	3,000	30,000	42,000	12,000	-	42,000	-	42,000
3	4,500	45,000	45,000	-	-	45,000	-	42,000
4	5,500	55,000	45,000	-	10,000	45,000	-	32,000
5	2,700	27,000	30,000	3,000	-	30,000	35,000	-

GEETHA PUBLICATION A/C

		Rs.			Rs.
1st year	To Royalty Receivable A/c To Short workings/c A/c	10000 30,000 40,000	1st year	By Bank	40,000 40000
2nd year	To Royalty Receivable A/c To Short workings/c A/c	30,000 12,000 42,000	2nd year	By Bank	42,000 42,000
3rd year	To Royalty Receivable	45,000 45,000	3rd year	By Bank	45,000 45,000
4th year	To Royalty Receivable A/c	55,000 55,000	4th year	By short workings Reserve A/c By Bank	10,000 45,000 55,000
5th year	To Royalty Receivable A/c To Short workings A/c	27,000 3,000 30,000	5th year	By Bank	30,000 30,000

NOTES

SHORTWORKINGS RESERVE A/C

		Rs.			Rs.
1st year	To Balance C/d	30,000	1st year	By Geetha publications A/c	30,000
		30,000			30000
2nd year	To Balance C/d	42,000	2nd year	By Balance b/d By Geetha publications A/c	30,000 12,000
		42,000			42,000
3rd year	To Balance C/d A/C	42,000	3rd year	By Balance b/d	42,000
		42,000			45,000
4th year	To Geetha publications A/c To Balance C/d	10,000 32,000	4th year	By Balance b/d	42,000
		42,000			42,000
5th year	To Profit and Loss A/c	35,000	5th year	By Balance b/d By Geetha publications A/c	32,000 3,000
		35,000			35,000

Illustration-4

On January 1, 1979 "A" obtained a mining lease on terms that on every unit of output a Royalty of 50 paisa is payable subject to a Minimum Rent of Rs.12,000 p.a.

On July "A" sub-leased a part of their mine to "S" on the basis that Royalty of 75 paise per unit of output was charge able merging into a Minimum Rent Rs.5, 000 p.a.

The recoupment of short workings was limited under the principal ease to a period of 3 years and under the sub-lease to a period of 2 years.

From the following information, you are required to show important ledger accounts in the books of "A"

Year ending 31st Dec	Own	Output in units sub-lease
1979	18,000	-
1980	18,000	3,000
1981	18,000	9,000
1982	15,000	10,000

Show the journal entries in the books of Mr. "A".

NOTES

Solution:

ALAYSIS OF ROYALTY RECEIVABLE

Year (July)	Output units	Royalty Rs	M.R Rs	S.W Rs	S.W. Recouped Rs	Receipt Rs	S.W Lapsed Rs	S.W C/F Rs
1980	3,000	2,250	2,500	250	-	2,500	-	250
1981	9,000	6,750	5,000	-	250	6500	-	-
1982	10,000	7,500	5,000	-	-	7,500	-	-

ANLAYSIS OF ROYALTY PAYABLE

Year	Total Output	Royalty Rs	M.R Rs	S.W Rs	S.W. Recouped Rs	Payment Rs	S.W Lapsed Rs	S.W C/F Rs
1979	18,000	9,000	12,000	3,000	-	12,000	-	3,000
1980	21,000	10,500	12,000	1,500	-	12,000	-	4,500
1981	27,000	13,500	12,000	-	1,500	12,000	3,000	-
1982	25,000	12,500	12,000	-	1,500	12,000	3,000	-

July 1980 to December = M.R Rs.5, 000 p.a.for 6 months M.R. Rs.2, 500

JOURNAL ENTRIES IN THE BOOKS OF Mr. "A"

Date	Particulars	L.F	Dr	Cr
1979 Dec-31	Royalty payable A/c Dr Short workings Recoverable/c Dr To Land Lord .A/c (Being the royalty payable to the Landlord at 50 paise 18,000 units subject to a Minimum Rent of Rs.12,000)		9,000 3,000	 12,000
	Land Lord A/c Dr To Bank A/c (Being the amount due to Landlord paid off)		12,000	 12,000
	Production A/c Dr To Royalty A/c (Being the transfer of royalty account)		9,000	 9,000
1980 Dec-31	S A/c Dr To Royalty Receivable .A/c To Short workings Allowable A/c (Being the royalty receivable from S at 75 paise on 3,000 units subject to a minimum Rent of Rs. 25,000 for half year)		2,500	 2,250 250
	Bank A/c Dr To S's A/c (Being the amount due to from S received)		2,500	 2,500
	Royalty Receivable A/c Dr To Royalty payable A/c (Being the royalty payable to the landlord at 50 paise on 3,000 units)		1,500	 1,500
	Royalty Receivable A/c Dr To Profit and Loss A/c (Being the transfer of Royalty Receivable account to the P&L a/c)		7,500	 7,500
	Royalty payable A/c Dr Short workings A/c Dr To Landlord A/c		10,500 1,500	 12,000

NOTES

	(Being the royalty payable to the landlord)			
1980 Dec-31	Land Lord A/c Dr To Bank A/c (Being the amount due to Land lord paid off)		12,000	12,000
	production A/c Dr To Royalty/c		9,000	9,000
1981 Dec-31	S A/c Dr To Royalty Receivable A/c (Being the royalty receivable from S's at 75 paisa on 9,000 units)		6,750	6,750
	Bank A/c Dr Short workings allowable A/c Dr To S's A/c (Being the amount due from S received)		6,500 250	6,750
	Royalty Receivable A/c Dr To Royalty payable A/c (Being the royalty payable to the landlord at 50 paisa on 9,000 units)		4,500	4,500
	Royalty Receivable A/c Dr To Profit and Loss A/c (Being the transfer of Royalty Receivable account to the profit and loss account)		2,500	2,500
	Royalty payable A/.c Dr To Land lord A/c (Being the royalty to the landlord 50 paisa on 27,000 units)		13,500	13,500
	Landlord A/c Dr To short workings Recoverable A/c		1,500	1,500
1981 Dec-31	Landlord A/c Dr To Bank (Being the amount due to the landlord paid off.)		12,000	12,000

	Profit and Loss A/c Dr To Short working Recoverable (Short workings transferred)		3,000	3,000
	Production A/c Dr To Royalty payable (Being the transfer of balance in Royalty payable account to production account)		9,000 217	9,000
1982 Dec-31	S's A/C Dr To Royalty Receivable A/c (Being the Royalty receivable from "S" at 75 paise on 10,000 units)		7,500	7,500
	Bank A/C Dr To S's A/c (Being the amount due from "S" received)		7,500	7,500
1982 Dec-31	Royalty Receivable A/C Dr To Royalty payable A/c (Being the royalty payable to the landlord at 50 paise on 10,000 units)		5,000	5,000
	Royalty Receivable A/c Dr To Royalty payable A/c (Being the transfer of Royalty Receivable account to the profit and loss account)		2,500	2,500
	Royalty payable A/c Dr To Landlord A/c (Being the royalty payable to the Landlord at 50 paise on 25,000 units)		12,500	12,500
	Landlord A/c Dr To Bank A/c (Being the amount due to Landlord paid off)		12,500	12,500
	Production A/c Dr To Royalty payable A/c (Being the transfer of balance in Royalty payable account to production account)		7,500	7,500

NOTES

Exercise

1. The Drug coal co. are lessee of a mine on a royalty of 50 paise per ton of coal raised with a dead rent of Rs.40,000 p.a., and power to recoup short workings during the first five years of the lease. The output for the first five years was as follows:

   1st year 10,000 tonnes

   2nd year 48,000 tonnes

   3rd year 80,000 tonnes

   4th year 1, 20,000 tonnes

   5th year 1, 20,000 tonnes

Write up the Dead rent account, Royalty, short workings and Landlord's account in company's ledger.

(Ans: short workings irrecoverable written off in 5th year Rs.11, 000)

2. A Colliery is leased to Gurdial Coal Co. on a royalty of Re.1 per ton on the output. A minimum rent of Rs.16, 000 a year and allowances for short workings are provided in the lease. The coal actually raised in a serious of years is as follows.

   1st year 8,000 tonnes

   2nd year 10,000 tonnes

   3rd year 18,000 tonnes

   4th year 28,000 tonnes

   5th year 14,000 tonnes

Prepare Royalty account, Landlord's account, short workings account and Minimum rent account in the books of Coal Co.

(Ans: Short workings recouped 3rd year Rs.2, 000; 4th year Rs.12, 000; Balance of short working at the end of 5th year Rs.2, 000)

3. The Dispur Minerals acquired a lease from M/s Rohra Bros. for the purpose of extracting a mineral. It was agreed that the lessee should pay Rs.2 per ton of mineral raised subject to a minimum annual rent of Rs.4, 000 and that the short workings could be recouped for the first three years. The tonnage raised for the first four years was:

1 Year	1,000 tonnes
II year	2,500 tonnes
III year	3,000 tonnes
IV year	5,000 tonnes

Prepare the necessary ledger accounts in the books of Dispur Minerals.

(Ans: Short workings I year Rs.2, 000; II year Rs.1, 000; III year Rs.1, 000)

4. Agro India Ltd., Madras entered into a collaboration agreement with Agro (U.C) Ltd., Birmingham , under which the former were to pay the latter., commencing with date on which they started production, a Royalty at 5% of sales during each quarter of the calendar year, subject to deduction to tax in India (which may be assumed at 50%) so however, that the remittance in any such quarter should not by less than *200, the short working being recoupable from out royalty payable in subsequent quarters during the same calendar year but not beyond.

The following are the sales figures of Agro (India) Ltd., Madras.

Quarters	Sales (Rs)
30-09-77	1,00,000
31-12-77	2,00,000
31-03-78	5,00,000
31-6-78	3,36,000
30-9-78	6,00,000
31-12-78	12,00,000

The production has begun on 1-7-77. The rate a exchange may be taken at £1=Rs.21/- The remittance has been made in each case within one month from the end of the relevant quarters. Show Royalty account, Agro (U.K) Ltd., account Short working account in the books of Agro (India) Ltd., No Minimum Rent A/C need be opened.

NOTES

LESSON-5

INSOLVENCY ACCOUNTS

What is Insolvency?

The lack of financial resources

A person is said to be insolvent when he is not able to meet or settle his liabilities. To get away from this financial difficult, the debtor may seek protection under the insolvency Act. The insolvency Act provided method to an insolvent debtor to free himself from his debts without full payment in legal sense the term insolvent in applied to a person when his liabilities exceed his assets and against whom the court has made an order of adjudication on application either of the creditor or debtor himself. The proceedings for the court are known as insolvency proceedings.

Insolvency and bankruptcy mean the same thing. The term insolvency is used in India; bankruptcy is used in United Kingdom. The law of insolvency is contained in the Presidency Town Insolvency Act, 1909 and the provincial insolvency Act, 1920. In the towns of Bombay, Calcutta and Madras the former Act applies, in the rest of India the latter Act applies. Except for details of the preferential creditors and powers of the persons of the persons in charge of the proceedings both the Act are similar.

5.1. INSOLVENCY PROCEEDIGNS

In a proper court of law after satisfying the conditions imposed by law insolvency petition either by the debtor himself or by his creditors should be filed. The court will either pass an order of adjudication or reject it. On the basis of an order of adjudication, the insolvent debtor is officially recognized as insolvent, all his property vests with official receiver (under the provincial insolvency Act) or Official Assignee (under the presidency towns insolvency act) who realizes the assets and distributes the available amount in the following order:

a. Secured Creditors
b. Realization expenses and remuneration of Official Assignee or Receiver
c. Preferential creditors
d. Unsecured Creditors

When the affairs of the debtor have been completely wound up he may apply to the court for the grant of a discharge. The court may grant absolute or conditional discharge. On obtaining an absolute discharge, insolvent debtor is free his debts to begin a new life.

In similar circumstances, a firm may also be declared insolvent. But a company is outside the purview of insolvency proceedings Liquidation proceedings are applied for winding up of the affairs of the company and they are applicable both to solvent and insolvent companies. In the case of individual insolvency to distinction is made between private assets and liabilities and business assets and liabilities, whereas in the insolvency of partnerships a distinction is made between private assets and liabilities of partners and firms assets and liabilities. If there is a surplus, it can be utilized to pay firms liabilities, if necessary. Firms' assets must be utilized first to pay firm's liabilities and if there is surplus a partner can utilize his share of the surplus to pay his private liabilities.

5.2. STATEMENT OF AFFAIRS

Upon being adjudicated under section 24 of the presidency Towns. Insolvency Act, the insolvent has to submit to the court a statement of affairs in the prescribed form. The form contains eight lists viz., A, B, C, D, E, F, G, and H, The contents are:

List

A: Unsecured creditors. This will also include (i) no preferential amount due for salaries, wages, and taxes etc. ii) bills payable and iii) the amount expected to rank on account of bills receivable dishonored.

B: Creditors fully secured stating the value of securities and showing the surplus available for general creditors

C: Partly secured creditors showing the estimated value of securities and the amount expected to rank

D: Preferential creditors

E: A statement showing of various assets both movable and immovable. The assets which have been mortgaged or charged in favour of fully partly secured creditors should not be included. The surplus, if any, after paying fully secured creditors should be shown on the assets side provided the surplus is not utilized for paying partly secured creditors.

F: List of Book Debts with details of good, doubtful or bad and the amount estimated to realize.

G: Bills of Exchange

H: Deficiency statement which explains by means of figures how the amount of deficiency appearing in the statement of affairs has been brought.

This is prepared as on the date on which insolvency petition is filed in the court.

The following is the statement of Affairs in proper form.

STATEMENT OF AFFAIRS

(As required by the presidency towns insolvency Act 1909 in the High court of justice)

In insolvency

To the insolvent , you are required to fill up carefully and accurately, this sheet and the several sheets A,B,C,D,E,F,G and H , showing the state of your affairs on the day on which the order of adjudication was against you, viz, the........ Day of ....19......

Such sheets, when filled up will constitute of your schedule and must be verified by Oath or Declaration.

Gross Liabilities Rs	Liabilities (as stated and estimated by debtor)	Expected to Rank Rs	Assets (as stated and estimated by Debtor)	Book value	Estimated to produce Rs
	Unsecured creditors as per List A Creditors fully secured as per List B Less: Estimated value of securities Surplus		**Property as per list E Viz** a) Cash at Bank b) Cash in hand c) Cash deposited with solicitor for costs of petition d) Stock in trade e) Machinery f) Trade fixtures, fittings utensils, etc. g) Furniture h) Life polices i) Other property		
	Less amount thereof carried to list C Balance thereof to contra		Books Debts as per list F. Viz. Good		
			Doubtful		
	Creditors partly secured as per list C Less: estimated value of securities		Bad		
	Preferential creditors for rent, taxes, salaries, wages , etc., payable in full as per list D		Bills of Exchange or other similar securities on hand as per list G Estimated to produce surplus from secures		

NOTES

	Deduction as per contra		in the hands of creditors fully secured (per contra) Deduct creditors for preferential rent, rates, taxes, wages, etc. (per contra) Deficiency as explained in list H		

I / we .... Make oath / solemnly affirm, and say that the above statement and the several lists hereunto annexed marked A,B,C,D,E,F,G and H are to the best of my / our knowledge and belief, a full, true and complete statement of my / our affairs on the date affirmed.

.... At ....this ...... day of ....

Before me

Signature

Commissioner

PREFERENTIAL CREDITORS

a) All debts due to Government or local authority
b) The salary of any clerk in respect of services rendered to the insolvent during four months before the date of the presentation of the petition, and exceeding Rs.400 for each such clerk. (in case of provincial insolvency Act the maximum amount per clerk is Rs.20)
c) The wages of any servant or laborer in respect of the service rendered to the insolvent during four months before the date of the presentation of the petition not exceeding Rs.100 each such laborer or servant (Rs.20 in cash of provincial insolvency Act)
d) Rent due to a landlord not exceeding one month's rent (Rent is not preferential under the provision insolvency Act)

DEFERRED CREDITORS

In England some creditors are treated as deferred and cannot be paid till others are paid off. Such creditors are:

a) Loan from wife to husband and husband to wife,
b) Creditors whose rate of interest varies with profit and
c) Creditors for goodwill who takes a share of profit

In India, there is no such thing as deferred creditors and hence no distinction is to be made between outside creditors and loan from wife or between creditors whose rate of interest is fixed and those whose rate of interest varies with profit.

AVOIDANCE OF VOLUNTARY TRANSFERS

All transfers of property made by an insolvent debtor within 2 years before the presentation of insolvency petition are void against the official receiver except i) transfer made consideration of marriage and ii) transfer in favor of purchasers in good faith and for valuable consideration.

NOTES

DEFICIENCY ACCOUNT

It shows by means of figures how the deficiency has been brought about. On the left hand side is put the capital and all that increase capital, viz., profit or interest on capital or salary to proprietor. On the right hand side, losses and withdrawals all that decrease capital are put. In case of a sole trader, any surplus of household assets over household liabilities should be put on the left hand side. If household liabilities exceed household assets, the difference is put on the right hand side. The difference between the right hand side and left hand side is deficiency. It must agree with the figure appearing in the statement of Affairs.

Where the profits and losses are given after charging interests on capital, the profits must be increased and the losses decreased by the amount of such interest. Where partner's salaries have been credited to capital accounts i.e., when salaries are not drawn out in cash), the profits and losses must be adjusted in a similar manner where the partner's salaries have been drawn out in cash , the profits and losses will not required any adjustment.

THE FORM OF DEFICIENCY ACCOUNT IS GIVEN BELOW.DEFICIENCY ACCOUNT (LIST-H)

Excess of Assets over Liabilities on ……………	Rs	Net loss arising from carrying on of business from …….. to date of adjudication	
Net profit arising from carrying on of business from……… to date of adjudication after meeting trade expenses ………..		Bad debts as per list F	
Income or profit from other sources since …………		Expenses incurred since …………………	
Deficiency as per statement of Affairs		Other than usual business expenses	

NOTES

		viz., Household Expenses Other Losses:- Loss on realization of stock in Trade Freehold property Fixtures and Fittings Loss on payment of bill discounted	

Illustration -1

Following is the trial balance of Shri Sundram who commenced business

On January 1, 1993, finds him insolvent on December 1995:

Particulars	Rs	Particulars	Rs
Cash	230	Creditors(Unsecured)	18,000
Stock-in-Trade	666	Secured creditors	2,500
Debtors (all good)	13,000	Preferential claims for rent, rates , taxes	190
Investment in shares	500	Capital	1,350
Value of securities held by secured	3,500	Profits (1993,1994)	5,554
creditors	2,500		
Loss (1995)			
Drawings (up to December 1995)	6,916		
	27,594		27,594

You are required to prepare statement of affairs and deficiency account.

NOTES

Solution:

Statement of Affairs of Sundram as on 31st December 1995

Gross Liabilities	Liabilities	Expected to rank	Property and assets	Book value	Expected to produce
18,000	Unsecured creditors as per A	18,000	Property as per list E		
			Cash	230	230
			Stock in trade	666	666
2,500	Fully secured creditors as per list B		Furniture	282	282
			Investment in shares	500	500
	Creditors 2,500		Debtors as per list F	13,000	13,00
	Estimated 3,500		Bills of exchange as per list G		
	1,000	–	Surplus as per contra	–	1,000
					15,678
	Partly secured creditors as per list "C"	–			
	Preferential creditors as per list D 190 Deducted as Per contra 190		Preferential creditors as per contra list D		190
					15,488
	Nil	–	Deficiency as per list H Rs		2,512
		18,000			18,000

Deficiency Account

Particulars	Rs	Particulars	Rs
Excess of assets over	Rs	Particulars	Rs
Liabilities as on Jan		Loss	2,500
1,1993	1,350	Drawings	6,916
Profits	5,554		
Deficiency as per			
statement of affairs	2,512		
	9,416		9,416

Illustration-2.

Raghunath Rai finds him insolvent on 31st December 1995. His position was as follows:

Sundry Debtors –Good, Rs.5, 000: Doubtful, Rs.30, 000

(Estimated to produce Rs.25, 000) Ba ! Rs.15, 000

1,000 shares in Asian &Co Ltd., (estimated to produce Rs.15, 000) 25,000

Shares in Alexander Co. Ltd (estimated to realize Rs.75, 000) 91,500

Loss through betting 2,000

Creditors on open 85,600

Creditors holding a second charge on the shares in Alexander Co.Ltd

To the extent of Rs.25, 000
30,000 Creditors holding a first charge on the shares of Alexander co.Ltd
40,000 Bills payable 4,000 creditors for Rent, Rates, Taxes, etc. (of which Rs.4, 600 are preferential 5,000

Furniture and Fixtures (estimated to realize Rs.3, 000) 1 5,000

Cash in hand and a Bank 550

Stock in Trade (estimated to realize Rs.30, 450) 35,950

Bills Receivable (estimated to realize Rs.7, 000) 9,000

Raghunath Rai started business with a capital of Rs.70, 000 on 1st Jan.1993, and the business resulted in a profit of Rs.8, 800 and Rs.10, 100 for the first two years respectively and in a loss of Rs.5, 000 for the third year, after allowing Rs.3, 500 as interest on capital each year. Withdrawals for the whole period amounted to Rs.30, 000.

Prepare a Deficiency Account and a statement of Affairs.

NOTES

Solution

Statement of Affairs or Raghunath Rai

Gross Liabilities	Liabilities	Expected to rank	Assets	Book value	Expected to produce
Rs		Rs		Rs	Rs
90,000	Unsecured creditors as per List A	90,000	Property as per List E:		
			Cash in hand & at Bank	550	550
40,000	Creditors fully secured as per List B 40,000 Estimated value of securities 75,000 --------- Surplus 35,000 Less Amount Carried to List C 25,000 --------- Balance to Contra 10,000 ---------		Stock in trade	39,950	30,450
			Furniture & fixtures	15,000	3,000
			Shares in Asian and Co. Ltd.	25,000	15,000
30,000	Creditors partly Secured as per List C 30,000 Less Estimated Value of Securities 25,000	5,000	Book debts as per list F: Goods Doubtful	5,000	5,000
4,600	Creditors for rent, rates etc. payable in full as per List D 4,600 Deducted as per Contra 4,600 ---------		Bad	30,000	
			Estimated to produce	15,000	25,000
1,64,600		95,000	Bills of Exchange as per list G Estimated to produce	9,000	

NOTES

			surplus from securities in the hands of fully secured creditors per contra	217	
					10,000
					96,000
			Deduct preferential creditors per contra		
					4,600
					91,400
			Deficiency as explained in list H		
					3,600
					95,000

NOTES

DEFICIENCY ACCOUNT (List H)

Particulars	Rs.	Particulars	Rs.
Estimated of Assets over Liabilities on 1-1-1993	70,000	Net loss arising from carrying on of business from 1-1-93 to date of adjudication	
Net profit arising from carrying on of business from 1-1-93 to date of adjudication after deducting usual trade expenses		Bad debts as per list F	
		Expenses incurred since 1-1-93 other than usual trade expenses, viz.,	5,000 20,000
		Household expenses	
Income or profit from other sources since 1-1-93:	18,900		
		Other losses:	
Interest on capital		Stock in trade 5,500	
Deficiency as per Statement of Affairs		Furniture 12,000	30,000
	10,500	Shares in Asian	
		& Co. Ltd. 10,000	
	3,600	Alexander Co.	
		Ltd. 16,500	
		Bills receivable 2,000	
		Loss through	
		Betting 2,000	48,000
	1,03,000		1,03,000

NOTES

Working note:

The unsecured creditors have been calculated as follows:	Rs.
Creditors on open accounts	85,600
Bills payable	4,000
Creditors for Rent, Rates, Taxes, etc.	400

	Rs 90,000

Illustration -3

Shri Govindraj filed his petition in bankruptcy on 31st December 1995 on which date his books showed the following balances:

	Dr. Rs.	Cr. Rs.
Cash in hand	200	
Fixtures and fittings (estimated to produce Rs.1, 600)	5,000	
Stock in trade (estimated to produce Rs. 24,000)	36,000	
Trade creditors		40,000
Bills payable		44,000
Sundry Debtors:		
Good	20,000	
Doubtful (estimated to produce 50%)	40,000	
Bad	40,000	
Bank overdraft		24,000
Capital		33,200
	-----------	-------
	Rs 1, 41,200	1, 41,200
	-----------	-------

Preferential creditors included in trade creditors amounted to Rs 700. Liability on bills discounted was Rs. 10,000, out of which Rs. 2,000 was expected to rank.

His household furniture etc. was valued at Rs.5, 000. He owned a house valued at Rs. 15,000 having a mortgage on it of Rs. 12,000 at 4%. Interest was paid up to 30th June, 1995. Creditors for rates on the house amounted to Rs.300. prepare a statement of affairs and deficiency account of Shri Govindraj.

Solution

Note: for solving this problem it is better to understand that information (given in italics) given in the trial balance is only in the nature of adjustment. This is only a way of showing adjustment. Alternatively, it could have been written at the foot of trial balance. For example, the adjustment relating to fall in value of fixtures and fittings Rs.3, 400 i.e.,(Rs. 5,000 – Rs. 1,600) has been stated in the question in a different style. Instead of saying that there is fall in the value of fittings of Rs. 3,400, the question has given the market value of furniture. Student will do well if he appreciates this point. Now the solution becomes simple. Rs.3, 400, a loss, is to be shown at two places (1) in deficiency account on the r5ight-hand side and (2) in statement of affairs by way of reduction from the book value. In the absence of this understanding student tries to mug up the point that the market values are shown in the expected to produce column and the difference between the two is shown in the deficiency account on the right-hand side if there is a loss, on the left-hand side if there is a gain.

NOTES

STATEMENT OF AFFAIRS OF GOVBINDRAJ

As on December 31, 1995

Gross liabilities	Liabilities	Expected to rank	Property and Assets	Book value	Expected to produce
Rs.		Rs.		Rs.	Rs.
1,17,300	Unsecured creditors as per List A*	1,09,300	Property as per list E :		
12,240			Cash in hand	200	200
	Fully secured creditors		Stock in trade	36,000	24,000
			Furniture	5,000	5,000
	As per list B+ 12,240		Fixtures & fittings	5,000	1,600
	Less: Estimated Value of Securities 15,000		Debtors as per List F:		
			Goods	20,000	20,000
			Doubtful	40,000	20,000
			Bad	40,000	-
	------		Bills of exchange		
Nil	----	Nil	as per List G	-	-
	Surplus as per		Surplus from	-	2,760
1,000	Contra 2,760		contra		73,560

	----		Preferential creditors as per List D:		
	Partly secured creditors as per list C	1,09,300	Deducted per		1,000
1,30,540	Preferential creditors as per list D ++ 1,000		Contra		72,560
	Deducted as Per contra 1,000		Deficiency as per List H		36,740
	--------				1,09,300
	--				
	Nil				

	--				

NOTES

*Unsecured creditors	Gross Liability	Expected to rank
As per trial balance	40,000	40,000
Less: Preferential creditors included in it	700	700
	39,300	39,300
Add: Bills Discounted	10,000	2,000
	49,300	41,300
Bank overdraft	24,000	24,000
Bills payable	44,000	44,000
	1,17,300	1,09,300

	Rs.
Fully secured creditors:	
Mortgage on property	12,000
Add Interest at 4% for 6 months to be the date of insolvency,	240
4/100*6/12*Rs.12,000	----------
	12,240

++ Preferential creditors:	
Preferential creditors included in trade creditors	700
Rates on house property	300

	1,000

DEFICIENCY ACCOUNT

Particulars	Rs.	Particulars	Rs.
Excess of assets over liabilities	33,200	Loss on fixtures and fittings	3,.400
Private furniture	5,000	Loss on stock-in-trade	
		Loss on debtors	12,000
Private house	15,000	Loss due to interest on loan taken on mortgage	60,000
Deficiency as per statement of affairs	36,740	Loss due to rates on property	240
		Bills discounted	300
		Mortgage on private house	2,000
			12,000
	89,940		89,940

Illustration 4:

The assets of Adhikari of Mumbai on 30th June 1996 as shown by his books were Rs.28, 000 and his liabilities Rs.22,000. He filed his petition in the insolvency court and estimated his deficiency to be Rs. 15,000. After making the above estimate he found that the following items were not passed through his account books:

Interest at 6% on his capital from 1st January 1996. A contingent liability for Rs.1,250 on bills discounted by him for Rs. 5,000.

Amounts due as wages Rs.300; Salaries Rs.200: Rent Rs.100 and rates and taxes Rs.150.

Prepare his statement of affairs and deficiency account.

Solution

For solving this problem it is necessary:

(1) To find out the capital of Adhikari. This is Rs.6, 000, i.e., the difference between assets Rs.28, 000 and liabilities Rs.22, 000.

(2) To find out the estimated to realize value of assets. This is Rs.7, 000, i.e., the difference between the book value of liabilities Rs.22, 000 and the estimated amount of deficiency Rs.15, 000. This is based on the logic that if Adhikari is not able to pay Rs.15, 000 out of the total liability of Rs. 22,000 then, in other words, it can be said that he is able to \pay Rs.7, 000. The amount which he is able to pay can be acquired only from assets and hence it is assumed that estimated to realize value of assets is Rs.7, 000.

The information relating to bills discounted, wages, salaries, rent, rates and taxes is in the nature of adjustment and will be considered at two places, i.e., (1) on the liability side of statement of affairs, and (2) right-hand side of deficiency account.

NOTES

The information relating to interest on capital is irrelevant inasmuch as there is no question of allowing interest on capital when the outside liabilities are not being paid in full. Even if interest on capital is calculated then too it will have no effect on the deficiency because the amount of interest on the one hand will be shown on the left-hand side of deficiency account and on the other on the right-hand side of deficiency account.

STATEMENT OF AFFAIRS OF ADHIKARI as on June 30, 1996

Gross liabilities	Liabilities	Expected to rank	Property and Assets	Book value	Expected to produce
Rs.		Rs.		Rs.	Rs.
27,000 (22,000+ 5,000)	Unsecured creditors as per List A(22,000+1,250)	23,250	Properties as per list E	28,000	7,000
--	Fully secured creditors as per List B		Debtors as per list F	--	--
--	Partly secured creditors as per List C		Bills receivable as per List G	--	--
750	Preferential creditors As per list D 750 Deducted as Per contra 750 ------	Nil	Add Surplus as per contra	--	7,000
			Preferential creditors deducted as per contra, list D		750 6,250
			Deficiency as per List H		17,000
27,750	Rs.	23,250			23,250

NOTES

DEFICIENCY ACCOUNT

PARTICULARS	RS.	PARTICULARS	RS.
Excess of assets over liabilities	6,000	Loss on realization of assets (Rs.28,000-Rs.7,000)	21,000
Deficiency as per statement of affairs	17,000	Contingent liability on bills discounted	1,250
		Preferential creditors not so far considered	750
	23,.000	Rs	23,000

Exercise

1. Mr.B.Srinivasan is insolvent. He supplies to you the following information as on March 31,1996:

Creditors for goods	52,500
Salary due	700
Taxes due	2,100
Bank loan secured by lien on stock of book Value of Rs.35, 000	17,500
Cash in hand	100
Further (expected to realize Rs.3, 500)	7,000
Stock (expected to realize 60%)	52,500
Book debts (good)	7,000
Book debts (doubtful, expected to realize 40%)	17,500
Bills Receivable (Rs.5, 250 bad)	8,750
Bills discounted (Rs.3, 500 bad)	10,500
Loan from Mrs. B.Srinivasan	17,500

Mr.B.Srinivasan commenced business six years ago with capital of Rs 43, 750. He drew Rs.8, 750 each year for private purposes, but did not maintain proper books of accounts. Mrs. B.Srinivasan gave up jewelers valued at Rs.7, 000 (purchased by her for Rs.5,500) to the receiver.

Prepare the statement of affairs and deficiency account of B.Srinivasan.

(Ans: Deficiency Rs.16, 700; Difference in the trial balance Rs.11, 300)

2. Shri chimanlal was adjudged insolvent on January 1, 1996. From the following information as to his position, prepare his statement of affairs as on that date and deficiency account for the three years, ended on that date.

Sundry Debtors (good Rs.20, 000; doubtful Rs.81, 000; estimated to realize Rs.40,000)
Shares in platinum Ltd. (estimated to produce Rs.1, 82,000) 2, 20,000
Creditors on open account 1, 90,000
Creditors holding a first charge on investment 80,000
Creditors holding a second charge on investments to the extent Of Rs.60,000 70,000
Bills receivable discounted (out of which Rs.7,000 are expected to rank) 12,000
Creditors for rent, taxes, etc. (Rs.3,000 preferential) 6,000
Furniture (estimated to realize Rs.6,000) 8,000
Cash in hand 240
Stock in trade (estimated to realize Rs.60,000) 71,760
Bills receivable (estimated to realize Rs. 14,000) 26,000
Loss on stock exchange 30,000

Shri Chimanlal started business on Jan 1, 1993 with capital of Rs.1, 00,000. In first two years, there was a profit of Rs.55, 000 and in the third year, there was a loss of Rs.10, 000. He has been allowed interest at 6% per annum on his original capital for each of the three years. Withdrawals for the whole period amounted to Rs.52, 000. Out of his withdrawals he had purchased jeweler for his wife at a price of Rs.6, 000. His wife has offered this jewellery towards paying the debts of her husband. The jewelers are expected to realize Rs.8, 000.
(Ans: Deficiency Rs.22, 760)

3. From the following details of Shri Garbadadas on 31-12-95. Prepare a statement of affairs and deficiency account:

According to his books of accounts total debts were of Rs.41,000 out of which a creditor for Rs.6,500 holds the stock of worth Rs.7,000. Another creditor for Rs.29,000 holds stock worth Rs.15,500 and a building of the firm valued at Rs.13,000. Unpaid taxes are Rs.100.

The firm has to pay Rs.500 for discounted bills which were discounted for Rs.3,500 totally.

Debtors : Good debtors are of Rs.1,500, bad of Rs.700 and remaining of rs.600 will bring in Rs. 330.

The book value of the furniture is of Rs.300, which is expected to be sold for Rs.150

Cash on hand Rs.50, bills receivable Rs.350, and stock Rs.1,600 which is expected to realize Rs.1,200

Shri. Garbadadas commenced his business from 1-1-1991 with the initial capital of Rs.25,000. After allowing interest on capital Rs.2,300 every year (which was credited to his capital account, but was not withdrawn), he has made profit of Rs.2,700 in the first year and subsequently for four years he incurred loss of Rs.2,500 , Rs.3,200, Rs.4,500 and Rs.6,000 respectively. Drawings amounted to RS.1,200 in each year.

The book value of the building was Rs.22,000 and the cost price of building was Rs.30,000. The mortgage stock was valued at 25% discount.

(Ans: Deficiency Rs.1,520)

4. From the following information, prepare a statement of affairs and a deficiency account of Mr.Lal, who is declared insolvent on June 30, 1996:

Cash in hand	2,500
Debtors-Good	12,500
Doubtful	6,000 (estimated to realize Rs.2, 000)
Bad	10,000
Shares in X company of par value	50,000
Bills receivable-good	42,500
Other securities secured	2, 80,000 (Rs.30,000 pledged with partly creditors and the remaining with fully secured creditors)
Drawings	1,74,000
Trade expenses	74,000
Creditors (unsecured)	2,50,000
Creditors (partly secured)	2,39,000
Creditors fully secured	1,70,000
Capital	2,60,000

(Ans: Deficiency Rs.2, 77,000)

Hint: prepare Trial balance and find out accumulated losses