UNIT-2

Accounting for Partnership Firms

CHAPTER

2 BASICS OF PARTNERSHIP

TOPIC-8

Treatment of Goodwill (Concepts : Needs for Valuation of Goodwill; Raising and Writing off Goodwill

Revision Notes

Need for valuation of Goodwill

Generally, at the time of liquidation, the need for valuation of goodwill arises. But, in the context of a partnership firm it may also arise in the following circumstances:

1. Change in the profit sharing ratio amongst the existing partners;
2. Admission of new partner;
3. Retirement of a partner;
4. Death of a partner;
5. Dissolution of a firm involving sale of business as a going concern; and
6. Amalgamation of partnership firms.

Raising and Writing Off Goodwill

When the new partner does not bring goodwill in cash, partly or fully

Goodwill not brought by the new partner will be debited to current account of new partner while sacrificing partners' capital accounts will be credited for their respective shares.

When the new partner does not bring the share of goodwill, there exists two possibilities :

(a) Goodwill does not exist in the books; and

(b) Goodwill exists in the books.

Goodwill does not exist in the books

When goodwill does not exist in the books, sacrificing partners are credited with their share of goodwill and new partner is debited by the amount of goodwill not brought by him.

The journal entry in this case is:

Incoming (New) Partners Current A/c Dr.

To Sacrificing Partners Capital A/c (individually) (Account of goodwill not brought in by new partner)

Sometimes the new partner brings part of premium for goodwill in cash. In such a situation, new partners current account will be debited by the amount not brought by new partner.

Example

Kapish and Tanuja are partners in a firm sharing profits and losses in the ratio of 2:3. They decide to admit Harsh into partnership for 1/5 share of profits, which he acquires equally from Kapish and Tanuja. Goodwill is valued at Rs. 50,000. Harsh brings in Rs. 20,000 as his capital but is not in a position to bring any amount for goodwill. No goodwill account exists in books of the firm. Goodwill account is to be raised at full value. Record the necessary journal entries.

Solution

Date	Particulars	L.F.	Amount (₹)	Amount (₹)
	Bank A/c Dr.		20,000	
	To Harsh's Capital A/c			20,000
	(Amount brought for capital)			
	Harsh's Current A/c Dr.		50,000	
	To Kapish's Capital A/c			20,000
	To Tanuja's Capital A/c			30,000
	(Goodwill credited to sacrificing partner's accounts)			

When goodwill exists in the books:

Goodwill appearing in the books will be written-off by debiting old partners' capital accounts in their old profit sharing ratio. Thereafter new value of goodwill will be given effect by crediting sacrificing partners' capital accounts and debiting new partners' current account.

The journal entries will be as under:

(i) When the value of goodwill appears in the books and is written - off

Partners' Capital A/c (old) Dr. (In profit sharing ratio)
To Goodwill A/c
(Goodwill appearing in the books written-off)

(ii) For new value of goodwill:

Incoming Partners' Current A/c. Dr.
To Sacrificing Partners' Capital A/c [In sacrificing ratio) (individually)

Example

Abhinav and Abhishek are partners in a firm sharing profits and losses in the ratio of 3:2. Ayur is admitted into partnership for 1/3 share in profits. He brings in ₹ 20,000 as capital, but is not in a position to bring any amount for his share of goodwill which has been valued at ₹ 30,000. Give necessary journal entries when the goodwill appears at ₹ 15,000 in the books of the firm.

Solution

Date	Particulars	L.F.	Amount (₹)	Amount (₹)
	Bank A/c Dr. To Ayur's Capital A/c (Amount brought for capital)		20,000	20,000
	Ayur's Current A/c Dr. To Abhinav's Capital A/c To Abhishek's Capital A/c (Goodwill not brought by Rahul debited to his current account and credited to old partners in sacrificing ratio)		15,000	9,000 6,000
	Abhinav's Capital A/c Dr. Abhishek's Capital A/c Dr. To Goodwill A/c (Goodwill appearing in the books written - off in old profit sharing ratio)		9,000 6,000	15,000

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UNIT-3

Accounting for Companies

CHAPTER

7

ACCOUNTING FOR SHARE CAPITAL

TOPIC-3

Features and Types of Companies

Revision Notes

A company may be viewed as an association of person who contribute money or money's worth to a common inventory and use it for a common purpose. It is an artificial person having corporate legal entity distinct from its members (shareholders) and has a common seal used for its signature. Thus, it has certain special features which distinguish it from the other forms of organization. These are as follows:

- Body Corporate: A company is formed according to the provisions of Law enforced from time to time. Generally, in India, the companies are formed and registered under Companies Law except in the case of Banking and Insurance companies for which a separate law is provided for.
- Separate Legal Entity: A company has a separate legal entity which is distinct and separate from its members. It can hold and deal with any type of property. It can enter into contracts and even open a bank account in its own name.
- Limited Liability: The liability of the members of the company is limited to the extent of unpaid amount of the shares held by them. In the case of the companies limited by guarantee, the liability of its members is limited to the extent of the guarantee given by them in the event of the company being wound up.
- Perpetual Succession: The company being an artificial person created by law continues to exist irrespective of the changes in its membership. A company can be terminated only through law. The death or insanity or insolvency of any member of the company in no way affects the existence of the company. Members may come and go but the company continues.
- Common Seal: The company being an artificial person, cannot sign its name by itself. Therefore, every company is required to have its own seal which acts as official signatures of the company. Any document which does not carry the common seal of the company is not binding on the company.
- Transferability of Shares: The shares of a public limited company are freely transferable. The permission of the company or the consent of any member of the company is not necessary for the transfer of shares. But the articles of the company can prescribe the manner in which the transfer of shares will be made.
- May Sue or be Sued: A company being a legal person can enter into contracts and can enforce the contractual rights against others. It can sue and be sued in its name if there is a breach of contract by the company.

Kinds of Companies: Companies can be classified either on the basis of the liability of its members or on the basis of the number of members. On the basis of liability of its members the companies can be classified into the following three categories:

(i) Companies Limited by Shares: In this case, the liability of its members is limited to the extent of the nominal value of shares held by them. If a member has paid the full amount of the shares, there is no liability on his part whatsoever may be the debts of the company. He need not pay a single paise from his private property. However, if there is any liability involved, it can be enforced during the existence of the company as well as during the winding up.

(ii) Companies Limited by Guarantee: In this case, the liability of its members is limited to the amount they undertake to contribute in the event of the company being wound up. Thus, the liability of the members will arise only in the event of its winding up.

(iii) Unlimited Companies: When there is no limit on the liability of its members, the company is called an unlimited company. When the company's property is not sufficient to pay off its debts, the private property of its members can be used for the purpose. In other words, the creditors can claim their dues from its members. Such companies are not found in India even though

permitted by the Companies Act, 1956. On the basis of the number of members, companies can be divided into two categories as follows:

(i) Public Company: A public company means a company which

(a) is not a private company,

(b) has minimum paid up capital of Rs. 5 lakh rupees or such higher paid-up capital, as may be prescribed and © is a company which is not a subsidiary of a private company.

(ii) Private Company: A private company is one which has a minimum paid up capital of Rs. 1 lakh rupees or such higher paid-up share capital as may be prescribed, and which by its articles:

(a) restricts the right to transfer its shares;

(b) limits the number of its members to fifty (excluding its employees); © prohibits any invitation to the public to subscribe for any shares in or debentures of the company.

(d) prohibits any invitation or acceptance of deposits from person other than its members, directors, and relatives.

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UNIT-4

Financial Statement Analysis

CHAPTER

9

FINANCIAL STATEMENTS OF A COMPANY

Uses and Importance of Financial Statements

Revision Notes

Uses of Financial Statements:

George O. May points out the following major uses of financial statements:

(1) As a report of stewardship;

(2) As a basis for fiscal policy;

(3) To determine the legality of dividends;

(4) As guide to advise dividend action;

(5) As a basis for the granting of credit;

(6) As informative for prospective investors in an enterprise;

(7) As a guide to the value of investment already made;

(8) As an aid to government supervision;

(9) As a basis for price or rate regulation;

(10) As a basis for taxation.

Importance of Financial Statements:

The utility of financial statements to different parties is discussed in detail as follows:

(1) Management: Financial statements are useful in evaluating the effectiveness of different cost centers. Managers can control costs through these statements. Efficient and inefficient areas are notified by management. Managers can decide which course of action to take next.

(2) Creditors: Commercial debt should be paid on a short-term basis. This liability is met out of current assets. The creditors will be interested in current solvency of the concern. Creditors can assess the current financial position of the concern by calculating current ratio and liquid ratio.

(3) Bankers: The banker is interested in ensuring that the loan amount is secured and the customer is able to pay interest on a regular basis. The banker will analyze the balance sheet to determine the financial viability of the concern and the profit and loss account will also be analysed to determine earning status. A banker has a large number of clients and it is not possible to monitor his or her business activities. It is because of the financial statements that the banker is able to keep a watch on the business plans and operations of his customers. These statements also help the banker to determine the amount of collateral he will apply to customers as a loan cover.

(4) Investors: Investors include both short-term and long-term investors. They are interested in the security of the principal amount of the loan and the interest rate payments with concern. Investors will learn the long-term solvency of concern with the help of financial statements. Investors will not only analyze the current financial situation but will also study future prospects and plans for expansion of the business. Opportunities to repay a loan when the concern is liquidated are also considered.

(5) Government: Financial statements are used to assess corporate tax liability. The government uses financial statements to study economic situation of the country. These statements enable the government to determine whether a business complies with various laws and regulations. These statements also form the basis for formulating and amending the various rules of business governance

(6) Trade Associations: These associations provide assistance and protection to members. They may analyze financial statements in order to provide services to these members. They may develop standard ratios and design a similar account system.

(7) Stock Exchange: The stock exchanges deal in purchase and sale of securities of different companies. The financial statements enable the stock brokers to judge the financial position of different concerns. The fixation of prices for securities, etc., is also based on these statements.

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UNIT-4

Financial Statement Analysis

CHAPTER

11

ACCOUNTING RATIOS

Solvency Ratio : Debt to Capital Ratio; Net Assets Turnover Ratio

Revision Notes

Solvency ratio

Debt to Capital Employed Ratio: The debt-to-capital ratio is a measurement of a company's financial leverage. The debt-to-capital ratio is calculated by taking the company's interest-bearing debt, both short and long-term liabilities and dividing it by the total capital. Low ratio provides security to lenders and high ratio helps management in trading on equity.

Debt to Capital Employed Ratio = Long-term Debt/Capital Employed (or Net Assets)

Example:

From the following information calculate debt to capital employed ratio:

Balance Sheet as at March 31, 2017

Particulars	Note No.	₹
I. Equity and Liabilities:		
1. Shareholders' funds		
a) Share capital		4,00,000
b) Reserves and surplus		1,00,000
2. Non-current Liabilities		
Long-term borrowings		1,50,000
3. Current Liabilities		1,00,000
		7,50,000
II. Assets		
1. Non-current Assets		
a) Fixed assets		4,00,000
b) Non-current investments		1,00,000
2. Current Assets		2,50,000
		7,50,000

Solution:

$$\text{Debt to Capital Employed Ratio} = \frac{\text{Long - term debts}}{\text{Capital Employed}}$$

Capital Employed = shareholders' Funds + Long-term borrowing

= ₹ 5,00,000 + ₹ 1,50,000

= ₹ 6,50,000

$$\text{Debt to Capital Employed Ratio} = \frac{\text{Long - term debts}}{\text{Capital Employed}}$$

$$= \frac{₹\,1,50,000}{₹\,6,50,000} = 0.23 : 1$$

Solvency ratio

Net Assets Turnover Ratio: Net assets turnover ratio reflects relationship between revenue from operations and net assets (capital employed) in the business. Higher turnover means better activity and profitability. It is calculated as follows:

$$\text{Net Assets or Capital Employed Turnover ratio} = \frac{\text{Revenue from Operation}}{\text{Capital Employed}}$$

Capital employed turnover ratio which studies turnover of capital employed (or Net Assets) is analysed further by following two turnover ratios:

i. Fixed Assets Turnover Ratio

ii. Working Capital Turnover Ratio

Fixed Assets Turnover Ratio: The fixed asset turnover ratio is an efficiency ratio that measures company's return on their investment in assets such as machineries, property, plant, and equipment by comparing net revenue from operations or sales with fixed assets. In other words, it shows how efficiently a company is producing a revenue with its fixed assets. High turnover of capital employed, fixed assets is a good sign and implies efficient utilisation of resources. It is calculated as follows:

$$\text{Fixed asset turnover Ratio} = \frac{\text{Net Revenue from Operation}}{\text{Net Fixed Assets}}$$

Example:

From the following information, calculate (i) Net assets turnover and (ii) Fixed assets turnover:

	Amt. (₹)		**Amt. (₹)**
Preference shares capital	6,00,000	Plant and Machinery	7,00,000
Equity share capital	4,00,000	Land and Building	4,00,000
General reserve	1,50,000	Motor Car	3,00,000
Balance in Statement of Profit and Loss	2,50,000	Furniture	2,00,000
15% debentures		Inventory	1,80,000
14% Loan	3,00,000	Debtors	1,10,000
Creditors	1,00,000	Bank	80,000
Bills payable	1,40,000	Cash	30,000
Outstanding expenses	50,000		
	10,000		

Revenue from operations for the year 2016-17 were ₹ 50,00,000

Solution:

Revenue from Operations = ₹ 50,00,000

Capital Employed = Share Capital + Reserves and Surplus + Long-term Debts (or Net Assets)

= (₹ 6,00,000 + ₹ 4,00,000) + (₹ 1,50,000 + ₹ 2,50,000) + (₹ 3,00,000 + ₹ 1,00,000) = ₹ 18,00,000

Fixed Assets = ₹ 8,00,000 + ₹ 5,00,000 + ₹ 2,00,000 + ₹ 1,00,000 = ₹ 16,00,000

Net Assets Turnover Ratio = ₹ 50,00,000/₹ 18,00,000 = 2.77 times

Fixed Assets Turnover Ratio = ₹ 50,00,000/₹ 16,00,000 = 3.125 times

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UNIT-4
Cash flow Statement

CHAPTER
12 CAST FLOW STATEMENT

Benefits, Cash and Cash Equivalents, Classification of Activities and Preparation (as per As 3 (Revised) Indirect Method only

Revision Notes

Benefits of Cash Flow Statement

- Cash Flow Statement is useful in knowing the exact figure of cash inflows and outflows from various operations of the business. It helps in assessing future requirements of the cash by comparing the cash budgets of past assessments with the present. It gives the accurate information about the cash-based transactions in the business.
- Cash flow statement helps in knowing the periodical requirement of cash in the business as it is used in preparing the cash budget for future needs.
- A cash flow statement when used along with other financial statements reveals the key changes required for the financial positioning of the business and prioritizes important activities to the management.
- Cash flow statement also provides the information about various investing and financing cash transactions takes place during the year and helps in evaluating the financial structure of the business. Cash Flow statement helps in identifying the profitability of the business when it compared with the ratio analysis, keeping in response to changing condition.

Cash and Cash Equivalents

Cash and cash equivalents refers to the line item on the balance sheet that reports the value of a company's assets that are cash or can be converted into cash immediately. Cash equivalents include bank accounts and marketable securities, which are debt securities having short maturity, of say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are in substantial cash equivalents.

Examples of cash equivalents include commercial paper, treasury bills, and short-term government bonds with a maturity date of three months or less. As marketable securities are highly liquid and not subject to material fluctuations in value, money market holdings are considered cash equivalents.

Classification of Activities for the Preparation of Cash Flow Statement

Cash flow activities majorly classified into three categories, these are:

- Operating activities
- Investing activities
- Financing activities

As per AS-3, these activities are to be classified into three categories: (1) operating, (2) investing, and (3) financing activities so as to show separately various cash and cash equivalent transactions incurred under these three categories. These three activities help us to assess the impact of these activities on the financial position of an enterprise and also on its cash and cash equivalents.

Operating Activities

Operating activities are the activities that constitute the main or primary activities of a business. These activities mainly deals with major activities of the business, i.e., buying and selling of goods and services of a business firm including manufacturing, distributing, selling, marketing, etc. Even though these activities does not include investing and financing activities but these are the principal revenue generating activities (or the main activities) of the enterprise thus, provides a major cash flow in the organization. These activities also helps in better assessing the profitability of the firm.

Cash Flow From Operating Activities = Earnings before interest and Tax + depreciation – Taxes +/- Change in working capital

Cash Inflows from Operating Activities

- Receipts from the sale of goods and services.
- Cash receipts from the fees, commissions and other revenues.

Cash Outflows from Operating Activities

- Payments made on salaries to the employees.
- Cash payments made to suppliers.
- Cash payments to an insurance enterprise for premiums and claims, annuities, and other policy benefits.
- Cash payments of income taxes unless they can be specifically identified with financing and investing activities.
- Increase in current assets & decrease in current liability.

Investing Activities

Investing activities are the other type of cash flow statement activities in which cash transactions made on the acquisition and disposal of long-term assets and other investments not included in cash equivalents. These activities include money spent on long-term assets, shares, debentures, etc.

In comparison of operating activities, these activities provide minor cash flow in the firm but have a great impact on the profitability of the firm. Cash flow from investment activities helps to know represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Cash Inflow from Investment Activities

- Investment activities cash inflow include the sale of assets.
- Cash received on interest on loans and advances given to the third parties.
- Cash receipts received on the investment made in the other companies or firms.
- Receipts received on trading of shares, debentures, bonds etc.

Cash Outflow from Investment Activities

- Cash payments on purchasing long-term assets and other intangible goods like patents.
- Payments made on acquiring of other company shares, debentures and other debt issues.
- Advances and loans given to third parties

Financing Activities

As the name suggests, financing activities are the activities involving in the rise of the company's capital. As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a company) and borrowings of the enterprise. Even though these lie at the bottom of the statement but had its own importance. These activities are confined mainly financial activities of the firm like trading of company's shares, cash proceeds from issue of equity shares, debentures, raising long-term bank loans, repayment of bank loan, etc.

Cash Flow from Financing activity = Cash Received from Issuing shares or debts – Cash Paid as Dividends and Reacquiring of shares or debts

Cash Inflow from Financing Activities

- Receipts on the issuing of shares and other debt instruments.
- Cash received from issuing of debentures, loans and other borrowings.

Cash Outflow from Financing Activities

- Interest paid on long-term borrowings and debentures.
- Dividends paid to the shareholders of the company.
- Repaid borrowings made by the firm.

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