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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Principles of Accounting (438) • Level: ADC

Semester: Autumn 2026

Assignment No. 2 (Units 5–9)

Total Marks: 100 • Pass Marks: 50

SOLVED ASSIGNMENT GUIDE

(For Study & Reference)

Note: This guide is prepared for study and reference purposes. Students are advised to read the relevant units of the course book, understand the concepts, and write the assignment in their own words.

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Question 1: Final Accounts of Ahmad Traders — Year Ended 30 June 2025 (20 Marks)

The following Trial Balance was extracted from the books of Ahmad Traders on 30th June 2025. From the given information, you are required to prepare a trading and profit and loss account and a balance sheet for the year ended 30th June 2025. Trial Balance: Cash Dr 570,000; Accounts Receivable Dr 190,000; Merchandise Inventory (opening) Dr 60,000; Plant and Machinery Dr 670,000; Furniture and Fixtures Dr 820,000; Capital Cr 2,360,000; Accounts Payable Cr 38,000; Purchases Returns and Allowances Cr 22,000; Purchases Dr 600,000; Discount on Purchases Cr 6,000; Sales Cr 700,000; Sales Returns and Allowances Dr 30,000; Sales Discount Dr 16,000; Insurance Prepaid Dr 10,000; Advertisement Expenses Dr 40,000; Salaries Expenses Dr 120,000; Totals Dr 3,126,000 / Cr 3,126,000. Additional information: (1) Prepaid insurance on 30th June 2025 is Rs 4,000; (2) Outstanding salaries Rs 15,000; (3) Depreciation on plant and machinery @ 10% p.a.; (4) Closing merchandise inventory valued at Rs 60,000.

Introduction

The final accounts are the destination of the whole book-keeping process. From the trial balance, a trading business prepares, first, a trading account, which matches the net sales of the year with the cost of the goods sold and so reveals the gross profit; second, a profit and loss account, which sets all the remaining revenue expenses of running the business against the gross profit and the other incomes of the year and so reveals the net profit or net loss; and, third, a balance sheet, which lists the assets, liabilities and capital remaining after those results have been worked out, and so displays the financial position of the business on the last day of the accounting year. The trial balance figures alone are not enough for these statements, because some amounts in it relate to other periods or are incomplete. The four items of additional information must therefore be adjusted first: each adjustment affects two places — once in the trading or profit and loss account and once in the balance sheet (or twice within the profit calculation) — because the double-entry principle must be preserved. A note on dates: the printed paper dates the opening inventory '1st July 2016' and the closing inventory '30th June 2017', which are inconsistent with the trial balance date of 30 June 2025 and are plainly printing slips; the inventories are therefore treated here as the opening inventory of the year ended 30 June 2025 and the closing inventory on that date, both of Rs 60,000, which is the only reading that makes the question workable.

Working Notes — The Four Adjustments

Adjustment 1 — Prepaid insurance: the trial balance shows insurance prepaid of Rs 10,000 standing as a debit, while the prepaid insurance actually remaining on 30 June 2025 is only Rs

4,000. It follows that insurance of Rs 10,000 − Rs 4,000 = Rs 6,000 belongs to the current year and must be charged as an expense in the profit and loss account, while Rs 4,000 remains an asset (prepaid insurance) in the balance sheet. Adjustment 2 — Outstanding salaries: salaries of Rs 15,000 for the year have not yet been paid or recorded. The year's true salaries expense is therefore Rs 120,000 + Rs 15,000 = Rs 135,000 in the profit and loss account, and Rs 15,000 is shown as a current liability (outstanding salaries) in the balance sheet. Adjustment 3 — Depreciation: plant and machinery of Rs 670,000 is depreciated at 10 per cent per annum, giving a charge of Rs 67,000 in the profit and loss account and a written down value of Rs 670,000 − Rs 67,000 = Rs 603,000 in the balance sheet. (No depreciation is charged on furniture and fixtures, because the additional information mentions plant and machinery only.) Adjustment 4 — Closing inventory: stock of Rs 60,000 unsold on 30 June 2025 is credited to the trading account (reducing the cost of goods sold) and shown as a current asset in the balance sheet. With these workings settled, the final accounts can be prepared directly, and the student should notice in advance the two figures that decide the result: net sales will be Rs 700,000 − Rs 30,000 = Rs 670,000, and the cost of goods sold will be Rs 60,000 + (Rs 600,000 − Rs 22,000) − Rs 60,000 = Rs 578,000.

Trading and Profit and Loss Account for the Year Ended 30 June 2025

Table 1: Trading and Profit and Loss Account — Ahmad Traders, year ended 30 June 2025

Debit (Expenses / Cost)	Rs	Credit (Incomes)	Rs
To Opening Inventory	60,000	By Sales 700,000	
To Purchases 600,000		Less: Sales Returns and Allowances (30,000)	670,000
Less: Purchases Returns and Allowances (22,000)	578,000		

To Closing Inventory adjustment — see credit side	—	By Closing Inventory	60,000
To Gross Profit c/d	**92,000**		
Total	**730,000**	**Total**	**730,000**
To Sales Discount	16,000	By Gross Profit b/d	92,000
To Insurance Expense (10,000 − 4,000 prepaid)	6,000	By Discount on Purchases	6,000
To Advertisement Expenses	40,000		
To Salaries 120,000 + Outstanding 15,000	135,000		
To Depreciation on Plant and Machinery (10%)	67,000		
		By Net Loss transferred to Capital Account	**166,000**
Total	**264,000**	**Total**	**264,000**

The result is a gross profit of Rs 92,000 but a net loss of Rs 166,000, and the student should be able to explain this apparently surprising outcome rather than merely present it. The trading section is healthy in itself: the business bought goods for a net Rs 578,000 and, with opening and closing stocks equal at Rs 60,000, the cost of goods sold is exactly the net purchases figure, so net sales of Rs 670,000 leave a gross margin of Rs 92,000, about 13.7 per cent on net sales. The loss is created below the gross profit line: the operating expenses of the year — salaries Rs 135,000 (the single largest item, by itself exceeding the whole gross profit), advertisement Rs 40,000, depreciation Rs 67,000, sales discount Rs 16,000 and insurance Rs 6,000 — total Rs 264,000, against total credits of only Rs 98,000 (gross profit Rs 92,000 plus discount on purchases Rs 6,000). The difference, Rs 166,000, is therefore a genuine net loss, which must reduce the proprietor's capital in the balance sheet. This is a useful reminder that a business

can trade at a gross profit and still lose money overall when its establishment and selling expenses grow faster than its sales, and that depreciation, though a non-cash charge, is a real cost of using plant and machinery which cannot be ignored in judging performance.

Balance Sheet as on 30 June 2025

Table 2: Balance Sheet — Ahmad Traders, as on 30 June 2025

Liabilities and Capital	Rs	Assets	Rs
Capital 2,360,000		Cash	570,000
Less: Net Loss for the year (166,000)	**2,194,000**	Accounts Receivable	190,000
Accounts Payable	38,000	Closing Merchandise Inventory	60,000
Outstanding Salaries	15,000	Prepaid Insurance	4,000
		Plant and Machinery 670,000	
		Less: Depreciation @ 10% (67,000)	603,000
		Furniture and Fixtures	820,000
Total	**2,247,000**	**Total**	**2,247,000**

The balance sheet balances at Rs 2,247,000 on both sides, which confirms that every adjustment has been recorded twice and that the net loss has been correctly carried into capital: Rs 2,360,000 − Rs 166,000 = Rs 2,194,000, plus accounts payable Rs 38,000 and outstanding salaries Rs 15,000, gives total claims of Rs 2,247,000, exactly equal to the assets of cash Rs 570,000, receivables Rs 190,000, closing inventory Rs 60,000, prepaid insurance Rs 4,000, plant at written down value Rs 603,000 and furniture Rs 820,000. The position shown is solvent but weakened by the year's trading: the business still commands substantial liquid resources (cash and receivables together are Rs 760,000 against current liabilities of only Rs

53,000), so the loss is a profitability problem, not an immediate liquidity crisis. Management's attention is directed by these accounts to the expense structure — above all salaries and advertisement relative to a gross profit of Rs 92,000 — because unless sales rise or those expenses are controlled, continued losses of this size would erode the capital of Rs 2,194,000 within a few years.

Conclusion

To conclude, Ahmad Traders earned a gross profit of Rs 92,000 on net sales of Rs 670,000 for the year ended 30 June 2025, but after charging sales discount Rs 16,000, insurance Rs 6,000, advertisement Rs 40,000, salaries Rs 135,000 (including Rs 15,000 outstanding) and depreciation on plant and machinery Rs 67,000, and crediting discount on purchases of Rs 6,000, the business suffered a net loss of Rs 166,000. The balance sheet as on 30 June 2025 balances at Rs 2,247,000, with capital reduced to Rs 2,194,000. The exercise demonstrates the complete logic of final accounts: the trial balance supplies the raw balances, the adjustments correct them to the accrual basis for the year, the trading and profit and loss account measures performance, and the balance sheet — which must balance if the work is right — reports the resulting financial position.

Question 2: Partnership, Kinds of Partners, and Goodwill (10 + 10 Marks)

(i) Define partnership and discuss kinds of partners. (ii) If the profit earned during the last five years is Rs 60,000, Rs 62,000, Rs 61,000, Rs 55,000 and Rs 60,000, calculate the value of

goodwill under the average profit method, at 3 years' purchase of the average profits of the last five years.

Part (i): Definition and Features of Partnership

A partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. In the classical statutory wording, partnership is 'the relationship which subsists between persons carrying on a business in common with a view to profit'. Every element of this definition matters. There must be an agreement, which may be written (a partnership deed) or oral, though a written deed is always safer because it records the profit-sharing ratio, capital contributions, salaries, interest on capital and the duties of each partner. There must be a lawful business actually being carried on; a mere joint ownership of property, or an agreement to do a single charitable act, is not a partnership. The business must be carried on with a view to profit, and the profits must be shared in the agreed ratio — sharing profits is the very essence of the relation, while losses, if they arise, are borne in the same ratio unless the deed provides otherwise. Finally, there must be mutual agency: every partner is both an agent and a principal of the firm, so that the act of one partner done in the ordinary course of the firm's business binds all the others. This mutual agency, combined with the unlimited liability of each partner for the debts of the firm, is what distinguishes partnership from mere co-ownership and from a company, in which the members' liability is limited and the company has a legal personality separate from its members. A partnership firm has no separate legal identity from its partners; the minimum number of

partners is two, and the maximum is fixed by company law (commonly twenty for an ordinary business).

Kinds of Partners

Although all partners share the profits, they do not all take the same part in the business, and partnership law recognises several kinds of partner, distinguished by the role they actually play. The student should be able to describe each kind with its rights and liabilities, because the kind of partner determines both his authority to bind the firm and the extent of his risk.

- Active (working) partner: He takes an active part in the management and daily conduct of the business and acts as an agent of the firm in dealing with outsiders. He usually contributes capital as well as labour, and in return the deed may allow him a salary or commission in addition to his share of profit. Because he represents the firm publicly, his acts bind the firm fully.
- Sleeping (dormant) partner: He contributes capital and shares profits and losses but takes no part in management, and his connection with the firm is not known to the public. He is nevertheless fully liable to third parties for the firm's debts, because liability follows the sharing of profits, not the performance of work; his protection is that retiring sleeping partners need not give public notice to escape liability for later debts in the same strict way as known partners.
- Nominal partner: He lends his name and reputation to the firm and allows himself to be held out as a partner, but contributes no capital, takes no part in management and receives no share of profit (though he may receive a fixed fee for the use of his name). Despite

having no real interest, he is liable to third parties who gave credit to the firm relying on his name, because the law protects those who were misled by the appearance he created.

- Partner in profits only: By special agreement he shares in the profits of the firm but does not share its losses beyond any amount agreed, and he takes no part in management. His arrangement must be clearly recorded, because outsiders dealing with the firm will still treat him as a full partner unless the limitation is properly a matter of the internal agreement only.
- Secret partner: His connection with the firm is deliberately kept secret from outsiders, but unlike a sleeping partner he takes an active part in the management of the business from behind the scenes. He shares profits and losses and is liable for the firm's debts like any other partner once his membership is discovered.
- Minor partner: A minor (a person below the age of majority) cannot become a full partner, because he cannot enter into a binding contract, but with the consent of all the partners he may be admitted to the benefits of an existing partnership. He shares profits and the firm's property to the extent agreed, his liability is limited to his share in the firm, he cannot be made personally liable for losses, and within six months of attaining majority he must elect whether to become a full partner.
- Partner by estoppel (holding out): A person who, by words or conduct, represents himself — or knowingly allows himself to be represented — as a partner, and on the faith of that representation someone gives credit to the firm, is stopped (estopped) from denying that he is a partner and is liable as if he were one. A retired partner who fails to give public

notice of his retirement can be held liable on this principle for debts contracted after his retirement.

- Incoming and outgoing partners: An incoming partner is one admitted into an existing firm; he is not liable for debts incurred before his admission unless he expressly agrees. An outgoing (retiring) partner leaves by retirement, expulsion or death; he remains liable for debts incurred while he was a partner, and for later debts unless proper public notice of his leaving is given.

These kinds are not mutually exclusive labels but descriptions of roles: the same person may be, for instance, a secret and active partner, or a nominal partner who is liable only because of estoppel. What never changes is the foundation of the relation — agreement, a lawful business carried on in common, profit-sharing and mutual agency — and the student should test every described person against those essentials before calling him a partner at all.

Part (ii): Valuation of Goodwill — Average Profit Method

Goodwill is the value of the reputation and earning capacity of a business over and above the value of its net tangible assets — the intangible advantage that makes customers return and profits continue when ownership changes. When a new partner is admitted, or a partner retires or dies, or a firm is sold, the existing partners must be compensated for the goodwill they helped to build, so goodwill has to be valued. Under the average profit method, goodwill is valued at an agreed number of years' purchase of the average profit of a specified past period, on the reasoning that the buyer is paying in advance for the profits he expects the established business to keep earning for that many years. The profits of the last five years are given as Rs

60,000, Rs 62,000, Rs 61,000, Rs 55,000 and Rs 60,000. Total profits = Rs 60,000 + Rs 62,000 + Rs 61,000 + Rs 55,000 + Rs 60,000 = Rs 298,000. Average profit = Rs 298,000 ÷ 5 = Rs 59,600. Years' purchase = 3. Therefore Goodwill = Average Profit × Number of Years' Purchase = Rs 59,600 × 3 = Rs 178,800.

Table 1: Goodwill under the average profit method

Step	Working	Amount (Rs)
Total profits of 5 years	60,000 + 62,000 + 61,000 + 55,000 + 60,000	298,000
Average annual profit	298,000 ÷ 5	59,600
Years' purchase	Given in the question	3 years
Value of Goodwill	**59,600 × 3**	**178,800**

Two points of interpretation complete the answer. First, the averaging process deliberately smooths out the fluctuation visible in the figures — the dip to Rs 55,000 in the fourth year and the recovery to Rs 60,000 in the fifth — so that the valuation rests on the business's normal earning power rather than on its best or worst single year; had only the latest year's profit been used, the goodwill would have been overstated or understated by chance. Second, in a partnership admission this valued goodwill of Rs 178,800 is not normally paid in cash to the firm as an asset to be kept in the books; it is adjusted through the partners' capital accounts — the incoming partner's capital (or current) account is debited with his share of the goodwill, and the old partners are credited in their sacrificing ratio — unless the firm adopts the policy of raising a goodwill account, in which case goodwill appears as an intangible asset. The average profit method is the simplest of the goodwill methods; where profits show a clear rising or falling trend, a weighted average is preferred, and where a normal rate of return on capital employed

must also be considered, the super profit method is used instead — a method illustrated in part (iii) of Question 5 of this assignment.

Conclusion

To conclude, a partnership is an agreement-based relation between persons carrying on a lawful business in common for profit, marked by profit-sharing, mutual agency and unlimited liability; its members may be active, sleeping, nominal, secret, profit-only, minor, or partners by estoppel or holding out, with rights and liabilities following the role each actually plays and the appearance each presents to the outside world. The goodwill of the given business, valued by the average profit method at three years' purchase of the five-year average profit of Rs 59,600, is Rs 178,800 — the amount that fairly compensates the existing owners for the earning reputation built up over those five years.

Question 3: Income and Expenditure Account and Balance Sheet of a Society (20 Marks)

From the given Receipts and Payments Account — Receipts: Balance b/d 3,000; Entrance fee 5,000; Subscription 2,500; Donation 20,000; Life membership fee 10,000; Receipts from entertainment 1,500; total 42,000. Payments: Rent and rates 1,200; Wages 1,300; Lecturer's fee 1,700; Electricity 500; Books 15,000; Office expenses 3,800; Entertainment expenses 1,000; Balance c/d 17,500; total 42,000 — prepare (i) the Income and Expenditure Account and (ii) the Balance Sheet. Additional information: the accumulated fund of the society is Rs 43,000; subscription in arrears is Rs 1,500; rent is unpaid Rs 800; depreciation is to be provided on books

Rs 2,000 and on furniture Rs 1,000; the opening balance of books is Rs 25,000 and of furniture Rs 15,000.

Introduction

This is the standard practical problem of a non-trading concern — here, a society — in which a receipts and payments account, which is only a summary of the cash book, must be converted into an income and expenditure account on the accrual basis, and a balance sheet must then be drawn up. The conversion follows the rules explained in Assignment No. 1: capital receipts and payments are removed to the balance sheet; revenue items are adjusted so that they relate to the current year only, whether the cash has moved or not; and non-cash charges, above all depreciation, are brought in. Working through the given figures item by item before writing the statements prevents the two classic errors of this topic: treating the life-membership fee as income, and forgetting that the books purchased during the year must be added to the opening stock of books before depreciation is charged. The standard treatments applied are stated openly: the entrance fee and the general donation are treated as revenue income of the year (no instruction is given to capitalise them), while the life-membership fee is treated as a capital receipt, because it is paid once for membership of many future years and is therefore added to the accumulated fund in the balance sheet.

Working Notes

Working 1 — Subscription income for the year: received Rs 2,500 + in arrears at the end of the year Rs 1,500 = Rs 4,000. The arrears are income earned but not yet received, so they increase the income of the year and appear as an asset in the balance sheet. Working 2 — Rent expense

for the year: paid Rs 1,200 + unpaid at the end of the year Rs 800 = Rs 2,000 (rent and rates). The unpaid rent is an expense of this year and a liability in the balance sheet. Working 3 — Books: opening balance Rs 25,000 + purchased during the year (the payment of Rs 15,000 shown in the receipts and payments account) Rs 15,000 − depreciation Rs 2,000 = closing value Rs 38,000. The purchase of books is a capital payment, so it does not appear as an expense in the income and expenditure account; only the depreciation of Rs 2,000 is charged there. Working 4 — Furniture: opening balance Rs 15,000 − depreciation Rs 1,000 = closing value Rs 14,000; again only the depreciation is charged as an expense. Working 5 — Cash: the closing balance c/d of Rs 17,500 from the receipts and payments account is the cash asset in the balance sheet (the opening balance b/d of Rs 3,000 is already inside the accumulated fund position and needs no separate treatment). Working 6 — Accumulated fund: opening Rs 43,000 + life-membership fee Rs 10,000 + surplus for the year (to be found from the income and expenditure account) gives the closing fund. With these workings, both statements can now be prepared, and the balance sheet provides the final check: if it balances, the surplus has been computed correctly.

(i) Income and Expenditure Account for the Year

Table 1: Income and Expenditure Account of the society for the year

Expenditure	Rs	Income	Rs
To Rent and Rates 1,200 + Unpaid 800	2,000	By Entrance Fee	5,000
To Wages	1,300	By Subscription 2,500 + In Arrears 1,500	4,000
To Lecturer's Fee	1,700	By Donation	20,000
To Electricity	500	By Receipts from Entertainment	1,500

To Office Expenses	3,800		
To Entertainment Expenses	1,000		
To Depreciation on Books	2,000		
To Depreciation on Furniture	1,000		
To Surplus (excess of income over expenditure)	**17,200**		
Total	**30,500**	**Total**	**30,500**

The income of the year is Rs 5,000 + Rs 4,000 + Rs 20,000 + Rs 1,500 = Rs 30,500, and the expenditure of the year is Rs 2,000 + Rs 1,300 + Rs 1,700 + Rs 500 + Rs 3,800 + Rs 1,000 + Rs 2,000 + Rs 1,000 = Rs 13,300, leaving a surplus of Rs 30,500 − Rs 13,300 = Rs 17,200. Note how the entertainment activity appears honestly on both sides: it produced receipts of Rs 1,500 against expenses of Rs 1,000, a small net contribution of Rs 500 to the society's funds. Note also what has been excluded and why: the life-membership fee of Rs 10,000 (capital receipt), the books purchased for Rs 15,000 (capital payment — only its depreciation is charged), and the opening and closing cash balances (which belong to the receipts and payments account and the balance sheet, not to the measurement of the year's surplus).

(ii) Balance Sheet of the Society

Table 2: Balance Sheet of the society as at the end of the year

Liabilities and Funds	Rs	Assets	Rs
Accumulated Fund 43,000		Books 25,000 + Purchased 15,000 = 40,000	
Add: Life Membership Fee 10,000		Less: Depreciation (2,000)	38,000

Add: Surplus for the year 17,200	**70,200**	Furniture 15,000	
Outstanding Rent	800	Less: Depreciation (1,000)	14,000
		Subscription in Arrears	1,500
		Cash in Hand (Balance c/d)	17,500
Total	**71,000**	**Total**	**71,000**

The balance sheet balances at Rs 71,000 on both sides, which verifies the whole conversion: funds and liabilities of Rs 70,200 + Rs 800 = Rs 71,000 are exactly matched by assets of books Rs 38,000 + furniture Rs 14,000 + subscription arrears Rs 1,500 + cash Rs 17,500 = Rs 71,000. The society's position is sound: its accumulated fund has grown during the year from Rs 43,000 to Rs 70,200, helped both by the life-membership receipts of Rs 10,000, which permanently strengthen the fund, and by the operating surplus of Rs 17,200, which shows that the year's ordinary income comfortably exceeded its ordinary expenditure even after providing Rs 3,000 of depreciation to maintain the real value of its books and furniture. The only liability is the small unpaid rent of Rs 800, and the only amount still to be collected is the subscription arrears of Rs 1,500, which the committee should pursue so that the surplus shown on paper is converted into cash.

Conclusion

To conclude, converting the receipts and payments account onto the accrual basis produces an income and expenditure account with income of Rs 30,500, expenditure of Rs 13,300 and a surplus of Rs 17,200 for the year, and a balance sheet totalling Rs 71,000 in which the accumulated fund stands at Rs 70,200 (opening Rs 43,000 + life-membership fee Rs 10,000 +

surplus Rs 17,200). The problem demonstrates the three conversion rules in action: capital items (life-membership fee, books purchased) are taken to the balance sheet, outstanding and accrued amounts (rent unpaid Rs 800, subscription in arrears Rs 1,500) are adjusted so each item belongs wholly to the current year, and non-cash depreciation (Rs 2,000 on books and Rs 1,000 on furniture) is charged even though no cash left the society for it during the year.

Question 4: Cash Book and Pass Book — Mr Zahid and Allied Bank Ltd, December 2025 (20 Marks)

Mr Zahid is the owner of a sole proprietorship business. During the month of December 2025, he opened a current account with Allied Bank Ltd. The following transactions were recorded. You are required to enter the transactions in the cash book and in the pass book. Dec. 1 — Mr Zahid opened a current account with Allied Bank Ltd for Rs 6,000,000; Dec. 5 — A cheque received from Noman Rs 50,000 and deposited into the bank on the same day; Dec. 11 — Purchased furniture Rs 70,000, paid by cheque; Dec. 17 — Cash drawn from the bank for office use Rs 45,000; Dec. 19 — Paid rent by cheque Rs 35,000; Dec. 21 — Miscellaneous expense debited by bank Rs 40,000; Dec. 25 — Purchased goods from Mr Asfer, paid by cheque Rs 95,000; Dec. 30 — Interest received from the bank Rs 35,000.

Introduction

Every banking transaction of a business is recorded twice over, in two independent records kept by two different parties. The trader records it in the bank column of his own cash book, which is part of his ledger and shows the bank balance according to his books. The bank records

the same transaction in the customer's account in its own books, and supplies the customer with a copy of that account, traditionally as a pass book and today also as a bank statement. Because the two records are made by different people from the same events, they ought to agree — and the exercise of comparing them is the heart of bank reconciliation. This question requires both records to be written up from the same list of December 2025 transactions. Two transactions originate with the bank rather than with the trader: the miscellaneous expense of Rs 40,000 debited by the bank on 21 December, and the interest of Rs 35,000 credited by the bank on 30 December. In real practice the trader first learns of such items from the pass book itself, and then records them in his cash book; in this exercise both books are completed for the full month, so both items appear in both records and, there being no cheques unpresented and no deposits uncredited at the month-end, the two balances agree exactly. A two-column cash book (cash and bank) is used, because the withdrawal of Rs 45,000 for office use on 17 December is a contra entry affecting both columns.

Cash Book (Cash and Bank Columns) — December 2025

Table 1: Cash Book of Mr Zahid (two-column) — December 2025

Date	Particulars (Debit)	Cash (Rs)	Bank (Rs)	Date	Particulars (Credit)	Cash (Rs)	Bank (Rs)
Dec 1	Capital / Cash deposited — Current Account opened	—	6,000,000	Dec 11	Furniture (cheque)	—	70,000
Dec 5	Noman (cheque deposited)	—	50,000	Dec 17	Cash (C) — drawn for office use	—	45,000
Dec 17	Bank (C) — cash drawn for office use	45,000	—	Dec 19	Rent (cheque)	—	35,000

Dec 30	Interest (credited by bank)	—	35,000	Dec 21	Misc. Expenses / Bank Charges (debited by bank)	—	40,000
				Dec 25	Purchases — Mr. Asif (cheque)	—	95,000
				Dec 31	Balance c/d	45,000	5,800,000
	Total	**45,000**	**6,085,000**		**Total**	**45,000**	**6,085,000**
Jan 1	Balance b/d	45,000	5,800,000				

The bank column can be verified arithmetically: deposits and credits total Rs 6,000,000 + Rs 50,000 + Rs 35,000 = Rs 6,085,000, and payments and charges total Rs 70,000 + Rs 45,000 + Rs 35,000 + Rs 40,000 + Rs 95,000 = Rs 285,000, leaving a bank balance of Rs 6,085,000 − Rs 285,000 = Rs 5,800,000. The cash column contains only the contra entry of 17 December: Rs 45,000 withdrawn from the bank for office use and not spent within the month in any transaction given, so it stands as the office cash balance carried down. The opening deposit of Rs 6,000,000 on 1 December is shown in the bank column as the amount with which the current account was opened; in the full ledger it is matched by the corresponding credit (capital introduced, or cash transferred from the cash column if the business had previously kept the money as cash in hand) — for the purpose of this exercise, which is directed at the bank record, it is entered as the opening deposit of the new account.

Pass Book (Bank Statement) — Allied Bank Ltd, Account of Mr Zahid, December 2025

The pass book is written from the bank's point of view, which reverses the trader's perspective: money deposited by the customer is a liability of the bank and is therefore credited to the customer's account, while money paid out on the customer's cheques, or charged to him, is debited. A credit balance in the pass book thus means the same thing as a debit balance in the cash book — money standing to the customer's credit at the bank. Dates of the bank's own entries follow the bank's record: the miscellaneous expense debited on 21 December and the interest credited on 30 December appear here as originating entries, exactly the items a trader discovers when he receives his pass book and then copies into his cash book.

Table 2: Pass Book — Allied Bank Ltd, current account of Mr Zahid, December 2025

Date (2025)	Particulars	Debit / Withdrawals (Rs)	Credit / Deposits (Rs)	Balance (Rs)
Dec 1	Cash deposited — account opened	—	6,000,000	6,000,000 Cr.
Dec 5	Cheque deposited (Noman)	—	50,000	6,050,000 Cr.
Dec 11	Cheque paid — furniture	70,000	—	5,980,000 Cr.
Dec 17	Cash withdrawn for office use	45,000	—	5,935,000 Cr.
Dec 19	Cheque paid — rent	35,000	—	5,900,000 Cr.
Dec 21	Miscellaneous expense debited by bank	40,000	—	5,860,000 Cr.
Dec 25	Cheque paid — purchases (Mr Asfer)	95,000	—	5,765,000 Cr.
Dec 30	Interest credited by bank	—	35,000	5,800,000 Cr.

The pass book closes with a credit balance of Rs 5,800,000, which agrees exactly with the debit balance of Rs 5,800,000 in the bank column of the cash book, so no bank reconciliation statement is required for December 2025 beyond noting the agreement. The student should understand when a reconciliation statement would become necessary: if a cheque issued late in the month had not yet been presented for payment, the pass book balance would be higher than the cash book balance; if a deposit made late in the month had not yet been credited, the pass book balance would be lower; and bank charges or interest appearing first in the pass book would have to be entered in the cash book before the comparison is made. In this month's figures both bank-originated items — the Rs 40,000 miscellaneous debit and the Rs 35,000 interest credit — have been taken into the cash book as well, which is precisely why the two records tally. The habit taught by this question — write up the cash book from the trader's documents, obtain the pass book, tick off the corresponding entries one by one, and investigate whatever remains unticked — is the standard monthly control by which businesses protect themselves against bank errors, omitted charges and fraud.

Conclusion

To conclude, Mr Zahid's cash book for December 2025 shows a bank balance of Rs 5,800,000 and office cash of Rs 45,000 carried down to January, and the pass book issued by Allied Bank Ltd shows the identical closing position as a credit balance of Rs 5,800,000, built up from deposits of Rs 6,050,000 and interest of Rs 35,000 against cheque payments, the office withdrawal and bank charges totalling Rs 285,000. Because every item, including the bank's

own debit of Rs 40,000 and credit of Rs 35,000, appears in both records, the two balances agree and the bank account stands verified for the month — the practical object for which cash book and pass book are maintained side by side.

Question 5: Admission of a Partner, Capitalisation and Capital vs Revenue Expenditure (20 Marks)

(i) A, B and C share profits and losses in the ratio of 6:5:3. D is admitted into partnership for a 1/8th share. Calculate the sacrificing ratio of A:B:C. (ii) At the time of admission of a new partner, on preparing the revaluation account, if there is a loss, then what entry should be passed to transfer the loss to the partners' capital accounts? (iii) If the actual profit of the business is Rs 100,000 and the normal rate of return is 5%, calculate the value of the whole business. (iv) State with reasons whether the following items of expenditure are capital or revenue: (a) wages paid on the purchase of goods; (b) land was purchased for Rs 1,000,000, and Rs 25,000 were paid for legal expenses; (c) old furniture was repaired at a cost of Rs 5,000; (d) compensation paid to workers for the termination of their services.

Introduction

This question brings together four short but frequently examined topics from the partnership and introductory units. The admission of a new partner changes the profit-sharing agreement of the firm, and every accounting consequence of that change — the share surrendered by the old partners, the revaluation of assets and liabilities, and the value placed on the business itself — must be computed and recorded correctly so that neither the old partners nor the incoming

partner gains or loses unfairly. Parts (i) and (ii) deal with the mechanics of admission, part (iii) with the capitalisation method of valuing a business (which is also the foundation of the super-profit method of valuing goodwill), and part (iv) with the capital–revenue distinction, the classification on which the correct measurement of profit and the correct statement of assets both depend. Each part is answered in turn with its working shown in full.

Part (i): Sacrificing Ratio on D's Admission

The sacrificing ratio is the ratio in which the old partners surrender a part of their shares of profit in favour of the incoming partner. It is calculated as: Sacrifice of each old partner = Old Share − New Share. The old ratio of A, B and C is 6:5:3, that is, A = 6/14, B = 5/14 and C = 3/14 of the profits. D is admitted for a 1/8 share. The question gives no special agreement about how D's share is to be provided, so the standard rule applies: the old partners surrender D's share in proportion to their old ratio — D's 1/8 is taken from A, B and C in the ratio 6:5:3. A's sacrifice = 6/14 × 1/8 = 6/112; B's sacrifice = 5/14 × 1/8 = 5/112; C's sacrifice = 3/14 × 1/8 = 3/112. The sacrificing ratio of A:B:C is therefore 6/112 : 5/112 : 3/112 = 6 : 5 : 3 — that is, where a new partner's share is given up by the old partners in their old profit-sharing ratio, the sacrificing ratio is the same as the old ratio. The new profit-sharing ratio can be checked from the same figures: A's new share = 6/14 − 6/112 = 48/112 − 6/112 = 42/112; B's new share = 40/112 − 5/112 = 35/112; C's new share = 24/112 − 3/112 = 21/112; D's share = 1/8 = 14/112. The new ratio A:B:C:D = 42:35:21:14, which simplifies to 6:5:3:2, and the shares total 42 + 35 + 21 + 14 = 112/112 = 1, confirming the calculation. The sacrificing ratio matters in practice because the goodwill premium brought in (or adjusted) by D is distributed among A, B and C in

this sacrificing ratio of 6:5:3 — each old partner is compensated exactly in proportion to the share of profit he has given up.

Part (ii): Entry for a Loss on Revaluation at Admission

On the admission of a new partner, the assets and liabilities of the old firm are revalued in a revaluation account (also called the profit and loss adjustment account) so that the incoming partner neither profits from a hidden increase in values earned before his admission nor suffers from a hidden decrease. Assets whose value has risen and liabilities whose value has fallen are credited to the revaluation account; assets whose value has fallen, liabilities whose value has risen, and newly recorded liabilities (such as a provision for doubtful debts created at admission) are debited to it. If the debits exceed the credits, the revaluation account shows a loss. That loss belongs entirely to the old partners, because it arose during the period before D joined, and it is transferred to their capital accounts in their old profit-sharing ratio. The journal entry is: A's Capital Account Dr.; B's Capital Account Dr.; C's Capital Account Dr. (each with his share of the loss, in the old ratio 6:5:3) — To Revaluation Account (with the total loss). In words: 'Old partners' capital accounts are debited and the revaluation account is credited, being the loss on revaluation transferred to the old partners in their old ratio.' The mirror-image entry applies to a revaluation profit, which is credited to the old partners' capital accounts by debiting the revaluation account. If the partners maintain fixed capital accounts, the debit is made to their current accounts instead. The essential points the examiner looks for are that the new partner D bears no part of the loss, and that the division among the old partners is in the old ratio, not the new ratio, because the loss relates to the old firm's period.

Part (iii): Value of the Whole Business by Capitalisation

The capitalisation method values a business by asking: what amount of capital, invested at the normal rate of return earned by similar businesses, would produce the profit this business actually earns? If the business earns more than a normal return on the capital actually employed, the excess is attributable to goodwill, and the total value of the business exceeds its net tangible assets. The formula is: Capitalised Value of the Business = (Actual Profit ÷ Normal Rate of Return) × 100. Applying the given figures: Actual Profit = Rs 100,000; Normal Rate of Return = 5%. Value of the whole business = Rs 100,000 × 100/5 = Rs 100,000 × 20 = Rs 2,000,000. Thus the whole business is worth Rs 2,000,000: an investor who paid that sum and earned Rs 100,000 a year would receive exactly the normal return of 5 per cent on his investment (5% of Rs 2,000,000 = Rs 100,000), which confirms the result. For completeness, if the net tangible assets (capital employed) of the business were known, the goodwill would be found as the difference: Goodwill = Capitalised Value − Net Assets Employed; and dividing the same relationship the other way gives the super profit, Actual Profit minus the normal profit on capital employed, on which the super-profit method of goodwill valuation is built. Since no figure of net assets is supplied in this part, the required answer is the capitalised value of the whole business, Rs 2,000,000.

Part (iv): Capital or Revenue Expenditure — With Reasons

Capital expenditure is expenditure incurred to acquire a fixed asset, or to increase the earning capacity, efficiency or life of an existing fixed asset; its benefit extends over several accounting periods, and it is shown in the balance sheet as part of the cost of an asset. Revenue

expenditure is expenditure incurred in the ordinary running of the business — to purchase goods for resale, or to maintain existing assets in working condition; its benefit is exhausted within the current accounting period, and it is charged to the trading or profit and loss account. The period of benefit, the purpose of the payment and its effect on earning capacity are the three tests to apply, and each of the four items is now judged by them.

Table 1: Classification of the four items of expenditure

Item	Nature	Reason
(a) Wages paid on the purchase of goods	**Revenue expenditure**	The wages are part of the cost of acquiring goods for resale in the ordinary course of trading; the benefit is exhausted when the goods are sold within the period, no fixed asset is created, and the amount is charged to the trading account as a direct expense.
(b) Legal expenses of Rs 25,000 on purchase of land for Rs 1,000,000	**Capital expenditure**	The legal charges are incurred to acquire the land and to perfect the buyer's title to it; they form part of the cost of the asset, so the land is capitalised at Rs 1,000,000 + Rs 25,000 = Rs 1,025,000 in the balance sheet.
(c) Repair of old furniture at a cost of Rs 5,000	**Revenue expenditure**	The repair merely restores and maintains the furniture in its existing working condition; it creates no new asset and does not increase the furniture's capacity, efficiency or life beyond its original standard, so it is charged to the profit and loss account.
(d) Compensation paid to workers for termination of their services	**Revenue expenditure**	The payment arises out of the employment relationship in the ordinary course of running the business and is in the nature of a labour cost of the period; it acquires no asset and confers no enduring benefit on future periods, so it is charged as an expense of the year in the profit and loss account. (Large

		abnormal amounts may be disclosed separately, but their nature remains revenue.)

Items (b) and (c) form an instructive contrast which is the examiner's real target. Money spent at the moment of acquiring an asset — price, legal fees, carriage, installation — is capitalised because without it the asset could not be owned or used, whereas money spent later merely on keeping an existing asset in its original condition is revenue, because the business is no richer in assets after the repair than before the damage occurred. If repairs had substantially rebuilt the furniture, extended its life by many years or increased its usefulness beyond its original standard, the answer for that part would change to capital expenditure; the Rs 5,000 routine repair described in the question does none of these things. Item (a) is occasionally confused with the capital treatment of wages paid for installing new machinery; those wages are capital because they bring a fixed asset into use, while wages connected with purchasing trading goods belong to the trading account, as here.

Conclusion

To conclude the four parts: (i) A, B and C sacrifice D's 1/8 share in their old ratio, so the sacrificing ratio is 6:5:3 and the new profit-sharing ratio becomes 6:5:3:2; (ii) a loss on revaluation at admission is transferred by debiting the old partners' capital (or current) accounts in their old ratio and crediting the revaluation account, the incoming partner bearing no part of it; (iii) by capitalisation, a business earning Rs 100,000 when the normal rate of return is 5 per cent is worth Rs 100,000 × 100/5 = Rs 2,000,000 as a whole; and (iv) wages on the purchase of goods, the routine repair of old furniture, and compensation for termination of

services are revenue expenditure, charged against the profits of the year, while the legal expenses of Rs 25,000 on buying land are capital expenditure, added to the land's cost to give a capitalised value of Rs 1,025,000. Together the four parts test one underlying skill: identifying which period, which partners and which statement each amount truly belongs to.

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