B.COM (HONS.)101
FINANCIAL ACCOUNTING

Unit-I

Introduction: Meaning and scope of Financial accounting, Objectives,Nature and Functions, Relationship of accounting with other disciplines, Accounting as an Information System. Advantages and Limitations of Accounting, Basis of Accounting-Cash Vs. Accrual, Accounting Principles, Concepts and Conventions.
Introduction to accounting standards: Concept, Benefits, Procedure of Issuing accounting standards in India. Need and Significance of (IFRS) International Financial Reporting Standards, XBRL.

Unit-II

Ledger Posting and Trial Balance: Ledger,Posting and preparation of Trial Balance.Capital and Revenue:Calssification of Income,Classification of Expenditure,Classification of Receipts.Journal and Subsidiary Books of Accounts.

Unit-III

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Final Accounts:Preparation of Financial Accounts of Sole proprietorship and partnership Firms from Trial Balance with adjustments.Preparation of Final accounts of Non-Profit Organisation,Bank Reconciliation Statement.

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Consignment and Joint Venture, Hire Purchase & Installment System. Branch Accounting: Dependent Branches, Debtors System, Stock & Debtors System. IndependentBranches-Accounting entries. Accounting for PartnershipFirms: Admission,Retirement,Death of Partner.

MEANING AND SCOPE OF ACCOUNTING

DEFINITION

Financial accountancy (or financial accounting) is the field of accountancy concerned with the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners and other stakeholders.

In 1966, American accounting Association (AAA) defined accounting as "Accounting is the process of identifying, measuring and communicating economic information to permit the informed judgements ands decisions by the users of the information."

In 1941, American Institute of Certified public Accountants (AICPA) defined accounting as "Accounting is the art of recording, classifying and summarizing in significant manner and in terms of money, transactions and events which are, in part, at least of a financial character and interpreting the results thereof."

Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. The central need for financial accounting is to reduce the various principal-agent problems, by measuring and monitoring the agents' performance and thereafter reporting the results to interested users.

SCOPE OF ACCOUNTING:

Accounting as compared to book-keeping has a very wide and huge role to play in the businesses whether there is a small firm engaged in few transactions to a large MNC with multiple transactions daily, Accounting is required everywhere. Accounting not only maintains the records but also analyzes and interprets the results also. Accounting is being done in any nature and size of the firm, example: schools, hospitals, banks, retail shops. Nowadays Accountants are serving the accounting requirements of various businesses and organizations for which they require expertise in the same field.

Accounting has grown in its importance today as a discipline that provides results online in a quick and accessible form that can be used by the management for decision-making.

It has been recognized as a tool for mastering the economic problems that a business organization may have to face.

There are several parties now connected with the accounting information they are as follows:

- Proprietors
- Managers
- Suppliers
- Investors
- Government
- Public

  Thus accounting is being used anywhere and everywhere as it is the need of an hour to give rise to any business event that occurs daily many a times as it accounts for the profitability and returns of the business.

NATURE OF ACCOUNTING:

Accounting as a discipline has been originated to serve the purpose of the organization in maintaining and updating the records and transactions of the various business events on a day-to-day basis.

It functions as a means from which various parties connected to the business can get the accounting information and the management is able to do the decision-making for various business plans and policies.

The accountants are hired for maintaining and preparing the records and financial statements, provide the results and also conduct analysis and conclusions drawn from them.

From the above on e can derive the basic nature as follows:

1. It keeps and maintains the record of the business.
2. It also helps to analyze and interpret the financial data.
3. It is useful in decision-making.
4. It is useful in preparation and compilation of financial results.
5. It also serves as a means to depict the financial position of the business.
6. It ignores the qualitatitive aspects of the business.
7. The information provided in accounting is based on estimates.

FUNCTIONS OF ACCOUNTING

1. Record Keeping
2. Protecting of properties
3. Communication of results
4. Meeting legal requirements

NEED FOR ACCOUNTING

1. Maintain complete and orderly prepared records of economic events
2. Net results in terms of profit or loss
3. Information to the investors

BRANCHES OF ACCOUNTING

1. Financial Accounting:

It is the original form of accounting. It is mainly confined to the preparation of financial statements for the use of outsiders like creditors, banks and financial institutions etc. The chief purpose of financial accounting is to calculate profit or loss made by the business during the year and exhibit financial position of the business on a particular date.

2. Cost Accounting:

Function of cost accounting is to ascertain the cost of the product and to help the management in the control of cost.

3. Management Accounting:

It is accounting for management. i.e., accounting which provides necessary information to the management for discharging its functions. It is the reproduction of financial accounts in such a way as will enable the management to take decisions and to control various business activities.

BOOK KEEPING AND ACCOUNTING:

In general bookkeeping is the recording of business data in the prescribed manner, this is the first phase. Much of the work of bookkeeper is of the clerical in nature. The sphere of accounting starts where the sphere of bookkeeping ends. Accounting is primarily concerned with the design of the system of records, the preparation of reports and the interpretation of reports. Accountants Often direct and review the work of bookkeepers.

End User of Accounting Information

1. Owners
2. Management
3. Creditors
4. Employees
5. Government

Objectives of Accounting are:—

1. **To keep systematic records:** Its main objective is to keep complete record of Business transactions. It avoids the possibility of omission and fraud.
2. **To calculate profit or loss:** Accounting helps to ascertain the net profit earned or loss suffered on account of business transactions during a particular period. To ascertain profit or loss at the end of each accounting period Trading and Profit& Loss is prepared.
3. **To facilitate decision making:** The information collected from various financial statements is useful in decision-making and is of use to the parties connected to the business.
4. **To ascertain the financial position of the business**: The businessman is able to know the financial position of the firm through the profits made or losses incurred by the firm during the accounting period as well as the balance-sheet serve as a basis of serving the financial status of the firm at a particular date.

Relationship of Accounting with Economics

Prof. Robbins has defined term 'economics' as follows-

"Economics is the science, which studies human behavior as a relationship between ends and scarce means which have alternatives uses."However when a person is to take any economical decision, he has to depend mainly on the accounting information. Generally an accountant is concerned with the economic problems of an only one enterprise only, but an economist is concerned with the problems of an industry as a whole. Micro levels data, arranged by the accounting system, is summed up to get macro level data base. Thus at the macro level, accounting provides the basic data, upon which the economic models are developed.

However, there exists a wide gulf between economists' and accountants' concept of income and capital For example, the profit according to an economist is not same thing as the profit according to an accountant. No doubt, accountants have derived the ideas of value, income and capital maintenance from economists, but suitably modified to make them usable in practical circumstances. Thus, Economics and Accounting are close related subjects.

Relationship of Accounting with Mathematics

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity etc. are some examples of fundamental uses of mathematics in accounting.

Presently graphs and charts are being widely used for communicating accounting information to the users. Thus the knowledge in geometry and trigonometry has become essential to have a better understanding about the accounting communication system.

Relationship of Accounting with Statistics

Collection, Tabulation, Analysis and presentation of data are some primary functions, which are performed by both Accountants and statisticians.The accountant is mainly concerned with the monetary data, although to some extent, he is also concerned with the quantitative data. But a statistician is concerned equally with the monetary and quantitative data.The use of statistics is accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But for decision-making purposes, such precision is not necessary and hence the statistical approximations are sought. Accounting records generally confined to one year, while statistical analysis is more useful if a longer period is taken. For example, a longer period will be required to fit the trend line. Statistical methods are helpful in developing accounting data and in their interrelation. Therefore the study and application of statistical methods will add extra edge to the accounting data.

Relationship of Accounting with Law

Every business house has to work within legal environment. All the transactions with suppliers and customers are governed by the Contract Act, Sale of Goods Act, Negotiable Instruments Act, etc. The entity, itself, created and controlled by laws. For example a partnership business is controlled by Partnership Act, a company is created and controlled by the Companies Act. Very often the accounting system to be followed has been prescribed by the law. For example the Companies Act has prescribed the format of financial statements.However legal prescription about the accounting system is the product of development in accounting knowledge. That is to say legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In what way, accounting influences law and is also influenced by law.

Relationship of Accounting with Management

Management is a broad occupational field, which comprises many functions and application of many disciplines including statistics, mathematics, economics, etc. Accountants are well placed in the management and play a key role in the management them. A large portion of accounting information is prepared for management decision-making. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirement. So, accounting system can be molded to serve the management purpose.

ROLE OF ACCOUNTANT:

Financial functions performed by an accountant in an organization related to the collection, accuracy, recording, analysis and presentation of a business, organization or company's financial operations. The accountant usually has a variety of administrative roles within a company's operations. In a smaller business, an accountant's role may consist of primarily financial data collection, entry and report generation. Middle to larger sized companies may utilize an accountant as an adviser and financial interpreter, who may present the company's financial data to people within and outside of the business. Generally, the accountant can also deal with third parties, such as customers, financial institutions and vendors.

DIFFERENCE BETWEEN FINANCIAL AND MANAGEMENT ACCOUNTING:

1. Management accounting provides information to people within an organization while financial accounting is mainly for those outside it, such as shareholders
2. Financial accounting is required by law while management accounting is not. Specific standards and formats may be required for statutory accounts such as in the I.A.S within Europe.
3. Financial accounting covers the entire organization while management accounting may be concerned with particular products or cost centres.

Principles of Financial Accounting

Financial accounting is based on several principles known as Generally Accepted Accounting Principles (GAAP) (Williamson 2007). These include Business entity principle, Objectivity principle, Cost principle and Going-concern principle.

• Business entity principle: Every business requires to be accounted for separately by the Proprietor. Personal and business-related dealings should not be mixed.
• Objectivity principle: The information contained in financial statements should be treated objectively and not shadowed by personal opinion.
• Cost principle: The information contained in financial statements requires it to be based on costs incurred in business transactions.
• Going-concern principle: The business will continue operating and will not close but will realize assets and discharge liabilities in the normal course of operations.

Advantages of Financial Accounting:

• It provides legal information to stakeholders such as financial accounts in the form of trading, profit and loss account and balance sheet.
• It shows the mode of investment for shareholders.
• It provides business trade credit for suppliers.
• It notifies the risks of loan in business for banks and lenders.

Limitations of Financial Accounting:

One of the major limitations of financial accounting is that it does not take into Account the non-monetary facts of the business like the competition in the market, change in the value for money etc.

The following limitations of financial accounting have led to the development of cost Accounting:

1. **No clear idea of operating efficiency**: You will agree that, at times, profits may be more or less, not because of efficiency or inefficiency but because of inflation or trade depression. Financial accounting will not give you a clear picture of operating efficiency when prices are rising or decreasing because of inflation or trade depression.

2. **Weakness not spotted out by collective results**: Financial accounting discloses only the net result of the collective activities of a business as a whole. It does not indicate profit or loss of each department, job, process or contract. It does not disclose the exact cause of inefficiency i.e.it does not tell where the weakness is because it discloses the net profit of all the activities of a business as a whole. Say, for instance, it can be compared with a reading on a thermometer. A reading of more than 98.4° or less than 98.4º discloses that

something is wrong with the human body but the exact disease is not disclosed. Similarly, loss or less profit disclosed by the profit and loss account is a signal of bad performance of the business in whole, but the exact cause of such performance is not identified.

3. **Not helpful in price fixation:** In financial accounting, costs are not available as an aid in determining prices of the products, services, production order and lines of products.

4. **No classification of expenses and accounts**: In financial accounting, there is no such system by which accounts are classified so as to give relevant data regarding costs by departments, processes, products in the manufacturing divisions, by units of product lines and sales territories, by departments, services and functions in the administrative division. Further expenses are not attributed as to direct and indirect items. They are not assigned to the products at each stage of production to show the controllable and uncontrollable items of overhead costs.

5. **No data for comparison and decision-making**: It will not provide you with useful data for comparison with a previous period. It also does not facilitate taking various financial decisions like introduction of new products, replacement of labour by machines, price in normal or special circumstances, producing a part in the factory or sourcing it from the market, production of a product to be continued or given up, priority accorded to different products and whether investment should be made in new products etc.

6. **No control on cost**: It does not provide for a proper control of materials and supplies, wages, labour and overheads.

7. **No standards to assess the performance**: In financial accounting, there is no such well developed system of standards, which would enable you to appraise the efficiency of the organization in using materials, labour and overhead costs. Again, it does not provide you any such information, which would help you to assess the performance of various persons and departments in order that costs do not exceed a reasonable limit for a given quantum of work of the requisite quality.

Basis of Accounting:

There are basically two systems of accounting:

1. **Cash System of Accounting.**
2. **Accrual System of Accounting.**

Cash system of Accounting:

It is a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipt is merely due. For example, the rent for December 2009 has not been paid till January 10the 2010. Under cash basis, rent expense for the month of December will not be recorded as payment has not been made. Government system of accounting is mostly on the cash system.

Accrual System of Accounting:

It is a system in which accounting entries are made on the basis of amount having become due for payment or receipt. This system recognizes the fact that if a transaction or an event occurred, its consequences cannot be avoided and therefore, should be brought into book in order to present a meaningful picture of profit earned or loss suffered.

Accounting Principles-Concepts and Conventions

Meaning of Accounting Principles:

Financial accounting is information that must be processed and reported objectively. Third parties, who must rely on such information, have a right to be assured that the data is free from bias and inconsistency, whether deliberate or not. For this reason, financial accounting relies on certain standards or guides that are called 'Generally Accepted Accounting Principles' (GAAP).
Principles derived from tradition, such as the concept of matching. In any report of financial statements (audit, compilation, review, etc.), the preparer/auditor must indicate to the reader whether or not the information contained within the statements complies with GAAP.

ACCOUNTING PRINCIPLES

• **Principle of regularity**: Regularity can be defined as conformity to enforced rules and laws.
• **Principle of consistency**: This principle states that when a business has fixed a specific method for the accounting treatment of an item, it will enter all similar items that follow, in exactly the same way.
• **Principle of sincerity**: According to this principle, the accounting unit should reflect in good faith the reality of the company's financial status.
• **Principle of the permanence of methods**: This principle aims at maintaining the coherence and comparison of the financial information published by the company.
Principle of non-compensation: One should show the full details of the financial information and not seek to compensate a debt with an asset, revenue with an expense etc.
• **Principle of prudence**: This principle aims at showing the reality 'as is': one should not try to make things look rosier than they are. Typically, revenue should be recorded only when it is certain and a provision should be entered for an expense, which is probable.
• **Principle of continuity**: When stating financial information, one assumes that business will not be interrupted. This principle mitigates the principle of prudence: assets do not have to be accounted at their disposable value, but it is accepted that they are at their historical value.
• **Principle of periodicity**: Each accounting entry should be allocated to a given period and split accordingly if it covers several periods. If a client pre-pays a subscription (or lease, etc.), the given revenue should be split to the entire time-span and not accounted for entirely on the date of the transaction.
• **Principle of full disclosure/materiality**: All information and values pertaining to the financial position of a business must be disclosed in the records.

Accounting Concepts and Conventions:

An accounting convention is a modus operandi of universally accepted system of recording and presenting accounting information to the concerned parties. They are followed judiciously and rarely ignored. Accounting conventions are evolved through the regular

and consistent practice over the years to aid unvarying recording in the books of accounts.
Accounting conventions help in comparing accounting data of different business units or of the same unit for different periods. These have been developed over the years.

1. **Convention of relevance**: The convention of relevance emphasizes the fact that only such information should be made available by accounting that is pertinent and helpful for achieving its objectives. The relevance of the items to be recorded depends on its nature and the amount involved. It includes information, which will influence the decision of its client. This is also known as convention of materiality. For example, business is interested in knowing as to what has been the total labor cost. It is neither interested in knowing the amount employees spend nor what they save.
2. **Convention of feasibility**: The convention of feasibility emphasizes that the time, labor and cost of analyzing accounting information should be comparable to the benefits arising out of it. For example, the cost of 'oiling and greasing' the machinery is so small that its break-up per unit produced will be meaningless and will amount to wastage of labor and time of the accounting staff.

3. **Convention of consistency**: The convention of consistency means that the same accounting principles should be used for preparing financial statements year on year. An evocative conclusion can be drawn from financial statements of the same enterprise when there is similarity between them over a period of time. However, these are possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period. If dissimilar accounting procedures and practices are followed for preparing financial statements of different accounting years, then the result will not be analogous.Generally, a businessman follows the above-mentioned general practices or methods year after year. Forexample, while charging depreciation on fixed assets or valuing unsold stock, if a particular method is used it should be followed year after year, so that the financial statements can be analyzed and a comparison made.

4. **Convention of objectivity**: The convention of objectivity highlights that accounting information should be measured and expressed by the standards which are universally acceptable. For example, unsold stock of goods at the end of the year should be valued at cost price or market price, whichever is less and not at a higher price even if it is likely to be sold at a higher price in the future.

5. **Convention of full disclosure**: Convention of full disclosure states that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be complete, reasonable and sufficient disclosure of accounting information.Full refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should disclose all pertinent information. For example, the business provides financial information to all interested parties like investors,lenders, creditors, shareholders etc. The shareholder would like to know the profitability of the firm while the creditors would like to know the solvency of the business. This is only possible if the financial statement discloses all relevant information in a complete, fair and an unprejudiced manner.

6. **Convention of conservatism**: This concept accentuates that profits should never be overstated or anticipated. However, if the business anticipates any loss in the near future, provision should be made for it in the books of accounts, for the same. For example, creating provision for doubtful debts, discount on debtors, writing off intangible assets like goodwill, patent and so on should be taken in to consideration. Traditionally, accounting follows the rule 'anticipate no profit and provide for all possible losses. 'For example, the closing stock is valued at cost price or market price, whichever is lower. The effect of the above is that in case market price has come down then provides for the 'anticipated loss', but if the market price has increased then ignore 'anticipated profits'. The convention of conservatism is a valuable tool in situation of ambiguity and qualms.

Introduction To Accounting Standards:

ACCOUNTING STANDARDS ISSUED BY ICAI

AS-1 DISCLOSURE OF ACCOUNTING POLICIES
AS-2 VALUATION OF INVENTORIES
AS-3 CASH FLOW STATEMENTS
AS-4 CONTINGECIES AND EVENTS OCCURING AFTER THE BALANCE SHEET DATE
AS-5 NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES
AS-6 DEPRECIATION ACCOUNTING
AS-7 ACCOUNTING FOR CONSTRUCTION CONTRACTS
AS-8 ACCOUNTING FOR RESEARCH AND DEVELOPMENT
AS-9 REVENUE RECOGNITION
AS-10 ACCOUNTING FOR FIXED ASSETS
AS-11 ACCOUNTING FOR THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES
AS-12 ACCOUNTING FOR GOVERNMENT GRANTS
AS-13 ACCOUNTING FOR INVESTMENTS
AS-14 ACCOUNTING FOR AMALGAMATIONS
AS-15 ACCOUNTING FOR RETIREMENT BENEFITS IN THE FINANCIAL STATEMENTS OF EMPLOYERS
AS-16 BORROWING COSTS

Basic Concepts of Accounting Standards:

Basic concepts of (GAAP) Accounting Standards :

In order to achieve the aforesaid objectives of GAAP and implement fundamental qualities, the set accounting standards feature four basic assumptions as listed below:

- **Going concern**

This assumption of GAAP accounting standards presumes that the business stays in operation indefinitely thus validating the techniques of asset capitalization, amortization, and depreciation. This assumption is, however, not applicable in case of liquidation. The business is believed to continue in the unforeseeable future.

- **Monetary Unit Principle**

This assumption presumes a stable currency going to be the unit of record.

- **Accounting Entity**

This assumption presumes the business to individually exist from its owners or other business entities. Also, revenue and expense need to be kept separate from personal expenses.

- **Time-period principle**

This assumption states that an entity's economic activities can be divided into simulated time-periods.

Benefits of Accounting Standards:

As per the accounting standards presented by GAAP, the financial reports should provide info which is:

- Useful in being presented to potential creditors and investors in addition to other users in making cogent investment, credit, and similar financial decisions.
- Helpful for the potential creditors and investors in addition to other users in evaluating the timing, amounts, and uncertainty of probable cash receipts.
- Related to economic resources, the claims to these resources, and the changes occurring in them.
- Helpful in taking financial decisions.
- Helpful in taking long-term decisions.
- Helpful in improving the business' performance.
- Useful in maintaining records.

Procedure for Issuing Accounting Standards in India

A summarized extract of the text of the "Preface to the Statements of Accounting Standards (Revised 2004)," issued by the council of the Institute of Chartered Accountants of India, explains the procedure of issuing Accounting Standards. They are:

1. The ASB determines the broad areas requiring formulation of Accounting Standards and lists them according to priority.
2. In the preparation of Accounting Standards, the ASB is assisted by a Study Group, constituted for this purpose. Views of government, public sector undertakings, industry and other organizations are obtained before formulating the Exposure Draft.
3. The Exposure Draft comprises the following:

    - Objective and scope of the standard.
    - Definition of the terms used in the standard.
    - The manner in which the accounting principles have been applied for formulating the standard.
    - The presentations and disclosure requirements of it comply with the standard.
    - Class of enterprises to which the standard will apply.
    - Date from which the standard will be effective.

Need and Significance of IFRS:

International Financial Reporting Standards (IFRS) are principles-based Standards, Interpretations and the Framework adopted by the International Accounting Standards Board (IASB). IFRS represent a set of internationally accepted accounting principles used by companies to prepare financial statements.

The goal with IFRS is to make international comparisons as easy as possible. More than 100 countries around the world currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies. All member states of the EU are required to use IFRS as adopted by the EU for listed companies since 2005. The US is also gearing towards IFRS. While some countries require all companies to adhere to IFRS, others merely allow it or try to coordinate their own country's standards to be similar.

IFRS include the following Standards:

- IFRS 1 First-time Adoption of International Financial Reporting Standards.
- IFRS 2 Share-based Payment.
- IFRS 3 Business Combinations.
- IFRS 4 Insurance Contracts.
- IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.
- IFRS 6 Exploration for and Evaluation of Mineral Resources.
- IFRS 7 Financial Instruments: Disclosures.
- IFRS 8 Operating Segments.
- IFRS 9 Financial Instruments.
- IAS 1 Presentation of Financial Statements.
- IAS 2 Inventories.
- IAS 7 Statement of Cash Flows.
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
- IAS 10 Events after the Reporting Period.
- IAS 11 Construction Contracts.
- IAS 12 Income Taxes.
- IAS 16 Properties, Plant and Equipment.

- IAS 17 Leases.
- IAS 18 Revenue.
- IAS 19 Employee Benefits.
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.
- IAS 21 The Effects of Changes in Foreign Exchange Rates.
- IAS 23 Borrowing Costs.
- IAS 24 Related Party Disclosures.
- IAS 26 Accounting and Reporting by Retirement Benefit Plans.
- IAS 27 Consolidated and Separate Financial Statements.
- IAS 28 Investments in Associates.
- IAS 29 Financial Reporting in Hyperinflationary Economies.
- IAS 31 Interests in Joint Ventures.
- IAS 32 Financial Instruments: Presentation.
- IAS 33 Earnings Per Share.
- IAS 34 Interim Financial Reporting.
- IAS 36 Impairment of Assets.
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets.
- IAS 38 Intangible Assets.
- IAS 39 Financial Instruments: Recognition and Measurement.
- IAS 40 Investment Property.
- IAS 41 Agriculture.

International Accounting Standards (IAS) are the older standards that IFRS are gradually replacing (IAS were issued from 1973 to 2000).

XBRL:

XBRL(Extensive Business Reporting Language) is a freely available and global standard for exchanging business information. XBRL allows the expression of semantic meaning commonly required in business reporting. The language is XML-based and uses the XML syntax and related XML technologies such as XML Schema, XLink, XPath, and Namespaces. One use of XBRL is to define and exchange financial information, such as a financial statement. The XBRL Specification is developed and published by XBRL International, Inc. (**XII**).

XBRL is a standards-based way to communicate and exchange business information between business systems. These communications are defined by metadata set out in taxonomies, which capture the definition of individual reporting concepts as well as the relationships between concepts and other semantic meaning. Information being communicated or exchanged is provided within an XBRL instance.

Early users of XBRL included regulators such as the U.S. Federal Deposit Insurance Corporation and the Committee of European Banking Supervisors (CEBS). Common functions in many countries that make use of XBRL include regulators of stock exchanges and securities, banking regulators, business registrars, revenue reporting and tax-filing agencies, and national statistical agencies.

JOURNALISING TRANSACTIONS

***Rules of Debit and Credit**

Any account that obtains a benefit is Debit.

OR

Anything that will provide benefit to the business is Debit.

Both these statements may look different but in fact if we consider that whenever an account benefits as a result of a transaction, it will have to return that benefit to the business then both the statements will look like different sides of the same picture. For credit,

Any account that provides a benefit is **Credit.**

OR

Anything to which the business has a responsibility to return a benefit in future is **credit**.

As explained in the case of Debit, whenever an account provides benefit to the business the business will have a responsibility to return that benefit at some time in future and so it is Credit.

***Rules of Debit and Credit for Assets**

Similarly we have established that whenever a business transfers a value / benefit to an account and as a result creates something that will provide future benefit; the `thing' is termed as **Asset**.

By combining both these rules we can devise following rules of Debit and Credit for Assets:

When an asset is created or purchased, value / benefit is transferred to that account, so it is debited.

I. Increase in Asset is Debit

Reversing the above situation if the asset is sold, which is termed as disposing off, for say cash, the asset account provides benefit to the cash account. Therefore, the asset account is credited.

II. Decrease in Asset is Credit

***Rules of Debit and Credit for Liabilities**

Anything that transfers value to the business, and in turn creates a responsibility on part of the business to return a benefit, is a **Liability**. Therefore, liabilities are the exact opposite of the assets.

When a liability is created the benefit is provided to business by that account so it is Credited

III. Increase in Liability is Credit

When the business returns the benefit or repays the liability, the liability account benefits from the business. So it is debited

IV. Decrease in Liability is Debit

***Rules of Debit and Credit for Expenses**

Just like assets, we have to pay for expenses. From assets, we draw benefit for a long time whereas the benefit from expenses is for a short run. Therefore, Expenditure is just like Asset but for a short run.

Using our rule for Debit and Credit, when we pay cash for any expense that expense account benefits from cash, therefore, it is debited.

Now we can lay down our rule for Expenditure:

V. Increase in Expenditure is Debit

Reversing the above situation, if we return any item that we had purchased, we will receive cash in return. Cash account will receive benefit from that Expenditure account. Therefore, Expenditure account will be credited

VI. Decrease in Expenditure is Credit

***Rules of Debit and Credit for Income**

Income accounts are exactly opposite to expense accounts just as liabilities are opposite to that of assets.

Therefore, using the same principle we can draw our rules of Debit and Credit for Income.

VII. Increase in Income is Credit

VIII. Decrease in Income is Debit

<u>Posting and Preparation of Trial Balance:</u>

<u>Trial Balance:</u>

Trial Balance is a list of closing balances of ledger accounts on a certain date and is the first step towards the preparation of financial statements. It is usually prepared at the end of an accounting period to assist in the drafting of financial statements. Ledger balances are segregated into debit balances and credit balances. Asset and expense accounts appear on the debit side of the trial balance whereas liabilities, capital and income accounts appear on the credit side. If all accounting entries are recorded correctly and all the ledger balances are accurately extracted, the total of all debit balances appearing in the trial balance must equal to the sum of all credit balances.

<u>How to prepare a Trial Balance:</u>

Following Steps are involved in the preparation of a Trial Balance:

1. All Ledger Accounts are closed at the end of an accounting period.
2. Ledger balances are posted into the trial balance.
3. Trial Balance is cast and errors are identified.
4. Suspense account is created to agree the trial balance totals temporarily until corrections are accounted for.
5. Errors identified earlier are rectified by posting corrective entries.
6. Any adjustments required at the period end not previously accounted for are incorporated into the trial balance.

Closing Ledger Accounts:

Ledger accounts are closed at the end of each accounting period by calculating the totals of debit and credit sides of a ledger. The difference between the sum of debits and credits is known as the closing balance. This is the amount which is posted in the trial balance.

How closing balances are presented in the ledger depends on whether the account is related to income statement (income and expenses) or balance sheet (assets, liabilities and equity). Balance sheet ledger accounts are closed by writing 'Balance c/d' next to the balancing figure since these are to be rolled forward in the next accounting period. Income statement ledger accounts on the other hand are closed by writing 'Income Statement' next to the residual amount because it is being transferred to the income statement as revenue or expense incurred for the period.

The steps involved in closing a ledger account may be summarized as below:

1. Add the totals of both sides of a ledger
2. The higher of the totals among the debit side and credit side must be inserted at the end of **BOTH** sides. Closing balance is the balancing figure on the side with the lower balance.
3. In case of ledger accounts of assets, liabilities and equity, 'balance c/d' is written next to the closing balance whereas in case of income and expenses ledger accounts, 'Income Statement' is written next to the closing balance.
4. The closing balances of all ledger accounts are posted into the trial balance.

Closing Balance of all ledger accounts are posted into the trial balance. It is important to remember that a debit closing balance in the ledger account appears on the credit side but in the trial balance it is presented in the debit column and vice versa.

Posting of closing balances should be done carefully as many errors may occur during the posting process such as Posting Error, Transposition Errors and Slide error.

Following is an example of a trial balance prepared from the closing balances of the ledgers detailed above.

ABC LTD Trial Balance as at 31 December 2011		
Account Title	**Debit (in rupees)**	**Credit (in rupees)**
Share Capital		10,000
Bank Loan		10,000
Cash	30,000	
Salaries Expense	5,000	
Sales Revenue		15,000
Total	**35,000**	**35,000**

Capital and Revenue:

Capital: The amount invested in the firm by the owner is referred to as the Capital. The expenditure borne/incurred in purchase of fixed assets, investments is known as Capital Expenditure.

Revenue: The profit/gain arising from the business from the sale proceeds is referred to as the revenue. Revenue includes the total cost/expenses (whether direct or indirect) and the total income earned during the accounting period by the firm.

Classification of Income:

- Gain on sale of Investments.
- Capital Income.
- Dividends Received.
- Interest Received.
- Commission Received.

Classification of Expenditure:

- Investment in Fixed Assets.
- Purchase of Land & Building.
- Repairs and Installation of Tools & Equipments.
- Payment of direct and indirect expenses.
- Deferred Revenue Expenditure.
- Depreciation on Fixed Assets.

Capital and Revenue Expenditure

Expenditure on fixed assets may be classified into Capital Expenditure **and** Revenue Expenditure. **The distinction between the nature of capital and revenue expenditure is important as only capital expenditure is included in the cost of fixed asset.**

Capital Expenditure:

Capital expenditure includes costs incurred on the acquisition of a fixed asset and any subsequent expenditure that increases the earning capacity of an existing fixed asset.

The cost of acquisition not only includes the cost of purchases but also any additional costs incurred in bringing the fixed asset into its present location and condition (e.g. delivery costs).

Capital expenditure, as opposed to revenue expenditure, is generally of a one-off kind and its benefit is derived over several accounting periods. Capital Expenditure may include the following:

- Purchase costs (less any discount received)
- Delivery costs
- Legal charges
- Installation costs
- Up gradation costs
- Replacement costs

Revenue Expenditure

Revenue expenditure incurred on fixed assets include costs that are aimed at 'maintaining' rather than enhancing the earning capacity of the assets. These are costs that are incurred on a regular basis and the benefit from these costs is obtained over a relatively short period of time. For example, a company buys a machine for the production of biscuits. Whereas the initial purchase and installation costs would be classified as capital expenditure, any subsequent repair and maintenance charges incurred in the future will be classified as revenue expenditure. This is so because repair and maintenance costs do not increase the earning capacity of the machine but only maintains it (i.e. machine will produce the same quantity of biscuits as it did when it was first put to use).

Revenue costs therefore comprise of the following:

- Repair costs
- Maintenance charges
- Repainting costs
- Renewal expenses

As revenue costs do not form part of the fixed asset cost, they are expensed in the income statement in the period in which they are incurred.

Journal and subsidiary Books:

JOURNAL

The word 'Journal' has been derived from the French word 'JOUR' means daily records. **Journal** is a book of original entry in which transactions are recorded as and when they occur in chronological order (in order of date) from source documents. Recording in journal is made showing the accounts to be debited and credited in a systematic manner. Thus, the journal provides a date-wise record of all the transactions with details of the accounts and amounts debited and credited for each transaction with a short explanation, which is known as narration.
Firms having limited number of transactions record those in journal and from there post these to the concerned ledger accounts. Firms having large number of transactions, maintain some special purpose journals such as, Purchase Book, Sales Books, Returns books, Bills Book, Cash Book, Journal proper etc.

COMPOUND JOURNAL ENTRY

A compound journal entry is an accounting entry which effects more than two account heads. A simple journal entry has one debit and one credit whereas a compound journal entries includes one or more debits and/or credits than a simple journal entry. A compound journal entry may combine two or more debits and a credit, or a debit and two or more credits, or two or more of both debits and credits.

OPENING ENTRY

In the case of continuing business we are required to pass an entry in the journal for bringing in the new books all assets and liabilities as appearing in the books on the last day of the previous year. This entry is known as 'opening entry'. Rule of passing opening entry is to debit each asset account; credit each liability account; excess of debits over credits represents capital balance.

SUB DIVISION OF JOURNAL

CASH JOURNAL

The number of cash transactions in a firm is generally larger, therefore, it becomes inconvenient to record all cash transactions in the journal. Since all cash transactions are recorded for the first time in the cash book, it is therefore called a book of original entry. Only cash transactions are recorded in the cash book.

PETTY CASH BOOK

It saves the time of chief cashier. Maintenance of petty cash book does not require any specialized knowledge of accounting. It provides control over small payments. It minimizes the chances of fraud.

PURCHASE JOURNAL

It is a subsidiary book which records transactions of credit purchases of goods. Cash purchases are not recorded in the purchases book since they are recorded in the cash book.

SALES JOURNAL

It is a subsidiary book which records transactions of credit sales of goods. Cash sales will be recorded in the cash book and not in the sales book. Sale of assets is not recorded in the sales books.

SALES RETURN JOURNAL

Sales returns journal is a subsidiary book in which seller records all the sales that have been returned to him by his customers. Sales returns journal is also known as returns inwards book and sales returns day book.

VOUCHER SYSTEM

Type of internal system used to control the cash (checks) being spent (written). The voucher system consists of vouchers, voucher files (paid and unpaid), voucher register that takes the place of the purchase journal, cash register that takes the place of the cash disbursement journal, and the general journal.

Journal Entries

Following are some examples of translations and Journal Entries, its analysis is done on the basis of rules of double entry system:

1. Cash brought in by proprietor as capital Rs. 30000

a) What comes in business will be debited

Cash has come in business; cash account will be debited in journal entry.

b) Who is giver will be credited

Proprietor is giver of cash to business but he has business motive and he gives the money to business as capital.

Journal Entry

Cash Account Debit 30, 000
Proprietor's capital Account Credit 30,000
2. Goods purchased on credit from Madan Lal Rs. 5,000

a) What comes in business will be debited

Goods have come in business, so its financial value will be debited with the name of purchase account.

b) Name of person is given from whom we bought the goods on credit, so Ist rule's second part will be applied.

Who is giver, will be credited.

Madan lal is giver, so its account will be credited.

Purchase account debit 5000

Madan Lal account credit 5000

3. Furniture purchased for cash Rs. 10000

a) What comes in business will be debited. In this transaction, furniture came in business, so we will open furniture account in the debit side of journal entry.

b) Cash is also asset and we paid for purchasing of furniture. 2nd rule's second part will be applied.

Furniture Account Debit 10,000

Cash Account Credit 10,000

4. Goods sold on credit to Dev Raj Rs. 1600

a) Dev Raj is receiver of goods, so his personal account will be debited.

b) Goods go out, so, goods or sale account will be credited.

Dev Raj Account Debit 1600

Sale Account Credit 1600

5. Goods purchased for cash Rs. 4500

a) Goods come in, so goods or purchase account will be debited

b) Cash goes out, so cash account will be credited.

Purchase account debit 4500

Cash account credit 4500

6. Goods sold for cash Rs. 2100

a) Cash comes in, so cash account will be debited.

b) Goods go out, so goods or sale account will be credited.

Cash account debit 2100

Sale account credit 2100

7. Rent paid for shop to landlord 3000

a) Rent is an item of expenses, so it will be debited.

b) Cash is an item of asset and it goes out, so it will be credited.

Rent Account Debit 3000

Cash Account Credit 3000

8. Commission received in cash 2000

a) Cash comes in, so cash account will be debited.

b) Commission is an item of income, so commission account will be credited.

Cash Account Debit 2000

Commission Account Credit 2000

9. Cash deposited into bank 5000

a) Bank is receiver of cash, so bank account will be debited.

b) Cash goes out, so cash account will be credited.

Bank Account Debit 5000

Cash Account Credit 5000

10. Cash withdrawn from bank for office use Rs. 2000

a) Cash comes in the business, so cash account will be debited.

b) Bank is the giver, so bank account will be credited.

Cash Account Debit 2000

Bank Account Credit 2000

Unit-III

Depreciation

Depreciation is systematic allocation the cost of a fixed asset over its useful life. It is a way of matching the cost of a fixed asset with the revenue (or other economic benefits) it generates over its useful life. Without depreciation accounting, the entire cost of a fixed asset will be recognized in the year of purchase. Depreciation is the measure of wearing out of a fixed asset. All fixed assets are expected to be less efficient as time goes on.

Depreciation is calculated as the estimate of this measure of wearing out and is charged to the Profit & Loss account either on a monthly or annual basis. The cost of the asset less the total depreciation will give you the Net Book Value of the asset. This will give a misleading view of the profitability of the entity. The observation may be explained by way of an example.

Example

ABC LTD purchased a machine costing $1000 on 1st January 2001. It had a useful life of three years over which it generated annual sales of $800. ABC LTD's annual costs during the three years were $300.

Causes for Depreciation:

The major causes of depreciation are as follows:

1. Wear And Tear
wear and tear refer to a decline in the efficiency of asset due to its constant use. When an asset losses its efficiency, its value goes down and depreciation arises. This is true in case of tangible assets like plant and machinery, building, furniture, tools and equipment used in the factory.

2. Effusion of Time
The value of asset may decrease due to the passage of time even if it is not in use. There are some intangible fixed assets like copyright, patent right, and lease hold premises which decrease its value as time elapse.

3. Exhaustion
An asset may loss its value because of exhaustion too. This is the case with wasting assets such as mines, quarries, oil-wells and forest-stand. On account of continuous extraction, a stage will come where mines and oil-wells get completely exhausted.

Objectives for providing Depreciation:

1. Ascertainment of True Profits
When an asset is purchased, it is nothing more than a payment in advance for for the use of asset. Depreciation is the cost of using a fixed asset. To determine true and correct amount of profit or loss, depreciation must be treated as revenue expenses and debited to profit and loss account.

2. Reporting of True And Fair Financial Position Of A Business
The value of assets decrease over a period of time on account of various factors. In order to present a true state of affairs of the business, the assets should be shown in the balance sheet, at their true and fair values. If the depreciation is not provided then the asset will appear in the balance sheet at the original value. So, in order to show the true financial position of a business, depreciation is required to be charged on the assets.

3. Replacement of Assets
Assets used in the business need to be replaced after the expiry of their useful life. Depreciation can be taken as a source of fund for replacing worn out asset by a new asset. Thus, depreciation charges help in accumulating funds for the replacement of an asset.

4. Saving In Taxes

The profit and loss account will show more profits if depreciation is not charged on asset. So, the business needs to pay more income tax to the government. Depreciation charges on assets save the amount of tax equivalent to tax rate. Since it is shown as expense in the profit and loss account, it reduces the amount of the profit.

4. Obsolescence

Changes in fashion are external factors which are responsible for throwing out of assets even if those are in good condition. For example black and white televisions have become obsolete with the introduction of color TVs, the users have discarded black and white TVs although they are in good condition. Such as loss on account of new invention or changed fashions is termed as obsolescence.

Methods of Calculating Depreciation:

There are two basic methods of depreciation to choose from when depreciating an asset. These methods include **Straight-line and Written Down Value Method.**.

The **Straight-Line** method is generally the most commonly used method due to its simplicity and consistency of allocating depreciation evenly over the useful life of the asset. To calculate depreciation under this method, the Cost of the Asset is reduced by the salvage or residual value to arrive at the depreciable basis. The resulting depreciable basis is then divided by the estimated useful life.

Straight Line Method (SLM)

This is the simple method of depreciation.

It charges equal amount of depreciation each year over useful life of asset.

It first add up all the costs incurred to bring the asset in use and then it divides that by the useful life of asset in years to calculate the depreciation expense.

E.g.: Say a Computer costs Rs. 30,000 and Rs. 11,000 (as additional set-up/installation/maintenance expenses) = Rs 41,000 and it is anticipated that its scrap value will be Rs. 1,000 at the end of its useful life, of say, 5 yrs.

Total Cost = Cost of Computer + Installation Exp. + Other Direct Costs

Depreciable Amount over No. of years = Total Cost - Salvage Value (At end of useful life)

30,000 +11,000 =41,000 (Total cost)

41,000 – 1,000 = 40,000 as the **Depreciable Amount**

Depreciable Amount = Rs. 40,000, Spread out over 5 years = Rs. 40,000/5(Yrs) = Rs. 8000/- depreciation per annum

Advantages:

- The straight-line method offers simplicity
- Write off the same amount each year and don't have to keep recalculating.
- Easy to determine profits for future years easily; at least as far as how much you will save because of depreciation. In other words, as your profits grow, your depreciation costs stay the same.
- This allows you to make financial forecasts for several years.
- You receive the benefit of depreciation evenly over the life of the asset.

Disadvantages:

- Assets tend to lose value more quickly in their early years.
- Straight-line depreciation does not take this fact into account. If you use assets as collateral for loans, the lender will assume your assets lose more of their value in their first years, so your straight-line method will make the asset look more valuable on your books than it really is for the lender.
- The efficiency of a machine declines in its later years and you will be writing off the same value in a later year as you did in the first year. The machine actually will have less value for you than your depreciation amount indicates.

Written Down Value Method (WDV)

- This method involves applying the depreciation rate on the Net Book Value (NBV) of asset. In this method, depreciation of the asset is done at a constant rate.
- In this method depreciation charges reduces each successive period.
- This method should be used in those assets, where high depreciation should be charged in initial years.

- Assume the price of a depreciable asset i.e. computer is Rs. 40,000 and its salvage value after 10 years is 0.
- In this method NBV will never be zero.

Depreciation Per year = (1/N) Previous year's value, Where N= No. of years

So in our example, the depreciation amount during the first year is

[Rs. 40,000*1/10] =Rs. 4,000

NBV of computer after 1^{st} year= Rs 40,000- 4,000 = Rs. 36,000

Depreciation for 2^{nd} year is

[Rs. 36,000*1/10] =Rs. 3,600

Advantages:

1. Since under this method higher depreciation is charged in early years it takes into account that asset is more efficient in early years and therefore it is more realistic way of depreciation.

2. Since in early years machines requires less repairs and as the year passes by repair cost began to rise, therefore this method by charging more depreciation in early years and less in later years make sure that total cost of repairs and depreciation is same every year.

Disadvantages:

1. Since the rate of depreciation is fixed by not following formula chances of subjectivity in fixing rate of depreciation becomes high.

2. The value of asset will never be zero in books of account under this even if asset is of no use to company.

Change in method of charging Depreciation:

CHOICE OF DEPRECIATION METHOD

Depreciation expenses differ from method to method. Choice of selecting a suitable depreciation method is not easy. The decision is based on the inherent characteristic features of an asset.

Accelerated depreciation methods may be of much use in case of the following:

- Quality of the asset decreases with its age years roll, assets may loose its effective working capacity – Maintenance costs grow.

- Introduction of new equipment due to Research and Development may adversely affect the effective usage of existing equipment.
- The other Straight Line Method may be suitable for assets like buildings, furniture, patents, leases, etc. and for assets which do not warrant frequent repairs and renewals.
- Choice of a method of depreciation affects the amount of net income because quite often the management employs depreciation as an instrument of financial policy of the entity. Hence, selection of a method depends on the management too.

Change in depreciation amount due to change in method is to be given retrospective effect but in all other cases (like Change in Cost, Life, Revaluation etc.) Change in depreciation is given prospective effect

1. The depreciation method selected should be applied consistently from period to period.
2. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.
3. When a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from the retrospective recomputation of depreciation in accordance with the new method would be adjusted in the accounts in the year in which the method of depreciation is changed.
4. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged to the profit and loss account. In case the change in the method results in surplus, it is recommended that the surplus be initially transferred to the 'Appropriations' part of the profit and loss account and thence to General Reserve through the same part of the profit and loss account. Such a change should be treated as a change in accounting policy and its effects should be quantified and disclosed.

Salient Features of Accounting Standards(AS-6)(ICAI)Revised:

The Institute of Chartered Accountants of India, keeping in view with international accounting principles, revised (AS)–6.This standard AS–6 deals with the concept: Depreciation

Depreciation is defined as "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the Expected Useful Life of the Asset. Depreciation includes amortization of assets whose useful life is predetermined".

Salient features of AS–6 (Revised) Accounting for Depreciation:

i. Existing Assets: The depreciable amount of existing assets = Cost of the asset (historical not market value) – salvage (scrap value) value.

ii. Revision of estimate useful life of an asset: In case, if there is a necessity to revise the estimated life of an asset, the unamortized depreciable amount will have to be charged over the remaining useful life.

iii. Addition (or) extension to an existing asset of capital nature: In such cases, two factors will have to be considered:
   a) such an addition should retain separate identity,
   b) It can still be used after the disposal of existing assets.

Then, depreciation is to be determined independently on the basis of an estimate of its own useful life.

In other cases, the depreciation has to be determined on the basis of remaining useful life of the existing asset plus addition or extension as an integral part.

Inventories:

The raw materials, work-in-process goods and completely finished goods that are considered to be the portion of a business's assets that is ready or will be ready for sale. Inventory represents one of the most important assets that most businesses possess, because the turnover of inventory represents one of the primary sources of revenue generation and subsequent earnings for the company's shareholders/owners.

Inventories are assets:

(a) held for sale in the ordinary course of business;
(b) In the process of production for such sale; or
(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Valuation of Inventories:

Inventory is valued on the basis of the following factors:

1. **Measurement**

Inventories should be valued at the lower of cost and net realizable value.
The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

2. **Costs of Purchase**

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

3. **Costs of Conversion**

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials.

4. **Other Costs**

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Method of valuation of Inventories:

There are three basis approaches to valuing inventory that are allowed by GAAP - (a) **First-in, First-out (FIFO):** Under FIFO, the cost of goods sold is based upon the cost of material bought earliest in the period, while the cost of inventory is based upon the cost of material bought later in the year. This results in inventory being valued close to current replacement cost. During periods of inflation, the use of FIFO will result in the lowest estimate of cost of goods sold among the three approaches, and the highest net income.

(b) **Last-in, First-out (LIFO):** Under LIFO, the cost of goods sold is based upon the cost of material bought towards the end of the period, resulting in costs that closely approximate current costs. The inventory, however, is valued on the basis of the cost of materials bought earlier in the year. During periods of inflation, the use of LIFO will result in the highest estimate of cost of goods sold among the three approaches, and the lowest net income.

(c) **Weighted Average:** Under the weighted average approach, both inventory and the cost of goods sold are based upon the average cost of all units bought during the period. When inventory turns over rapidly this approach will more closely resemble FIFO than LIFO.

Firms often adopt the LIFO approach for the tax benefits during periods of high inflation, and studies indicate that firms with the following characteristics are more likely to adopt LIFO - rising prices for raw materials and labor, more variable inventory growth, an absence of other tax loss carry forwards, and large size. When firms switch from FIFO to LIFO in valuing inventory, there is likely to be a drop in net income and a concurrent increase in cash flows (because of the tax savings). The reverse will apply when firms switch from LIFO to FIFO.

Given the income and cash flow effects of inventory valuation methods, it is often difficult to compare firms that use different methods. There is, however, one way of adjusting for these differences. Firms that choose to use the LIFO approach to value inventories have to specify in a footnote the difference in inventory valuation between FIFO and LIFO, and this difference is termed the LIFO reserve. This can be used to adjust the beginning and ending inventories, and consequently the cost of goods sold, and to restate income based upon FIFO valuation.

Periodic Inventory System:

Periodic inventory is a system of inventory in which updates are made on a periodic basis. This differs from perpetual inventory systems, where updates are made as seen fit.In a periodic inventory system no effort is made to keep up-to-date records of either the inventory or the cost of goods sold. Instead, these amounts are determined only periodically - usually at the end of each year. This physical count determines the amount of inventory appearing in the balance sheet. The cost of goods sold for the entire year then is determined by a short computation.

Perpetual Inventory System:

Under perpetual inventory system, inventory and cost of goods sold are updated for each sale/purchase and return transaction. We have already discussed the basic concept of perpetual inventory system in the comparison of perpetual-periodic inventory.

The perpetual inventory system is intended as an aid to material control. It is a system of stock control followed by stores department. The system follows a method of recording stores by which information about each receipt, issue and current balance of stock is always available.

Perpetual inventory system may be defined as a method of recording stores balances after every receipt and issue to facilitate regular checking and to obviate closing down for stock taking." So perpetual inventory system implies continuous maintenance of stock records and in its broad sense it covers both continuous stock taking as well as up to date recording of stores books. The balance of the same item of store in bin card should correspond with that shown in the materials or store ledger card and a frequent checking of these two records should be made and compared with the actual or physical quantity of materials in stock.

First in First Out (FIFO)

This method assumes that inventory purchased first is sold first. Therefore, inventory cost under FIFO method will be the cost of latest purchases. Consider the following example:

Example

Bike LTD purchased 10 bikes during January and sold 6 bikes, details of which are as follows:

January 1 Purchased 5 bikes @ $50 each

January 5 Sold 2 bikes

January 10 Sold 1 bike

January 15 Purchased 5 bikes @ 70 each

January 25 Sold 3 bikes

The value of 4 bikes held as inventory at the end of January may be calculated as follows:

The sales made on January 5 and 10 were clearly made from purchases on 1st January. Of the sales made on January 25, it will be assumed that 2 bikes relate to purchases on January 1 whereas the remaining one bike has been issued from the purchases on 15th January. Therefore, the value of inventory under FIFO is as follows:

Date	**Purchase**			**Issues**			**Inventory**		
	Units	**$/Units**	**$ Total**	**Units**	**$/Units**	**$ Total**	**Units**	**$/Units**	**$ Total**
Jan 1	**5**	**50**	**250**				**5**	**50**	**250**
Jan 5				**2**	**50**	**100**	**3**	**50**	**150**
Jan 10				**1**	**50**	**50**	**2**	**50**	**100**
Jan 15	**5**	**70**	**350**				**5**	**70**	**350**
Jan 15							**7**		**450**
Jan 25				**2**	**50**	**100**			
				1	**70**	**70**	**4**	**70**	**280**

As can be seen from above, the inventory cost under FIFO method relates to the cost of the latest purchases, i.e. $70.

Final Accounts:

The financial statements of an organization made up at the end of an accounting period, usually the fiscal year. For a manufacturer, the final accounts consist of (1) manufacturing account, (2) trading account, (3) profit and loss account, and (4) profit and loss appropriation account. A commercial company's final accounts will include all of the above except the manufacturing account. Together, these accounts show the gross profit, net income, and distribution of net income figures of the company.

Form of Final Accounts: There is a standard format of final accounts only in the case of a limited company. There is no fixed prescribed format of financial accounts in the case of a proprietary concern and partnership firm.

- Transactions
- Journal
- Ledger
- Trial Balance
- Trading & Profit & Loss Account
- Balance Sheet

MEANING

The Trading and Profit & loss account and Balance Sheet prepared at the end of a year is known as **Final accounts**. While preparing the final accounts, there may be some items so far not adjusted. These items are to be adjusted in the final accounts for calculating the correct profit or loss of the business. The usual adjustments in the final accounts are:-

a. Expenses owing: - These are the expenses incurred during the year but not paid in cash. This amount will be paid in the near future (next year). The owing expense is to be added with the amount of same expense already paid given in the trial balance and it should be shown in the balance sheet as a current liability.

The double entry for recording the expenses owing is

Debit   Expenses account

Credit   Expenses owing account

This expense is also known as outstanding expenses, expenses payable or expense payable.

b. Prepaid expense. :- This is the expense paid during the year for the benefit of the next year. The portion of the expense which is prepaid is to be deducted from the total expenses already paid during the year (given in the trial balance) and shown as current asset in the balance sheet.

The double entry for recording the prepaid expense is

Debit   Prepaid expense account and

Credit   Expense account

This expense is also known as expense paid in advance or unexpired expense

c. Accrued income: - The income earned during the year but not received in cash is known as accrued income. The amount of accrued income is to be considered as current year's income and added

With the concerned income received during the year (given in the trial balance) and shown as a current asset in the balance sheet.

The double entry for recording the accrued income is:

Debit   Accrued income account and

Credit   Income account

The accrued income is also known as outstanding income.

d. Income received in advance: - This is the income received during the year for the services to be rendered during the next year. Since this income is not related to the current year, it should be deducted from the concerned income (given in the trial balance) and shown as a current liability

in the balance sheet.

The double entry for recording the income received in advance is:

Debit   Income account and

Credit   Income received in advance

This is also known as unexpired income.

e. Depreciation: - The part of the cost of a fixed asset that is consumed by a business during the period of its use is known as depreciation. It is considered as an expense in the business therefore shown as an expense in the profit & loss account and deducted from the cost price of the concerned fixed asset in the balance sheet.

The double entry for recording depreciation is:

Debit Profit & loss account and

Credit Depreciation account

f. Bad debt: - The part of the amount of debtors which cannot be recovered is known as bad debt. It is an expense to be shown in the profit & loss account. If the bad debt appears in the trial balance, it is known as bad debt written off and shown in the profit & loss account only. If bad debt information appears among the adjustment points below the trial balance, then it should be shown as an expense in the profit & loss account and shown as a deduction from the debtors in the balance

sheet under the heading "current assets".

The double entry for recording the bad debt is:

Debit Bad debt account and

Credit Debtors account

g. Goods drawings by the owner for his personal use:-

The amount of goods withdrawn by the owner for his personal use is to be considered as drawing. The double entry for recording the goods drawings is:

Debit Drawings account and

Credit Purchase account or sales account

The amount of goods drawings should be deducted from purchases and capital in the Balance Sheet.

From the following Trial Balance and additional information, you are required to prepare profit and loss account and Balance Sheet.

TRIAL BALANCE as on 31st March 2012

Particulars	**Debit**	**Credit**

Capital		**2,90,000**
Sundry Debtors	**65,000**	
Drawings	**7,600**	
Building	**2,20,000**	
Sundry Creditors		**12,000**
Wages	**8,000**	
Purchases	**89,000**	
Opening Stock	**12,000**	
Cash in Hand	**1,900**	
Cash at Bank	**12,000**	
Carriage Charges	**20,000**	
Salaries	**8,000**	
Rent, Taxes & Insurance	**1300**	
Sales		**1,50,000**
Purchase Returns		**4,500**
Sales Returns	**2,800**	
Bills Receivable	**15,000**	
Bils Payable		**7,000**
Interest		**3,500**
Advertisement	**2,400**	
Trade Expenses	**2,000**	
	4,67,000	**4,67,000**

Additional Information:

i. Closing Stock as on 31st March2012 was Rs.15,000.
ii. Prepaid Insurance Rs.400
iii. Outstanding Salaries Rs.2,000;Outstanding Rent & Taxes Rs.1,300
iv. Depreciation charged on Building @2%p.a.

Solution:

Dr. Trading and Profit & Loss Account as on 31st March2012 Cr.

Particulars	**Amount**	Particulars	**Amount**
To Opening Stock	12,000	By Closing Stock	15,000
To Purchases 89,000 (-)Returns 4,500	84,500	By Sales 1,50,000 (-)Returns 2,800	147200
To Wages	8,000		
To Carriage	20,000		
To Gross profit c/d	37,700		
	1,62,200		**1,62,200**
To Trade Expenses	2,000	By Gross Profit b/d	**37,700**
To Advertisement	2,400	By Interest	**3,500**
To Salaries 8,000	10,000		

(+)Outstanding 2,000			
To Rent,Taxes & Insurance 1,300 (-)Prepaid 400 (+)Outstanding1,300	2,200		
To Depreciation on Building	4,400		
To Net Profit transferred to Capital A/C	20,200		
	41,200		**41,200**

Balance-Sheet as on 31st March2012

Liabilities	**Amount**	**Assets**	**Amount**
Capital 2,90,000 (+)Net Profit 20,200 (-)Drawings 7,600	3,02,600	Building 2,20,000 (-)Depreciation 4,400	2,15,600
Creditors	12,000	Cash at Bank	12,000
Bills Payable	7,000	Cash in Hand	1,900
Outstanding Rent & Taxes	1,300	Debtors	65,000
Outstanding Salaries	2,000	Bills Receivable	15,000
		Prepaid Insurance	400
		Closing Stock	15,000
	3,24,900		**3,24,900**

Preparation of Final Accounts of Non-Profit Organization

By preparing Receipts & Payments Account, Income and Expenditure Account and a Balance sheet.

Being a "non-profit" organization does not mean it doesn't make any profit, but rather that the profits are not distributed to investors as dividends. Many non-profit organizations make billions of dollars of profits per year, and often donate these corporate profits to charitable causes.

Bank Reconciliation Statement

A **Bank reconciliation** is a process that explains the difference between the bank balance shown in an organisation's bank statement, as supplied by the bank, and the corresponding amount shown in the organization's own accounting records at a particular point in time.[1]

Such differences may occur, for example, because a cheque or a list of cheques issued by the organization has not been presented to the bank, a banking transaction, such as a credit received, or a charge made by the bank, has not yet been recorded in the organisation's books, or either the bank or the organization itself has made an error.

It may be easy to reconcile the difference by looking at very recent transactions in either the bank statement or the organisation's own accounting records (cash book) and seeing if some combination of them tallies with the difference to be explained. Otherwise it may be necessary to go through and match every single transaction in both sets of records since the last reconciliation, and see what transactions remain unmatched. The necessary adjustments should then be made in the cash book, or any timing differences recorded to assist with future reconciliations.

A bank reconciliation statement is prepared to reconcile the two balances of Cash Book and Pass Book. So, when you will prepare a bank reconciliation statement you will start it with one balance make adjustments and then you will reach to the other balance. This way both the balances will agree.

Question: From the following prepare a bank reconciliation statement on June 30, 2006

The bank column of Cash Book showed a debit balance of Rs.49, 000 on June 30, 2006.Entries in Cash Book and the Pass Book were compared and the following differences were noticed:

i. Cheque of Shyam Rs.9,000 and of Mohan Rs.15,000 were deposited but were not collected upto June 30,2006.

ii. Ramesh, a creditor deposited cheque of Rs.8, 000 directly into bank.

iii. Bank allowed an interest of Rs.500.

iv. Cheque of Rs.10,000 issued to Radhey Shyam was not presented for payment.

v. Bank debited the account by Rs.100 being bank charges.

vi. Bank debited the account by Rs.6,000 being insurance premium.

Solution:

Bank Reconciliation Statement as on June 30,2006

Particulars	**Amount(Details)**	**Total**
Balance as per Cash Book(Dr.)		**49,000**
Add:		
Cheque directly deposited into bank	8,000	
Interest allowed by the bank	500	
Cheque issued but not presented for payment	10,000	
		67,500
Less:		
Cheque deposited but not cleared Shyam 9,000 Mohan 15,000	24,000	
Insurance Premium	6,000	
Bank Charges	100	
		30,100
Balance as per Pass Book(Cr.)		**37,400**

The reasons for difference in balance of the cash book and pass book are as under :

i. Cheques issued by the firm but not yet presented for payment: When cheques are issued by the firm, these are immediately entered on the credit side of the bank column of the cash book. Sometimes, receiving person may present these cheques to the bank for payment on some later date. The bank will debit the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.

ii. Cheques deposited into bank but not yet collected: When cheques are deposited into bank, the firm immediately enters it on the debit side of the bank column of cash book. It increases the bank balance as per the cash book. But, the bank credits the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.

iii. Amount directly deposited in the bank account :Sometimes, the debtors or the customers deposit the money directly into firm's bank account, but the firm gets the information only when it receives the bank statement. In this case, the bank credits the firm's account with the amount received but the same amount is not recorded in the cash book. As a result the balance in the cash book will be less than the balance shown in the Pass book.

iv. Bank Charges:The bank charge in the form of fees or commission is charged from time to time for various services provided from the customers' account without the intimation to the firm. The firm records these charges after receiving the bank intimation or statement. Example of such deductions is : Interest on overdraft balance, credit cards' fees, outstation cheques, collection charges, etc. As a result, the balance of the cash book will be more than the balance of the pass book.

v. Interest and dividend received by the bank: Sometimes, the interest on debentures or dividends on shares held by the account holder is directly deposited by the company through Electronic Clearing System (ECS). But the firm does not get the information till it receives the bank statement. As a consequence, the firm enters it in its cash book on a date later than the date it is recorded by the bank. As a result, the balance as per cash book and pass book will differ

vi. Direct payments made by the bank on behalf of the customers: Sometimes, bank makes certain payments on behalf of the customer as per standing instructions. Telephone bills, rent, insurance premium, taxes, etc are some of the expenses. These expenses are directly paid by the bank and debited to the firm's account immediately after their payment. but the firm will record the same on receiving information from the bank in the form of Pass

Book or bank statement. As a result, the balance of the pass book is less than that of the balance shown in the bank column of the cash book.

vii. Dishonor of Cheques/Bill discounted: If a cheque deposited by the firm or bill receivable discounted with the bank is dishonored , the same is debited to firm's account by the bank. But the firm records the same when it receives the information from the bank. As a result, the balance as per cash book and that of pass book will differ.

viii. Errors committed in recording transactions by the firm: There may be certain errors from firm's side, e.g., omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In this case, there would be a difference between the balances as per Cash Book and as per Pass Book.

ix. Errors committed in recording transactions by the Bank: Sometimes, bank may also commit errors, e.g., omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not agree.

Question: From the following particulars of M/s Ananaya Industries, prepare bank reconciliation statement as on December 31, 2006

1. Bank balance as per cash book Rs.32, 500

2. Cheques deposited into bank but not credited upto December 31, 2006; Rs.8, 900.

3. Cheques issued but not presented for payment Rs. 12,500.

4. Bank credited Rs.5,000 for receiving dividend through Electronic
Clearing System.

5. Bank charges debited by Bank Rs.400

Bank Reconciliation Statement of M/S Ananaya Industries as on 31st December 2006

Particulars	Amount (+)	Amount (-)
Balance as per cash book	32,500	
Cheques deposited but not credited by the bank		8900

Cheques issued but not presented for payment	12,500	
Dividend received through ECS	5,000	
Bank charges debited by bank		400
Balance as per Pass Book		40700
	50,000	**50,000**

Unit-IV

Consignment:

An arrangement whereby goods are left in the possession of another party to sell. Typically, the consignor receives a percentage of the sale (sometimes a very large percentage). Consignment deals are made on a variety of products - from artwork, to clothing, to books. In recent years, consignment shops have become rather trendy, especially those offering specialty products, infant wear and high-end fashion items.

It is also defined as a quantity of goods that are sent to a person or place to be sold the act or process of sending goods to a person or place to be sold.

Features of consignment are:

- The relation between the two parties is that of consignor and consignee and not that of buyer and seller
- The consignor is entitled to receive all the expenses in connection with consignment
- The consignee is not responsible for damage of goods during transport or any other procedure
- Goods are sold at the risk of consignor. The profit or loss belongs to consignor only

A consignor who consigns goods to a consignee transfers possession but not ownership of the goods to the consignee. The consignor retains title to the goods. The consignee takes possession of the goods subject to a trust. If the consignee converts the goods to a use not contemplated in the consignment agreement, for example selling them and keeping the proceeds of the sale for himself, then the consignee commits the crime of embezzlement.

Accounting Entries in the Books of Consignor:

(1)**On dispatch of goods:-**

Consignment account

To Goods sent on consignment account (With the cost of goods)

---

(2)**On payment of expenses on dispatch:-**

Consignment account

To Bank account (With the amount spent as expenses)

---

(3) **On receiving advance:**

Cash or bills receivable account

To Consignee's personal account (With the amount cash or bill)

---

(4)**On the consignee reporting sale (as per A/S):-**

Consignee's personal account

To Consignment account (With gross proceeds of sales)

---

(5) **For expenses incurred by the consignee (as per A/S):-**

Consignment account

To Consignee's personal account (With the amount of expenses)

---

(6) **For commission payable to the consignee:-**

Consignment account

To Consignee's personal account (With the amount of expenses)

<u>Difference between Consignment and Joint Venture</u>

The main differences between joint venture and consignment are as under:

1. Nature

Joint venture: It is a temporary partnership business without a firm name.

Consignment: It is an extension of business by principal through agent.

2. Parties

Joint venture: The parties involving in joint venture are known as co-ventures.

Consignment: Consignor and consignee are involving parties in the consignment.

3. Relation

Joint venture: The relation between co-ventures is just like the partners in partnership firm.

Consignment: The relation between the consignor and consignee is 'principal and agent'.

4. Sharing Profit

Joint venture: The profits ans losses of joint venture are shared among the co-ventures in their agreed proportion.

Consignment: The profits and losses are not shared between the consignor and consignee. Consignee gets only the commission.

5. Rights

Joint venture: The co-ventures in a joint venture have equal rights.

Consignment: In consignment, the consignor enjoys principal's right whereas consignee enjoys the right of agent.

6. Exchange Of Information

Joint venture: The co-ventures exchange the required information among them regularly.

Consignment: The consignee prepares an account sale which contains a details of business activities carried on and is being sent to the consignor.

7. Ownership

Joint Venture: All the co-ventures are the owners of the joint venture.

Consignment: The consignor is the owner of the business.

8. Method Of Maintaining Accounts

Joint venture: There are different methods of maintaining accounts in joint venture.As per agreement the co-ventures maintain their account.

Consignment: In consignment, there is only one method of maintaining account.

9. Basis of Account

Joint venture: Cash basis of accounting is applicable in joint venture.

Consignment: Actual basis is adopted in consignment.

10. Continuity

Joint venture: As soon as the particular venture is completed, the joint venture is terminated.

Consignment: The continuity of business exists according to the willingness of both consignor and consignee.

Loss of Goods on Consignment

The goods are consigned from one place to another. After receiving the goods by consignee, the goods are stored by the consignee before selling them to customers. It is natural that some loss to the goods may take place within that period. The goods may be lost, destroyed or damaged either in transit or in consignee's store. Such loss can be divided into two parts.

1. Normal Loss

The loss which is caused by unavoidable reasons is known as normal loss. For examples shrinkage, evaporation, leakage and pilferage. Such losses form part of cost of goods and no additional adjustment is required for this purpose. The normal loss is borne by goods units. The quantity of such loss is to be deducted from the total quantity sent by the consignor. The following formula may be used for the valuation of unsold stock.

Value of closing stock= (Total value of goods sent/Net quantity received by consignee) X unsold quantity

Net quantity received = Goods consigned quantity - Normal loss quantity.

2. Abnormal Loss

The loss which could be avoided by proper planning and care are abnormal loss. They are like theft, riots, accidents, fire, earthquake etc. These losses could occur in transit or in consignee's store and solely to be borne by consignor.

The abnormal loss should be adjusted before ascertaining the result of the consignment. The valuation of abnormal loss is done on the same basis as the unsold stock is valued. The journal entries for abnormal loss in different cases are as under:

If goods are not insured

For recording abnormal loss:

Abnormal loss A/C ....Dr.

To consignment A/C

For abnormal loss transferred:

Profit and loss A/C........Dr.

To abnormal loss A/C

If goods are insured and claim admitted in full

Bank/Consignee's/Insurance company A/C...........Dr.

To consignment A/C

If goods are insured and claim admitted in partial

Profit and loss A/C...........Dr. (Net loss amount)

Insurance Co./bank/consignee's A/c.......Dr. (Claim admitted)

To consignment A/c (total loss amount)

The following method should be followed while valuing abnormal loss:

A) Goods sent on consignment (at cost price)…............$ XXX

B) Add: Non-recurring expenses:

Consignor's expenses…...$ XXX

Consignee's expenses…...$ XXX

Total cost before abnormal loss A+B….........................$ XXX

Value of abnormal loss = (Total cost/Total units consigned) X abnormal loss units.

Question: A& Co. of Kolkata sent on consignment account goods to B& Co. of Mumbai at an invoice price of Rs.29675 and paid for freight Rs.762,Cartage rs.232 and insurance rs.700.Half the goods were sold by agents for Rs.17,500,subject to the agent's commission of Rs.875,storage expenses of Rs.200 and other selling expenses of Rs.350.One-fourth of the consignment was lost by fire and a claim of Rs.5000 was recovered. Draw up the necessary accounts in the books of A & Co. and ascertain the profit or loss made on the consignment. The consignor received a two months bill of exchange from the agents in satisfaction of the dues.

Solution:

Consignment of Mumbai Account

Particulars	**Amount**	**Particulars**	**Amount**
To Goods sent on consignment	29,675	By B& Co.(Sale proceeds)	17500
To Cash: Freight 762 Cartage 232 Insurance 700	1694	By Abnormal Loss A/C	7843
To B & Co. Commission 875 Storage Expenses 200	1425	By Consignment Stock A/C	7843

Other Selling Expenses 350			
To Net Profit (transferred to P&L A/C)	392		
	33186		**33186**

B & Co. Mumbai

Particulars	**Amount**	**Particulars**	**Amount**
To Consignment to Mumbai (sale proceeds)	17500	By Consignment to Mumbai(expense and commission)	1425
		By Bills Receiveble A/C	16075
	17500		**17500**

Abnormal Loss Account

Particulars	**Amount**	**Particulars**	**Amount**
To Consignment A/C	7843	By Bank(received from Insurance Co.)	5000
		By P&L A/C	2843
	7843		**7843**

Working Notes:

Calculation of Abnormal Loss

Particulars	Rupees
¼ of invoice Price of goods	7419(approx)
Add :¼ of Freight, Cartage and Insurance	424
Total Abnormal Loss	7843
Less: Recovered from insurance Co.	5000
Net Abnormal Loss	2843

Joint Venture:

An association of two or more individuals or companies engaged in a solitary business enterprise for profit without actual partnership or incorporation; also called a joint adventure.

A joint venture is a contractual business undertaking between two or more parties. It is similar to a business partnership, with one key difference: a partnership generally involves an ongoing, long-term business relationship, whereas a joint venture is based on a single business transaction. Individuals or companies choose to enter joint ventures in order to share strengths, minimize risks, and increase competitive advantages in the marketplace. Joint ventures can be distinct business units (a new business entity may be created for the joint venture) or collaborations between businesses. In a collaboration, for example, a high-technology firm may contract with a manufacturer to bring its idea for a product to market; the former provides the know-how, the latter the means.

Difference between a Joint venture and Partnership

Partnership

A partnership is a legal arrangement where two or more people own a business together. This means that the entire business is shared for as long as the business exists. Both partners contribute money, time and expertise to making a profitable enterprise, and that enterprise lasts until the partnership is dissolved.

Joint Venture

You enter a joint venture for a specific project. There is a time limit on joint ventures, and they have clearly stated limits on their purposes. You might enter a joint venture in order to make a product that neither partner can afford to make on her own. An example is developing new software. You do not give up half of your business in a joint venture; you share the profits and expenses for a particular venture.

Difference between Consignment and Joint Venture

The main differences between joint venture and consignment are as under:

1. Nature

Joint venture: It is a temporary partnership business without a firm name.

Consignment: It is an extension of business by principal through agent.

2. Parties

Joint venture: The parties involving in joint venture are known as co-ventures.

Consignment: Consignor and consignee are involving parties in the consignment.

3. Relation

Joint venture: The relation between co-ventures is just like the partners in partnership firm.

Consignment: The relation between the consignor and consignee is 'principal and agent'.

4. Sharing Profit

Joint venture: The profits ans losses of joint venture are shared among the co-ventures in their agreed proportion.

Consignment: The profits and losses are not shared between the consignor and consignee. Consignee gets only the commission.

5. Rights

Joint venture: The co-ventures in a joint venture have equal rights.

Consignment: In consignment, the consignor enjoys principal's right whereas consignee enjoys the right of agent.

6. Exchange Of Information

Joint venture: The co-ventures exchange the required information among them regularly.

Consignment: The consignee prepares an account sale which contains a details of business activities carried on and is being sent to the consignor.

7. Ownership

Joint Venture: All the co-ventures are the owners of the joint venture.

Consignment: The consignor is the owner of the business.

8. Method Of Maintaining Accounts

Joint venture: There are different methods of maintaining accounts in joint venture.As per agreement the co-ventures maintain their account.

Consignment: In consignment, there is only one method of maintaining account.

9. Basis of Account

Joint venture: Cash basis of accounting is applicable in joint venture.

Consignment: Actual basis is adopted in consignment.

10. Continuity

Joint venture: As soon as the particular venture is completed, the joint venture is terminated.

Consignment: The continuity of business exists according to the willingness of both consignor and consignee.

FEATURES OF A JOINT VENTURE

The main features of a joint venture are specifically made clear.

- Two or more person are needed.
- It is an agreement to execute a particular venture or a project.
- The joint venture business may not have a specific name.
- It is of temporary nature. So the agreement regarding the venture automatically stands terminated as soon as the venture is complete.
- The co-ventures share profit and loss in an agreed ratio. The profits and losses are to be shared equally if not agreed otherwise.

- The co-ventures are free to continue with their own business unless agreed otherwise during the life of joint venture.

Accounting Entries in a Joint Venture

Transactions	**Debit**	**Credit**
(1)When venture contributes cash to joint funds	Joint Bank A/C (total Amount)	Venturer's A/C(individual contribution)
(2) When amount is spent on account of expenses, for purchasing goods for the venture	Joint venture A/C	Joint Bank A/C
(3)If any expenses are paid by the venturers	Joint Venture A/C	Venturer's A/C
(4)For Sales: i. Cash ii. Credit	Joint Bank A/C Sundry Debtors A/C	Joint Venture A/C Joint Venture A/C
(5) If Stock is taken by a venturer	Venturer's A/C	Joint Venture A/C
(6)If any stock remains unsold	Joint Venture Stock A/C	Joint venture A/C
(7) Balance of the Joint venture A/C will be either profit or Loss.	Joint Venture A/C(if profit)	Venturer's A/C

If Loss	Venturer's A/c	Joint Venture A/C
(8)Joint Bank Account and personal account of the Venturer's A/C will be automatically closed by the introduction and the withdrawal of cash.		

Hire Purchase:

Hire Purchase is defined asa system for purchasing merchandise, such as cars or furniture, in which the buyer takes possession of the merchandise on payment of a deposit and completes the purchase by paying a series of regular installments while the seller retains ownership until the final installment is paid

A method of buying goods through making installment payments over time. The term hire purchase originated in the U.K., and is similar to what are called "rent-to-own" arrangements in the United States. Under a hire purchase contract, the buyer is leasing the goods and does not obtain ownership until the full amount of the contract is paid.

Parties in a Hire-Purchase System:

1. **Hirer-**who buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate (each jurisdiction has a different formula for calculating the amount of this rebate).He also to pay the hire installments and to take reasonable care of the goods (if the hirer damages the goods by using them in a non-standard way, he or she must continue to pay the installments and, if appropriate, recompense the owner for any loss in asset value).
2. **Seller-** a person who has the resources and the legal right to sell the goods on credit (which usually depends on a licensing system in most countries), the seller and the owner will be the same person. But most sellers prefer to receive a cash payment immediately

.He also has the right to terminate the agreement where the hirer defaults in paying the installments or breaches any of the other terms in the agreement.

Hire Purchase agreements must be in writing and signed by both [parties].They must clearly lay out the following information in a print that all can read without effort:

1. A clear description of the goods
2. The cash price for the goods
3. The Hire Purchase price, i.e., the total sum that must be paid to hire and then purchase the goods
4. The deposit
5. The monthly installments (most states require that the applicable interest rate is disclosed and regulate the rates and charges that can be applied in HP transactions) and
6. A reasonably comprehensive statement of the parties' rights (sometimes including the right to cancel the agreement during a "cooling-off" period).
7. The right of the hirer to terminate the contract when he feels like doing so with a valid reason.

Characteristics of Hire-Purchase System

The characteristics of hire-purchase system are as under

- Hire-purchase is a credit purchase.
- The price under hire-purchase system is paid in installments.
- The goods are delivered in the possession of the purchaser at the time of commencement of the agreement.
- Hire vendor continues to be the owner of the goods till the payment of last installment.
- The hire-purchaser has a right to use the goods as a bailer.
- The hire-purchaser has a right to terminate the agreement at any time in the capacity of a hirer.
- The hire-purchaser becomes the owner of the goods after the payment of all installments as per the agreement.
- If there is a default in the payment of any installment, the hire vendor will take away the goods from the possession of the purchaser without refunding him any amount.

Thus," **hire- purchase agreement**" means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-

- possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical installments, and
- the property in the goods is to pass to such person on the payment of the last of such installments, and (iii) such person has a right to terminate the agreement at any time before the property so passes;
- " hirer" means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement, and includes a person to whom the hirer' s rights or liabilities under the agreement have passed by assignment or by operation of law;
- “owner" means the person who lets or has let, delivers or has delivered possession of goods, to a hirer under a hire- purchase agreement and includes a person to whom the owner' s property in the goods or any of the owner' s rights or liabilities under the agreement has passed by assignment or by operation of law.

Difference between Hire-Purchase System and Installment System

Installment Payment System is system of purchase and sale of goods in which title of goods is immediately transferred to the purchaser at the time of sale of goods and the sale price of the goods is paid in installments. In the event of default in payment of any installment, the seller has no right to take back goods from the possession of the purchaser. He can file a suit for the recovery of the outstanding balance of the price of goods sold.

The followings are the differences between Hire-purchase system and Installment payment system:

- In **Hire-purchase system**, the transfer of ownership takes place after the payment of all installments while in case of **Installment payment system**, the ownership is transferred immediately at the time of agreement.
- In **Hire-purchase system**, the hire-purchase agreement is like a contract of hire though later on it may become a purchase after the payment of last installment while in **Installment payment system**, the agreement is like a contract of credit purchase.
- In case of default in payment, in **Hire-purchase system** the vendor has a right to back goods from the possession of the hire-purchaser while in case of **Installment payment system**, the vendor has no right to take back the goods from the possession of the purchaser; he can simply sue for the balance due.
- In **Hire-purchase system**, if the purchaser sells the goods to a third party before the payment of last installment, the third party does not get a better title on the goods

purchased. But in case of **Installment payment system**, the third party gets a better title on the goods purchased.

- In **Hire-purchase system** the provisions of the Hire-purchase Act apply to the transaction while in case of **Installment payment system**, the provisions of Sale of Goods Act apply to the transaction.

Accounting Entries in the Books of Hire purchaser

Journal Entries in the Books Of Hire Purchaser

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

i. When the asset is recorded in full cash price-full cash price method

ii. When the asset is recorded at cash price actually paid in each installment-: Actual cash price method.

1. **For the purchase of asset**:

First Method

Asset A/C (full cash price)...........Dr.

To vendor A/C

Second Method

No entry

2. **For the payment made for 'down payment'**

First Method

Vendor A/C.............Dr.

To bank A/C

Second Method

Asset A/C............Dr.

To Bank A/C

3. **For installment due**

First Method

Interest A/C............Dr.

To vendor A/C

Second Method

Asset A/C (part of cash value)............Dr.

To Interest A/C

4. **For the payment of installment (both method)**

Vendor A/C............Dr.

To Bank A/C

5. **For charging depreciation(on the basis of cash value) (both methods)**

Depreciation A/C...................Dr.

To Asset A/C

6. **For transfer of interest and depreciation (both methods)**

Profit and loss A/C............Dr.

To depreciation A/C

To interest A/C

Journal Entries In The Books Of Vendor

1. **For selling goods on hire purchase**

Hire purchase A/C...........Dr. (full cash price)

To sales/hire purchase sales A/C

2. **For receiving down payment**

Cash/bank A/C.................Dr.

To hire purchaser A/C

3. **For installment due**

Hire purchaser A/C............Dr.

To Interest A/C

4. **For receiving the installment**

Cash/bank A/C ....Dr.

To hire purchaser A/C

5. **For transferring interest**

Interest A/C............Dr.

To profit and loss A/C

Posting in Ledger Accounts: After passing journal entries under any of the methods discussed above, the following ledger accounts are opened in the ledger and the postings are made accordingly.

(i) Asset A/c. (e.g. Trucks A/c, Machinery A/c. etc.)
(ii) Vendor's A/c.
(iii) Interest A/c.
(iv) Depreciation A/c.

Note: Before recording the entries the amounts of interest and depreciation will be calculated in two separate tables showing the calculations of interest and depreciation.

Calculation of Interest

The total payment made under hire-purchase system is more than cash price. In fact, this excess of payment over the cash price is interest. It is very essential to calculate interest because the amount paid for interest is charged to revenue and the asset is capitalized at cash price. Thus normally all installments will include a part of cash price and a part of interest on the outstanding balance. However the amount paid at the time of agreement (down payment) will not include any interest. The calculation of interest is made under two conditions:

(a) When interest is included in amount of installment: Where the hire-purchase price i.e. payment made in the form of down payment and all installments is more than the cash price, it is regarded that the interest is included in installments.

Illustration: On Ist April, 2005 Mr. X purchased from M/s Y & Co. one 'Motor Truck' under hire-purchase system, Rs. 5,000 being paid on delivery and the balance in five annual installments of Rs. 7,500 each payable on 31st March each year. The cash price of the motor truck is Rs. 37,500 and vendors charge interest at the rate of 5 per cent per annum on yearly balances. Find out the amounts of principal and interest included in each installment.

Calculation of Interest

Calculation of Intt.		Cash Price Rs.	Instalments Principal Rs.	Intt. Rs.	Total Rs.
Cash Price		37,500			
Less paid on delivery		- 5,000	5,000	-	5,000
		32,500			
First Instalment	7,500				
Less Intt. on Rs. 32,500 @ 5%	1,625				
Principal	5,875	-5,875	5,875	1,625	7,500
		26,625			
Second Instalment	7,500				
Less Intt. on Rs. 26,625 @ 5%	1,331				
Principal	6,169	- 6,169	6,169	1,331	7,500
		20,456			
Third Instalment	7,500				
Less Intt. on Rs. 20,456 @ 5%	1,023				
Principal	6,477	-6,477	6,477	1,023	7,500
		13,979			
Fourth Instalment	7,500				
Less Intt. on Rs. 13,979 @ 5%	699				
Principal	6,801	- 6801	6,801	699	7,500
		7,178			
Fifth Instalment	7,500				
Less Amount unpaid	7,178				
Interest	322	- 7,178	7,178	322	7,500
Total:		x	37,500	5,000	42,500

(b) When interest is not included in installments: Where the total amount paid in the form of down payment and all installments is exactly equal to the cash price, it is regarded that the interest is not included in installments. It means that interest is payable in addition to the agreed amount of installment.

Question: On April 1,2005, A Transport Company purchased a Motor Lorry from Motor Supply Co. Ltd. on hire-purchase basis, the cash price being Rs. 60,000. Rs. 15,000 on signing of the contract and balance in three annual installments of Rs. 15,000 each on 31st March every year. In addition to it, interest at 5 per cent per annum was also payable to vendors on outstanding balances.

Calculation of Interest

Calculation of Intt.		Cash Price	Instalments		
			Principal	Intt.	Total
		Rs	Rs	Rs.	Rs.
Cash Price		60,000			
Less:Down payment		15,000	15,000	-	15,000
		45,000			
Ist Instalment	15,000				
Int. @ 5% on 45,000	2,250				
Total:	17,250	15,000	15,000	2,250	17,250
		30,000			
2nd Instalment	15,000				
Int. @ 5% on 30,000	1,500				
Total:	16,500	15,000	15,000	1,500	16,500
		15,000			
3rd Instalment	15,000				
Int. @ 5% on 15,000	750				
Total:	15,750	-	15,000	750	15,750
		15,000			
Total:		Nil	60,000	4,500	64,500

Branch Accounting

An accounting system in which separate accounts are maintained for each branch of a corporate entity or organization. The primary objectives of branch accounting are better accountability and control, since profitability and efficiency can be closely tracked at the branch level.

Branch accounting may involve added expenses for an organization in terms of accounting and infrastructure. This is because it may be necessary to appoint branch accountants to ensure accurate financial reporting and compliance with head office procedures and processes.

Types of Branches

The branches opened in the different parts of the nation, where the original undertaking being registered are called inland branches. These types of branches are also called home branches or national branches. There are two types of inland branches, which are:

a) Dependent branch

b) Independent branch

a) Dependent Branch:

Dependent branches are the branches that do not keep their records but all the records are maintained by head office. They are not authorized to act solely without the prior permission of the head office. All the plans, policies, rules and regulations of these branches are totally formulated and executed by the head office. In other words, all the functions of dependent branch are totally controlled by head office.

b). Independent Branch:

The branches that can keep their accounts themselves and sell goods that are sent by the head office as well as those purchased by themselves are known as independent branches. These are the branches which can sell the goods to head office too. They can pay their own expenses and can deposit their collection in their own name in the bank. These branches record separately and independently all the transactions which are even recorded by the head office.

Systems of Accounting:

Stock and Debtors system is generally used when the goods are sent to the branch at pro-forma invoice price and the size of the branch is large. Under this system, the branch maintains a few central accounts to exercise greater control over the branch stock and other related expenses. These accounts are as follows:

1.Branch Stock Account
2.Branch Debtors Account
3.Branch Expenses Account
4.Branch Adjustment Account
5.Goods Sent to Branch Account
6.Branch Stock Reserve Account

Branch Stock Account

This account is on the pattern of a stock account. The account helps the Head Office in maintaining an effective control over the Branch Stock and tells about shortage and surplus in the branch stock because of the difference between the pro-forma invoice price and the selling price.

Unlike traditional accounting practice, branch stock a/c is always maintained on the selling price or pro-forma invoice price. Selling price is used to record the goods sold by the branch to its customer and goods returned by the branch customers.

Branch Debtors Account

Branch debtors' a/c is maintained in the traditional manner to record transactions in between branch and its credit customers

Branch Expense Account

The purpose of maintaining this account is nothing but the compile all branch expenses at one place. This will include all types of expenses i.e. cash based expenses and receivables based expenses

Branch Adjustment Account

Branch adjustment a/c replaces the branch income statement (profit & loss a/c). This is the account in which all expenses and losses are closed along with the margin that is a difference between cost and the selling price. This difference is split into two; one is termed as "surplus" that comes from the branch stock a/c representing the difference between selling price and pro-forma invoice price, the second is termed as "loading" that represents the difference between pro-forma invoice price and cost. This loading is calculated on opening and closing stock balances and also on the net of the goodssent branch.

Goods Sent to Branch Account

This is a supporting account, which is maintained to show second effects of the goods sent to branch and the goods returned from branch at pro-forma invoice price.
Although the goods sent to and returned form the branch should be adjusted in the purchases a/c of the head office, but as we know that the branch stock a/c is not maintained at cost price, therefore, second effect of goods sent to and returned from branch is not recorded directly into the purchases a/c instead this second effect is recorded into the goods sent to branch a/c which after adjustment of the loading is finally closed into the purchases a/c.

Branch Stock Reserve Account

This is contra to branch stock account. In this account opening and closing balance of loading on branch stock is maintained.

Accounting Entries in books of head office under Debtors system of Branch Accounting

1) For Goods sent by Head Office to the Branch

   Branch A/C   Dr.

   To Goods sent to the Branch A/C

2) For Goods returned by the Branch to H.O.

   Goods sent to the Branch A/C   Dr.

   To Branch A/C

3) For Goods sent by the Branch to another Branch at instructions from the H.O.

Goods sent to Branch A/C Dr.

To Branch A/C

4) For Goods returned by the Branch Debtors to H.O. directly

Goods sent to Branch A/C Dr.

To Branch A/C

5) For Expenses at the Branch met by the H.O.

Branch A/C Dr.

To Bank A/C

6) For Assets at the Branch at end of accounting period

Branch Assets A/C Dr.

To Branch A/C

7) For Liabilities at the end of the accounting period

Branch A/C Dr.

To Branch Liabilities/C

8) For Profit/Loss

If Profit: Branch A/C Dr.

To General P&L A/C

If Loss: General P&L A/c

To Branch A/C

9) For transfer of Balance in Goods sent to Branch account

Goods sent to Branch A/C Dr.

To Purchases/Trading A/C

10) For remittance of cash or cheque to the branch

Branch A/C Dr.

To Cash/Bank A/C

Question:Excellent Garments of Multan has a branch at Lahore. Goods are supplied to the branch at cost. The expenses of the branch are paid from Multan and the branch keeps a sales journal and the debtors' ledger only. From the following information supplied by the branch, prepare a Branch Account in the books of the head office. Goods are sent to branch at pro-forma invoice price which is cost plus 20%.(All figures in rupees).

Opening Stock (at Pro-forma invoice) 28,800, Closing Debtors9,150

Closing Stock (at Pro-forma invoice) 21,600

Opening Debtors 6200

Goods received from HO(at Pro-forma invoice)

Bad Debt 140

Credit Sales 41,000

Expenses paid by Head office 10,400

Cash Sales 17,500

Cash received from Debtors 37,900

Pilferage of goods by the employees(Normal Loss) 2,000

<u>Solution:</u>

(Debtors System)

In the books of H.O. (Multan)

Lahore Branch Account

Particulars	Amount	Particulars	Amount
Opening Stock	24,000	Cash Recd.fromBranch	17500
Opening Debtors	6200	Cash Recd. From Debtors	37900
Cash sent to Branch	10400	Goods sent to Branch	6720
Goods sent to Branch	40,320	Closing Stock	18000
To general P&L A/C	8360	Closing Debtors	9160

	89280		**89280**

Debtors Account

Particulars	Amount	Particulars	Amount
Opening Debtors(bal.fig.6200)		Cash recd.from Debtors	37900
Credit Sales	41000	Bad Debt	140
		Closing Debtors (c/.f.)	9160
	47200		**47200**

<u>Question:</u> On 1st January, 2008 goods costing Rs. 132,000 were invoiced by Multan head office to its new branch at Lahore and charged at selling price to produce a gross profit of 25% on the selling price. At the end of the year, the return from Lahore Branch showed that the credit sales were Rs. 150,000. Goods invoiced at Rs. 2,000 to Lahore branch have been returned to Multan head office. The closing stock at Lahore branch was Rs. 24,000 at selling price. Record the above transactions in the books of

(i)Lahore Branch Stock Account; (ii) Goods Sent to Lahore Branch Account; (iii)Lahore Branch Adjustment Account; and (iv) Lahore Branch Debtors Account in the head office book and close the said accounts on 31st December 2008.

In the Books of the Head Office, Multan

Lahore Branch Stock Account

Particulars	Amount	Particulars	Amount
To Goods sent to Lahore Branch	176000	By goods sent to Lahore Branch	2000
		By a/c returns	150000
		By Branch Debtors(Cr.Sales)	24,000
	176000		**176000**

Goods Sent to Lahore Branch Account

Particulars	Amount	Particulars	Amount
To Lahore Branch Stock A/c(Returns)	2000	By Lahore Branch stock a/c	176000
To Lahore branch adj.a/c	43500		
Topurchases(bal.fig.)	130500		
	176000		**176000**

Lahore Branch Debtors Account

Particulars	Amount	Particulars	Amount
To Lahore Branch Stock a/c	150000	By balance c/d	150000
	150000		150000

Lahore Branch adjustment Account

Particulars	Amount	Particulars	Amount
To Stock Reserve	6000	By goods sent to Delhi Branch	43500
To general P&L a/c	37500		
	43500		43500

<u>Independent Branch Accounting:</u>

Accounting Entries under Independent Branch:

A. For goods supplied by head office to branch:

Branch book:

Goods supplied by head office A/C.........Dr.
To Head office A/C
(Being receipt of goods)

Head office book:
Branch A/C..............Dr.
To goods supplied to branch A/C
(Being goods sent to branch)

B. **For cash remitted by head office to branch:**
Branch book:
Cash A/C..............Dr.
To head office A/C
(Being cash received)

Head office book:
Branch A/C ....Dr.
To cash A/C
(Being cash sent to branch)

C. **For goods returned by branch:**
Branch book:
Head office A/C............Dr.
To goods supplied to head office A/C
(Being goods return to head office)

Head office book:

Goods supplied from branch A/C............Dr.

To Branch A/C

(Being goods returned from branch)

D. **For cash remitted by branch to head office:**

Branch book:

Head office A/C.............Dr.

To cash

(Being cash sent to head office)

Head office book:

Cash A/C.................Dr.

To Branch A/C

(Being cash received from branch)

E. **For assets purchased by branch on behalf of head office:**

Branch book:

Head office A/C ....Dr.

To cash A/C

(Being purchase of assets)

Head office book:

Branch assets A/C.............Dr.

To branch A/C

(Being assets purchased by branch)

F. **For depreciation charged:**

Branch book:

Depreciation A/C ....Dr.

To Head office A/C

(Being depreciation on branch fixed assets)

Head Office book:

Branch A/C...................Dr.

To branch assets A/C

(Being depreciation of branch fixed assets)

G. **For expenses incurred by head office**

Branch book

Expenses A/C.............Dr.

To head office A/C

(Being expenses incurred by head office)

Head office book:

Branch A/C......................Dr.

To profit and loss A/C

(Being expenses incurred for branch)

<u>Accounting For Partnership/LLP Firms:</u>

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners, when a partner is admitted to the existing partnership firm, it is called admission of a partner.
According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon.
On admission of a new partnerthe partnership firm is reconstituted with a new agreement. For example, Rekha and Nitesh are partners sharing profit in the ratio of 5:3. On April 1, 2006 they admitted Nitu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Nitu as partner, the firm stands reconstituted.
On the admission of a new partner, the following adjustments become necessary:
(i) Adjustment in profit sharing ratio;
(ii) Adjustment of Goodwill;
(iii) Adjustment for revaluation of assets and reassessment of liabilities;
(iv) Distribution of accumulated profits and reserves; and
(v) Adjustment of partners' capitals

Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either incoming from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner, hence the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in the favour of the new partner.
Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Question:

Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution:

Calculation of new profit sharing ratio:

Let total Profit = 1
New partner's share = 1/5
Remaining share = 1 – 1/5 = 4/5

Deepak's new share = 3/5 of 4/5 i.e. 12/25

Vivek's new share = 2/5 of 4/5 i.e. 8/25
Ashu's Share = 1/5
The new profit sharing ratio of Deepak, Vivek and Ashu is :
= 12/25 : 8/25 : 1/5 = 12 : 8 : 5/25 = 12 : 8 : 5
So Deepak Sacrificed = 3/5 – 12/25 = 15 – 12/25 = 3/25
Vivek Sacrificed = 2/5 – 8/25 = 10 – 8/25 = 2/25
Sacrificing Ratio = 3 : 2
Sacrificing ratio of the existing partners is same as their existing ratio.

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.
In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Only the new partner's share is given
In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

When a new partner is admitted in the firm, the existing/old partners have to sacrifice, what is given to the new partner, from their future profits, the reputation they have gained in their past efforts and the side of capital they have taken before. The new partner when admitted, has to compensate for all these sacrifices made by the old ones. The compensation for such sacrifice can be termed as 'goodwill'. Hence, at the time of admission of the new partner, it is necessary to account the valuation of goodwill in the firm.

If the new partner brings in cash for his share of goodwill, in addition to his capital, it is known as premium method. When the new partner brings nothing but only the capital, and the value of goodwill is erected or raised, this method of treatment is called Revaluation Method. However, once creating the value of goodwill and writing of the same after admission is done, it can be said to be Memorandum Revaluation Method. Thus, keeping in mind, all these methods, the various ways of treating goodwill in the books of the firm at the time of admission of the new partner, are as follows:

1. Share of goodwill brought by the new partner in cash.
2. Share of goodwill brought by the new partner in kind.
3. Nothing is brought by the new partner as his share of goodwill.
4. Share of goodwill brought by the new partner in cash only a portion not as a whole.
5. Hidden goodwill

1. When the new partner brings his share of goodwill in cash

When the new partner brings his share of goodwill in cash, the payment ma be made to the old partners, as if outside/private transaction. It may be retained in the business or after recording the same in the firm, the old partners may withdraw the whole amount or some portion only,

a. When the amount of goodwill brought by the new partner is not recorded in the books and the payment is made to the old partners as outside or private transaction, it does not affect in the transaction of the firm and hence no entry is passed in the books of the firm

b.When the amount of goodwill brought in by the new partner is retained in the business to increase cash resources, and if there exists already no-goodwill:

i) Cash/Bank A/C.......................Dr.

To Goodwill A/c

(Being goodwill brought in by the new partner)

ii) Goodwill A/C..........................Dr.

To old partners' capital A/C

(Being goodwill credited to old partners in the sacrificing ratio)

c. When there is no-goodwill already appeared in the books and the amount of goodwill brought in by the new partner, is fully or partially withdrawn by the old partners:

i) Cash A/C.......................Dr.

To Goodwill A/C

(Being goodwill brought by the new partner)

ii) Goodwill A/C................Dr.
To old partners' capital A/C
(Being goodwill divided among old partners)
iii) Old partners' capital A/C...............Dr.
To Cash/Bank A/C
(Being the amount withdrawn)

d. When there is goodwill already appeared in the books and even then if the new partner brings his share of goodwill in cash, the amount may be retained or withdrawn by the old partners. If the amount of goodwill brought in by the new partner is retained in the business:
i) Old partners' capital A/C..............................Dr.
To Goodwill A/C
(Being goodwill appearing in the book written off in the old ratio)
ii) Cash/Bank A/C.......................Dr.
To Goodwill A/C
(Being goodwill brought in by the new partner)
iii) Goodwill A/C.......................Dr.
To old partners' capital A/C
(Being goodwill brought in by new partner shared by the old partners)

If the goodwill amount brought by the new partner is withdrawn by the old partners, the following extra entry should also be passed:
Old partners' capital A/C.............Dr.
To Cash/Bank
(Being amount withdrawn)

If they agree to show the original value of goodwill in the books, it is raised by passing the entry:
Goodwill A/C ....Dr.
To All partners capital A/C
(Being goodwill raised)

2. When the new partner brings his share of goodwill in kind

The new partner may bring his share of goodwill and capital in kind i.e. the form of assets instead of cash. Again, new partner may have an established name in the market among the customers. In such case, he may be recognized for his goodwill. As a result he will bring a lesser amount of assets than the amount of credited to him. This requires two journal entries:

i) All assets A/C............................Dr.
Goodwill A/C/New partner's capital A/C
(Being goodwill brought in kind by the new partner)
ii) Goodwill A/C/New partner's capital A/C................Dr.
To old partners' capital A/C
(Being goodwill shared by the old partners)

3. When the new partner is unable to bring his share of goodwill in cash or kind

When the new partner cannot bring anything for his share of goodwill, first of all we have to see if there exists goodwill already or not. If there is no-goodwill already appearing in the books of the firm, goodwill is raised at its full value. If goodwill already appears in the books, it is compared to the full value of goodwill raised or created and the adjustment is done accordingly.

a. When the new partner is unable to bring his share of goodwill and if there is no-goodwill already appearing in the books, goodwill is raised at its full value:

i) Goodwill A/C.................Dr.
To old partners' capital A/C
(Being goodwill is created at its full value and credited to the old partners in old ratio)
* By this entry, goodwill A/C then appears as an asset in the balance sheet of the firm.

b. If the new partner cannot bring his share of goodwill and there appears goodwill already in the books, even then goodwill is raised at its full value. If the raised value of goodwill is equal to the existing value of goodwill, no entry what so ever is needed. If the raised goodwill is more than the existing goodwill, then goodwill will be credited to the old partner's capital A/C by the excess amount only:

Goodwill A/C......................Dr. (excess value)
To old partners' capital A/C
(Being the value of goodwill increased to..../increased by......)
* Goodwill then appears at its full value in the balance sheet of the firm

c. If the raised value of goodwill is less than the existing value of goodwill, then excess over raised value of goodwill is written off:
Old partners' capital A/C................Dr.
To Goodwill A/C
(Being the goodwill written off by the reduction in value)

d. Whatever the case may be stated in a,b,c, the partners may not wish goodwill in the books for an indefinite period after the admission of new one, as the value of goodwill changes constantly. They may write off the whole or some portion of the value of goodwill. For writing off the goodwill:
All partners' capital A/C.............Dr.
To Goodwill A/C
(Being goodwill written off)

4. When the new partner can bring only a portion of his share of goodwill

When the new partner cannot bring the entire amount of his share of goodwill and he brings only a part of this, it is shared by the old partners in sacrificing ratio. Then goodwill A/C is raised in the books for the portion not brought by the new partner which is also credited to the old partners in their sacrificing ratio. Goodwill raised for the part of goodwill not brought in by the new partner is calculated as under:
= (Full value of goodwill/share of goodwill of new partner) X goodwill not brought in

But it should be remembered that , if there exists any goodwill in the books, first it should be written off by crediting to the old partners in old ratio. Therefore, the entries are:
i) Old partners' capital A/C..................Dr.
To Goodwill A/C

(Being goodwill written off)

ii Cash/Bank A/C........................Dr.

To Goodwill A/C

(Being the portion of goodwill brought in by new partner)

iii) Goodwill A/C.......................Dr.

To old partners' capital A/C

(Being the goodwill brought in by new partner credited to old partners)

iv) When the goodwill is raised for the part of goodwill not brought in by the new partner, the amount of goodwill is calculated as said above. The entry would be the same as in iii), only the amount being different, which is shared by the old partners in their old profit sharing ratio.

5. Hidden Goodwill

When the value of goodwill is not given in the question, the value of goodwill has to be calculated on the basis of total capital/net worth of the firm and profit sharing ratio.

A. New partner's capital X Reciprocal of the share of new partner....XXX

B. Less net worth(excluding goodwill) of new firm..............................XXX

C. A-B = Value of goodwill...XXX

<u>Retirement of a Partner:</u>

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

A partner retires either :

(i) with the consent of all partners, or

(ii) as per terms of the agreement; or

(iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. At the time of retirement the following accounting issues are dealt :
(a) New profit sharing ratio and gaining ratio.
(b) Goodwill
(c) Adjustment of changes in the value of Assets and liabilities
(d) Treatment of reserve and accumulated profits.
(e) Settlement of retiring partners dues,
(f) New capital of the continuing partners.

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

Gaining Ratio = New Ratio – Existing Ratio

Various cases of new ratio and gaining ratio are illustrated as follows:
(i) Retiring partner's share distributed in Existing Ratio :
In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio.
The following example illustrates this :
Tanu, Manu and Rena are partners sharing profits and losses in the ratio of = 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.
Existing Ratio between Manu and Rena = 3/9 and 2/9
Tanu's Ratio (retiring partner) = 4/9
Tanu's share taken by the Manu and Rena in the ratio of 3 : 2
Manu's gets = 4/9 × 3/5 = 12/45
Manu's New Share = 3/9 + 12/45 = 27/45
Rena's gets = 4/9 × 2/5 = 8/45
Rena's New Share = 2/9 + 8/45 = 18/45
New ratio between Manu and Rena is 27/45 : 18/45 = 27 : 18 = 3 : 2.
Gaining Ratio = New Ratio – Existing Ratio
Manu Gain = 27/45 – 3/9 = 12/45

Rena Gain = 18/45 – 2/9 = 8/45
12/45 : 8/45
3 : 2
You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.
Note: In absence of any information in the question, it will be presumed that retiring partner's share has been distributed in existing ratio.

(ii) Retiring partner's share distributed in Specified proportions:
Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.
B's Share = 2/6
B's share is divided between A and C in the ratio of 1 : 1.
A gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6
A's New Share = 3/6 + 1/6 = 4/6
C's gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6
C's New share = 1/6+1/6 = 2/6

Gaining Ratio = New Ratio – Existing, Ratio

(iii)Retiring Partner's share is taken by one of the partners
The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of partner's existing share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:
Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is 2/11 + 4/11 = 6/11, Anuj share will remain unchanged i.e, 5/11. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.

Treatment of Goodwill

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS-10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own. Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with. his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c Dr. (individually)
To Retiring Partner's Capital A/c
(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio).

When the Goodwill Account already appears in the Books
Normally the goodwill is not shown in the books of the firm. If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital account in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)

To Goodwill A/c

(Existing goodwill written-off)

<u>Revaluation of Assets and Liabilities:</u>

At the time of retirement of a partner the assets and liabilities of the firm are revalued and Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner.

Any profit or loss due to revaluation is divided amongst all the partners including Retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose :

(i) **For increase in value of assets:**
Assets A/c Dr. [Individually]
To Revaluation A/c
(Increase in the value of assets)

(ii) **For decrease in value of assets:**
Revaluation A/c Dr.
To Assets A/c (Individually)

(decrease in the value of asset)

(iii) **For increase in value of Liabilities**:
Revaluation A/c Dr.

To Liabilities A/c [Individually]

(Increase in the value of liabilities)

(iv) **For decrease in value of Liabilities:**
Liabilities A/c Dr. [Individually]
To Revaluation A/c
(decrease in the value of liabilities)

Revaluation account is prepared to record the change in the value of assets or liabilities. It will reveal profit or loss on revaluation. This profit or loss is divided amongst all partners including the retiring/deceased partner in existing profit sharing ratio.

(iv) **For Profit on Revaluation :**
Revaluation A/c Dr. (Individually)
To Partner's Capital A/c
(Profit on revaluation divided amongst all partners in their existing profit sharing ratio)

(v**) For loss on Revaluation:**
Partner's Capital A/c Dr. (Individually)
To Revaluation A/c
(Loss on revaluation borne by all partners in their existing profit sharing ratio.

(vi) **For distribution of undistributed profit and reserve.**
Reserves A/c Dr
Profit & Loss A/c (Profit) Dr.
To Partners' Capital A/c (individually)

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

(vii)**For distribution of undistributed loss**
Partners' Capital A/c Dr. (individually)
To Profit & Loss A/c (Loss)
[Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio]

Death of a Partner:

The death of a partner dissolves the partnership. On the date of death, the accounts are closed and the net income for the year to date is allocated to the partners' capital accounts. Most agreements call for an audit and revaluation of the assets at this time. The balance of the deceased partner's capital account is then transferred to a liability account with the deceased's estate.

The surviving partners may continue the business or liquidate. If the business continues, the procedures for settling with the estate are the same as those described earlier for the withdrawal of a partner.

On the death of a partner, the accounting treatment regarding goodwill, Revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :
(a) The amount standing to the credit to the capital account of the deceased partner
(b) Interest on capital, if provided in the partnership deed upto the date of death:
(c) Share of goodwill of the firm;
(d) Share of undistributed profit or reserves;
(e) Share of profit on the revaluation of assets and liabilities;
(f) Share of profit upto the date of death;
(g) Share of Joint Life Policy.
The following amounts are debited to the account of the deceased partner's legal representatives:
(i) Drawings
(ii) Interest on drawings
(iii) Share of loss on the revaluation of assets and liabilities;
(iv) Share of loss that have occurred till the date of his/her death.
The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.
The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement the legal representative of adeceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment.

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

(ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly throughout the year.
For example:
The total profit of previous year is Rs. 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is Rs. 31,250 i.e. 1,25,000 × 3/12, if the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is Rs. 6,250 i.e. Rs. 31,250 × 2/10.

(ii) Turnover or Sales Basis

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

Illustration 12

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

Solution :

Profit from 1st April 2006 to 31st May 2006 on the basis of sales:
If sales are Rs.4,00,000, profit is Rs.60,000
If the sales are Rs.1,00,000 profit is : 60,000/4,00,000 × 1,00,000
= Rs.15,000
Neha's share= 15,000 × 1/6 = Rs.2,500
Alternatively profit is calculated as
Rate of profit =60000/400000×100 = 15%
Sale up to date of death = 1,00,000
Profit = 1 00 000X15/100
= Rs 15000.

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