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# K V MATRIC. HIGHER SECONDARY SCHOOL

CREATIVITY \* PROSPERITY \* ACHIEVEMENT

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HIGHER SECONDARY SECOND YEAR \* ACCOUNTANCY THEORY - QUESTION & ANSWER.

## 3. ACCOUNTS OF PARTNERSHIP FIRMS- FUNDAMENTALS

### VERY SHORT ANSWER QUESTIONS

#### 1) Define partnership.

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

-Section 4 of the Indian Partnership Act, 1932.

#### 2) What is a partnership deed?

- ❖ Partnership deed is a document in writing that contains the terms of the agreement among the partners.
- ❖ It is not compulsory for a partnership to have a partnership deed as per the Indian Partnership Act, 1932.
- ❖ But, it is desirable to have a partnership deed as it serves as an evidence of the terms of the agreement among the partners.

#### 3) What is meant by fixed capital method?

- ❖ Under fixed capital method, the capital of the partners is not altered and it remains generally fixed.
- ❖ Two accounts are maintained for each partner namely (a) Capital account and (b) Current account.
- ❖ The transactions relating to initial capital introduced, additional capital introduced and capital permanently withdrawn are entered in the capital account and all other transactions are recorded in the current account.

#### 4) What is the journal entry to be passed for providing interest on capital to a partner?

- ❖ Interest on capital is the interest allowed on capital of the partners.
- ❖ In general, if the capitals of partners are disproportionate to the profit sharing ratio the partners may agree to allow interest on capital.
- ❖ Following are the journal entries to be made in the books of the partnership firm.
- ❖ (a) For providing interest on capital.

DATE	PARTICULARS	LF	DEBIT(Rs)	CREDIT(Rs)
	Interest on capital A/c Dr.		xxx	
	To Partner's capital / current A/c			xxx

(b) For closing interest on capital account

DATE	PARTICULARS	LF	DEBIT(Rs)	CREDIT(Rs)
	Profit and loss appropriation A/c Dr. To Interest on capital A/c		xxx	xxx

**5) Why is Profit and loss appropriation account prepared?**

- ❖ The profit and loss appropriation account is an extension of profit and loss account prepared for the purpose of adjusting the transactions relating to amounts due to and amounts due from partners.
- ❖ It is nominal account in nature. It is credited with net profit, interest on drawings and it is debited with interest on capital, salary and other remuneration to the partners.
- ❖ The balance being the profit or loss is transferred to the partners' capital or current account in the profit sharing ratio.

**SHORT ANSWER QUESTIONS**

**6) State the features of partnership.**

- ❖ Partnership is an association of two or more persons. The maximum number of partners is limited to 50.
- ❖ There should be an agreement among the persons to share the profit or loss of the business.
- ❖ The agreement may be oral or written or implied.
- ❖ The agreement must be to carry on a business and to share the profits of the business.
- ❖ The business may be carried on by all the partners or any of them acting for all.

**7) State any six contents of a partnership deed.(Any 6)**

- ❖ Name of the firm and nature and place of business
- ❖ Date of commencement and duration of business
- ❖ Names and addresses of all partners
- ❖ Capital contributed by each partner
- ❖ Profit sharing ratio
- ❖ Amount of drawings allowed to each partner
- ❖ Rate of interest to be allowed on capital
- ❖ Rate of interest on drawings of partners
- ❖ Rate of interest on loans provided by partners
- ❖ Amount of salary to be allowed to any partner
- ❖ Maintenance of accounts and audit procedures
- ❖ Procedure for admission of a new partner

- ❖ Settlement of accounts on dissolution of the firm.

**8) State the differences between fixed capital method and fluctuating capital method.**

Basis of distinction	Fixed capital method	Fluctuating capital method
Number of accounts	Two accounts are maintained for each partner, that is, capital account and current account	Only one account that is, capital account is maintained for each partner.
Change in capital	The amount of capital normally remains unchanged except when additional capital is introduced or capital is withdrawn permanently.	The amount of capital changes from period to period
Closing balance	Capital account always shows a credit balance. But, current account may show either debit or credit balance	Capital account generally shows credit balance. It may also show a debit balance
Adjustments	All adjustments relating to interest on capital, interest on drawings, salary or commission, share of profit or loss are done in current account	All adjustments relating to interest on capital, interest on drawings, salary or commission, share of profit or loss are done in the capital account

**LESSON INSIDE QUESTIONS & ANSWERS:**

**1) How do calculate Interest on Capital ?**

- ❖ Calculation of interest on capital Interest on capital is to be calculated on the capitals at the beginning for the relevant period.
- ❖ If there is any additional capital introduced or capital withdrawn during the year, it will cause change in the capitals and interest is to be calculated proportionately on the changed capitals for the relevant period.
- ❖ Interest on capital = Amount of capital x Rate of interest per annum x Period of interest.

**2) What is the maximum number of partners in a partnership firm as per act?**

- ❖ The maximum number of partners is not specified/ prescribed in the Indian Partnership Act, 1932.

- ❖ But, the Indian Companies Act, 2013 specifies the maximum number of partners. As per Section 464(1) of the Indian Companies Act, 2013, no association or partnership consisting of more than such number of persons as may be prescribed shall be formed for the purpose of carrying on any business, provided that the number of persons which may be prescribed under this sub-section shall not exceed one hundred.
- ❖ Rule 10 of Companies (Miscellaneous) Rules 2014 specifies the limit as 50.
- ❖ Thus, the maximum number of partners in a partnership firm is 50.

**3) There is no partnership deed. How will you deal with the following?**

- Remuneration to partners,
- Profit sharing ratio:.
- Interest on capital
- Interest on loans advanced by partners to the firm
- Interest on drawings :
- ❖ Application of the provisions of the Indian Partnership Act 1932 in the absence of partnership deed.
- ❖ If there is no partnership deed or when there is no express statement in the partnership deed, then the following provisions of the Act will apply:
- ❖ Remuneration to partners:
  - ✓ No salary or remuneration is allowed to any partner. [Section 13(a)]
- ❖ Profit sharing ratio:
  - ✓ Profits and losses are to be shared by the partners equally. [Section 13(b)]
- ❖ Interest on capital
  - ✓ No interest is allowed on the capital. Where a partner is entitled to interest on capital contributed as per partnership deed, such interest on capital will be payable only out of profits. [Section 13(c)]
- ❖ Interest on loans advanced by partners to the firm :
  - ✓ Interest on loan is to be allowed at the rate of 6 per cent per annum. [Section 13(d)]
- ❖ Interest on drawings :
  - ✓ No interest is charged on the drawings of the partners.

**4) Write Short note on Limited Liability Partnership (LLP) .**

- ❖ Limited Liability Partnership (LLP) is a type of partnership in which the liability of the partners is limited to the extent of their capital contribution.
- ❖ It is a legal entity separate from that of its partners.
- ❖ It is formed as per the provisions of The Limited Liability Partnership Act, 2008.
- ❖ It has perpetual succession. Any change in the partners of LLP shall not affect the existence, rights or liabilities of LLP.

- ❖ Provisions of the Partnership Act, 1932 will not apply to a Limited Liability Partnership.
- ❖ An individual or a body corporate can become a partner.
- ❖ Partners are not personally liable for the obligations of the partnership unless the obligations arise due to their own wrongful acts or omissions

#### 5) How do prepare the Final accounts of partnership firms?

The final accounts prepared by partnership firms are:

- ❖ Manufacturing account - if manufacturing activity is carried on.
- ❖ Trading and profit and loss account - to ascertain profitability.
- ❖ Profit and loss appropriation account - to show the disposal of profits and surplus.
- ❖ Balance sheet - to ascertain the financial status.

#### 6) How many methods to maintaining capital accounts Method?

- ❖ Amount invested by partners in the partnership business is called partners' capital. Capital may be contributed by a partner in cash or in the form of assets, etc.
- ❖ For each partner, a separate capital account is maintained.
- ❖ Capital accounts of partners of a firm may be maintained by following two methods:
  - ❖ (i) Fixed capital method and
  - ❖ (ii) Fluctuating capital method.

#### 7) Explain Partners' capital account.

- ❖ Capital account is credited with the original amount of capital introduced by a partner into the business and any additional capital introduced by him/her in the subsequent years.
- ❖ The account is debited with the amount of capital permanently withdrawn by a partner from the business.
- ❖ No other items are debited or credited to this account.
- ❖ Capital account will always show credit balance under this method.
- ❖ The balance of capital account remains the same unless any additional capital is introduced or capital is permanently withdrawn.

#### 8) Explain Partners' current account.

- ❖ Partners' current account is prepared for recording all transactions between the partner and the firm other than initial capital introduced, additional capital introduced and capital permanently withdrawn.
- ❖ This account is credited with interest on capital, partner's salary or commission and share of profit to the partner.
- ❖ This account is debited with drawings, interest on drawings and share of loss of the partner.
- ❖ As a result, the balance in this account changes periodically.
- ❖ Current account may show either credit balance or debit balance.



**9) What is mean by Fluctuating capital method?**

- ❖ Under this method, only capital account is maintained for each partner.
- ❖ All the transactions between the partner and the firm are recorded in the capital account.
- ❖ This account is credited with initial and additional capital introduced by the partner, interest on capital, partner's salary or commission and share of profit of the partner.
- ❖ The account is debited with capital withdrawn, drawings, interest on drawings and share of loss of the partner.
- ❖ As a result, the balance in this account goes on fluctuating periodically.
- ❖ Under this method, the partner's capital account may show either credit balance or debit balance.

**10) What is mean by direct method? (Interest on calculation).**

- ❖ Direct method Interest is calculated on drawings for the period from the date of drawings to the date of closing date of the accounting year.
- ❖ The following formula is used to compute the interest on drawings:  
Interest on drawings = Amount of drawings × Rate of interest × Period of interest.

**11) What is mean by Product method? (Interest on calculation).**

- ❖ Under product method, interest is calculated on the total of the products, that is, the product of amount of drawings and the period for which the amount remained withdrawn.
- ❖ If the product is calculated in terms of months, then interest is calculated on the total of products at the rate per month.
- ❖ If the product is calculated in terms of days, then interest is calculated on the total of products at the rate per day.
- ❖ This method can be used in all situations as an alternative to direct method.

**4. GOODWILL IN PARTNERSHIP ACCOUNTS****VERY SHORT ANSWER QUESTIONS****1) What is goodwill?**

- ❖ Goodwill is the good name or reputation of the business which brings benefit to the business.
- ❖ It enables the business to earn more profit.
- ❖ It is the present value of a firm's future excess earnings.
- ❖ It is an intangible asset as it has no physical existence.
- ❖ It is shown under fixed assets in the balance sheet.
- ❖ An old and well established business entity develops a good name and reputation among the public over a period of time, because of various reasons such as good quality of goods and services, location of the business, etc.
- ❖

**2) What is acquired goodwill?**

- ❖ Goodwill acquired by making payment in cash or kind is called acquired or purchased goodwill.
- ❖ When a firm purchases an existing business, the price paid for purchase of such business may exceed the net assets (Assets - Liabilities) of the business acquired.
- ❖ The excess of purchase consideration over the value of net assets acquired is treated as acquired goodwill.
- ❖ The Indian Accounting Standard 10 (AS10) on accounting for fixed assets states that goodwill must be recorded in the books of accounts only when some consideration in money or money's worth has been paid for it.
- ❖ Therefore, acquired goodwill can be recorded in the books of accounts and is shown on the assets side of the balance sheet under fixed assets.

**3) What is super profit?**

- ❖ Under these methods, super profit is the base for calculation of the value of goodwill.
- ❖ Super profit is the excess of average profit over the normal profit of a business.

Super profit = Average profit - Normal profit

**4) What is normal rate of return?**

→ Normal rate of return = It is the rate at which profit is earned by similar business entities in the industry under normal circumstances

**5) State any two circumstances under which goodwill of a partnership firm is valued.**

- ❖ Following are the circumstances that require valuation of goodwill of partnership firms in order to protect the rights of the partners
  - ✓ When there is a change in the profit sharing ratio
  - ✓ When a new partner is admitted into a firm
  - ✓ When an existing partner retires from the firm or when a partner dies
  - ✓ When a partnership firm is dissolved

**SHORT ANSWER:****1) State any six factors determining goodwill.**

The following factors determine the value of goodwill of a partnership firm:

**❖ PROFITABILITY OF THE FIRM:**

- ✓ The profit earning capacity of the firm determines the value of its goodwill.
- ✓ A firm earning higher profits and having potential to generate higher profits in future will have higher value of goodwill.

**❖ FAVORABLE LOCATION OF THE BUSINESS ENTERPRISE:**

- ✓ If the firm is located in a prominent place which is easily accessible to the customers, it can attract more customers. Its sales and profit will be higher when compared to a



firm which is not located in a prominent place. Hence, it will have high value of goodwill

❖ **GOOD QUALITY OF GOODS OR SERVICES OFFERED:**

- ✓ If a firm enjoys good reputation among the customers and general public for the good quality of its products or services, the value of goodwill for the firm will be high.

❖ **TENURE OF THE BUSINESS ENTERPRISE :**

- ✓ A firm which has carried on business for several years will have higher reputation among its customers as it is better known to the customers. Such a firm will have higher earnings and higher value of goodwill when compared to a new firm.

❖ **EFFICIENCY OF MANAGEMENT :**

- ✓ A firm having efficient management will earn more profits and the value of its goodwill will be higher compared to a firm with less efficient managerial personnel.

❖ **DEGREE OF COMPETITION:**

- ✓ In the case of business enterprises having no competition or negligible competition, the value of goodwill will be high.

❖ **OTHER FACTORS :**

- ✓ There are other factors which add to the value of goodwill of a business such as popularity of the proprietor, impressive advertisements and publicity, good relations with customers, etc.

**2) How is goodwill calculated under the super profits method?**

- ❖ Super profit methods Under these methods, super profit is the base for calculation of the value of goodwill.
- ❖ Super profit is the excess of average profit over the normal profit of a business.
- ❖  $\text{Super profit} = \text{Average profit} - \text{Normal profit}$
- ❖ Average profit is calculated by dividing the total of adjusted actual profits of certain number of years by the total number of such years.
- ❖ Normal profit is the profit earned by the similar business firms under normal conditions.
- ❖  $\text{Normal profit} = \text{Capital employed} \times \text{Normal rate of return}$
- ❖  $\text{Capital employed} = \text{Fixed assets} + \text{Current assets} - \text{Current liabilities}$
- ❖ Normal rate of return = It is the rate at which profit is earned by similar business entities in the industry under normal circumstances

**3) How is the value of goodwill calculated under the capitalisation method?**

- ❖ Under this method, goodwill is the excess of capitalised value of average profit of the business over the actual capital employed in the business.
- ❖  $\text{Goodwill} = \text{Total capitalised value of the business} - \text{Actual capital employed}$

- ❖ The total capitalised value of the business is calculated by capitalising the average profits on the basis of the normal rate of return.
- ❖ Capitalised value of the business =  $\frac{\text{Average profit} \times 100}{\text{Normal rate of return}}$
- ❖ Actual capital employed = Fixed assets (excluding goodwill) + Current assets – Current liabilities

### LESSON INSIDE QUESTIONS & ANSWERS:

#### 1) Describe the Nature of goodwill?

The nature of goodwill can be described as follows:

- ❖ Goodwill is an intangible fixed asset.
- ❖ It is intangible because it has no physical existence.
- ❖ It cannot be seen or touched.
- ❖ It has a definite value depending on the profitability of the business enterprise.
- ❖ It cannot be separated from the business.
- ❖ It helps in earning more profit and attracts more customers.
- ❖ It can be purchased or sold only when the business is purchased or sold in full or in part

#### 2) What are the classification of Good Will?

Goodwill may be classified into acquired goodwill and self-generated goodwill.

##### ❖ ACQUIRED OR PURCHASED GOODWILL:

- ✓ Goodwill acquired by making payment in cash or kind is called acquired or purchased goodwill.
- ✓ When a firm purchases an existing business, the price paid for purchase of such business may exceed the net assets (Assets – Liabilities) of the business acquired.
- ✓ The excess of purchase consideration over the value of net assets acquired is treated as acquired goodwill.
- ✓ The Indian Accounting Standard 10 (AS10) on accounting for fixed assets states that goodwill must be recorded in the books of accounts only when some consideration in money or money's worth has been paid for it.
- ✓ Therefore, acquired goodwill can be recorded in the books of accounts and is shown on the assets side of the balance sheet under fixed assets.

##### ❖ SELF-GENERATED GOODWILL :

- ✓ It is the goodwill which is self-generated by a firm based on features of the business such as favourable location, loyal customers, etc.
- ✓ Such self-generated goodwill cannot be recorded in the books of accounts.

#### 3) Write Short notes on : Annuity method :

- ❖ Under this method, value of goodwill is calculated by multiplying the super profit with the present value of annuity.

- ❖ Goodwill = Super profit × Present value annuity factor  
Present value annuity factor is the present value of annuity of rupee one at a given time.
- ❖ It can be found out from annuity table or by using formula.

#### 4) Write Short notes on Average profit method :

- ❖ Under this method, goodwill is calculated as certain years of purchase of average profits of the past few years.
- ❖ The number of years of purchase is generally determined on the basis of the average period a new business will take in order to bring it to the current state of the existing business.
- ❖ It may also be determined on the basis of the number of years for which the past average profit will be earned in future.

#### 5) Give a short note on Simple average profit method :

- ❖ Under this method, goodwill is calculated by multiplying the average profits by a certain number of years of purchase.
- ❖ Simple average profit is calculated by adding the adjusted profits of certain number of years by dividing the total number of such years.
- ❖ Goodwill = Average profit × Number of years of purchase  
Average profit =  $\frac{\text{Total profit}}{\text{Number of years}}$

#### 6) Give a short note on Weighted average profit method :

- ❖ Under this method, goodwill is calculated by multiplying the weighted average profit by a certain number of years of purchase.
- ❖ Goodwill = Weighted average profit × Number of years of purchase  
In this method, weights are assigned to each year's profit.
- ❖ Weighted profit is ascertained by multiplying the weights assigned with the respective year's profit.
- ❖ The sum of the weighted profits is divided by the sum of weights assigned to determine the weighted average profit.
- ❖ Weighted average profit =  $\frac{\text{Total of weighted profits}}{\text{Total of weights}}$
- ❖ This method is used when the profits show an increasing or decreasing trend. More weight is generally given to the profits of the recent years.

## CHAPTER 05. PARTNERSHIP ADMISSION

### VERY SHORT ANSWER QUESTIONS.

#### 1) What is meant by revaluation of assets and liabilities?.

- ❖ When a partner is admitted into the partnership, the assets and liabilities are revalued as the current value may differ from the book value.

- ❖ Determination of current values of assets and liabilities is called revaluation of assets and liabilities.
- ❖ The reasons for revaluation of assets and liabilities are as follows:
  - ✓ To give a true and fair view of the state of affairs of the firm and
  - ✓ To share the gain arising from the revaluation of assets and liabilities as it is due to the old partners.
- ❖ There are two ways in which the revaluation of assets and liabilities may be dealt with in the accounts.

(a) Revised value of assets and liabilities are shown in the books

(b) Revised value of assets and liabilities are not shown in the books

## 2) How are accumulated profits and losses distributed among the partners at the time of admission of a new partner?

### Distribution of Accumulated Profits & Losses.

- ❖ Profits and losses of previous years which are not distributed to the partners are called Accumulated profits and losses.
- ❖ Any reserve and accumulated profits and losses belong to the old partners and hence these should be distributed to the old partners in the old profit sharing ratio.

DATE	PARTICULARS	L.F	DEBIT(Rs)	CREDIT(Rs)
	Profit and loss appropriation A/c Dr		xxxxx	
	To Old partners' capital / current A/c (in the old ratio)			xxxxx

## 3) What is sacrificing ratio?

- ❖ The old partners may sacrifice a portion of the share of profit to the new partner.
- ❖ The sacrifice may be made by all the partners or some of the partners.
- ❖ Sacrificing ratio is the proportion of the profit which is sacrificed or foregone by the old partners in favour of the new partner.
- ❖ The purpose of finding the sacrificing ratio is to share the goodwill brought in by the new partner.
- ❖ The share sacrificed is calculated by deducting the new share from the old share.

Share sacrificed = Old share - New share

Sacrificing ratio = Ratio of share sacrificed by the old partners

## 4) Give the journal entry for writing off existing goodwill at the time of admission of a new partner.

- ❖ If goodwill already appears in the books of accounts, at the time of admission if the partners decide, it can be written off by transferring it to the existing partners' capital account / current account in the old profit sharing ratio.

- ❖ The following journal entry is to be passed:

DATE	PARTICULARS	L.F	DEBIT(Rs)	CREDIT(Rs)
	Old partners' capital / current A/c Dr (in old ratio)		xxxxx	
	To Goodwill A/c xxx (Existing goodwill written off)			xxxxx

5) State whether the following will be debited or credited in the revaluation account.

- (a) Depreciation on assets - REVALUATION - DEBIT  
 (b) Unrecorded liability - REVALUATION - DEBIT  
 (c) Provision for outstanding expenses - REVALUATION - DEBIT  
 (d) Appreciation of assets - REVALUATION - CREDIT

### SHORT ANSWER:

1) What are the adjustments required at the time of admission of a partner?

- ❖ On the admission of a partner, generally there is a change in the mutual rights of the partners.
- ❖ The new partner becomes liable for all the acts which are carried out by the firm from the date of his / her admission into the firm.
- ❖ The following adjustments are necessary at the time of admission of a partner:
  - ✓ Distribution of accumulated profits, reserves and losses
  - ✓ Revaluation of assets and liabilities
  - ✓ Determination of new profit-sharing ratio and sacrificing ratio
  - ✓ Adjustment for goodwill
  - ✓ Adjustment of capital on the basis of new profit sharing ratio (if so agreed)

2) What are the journal entries to be passed on revaluation of assets and liabilities?

DATE	PARTICULARS	L.F	DEBIT (Rs)	CREDIT (Rs)
	<u>1. FOR INCREASE IN THE VALUE OF ASSET</u>			
	Concerned\asset A/c Dr.		xxx	
	To Revaluation A/c			xxx
	<u>2.FOR DECREASE IN THE VALUE OF ASSET</u>			



	Revaluation A/c Dr To Concerned asset A/c		xxx	xxx
	<u>3. FOR INCREASE IN THE AMOUNT OF LIABILITIES</u> Revaluation A/c Dr. To Concerned liability A/c		xxx	xxx
	<u>4. FOR DECREASE IN THE AMOUNT OF LIABILITY</u> Concerned liability A/c Dr. To Revaluation A/c			
	<u>5. FOR RECORDING AN UNRECORDED ASSET</u> Concerned asset A/c Dr. To Revaluation A/c		xxx	xxx
	<u>6. FOR RECORDING AN UNRECORDED LIABILITY</u> Revaluation A/c Dr. To Concerned liability A/c		xxx	xxx
	<u>7. FOR TRANSFERRING THE BALANCE IN REVALUATION A/C</u> (a) <u>IF THERE IS PROFIT ON REVALUATION</u> Revaluation A/c Dr To Old partners' capital A/c (individually in old ratio)  (b) <u>IF THERE IS LOSS ON REVALUATION</u> Old partners' capital A/c (individually in old ratio) Dr. To Revaluation A/c		xxx	Xxx      xxx

### 3) Write a short note on accounting treatment of goodwill.

Accounting treatment for goodwill on admission of a partner is discussed below:

- ❖ When new partner brings cash towards goodwill
- ❖ When the new partner does not bring goodwill in cash or in kind

- ❖ When the new partner brings only a part of the goodwill in cash or in kind
- ❖ Existing goodwill.
- ❖ WHEN NEW PARTNER BRINGS CASH TOWARDS GOODWILL:
  - ✓ When the new partner brings cash towards goodwill in addition to the amount of capital, it is distributed to the existing partners in the sacrificing ratio.
- ❖ WHEN THE NEW PARTNER DOES NOT BRING GOODWILL IN CASH OR IN KIND
  - ✓ If the new partner does not bring goodwill in cash or in kind, his share of goodwill must be adjusted through the capital accounts of the partners.
- ❖ WHEN THE NEW PARTNER BRINGS ONLY A PART OF THE GOODWILL IN CASH OR IN KIND
  - ✓ Sometimes the new partner may bring only a part of the goodwill in cash or assets.
  - ✓ In such a case, for the cash or the assets brought, the respective account is debited and for the amount not brought in cash or kind, the new partner's capital account is debited.
- ❖ EXISTING GOODWILL
  - ✓ If goodwill already appears in the books of accounts, at the time of admission if the partners decide, it can be written off by transferring it to the existing partners' capital account / current account in the old profit sharing ratio.

### LESSON INSIDE QUESTION:

#### 1) What is mean by Investment fluctuation fund? (IFF)

- ❖ Investment fluctuation fund is created out of profit to adjust the reduction in the market value of the investments.
- ❖ If the market value of the investments is greater than or equal to the book value, then, the entire investment fluctuation fund is transferred to the old partners' capital account in old profit sharing ratio.
- ❖ If the market value of the investments is less than the book value, then the difference is to be subtracted from the investment fluctuation fund and the balance of investment fluctuation fund is to be transferred to the old partners' capital account in old profit sharing ratio.

#### 2) What is mean by admission of a new partner?

- ❖ A person may join as a new partner in an existing partnership firm.
- ❖ This is called admission of a partner.

#### 3) What purpose an admission of a new partner?

- ❖ The purpose of admission of a new partner may be to raise additional capital for expansion of business or managerial skill of the new partner or both.

- ❖ Generally, the new partner has to contribute capital to the firm and thereby he / she acquires the right to share the future profits and the assets of the firm.

**4) Which purpose of admission of a new partner in a partnership firm?**

The purpose of admission of a new partner may be

- ❖ To raise additional capital for expansion of business or
- ❖ Managerial skill of the new partner or
- ❖ Both Purposes.

**5) What are the situations to Calculation of sacrificing ratio and new profit sharing ratio?**

**❖ WHEN NEW PROFIT SHARING RATIO IS GIVEN**

- ✓ When new profit sharing ratio is given, sacrificing ratio has to be calculated as follows:
- ✓  $\text{Sacrificing ratio} = \text{Ratio of share sacrificed by the old partners}$
- ✓  $\text{Share sacrificed} = \text{Old share} - \text{New share.}$

**❖ WHEN NEW PROFIT SHARING RATIO IS NOT GIVEN:**

**(a) WHEN SHARE SACRIFICED IS GIVEN.**

- ✓ When new profit sharing ratio is not given, but the share sacrificed by the old partner(s) is given, new profit sharing ratio is calculated as follows:
- ✓  $\text{New share of old partner} = \text{Old share} - \text{Share sacrificed}$
- ✓  $\text{Share of new partner} = \text{Sum of shares sacrificed by old partners.}$

**❖ WHEN PROPORTION OF SHARE SACRIFICED IS GIVEN**

**(I) WHEN SHARE SACRIFICED IS GIVEN AS A PROPORTION ON OLD PARTNERS' SHARE**

- ✓ When new profit sharing ratio is not given, but the share sacrificed is given as a proportion on old partners' share, new profit sharing ratio is calculated as follows:
- ✓  $\text{Share sacrificed by old partner} = \text{Old share} \times \text{Proportion of share sacrificed}$
- ✓  $\text{New share of old partner} = \text{Old share} - \text{Share sacrificed}$
- ✓  $\text{Share of new partner} = \text{Sum of shares sacrificed by old partners.}$

**❖ WHEN PROPORTION OF SHARE SACRIFICED ON NEW PARTNER'S SHARE IS GIVEN**

- ✓ When new profit sharing ratio is not given, but the proportion of share sacrificed on new partner's share is given, new profit sharing ratio is calculated as follows:
- ✓  $\text{New share of old partner} = \text{Old share} - \text{Share sacrificed}$
- ✓  $\text{Share sacrificed} = \text{New partner's share} \times \text{Proportion of share sacrificed.}$

### ❖ WHEN SHARE SACRIFICED AND PROPORTION OF SHARE SACRIFICED IS NOT GIVEN

- ✓ When new profit sharing ratio, share sacrificed and the proportion of share sacrificed is not given, but only the share of new partner is given, new profit sharing ratio is calculated by assuming that the share sacrificed is the proportion of old share.
- ✓ New profit sharing ratio is calculated as follows:
- ✓ Share sacrificed = New partner's share  $\times$  Old share
- ✓ New share of old partner = Old share - Share sacrificed

\*\*\*\*\* ALL THE BEST \*\*\*\*\*

## CHAPTER 06. RETIREMENT AND DEATH OF A PARTNER

### VERY SHORT ANSWER QUESTIONS

#### 1. What is meant by retirement of a partner? (OR) outgoing partner.

- ❖ When a partner leaves from a partnership firm, it is known as retirement.
- ❖ The reasons for the retirement of a partner may be illness, old age, better opportunity elsewhere, disagreement with other partners, etc.
- ❖ On retirement of a partner, existing agreement comes to an end.
- ❖ A partner who retires from the firm is called an outgoing partner or a retiring partner

#### 2. What is gaining ratio?.

- ❖ The continuing partners may gain a portion of the share of profit of the retiring partner.
- ❖ The gain may be shared by all the partners or some of the partners.
- ❖ Gaining ratio is the proportion of the profit which is gained by the continuing partners.
- ❖ The purpose of finding the gaining ratio is to bear the goodwill to be paid to the retiring partner.
  - The share gained is calculated as follows:
  - Share gained = New share - Old share
  - Gaining ratio = Ratio of share gained by the continuing partners

#### 3. What is the purpose of calculating gaining ratio? .

- ❖ The continuing partners may gain a portion of the share of profit of the retiring partner.
- ❖ The purpose of finding the gaining ratio is to bear the goodwill to be paid to the retiring partner.

The share gained is calculated as follows:

- ✓ Share gained = New share - Old share
- ✓ Gaining ratio = Ratio of share gained by the continuing partners.

**4. What is the journal entry to be passed to transfer the amount due to the deceased partner to the executor of the deceased partner?**

- ❖ When a partner dies the amount due from the firm is paid to the executor or legal representative of the deceased partner.
- ❖ To transfer the amount due to the deceased partner to the executor or legal representative of the deceased partner.

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	Deceased partner's capital A/c Dr.		xxxxx	
	To Deceased partner's executor A/c			xxxxx

### SHORT ANSWER:

**1) List out the adjustments made at the time of retirement of a partner in a partnership firm.**

The following adjustments are necessary at the time of retirement of a partner:

- ❖ Distribution of accumulated profits, reserves and losses
- ❖ Revaluation of assets and liabilities
- ❖ Determination of new profit sharing ratio and gaining ratio
- ❖ Adjustment for goodwill
- ❖ Adjustment for current year's profit or loss upto the date of retirement
- ❖ Settlement of the amount due to the retiring partner

**2) Distinguish between sacrificing ratio and gaining ratio.**

Basis	Sacrificing ratio	Gaining ratio
Meaning	It is the proportion of the profit which is sacrificed by the old partners in favour of a new partner	It is the proportion of the profit which is gained by the continuing partners from the retiring partner
Purpose	It is calculated to determine the amount to be adjusted towards goodwill for the sacrificing partners.	It is calculated to determine the amount to be adjusted towards goodwill for the gaining partners.
Time of calculation	It is calculated at the time of admission of a new partner	It is calculated at the time of retirement of a partner.
Method of calculation	It is the difference between the old ratio and the new ratio.	Gaining ratio = New profit sharing ratio - Old profit sharing ratio.



	Sacrificing ratio = Old profit sharing ratio - New profit sharing ratio	Gaining ratio = New profit sharing ratio - Old profit sharing ratio
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### 3) What are the ways in which the final amount due to an outgoing partner can be settled?

- ❖ The settlement is to be done in the manner prescribed in the partnership deed. The amount due to the retiring partner may be settled in one of the following ways:
- ❖ Paying the entire amount due immediately in cash.
- ❖ Transfer the entire amount due, to the loan account of the partner.
- ❖ Paying part of the amount immediately in cash and transferring the balance to the loan account of the partner.

#### (a) When the amount due is paid in cash immediately:

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	Retiring partner's capital A/c Dr		xxxxx	
	To Cash / Bank A/c			xxxxx

#### (b) When the amount due is not paid immediately in cash.

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	Retiring partner's capital A/c Dr		xxxxx	
	To Retiring partner's A/c			xxxxx

#### (c) When the amount due is partly paid in cash immediately

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	Retiring partner's capital A/c Dr		xxxxx	
	To Retiring partner's A/c			xxxxx
	To Cash / Bank A/c (amount paid)			xxxxx

## LESSON INSIDE QUESTIONS & ANSWERS:

### 1) What are the Adjustments required on the death of a partner?

- Adjustments required on the death of a partner When a partner dies, there is dissolution or reconstitution of partnership.

**The following adjustments are made on the death of a partner:**

- ✓ Distribution of accumulated profits, reserves and losses
- ✓ Revaluation of assets and liabilities
- ✓ Determination of new profit sharing ratio and gaining ratio
- ✓ Adjustment for goodwill
- ✓ Adjustment for current year's profit or loss upto the date of death
- ✓ Settlement of the amount due to the deceased partner

### 2) Write Short note on Life policies

- Life policies may be taken on the life of the partners in a partnership firm.
- The life policy may be individual policy or joint life policy.
- In case of individual policy, if a partner dies, his policy alone matures and the policy amount is received from the insurance company.
- In case of joint life policy, one policy is taken on the lives of all partners.
- When any one of the partners dies, the policy matures and the policy amount is received.
- In both types of policies, the insurance premium is paid by the partnership firm.
- The policy amount received from the insurance company is used to settle the amount due to the deceased partner

### 3) If the amount due to the retiring/deceased partner is not paid in cash immediately and if there is no contract entered into concerning settlement of account, what will say the Indian partnership Act.?

- Then provisions of Section 37 of the Indian Partnership Act, 1932 will apply. As per section 37, the retiring partner or the representatives of the retiring or deceased partner is entitled to choose any of the following options:
  - ✓ Share of profits attributable to the use of his share of property of the firm or
  - ✓ Interest at the rate of 6 per cent per annum on the amount of his share on the property of the firm.

### 4) How do Distribution of accumulated profits reserves and losses

- ✓ Profits and losses of previous years which are not distributed to the partners are known as accumulated profits and losses.
- ✓ Reserve includes general reserve, reserve fund, workmen compensation fund and investment fluctuation fund.

- ✓ As the accumulated profits and losses belong to all the partners, these should be distributed to all the partners in the old profit sharing ratio.
- ✓ In case of workmen compensation fund, the excess amount after providing for anticipated claim is to be transferred.
- ✓ Following are the journal entries to be passed:

**FOR TRANSFERRING ACCUMULATED PROFITS AND RESERVES**

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	Profit and loss Appropriation A/c Dr		xxxxxx	
	General reserve A/c Dr		xxxxxx	
	Reserve fund A/c Dr		xxxxxx	
	Workmen compensation fund A/c Dr		xxxxxx	
	Investment fluctuation fund A/c Dr		xxxxxx	
	To All partners' capital / current A/c (in the old ratio)			xxxxxx

✓ **FOR TRANSFERRING ACCUMULATED LOSS :**

Date	Particulars	L.F.	Debit(Rs)	Credit(Rs)
	All partners' capital / current A/c Dr		xxxxxx	
	To Profit and loss A/c (in old ratio)			xxxxxx

5) Give Any three reasons for a partner for leaving a partnership firm?

- Illness,
- Old Age,
- Better Opportunity Elsewhere,
- Disagreement With Other Partners, Etc. .

6) How many ways to Revaluation of Assets and Liabilities?

- The assets and liabilities are revalued as the current value may differ from the book value.
- There are two ways in which the revaluation of assets and liabilities may be dealt with in the accounts.
  - ✓ Revised value of assets and liabilities are shown in the books
  - ✓ Revised value of assets and liabilities are not shown in the book

\*\*\*\* ALL THE BEST \*\*\*\*

## CHAPTER 07. COMPANY ACCOUNTS

### VERY SHORT ANSWER QUESTIONS

#### 1. What is a share?

- ❖ The capital of a company is divided into small units of fixed amount.
- ❖ These units are called shares.
- ❖ The shares which can be issued by a company are of two types
  - ✓ preference shares and
  - ✓ Equity shares.

#### 2. What is over-subscription?

- ❖ When the number of shares applied for is more than the number of shares offered for subscription, it is said to be over subscription.
- ❖ This situation can be dealt with as per any of the following three alternatives:
  - (a) Some applications are accepted in full and others are totally rejected. Application money is returned to the applicants for rejected applications.
  - (b) All applications are allotted in proportion of shares applied for. This is called pro rata allotment. Excess application money may be returned or may be retained for adjustment towards allotment money and call money.
  - (c) A combination of the above two may be applied.

#### 3. What is meant by calls in arrear?

- ❖ When a shareholder fails to pay the amount due on allotment or on calls, the amount remaining unpaid is known as calls in arrears.
- ❖ In other words, the amount called up but not paid is calls in arrear.
- ❖ As per Table F of the Indian Companies Act, 2013, interest may be charged on calls in arrear if Articles of Association so provide not exceeding 10% per annum.
- ❖ There are two methods of accounting of calls in arrear.
  - (i) By not opening calls in arrear account
  - (ii) By opening calls in arrear account

#### 4. Why are the shares forfeited?

- ❖ When a shareholder defaults in making payment of allotment and/or call money, the shares may be forfeited.
- ❖ On forfeiture, the share allotment is cancelled and to that extent, share capital is reduced.
- ❖ The person ceases to be a shareholder of the company after the shares are forfeited.
- ❖ On forfeiture, the amount so far paid by the shareholder is forfeited which is a gain to the company and is credited to forfeited shares account.

- ❖ Forfeited shares account is shown under share capital as a separate head in the Note to Accounts to the balance sheet.

**SHORT ANSWER:****1. State the differences between preference shares and equity shares.**

<b>BASIS</b>	<b>PREFERENCE SHARES</b>	<b>EQUITY SHARES</b>
<b>Meaning</b>	Preference shares Preference shares are the shares which have the two preferential rights over the equity shares	Equity shares are those shares which are not preference shares. These shares do not enjoy any preferential rights
<b>Rights about dividend</b>	Preference towards the payment of dividend at a fixed rate during the life time of the company	Rate of dividend is not fixed on equity shares and it depends upon the profits earned by the company
<b>Return on share capital</b>	Preference towards the repayment of capital on winding up of the company	In case of winding up of a company equity shareholders are paid after the payments are made to preference shareholders.
<b>Types of shares</b>	Preference share have many types	Equity shares are also known as ordinary shares.

**2. Write a brief note on calls in advance.**

- ❖ The excess amount paid over the called up value of a share is known as calls in advance.
- ❖ It is the excess money paid on application or allotment or calls.
- ❖ Such excess amount can be returned or adjusted towards future payment.
- ❖ If the company decides to adjust such amount towards future payment, the excess amount may also be transferred to a separate account called calls in advance account.
- ❖ Calls in advance does not form part of the company's share capital and no dividend is payable on such amount.
- ❖ In the balance sheet, it should be shown under current liabilities.
- ❖ As per Section 50 of the Indian Companies Act, 2013, the company can accept calls in advance only if it is authorised by its Articles of Association.
- ❖ As per Table F of the Indian Companies Act, 2013, interest may be paid on calls in advance if Articles of Association so provide not exceeding 12% per annum.



**3. What is reissue of forfeited shares?.**

- ❖ Shares forfeited can be reissued by the company.
- ❖ The shares can be reissued at any price.
- ❖ But, the reissue price cannot be less than the amount unpaid on forfeited shares. Example: If a share of Rs.10 on which Rs.4 has already been paid as application money is forfeited and reissued as fully paid up, then a minimum of Rs.6 must be fixed as the new price ( $10 - 4 = 6$ ).
- ❖ When forfeited shares are reissued at a loss, such loss is to be debited to forfeited shares account.
- ❖ When forfeited shares are reissued at a premium, the amount of such premium will be credited to securities premium account.

**4. Write a short note on (a) Authorised capital (b) Reserve capital.**❖ **AUTHORISED CAPITAL :**

- ✓ It means such capital as is authorised by the memorandum of association.
- ✓ It is the maximum amount which can be raised as capital.
- ✓ It is also known as registered capital or nominal capital.

❖ **RESERVE CAPITAL :**

- ✓ The company can reserve a part of its subscribed capital to be called up only at the time of winding up.
- ✓ It is called reserve capital.

**5. What is meant by issue of shares for consideration other than cash?**

- ❖ Issue of shares for consideration other than cash a company may issue shares for consideration other than cash when the company acquires fixed assets such as land and buildings, machinery, etc

**LESSON INSIDE QUESTION:****1) Explain the Divisions of share capital ?**

The share capital of a company is divided into the following categories:

❖ **Authorised capital :**

- ✓ It means such capital as is authorised by the memorandum of association.
- ✓ It is the maximum amount which can be raised as capital.
- ✓ It is also known as registered capital or nominal capital.

❖ **Issued capital :**

This represents that part of authorised capital which is offered for subscription.

❖ **Subscribed capital:**

- ✓ It refers to that part of issued capital which has been applied for and also allotted by the company.

❖ Called up capital:

- ✓ It refers to that part of subscribed capital which has been called up by the company for payment.

❖ Paid up capital :

- ✓ It is that part of called up capital which has been actually paid by the shareholders.

❖ Reserve capital :

- ✓ The company can reserve a part of its subscribed capital to be called up only at the time of winding up.
- ✓ It is called reserve capital.

**2) How do raise the capital of the public company?**

A public company may raise capital by issue of equity shares through the following ways

- ❖ Public issue
- ❖ Private placement
- ❖ Rights issue
- ❖ Bonus issue

❖ Public issue :

- ✓ Issue of equity shares to the public through prospectus by a public company is called public issue.
- ✓ It includes initial public offer and further public offer.

❖ Private placement :

- ✓ Private placement means any offer of equity shares or invitation to subscribe equity shares to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in Section 42 of the Indian Companies Act, 2013.

❖ Rights issue:

- ✓ Issue of equity shares to the existing shareholders of the company through a letter of offer is known as rights issue.

❖ Bonus issue:

- ✓ Issue of equity shares to the existing shareholders of the company at free of cost out of accumulated profit is known as bonus issue.

**3) Explain the Process of issue of equity shares.**

The Process of issue of equity shares a company can issue shares as per the provisions of the Indian Companies Act and as per the guidelines issued by Securities and Exchange Board of India (SEBI).

❖ **Inviting subscription:**

- ✓ A public company has to issue a prospectus and invite the general public to subscribe for its shares.

❖ **Receipt of application:**

- ✓ On the basis of the prospectus, applications are deposited in a scheduled bank by the applicants along with application money within the time specified.
- ✓ Application money must be at least 5 per cent of the nominal value of the shares.

❖ **Allotment of shares:**

- ✓ When the minimum subscription stated in the prospectus has been subscribed for by the public, a company can allot shares.
- ✓ For those to whom shares could not be allotted, their application money will be refunded. If the minimum subscription is not received, all the application money received has to be refunded to the applicants.

**4) Explain the Shares issued at premium :**

- ❖ When a company issues shares at a price more than the face value (nominal value), the shares are said to be issued at premium.
- ❖ The excess is called as premium amount and is transferred to securities premium account.
- ❖ The amount of securities premium may be included in application money or allotment money or in a call.
- ❖ Securities premium account is shown under reserves and surplus as a separate head in the Note to Accounts to the balance sheet.

\*\*\*\*\* ALL THE BEST \*\*\*\*\*

**CHAPTER 08. FINANCIAL STATEMENT ANALYSIS****VERY SHORT ANSWER QUESTIONS****5. What are financial statements?**

- ❖ Financial statements are the statements prepared by the business concerns at the end of the accounting period to ascertain the operating results and the financial position.
- ❖ The basic financial statements prepared by business concerns are income statement and balance sheet.

**6. List the tools of financial statement analysis.****Tools of financial statement analysis:**

- ✓ Comparative statement
- ✓ Common-size statements

- ✓ Trend analysis
- ✓ Funds Flow analysis
- ✓ Cash Flow analysis

**7. What is working capital?**

- ❖ The term 'fund' refers to working capital.
- ❖ Working capital refers to the excess of current assets over current liabilities.

**8. When is trend analysis preferred to other tools?**

- ❖ When data for more than two years are to be analysed, it may be difficult to use comparative statement. For this purpose, trend analysis may be used.
- ❖ Trend refers to the tendency of movement.
- ❖ Trend analysis refers to the study of movement of figures over a period.
- ❖ The trend may be increasing trend or decreasing trend or irregular.
- ❖ One year, generally, the first year is taken as the base year. The figures of the base year are taken as 100.
- ❖ The figures for the other years are expressed as a percentage to the base year and the trend is determined

**SHORT ANSWER:**

**1. 'Financial statements are prepared based on the past data'. Explain how this is a limitation.**

- ❖ Record of historical data:
  - ✓ Financial statements are prepared based on historical data.
  - ✓ They may not reflect the current position.
  - ✓ Financial statements are prepared at the end of every accounting period. But, the actual position of the business can be known only when the business is closed.
  - ✓ Hence, financial statements may not reveal the exact position of the business concern.

**2. Write a short note on cash flow analysis.**

- ❖ Cash flow analysis is concerned with preparation of cash flow statement which shows the inflow and outflow of cash and cash equivalents in a given period of time.
- ❖ Cash includes cash in hand and demand deposits with banks.
- ❖ Cash equivalents denote short term investments which can be realised easily within a short period of time, without much loss in value.
- ❖ Cash flow analysis helps in assessing the liquidity and solvency of a business concern.

**3. Briefly explain any three limitations of financial statements.**

- ❖ Following are the limitations of financial statements:

→ **LACK OF QUALITATIVE INFORMATION:**

- ❖ Qualitative information that is non-monetary information is also important for business decisions.
- ❖ For example, efficiency of the employees, efficiency of the management, etc. But, this is ignored in financial statements.
- **RECORD OF HISTORICAL DATA:**
- ❖ Financial statements are prepared based on historical data. They may not reflect the current position.
- **IGNORE PRICE LEVEL CHANGES:**
- ❖ Adjustments for price level changes are not made in the financial statements. Hence, financial statements may not reveal the current position.
- **LACK OF CONSISTENCY:**
- ❖ Different business concerns may use different accounting methods. Hence, comparison between two business concerns becomes difficult.
- **GIVE ONLY INTERIM REPORTS:**
- ❖ Financial statements are prepared at the end of every accounting period. But, the actual position of the business can be known only when the business is closed. Hence, financial statements may not reveal the exact position of the business concern.
- **LIMITED ACCESS TO EXTERNAL USERS:**
- ❖ The external users do not have detailed and frequent information of financial results as they have limited access.
- **INFLUENCED BY PERSONAL JUDGEMENT:**
- ❖ Preparation of financial statements may be influenced by personal judgements and therefore these are not free from bias.

#### 4. Explain the steps involved in preparing comparative statement.

Preparation of comparative statements A comparative statement has five columns.

Following are the steps to be followed in preparation of the comparative statement:

- ✓ Column 1: In this column, particulars of items of income statement or balance sheet are written.
- ✓ Column 2: Enter absolute amount of year 1.
- ✓ Column 3: Enter absolute amount of year 2.
- ✓ Column 4: Show the difference in amounts between year 1 and year 2. If there is an increase in year 2, put plus sign and if there is decrease put minus sign.
- ✓ Column 5: Show percentage increase or decrease of the difference amount shown in column 4 by dividing the amount shown in column 4 (absolute amount of increase or decrease) by column 2 (year 1 amount). That is,
- ✓ Percentage increase or decrease =  $\frac{\text{Absolute amount of increase or decrease}}{\text{Year 1 amount}} \times 100$

Particulars	Year-1 (Rs)	Year-2 (Rs)	Absolute amount of increase (+)	Percentage increase (+)
-------------	-------------	-------------	---------------------------------	-------------------------



			or decrease (-)	or decrease (-)

### 5. Explain the procedure for preparing common-size statement.

Preparation of common-size statements Common-size statement can be prepared with three columns.

Following are the steps to be followed in preparation of common-size statement:

- ✓ Column 1: In this column, particulars of items of income statement or balance sheet are written.
- ✓ Column 2: Enter absolute amount.
- ✓ Column 3: Choose a common base as 100. For example, revenue from operations can be taken as the base for income statement and total of balance sheet can be taken as the base for balance sheet. Work out the percentage for all the items of column 2 in terms of the common base and enter them in column 3.
- ✓ Format of common-size statement.
- ✓

Particulars	Absolute amount	Percentage

### LESSON INSIDE QUESTION:

#### 1) What are the Features of financial statements?

Following are the features of financial statements:

- ❖ Financial statements are generally prepared at the end of an accounting period based on transactions recorded in the books of accounts.
- ❖ These statements are prepared for the organisation as a whole.
- ❖ Information is presented in a meaningful way by grouping items of similar nature such as fixed assets and current assets.
- ❖ Financial statements are prepared based on historical cost.
- ❖ Financial statements are prepared based on accounting principles and Accounting Standards, which make financial statements comparable and realistic.
- ❖ Financial statements involve personal judgement in certain cases.
- ❖ For example, selection of method of depreciation, percentage of reserve, etc

#### 2) What are Significance of financial statements?

→ Financial statements reveal the operating results and financial position of the business concern. The significance of financial statements to various stakeholders is as follows:

- ❖ To management:

- ✓ Financial statements provide information to the management to take decision and to have control over business activities, in various areas.

❖ To shareholders:

- ✓ Financial statements help the shareholders to know whether the business has potential for growth and to decide to continue their shareholding.

❖ To potential investors:

- ✓ Financial statements help to value the securities and compare it with those of other business concerns before making their investment decisions.

❖ To creditors:

- ✓ Creditors can get information about the ability of the business to repay the debts from financial statements.

❖ To bankers:

- ✓ Information given in the financial statements is significant to the bankers to assess whether there is adequate security to cover the amount of the loan or overdraft.

❖ To government:

- ✓ Financial statements are significant to government to assess the tax liability of business concerns and to frame and amend industrial policies.

❖ To employees:

- ✓ Through the financial statements, the employees can assess the ability of the business to pay salaries and whether they have future growth in the concern

### 3) What are the Objectives of financial statement analysis ?

Financial statement analysis may be done with any of the following objectives:

- ❖ To analysis the profitability and earning capacity
- ❖ To study the long term and short term solvency of the business
- ❖ To determine the efficiency in operations and use of assets
- ❖ To determine the efficiency of the management and employees
- ❖ To determine the trend in sales, production, etc.
- ❖ To forecast for future and prepare budgets
- ❖ To make inter-firm and intra-firm comparisons

### 4) What is mean by Horizontal analysis ?

- ❖ When figures relating to several years are considered for the purpose of analysis, the analysis is called horizontal analysis.
- ❖ Generally, one year is taken as the base year and the figures relating to the other years are compared with that of the base year.
- ❖ Comparative statements and trend percentages are examples of horizontal analysis.

**5) What is mean by Vertical analysis?**

- ❖ When figures relating to one accounting year alone are considered for the purpose of analysis, the analysis is called vertical analysis.
- ❖ Here, relationship is established among items from various financial statements relating to the same accounting period.
- ❖ Preparation of common size statements and computation of ratios are examples of vertical analysis.

**CHAPTER 09. RATIO ANALYSIS****VERY SHORT ANSWER QUESTIONS****1. What is meant by accounting ratios?**

- ❖ Ratio is a mathematical expression of relationship between two related or interdependent items.
- ❖ It is the numerical or quantitative relationship between two items.
- ❖ It is calculated by dividing one item by the other related item.
- ❖ When ratios are calculated on the basis of accounting information, these are called 'accounting ratios'.

**2. What is quick ratio?**

- ❖ Quick ratio gives the proportion of quick assets to current liabilities.
- ❖ It indicates whether the business concern is in a position to pay its current liabilities as and when they become due, out of its quick assets.
- ❖ Quick assets are current assets excluding inventories and prepaid expenses. It is otherwise called liquid ratio or acid test ratio.
- ❖ It is calculated as follows:  

$$\text{Quick ratio} = \frac{\text{Current Assets}}{\text{current liabilities}}$$
- ❖ Quick assets = Current assets - Inventories - Prepaid expenses Higher the quick ratio, better is the short-term financial position of an enterprise.

**3. What is meant by debt equity ratio?**

- ❖ Debt equity ratio is calculated to assess the long term solvency position of a business concern.
- ❖ Debt equity ratio expresses the relationship between long term debt and shareholders' funds.
- ❖ It is computed as follows:  

$$\text{Debt equity ratio} = \frac{\text{Long term debt}}{\text{Shareholders' funds.}}$$

**4. What does return on investment ratio indicate?**

- ❖ Return on Investment (ROI) shows the proportion of net profit before interest and tax to capital employed (shareholders' funds and long term debts).
- ❖ This ratio measures how efficiently the capital employed is used in the business.
- ❖ It is an overall measure of profitability of a business concern.
- ❖ It is computed as below:

$$\text{Return on Investment (ROI)} = \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$$

Capital employed = Shareholders' funds + Non-current liabilities  
Greater the return on investment better is the profitability of a business and vice versa.

### 5. State any two limitations of ratio analysis.

#### → Accuracy of financial information:

- ❖ The accuracy of a ratio depends on the accuracy of information taken from financial statements. If the statements are inaccurate, ratios computed based on that will also be inaccurate.

#### → Consistency in preparation of financial statements:

- ❖ Inter firm comparisons with the help of ratio analysis will be meaningful only if the firms follow uniform accounting procedures consistently.

#### → Non-availability of standards or norms:

- ❖ Ratios will be meaningful only if they are compared with accepted standards or norms. Only few financial ratios have universally recognised standards. For other ratios, comparison with standards is not possible.

#### → Change in price level:

- ❖ Ratio analysis may not reflect price level changes and current values as they are calculated based on historical data given in financial statements.

## SHORT ANSWER QUESTIONS

### 1. Explain the objectives of ratio analysis.

Objectives of ratio analysis Following are the objectives of ratio analysis:

- ✓ To simplify accounting figures
- ✓ To facilitate analysis of financial statements
- ✓ To analyses the operational efficiency of a business
- ✓ To help in budgeting and forecasting
- ✓ To facilitate intra firm and inter firm comparison of performance.

### 2. What is inventory conversion period? How is it calculated?

- ❖ Inventory conversion period is the time taken to sell the inventory.
- ❖ A shorter inventory conversion period indicates more efficiency in the management of inventory. It is computed as follows:
- ❖ Number of days in a year

$$\text{Inventory conversion period (in days)} = \frac{\text{Number of days in a year}}{\text{Inventory turnover ratio}}$$

- Inventory conversion period =  $\frac{\text{Number of months in a year}}{\text{Inventory turnover ratio}}$   
( in Months )

### 3. How is operating profit ascertained?

- ❖ Operating profit ratio gives the proportion of operating profit to revenue from operations.
- ❖ Operating profit ratio is an indicator of operational efficiency of an organisation.
- ❖ It may be computed as follows:

$$\text{Operating profit ratio} = \frac{\text{Operating profit} \times 100}{\text{Revenue from operations}}$$

- ✓ Operating profit = Revenue from operations - Operating cost. A higher ratio indicates better profitability.
- ✓ Greater the operating ratio, higher is the margin available for paying non-operating expenses

### 4. State the advantages of ratio analysis.

Advantages of ratio analysis Following are the advantages of ratio analysis:

- ❖ Measuring operational efficiency:
  - ✓ Ratio analysis helps to know operational efficiency of a business by finding the relationship between operating cost and revenues and also by comparison of present ratios with those of the past ratios.
- ❖ Measuring financial solvency:
  - ✓ Ratio analysis helps to ascertain the liquidity or short term solvency and long term solvency of a business concern.
- ❖ Facilitating investment decisions:
  - ✓ Ratio analysis helps the management in making effective decisions regarding profitable avenues of investment.
- ❖ Analysing the profitability:
  - ✓ Ratio analysis helps to analyse the profitability of a business in terms of sales and investments
- ❖ Intra firm comparison:
  - ✓ Comparison of efficiency of different divisions of an organisation is possible by comparing the relevant ratios.
- ❖ Inter firm comparison:
  - ✓ Ratio analysis helps the firm to compare its performance with other firms.

### 6. State the limitations of ratio analysis.

Limitations of ratio analysis Following are the limitations of ratio analysis:

- ❖ Ratios are only means:



- ✓ Ratios are not end in themselves but they are only means to achieve a particular purpose.
- ✓ Analysis of related items must be done by the management or experts with the help of ratios.
- ❖ Accuracy of financial information:
  - ✓ The accuracy of a ratio depends on the accuracy of information taken from financial statements.
  - ✓ If the statements are inaccurate, ratios computed based on that will also be inaccurate.
- ❖ Consistency in preparation of financial statements:
  - ✓ Inter firm comparisons with the help of ratio analysis will be meaningful only if the firms follow uniform accounting procedures consistently.
- ❖ Non-availability of standards or norms:
  - ✓ Ratios will be meaningful only if they are compared with accepted standards or norms.
  - ✓ Only few financial ratios have universally recognized standards.
  - ✓ For other ratios, comparison with standards is not possible.
- ❖ Change in price level:
  - ✓ Ratio analysis may not reflect price level changes and current values as they are calculated based on historical data given in financial statements.

\*\*\*\*\* ALL THE BEST \*\*\*\*\*

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