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Lesson No.

2.1 : Depreciation

2.2 : Partnership Accounts-I

2.3 : Partnership Accounts-II

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LESSON NO. 2.1

DEPRECIATION (METHODS AND ACCOUNTING) (AS-6)

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2.1.0 objective

The objective of this lesson is to explain

i. Meaning of depreciation
ii. Accounting treatment of depreciation
iii. Methods of charging depreciation

2.1.1Introduction:

Depreciation is a permanent, continuing and gradual shrinkage in the book value of a fixed asset. It is charged on the fixed assets only, because current assets are never depreciated rather these are valued. It is not affected with the market value, but it is charged on the book value of the asset once the depreciation is charged, it reduces the value of asset permanently. Depreciation is charged on a continuous

basis and once it is charged it must be charged on regular basis.

2.1.2 Definition :

According to Institute of Chartered Accountants of India, "a measure of the wearing out, consumption or other loss of a value of a depreciable asset arising from use, affixation of time or obsolescence through technology and market charges."

A cco rding to Internati onal Accounti ng Standard Commit tee , "depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly."

Reasons of Depreciation :

Following are the main reasons for charging depreciation to a fixed asset :

1. Due to regular use and wear and tear of any fixed asset.
2. Due to economic factor like obsolescence and inadequacy.
3. There are certain assets with a fixed period of legal life. Its life is reduced with passage of time.
4. Some assets are of a wasting character perhaps due to the extractio n of raw material f ro m the m. To prov id e for the consumption of an asset of a wasting characters is called provision for depriciation.
5. An asset may reduce in value because of meeting of an accident.

2.1.3 Depreciation Accounting :

Depreciation accounting is a system of accounting which aims

to distribute the cost or other basic value of tangible capital assets loss salvage (if any). Over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that allocated to the year. Thus the main objective of depreciation accounting is to absorb the cost of using the asset to different accounting period in such a way so that profit and loss Account may give true figure of profit and loss made by the business.

2.1.4 Need For Providing Depreciation :

Following are reasons to provide depreciation on any fixed asset:

(1) To know the true profits:

We have seen that depreciation as an expenses and important element of cost of production. So the depreciation on fixed asset must be deducted out of income to calculate true net profit or loss.

(2) To show true financial position:

To know the true financial position fixed assets must be shown at a true value depreciation is required to be deducted out of assets.

(3) To make provision for replacement of assets :

If depreciation is not provided the profits of the concern will be overstated and can be distributed to the shareholders as dividend. At the time of replacement of an asset company will not have funds. So such provision is made to replace any asset.

Factors to be taken into consideration while calculating Depreciation:

- (i) The total cost of the assets including freight, insurance and installation charges.
- (ii) The scrap value at the end of life .
- (ii) Estimated no. of years of life.

2.1.5 Method of Recording Depreciation :

(1) When a provision for depreciation account is not maintained:-

Under such method the amo unt of de pre ciati on is charged to depreciation Account and credited to Asset A/c. The asset shown in Balance Sheet is at its written down value and depreciation being a nominal account is transfered to Profit and Loss A/c.

JOURNAL ENTRIES :

(i) For providing depreciation

Depreciation A/c -Dr

To Asset A/c

(ii) For transfer of depreciation to Profit and Loss A/c

Profit and Loss A/c -Dr

To Depreciation A/c

(iii) When additional asset is purchased during the year:-

Asset A/c -Dr

To Bank A/c

When the asset is sold, it is desirable to calculate its book value after charging even the current period's depreciation and this value is to be compared with the realiable value in order to calculate the profit or loss on the sale of an asset. The entries will be :

(a) When the asset is sold

Bank A/c -Dr

To Asset A/c

(b) For the depreciation of the current period

Depreciation A/c -Dr

To Asset A/c

(c) For Loss on sale of asset

Profit & Loss A/c -Dr

To Asset A/c

Reverse entry will be passed if there is profit on sale of asset

(1) When a provision for depreciation account is maintained:-

Under this method the amount of depreciation to be provided in a particular year is debited to Profit and Loss A/c and corresponding credit given to provision for Depreciation Account .The asset account appears in the book as its original value and provision for Depreciation A/c appears in the liability side.

JOURNAL ENTRIES:

(a) For providing depreciation out of Profit and Loss A/c

Profit and Loss A/c Dr
To Provision for depreciation A/c

(2) On sale of an asset:

(a) Provision for Depreciation A/c -Dr.
To Asset A/c

(b) Bank A/c -Dr
To Asset A/c

(c) For Profit: For Loss:

Asset A/c -Dr Profit and Loss A/c Dr.
To profit and Loss A/c To Asset A/c

2.1.6 self check exercise1

a) define depreciation

b) need for depreciation

2.1.7 Method of Depreciation:

Different methods of calculating provision for depreciation are mainly according custom which may be different concerns taking into consideration their individual peculiarities .The following are the main methods of providing depreciation:

(A) Fixed Instalment Method:

Under this method a fixed percentage of the of original value of the asset is written of every year so that asset is reduced to nil

$$\text{Depreciation} = \frac{\text{Cost price of asset-scrap value}}{\text{Estimated life of asset.}}$$

This method is suggested in case of assets where in the service value declines as a function of time and that too at a uniform rate. The repairs, maintenance and revenue also remain more or less constant.

Merits:

(i) It is a very simple to understand.
(ii) It helps in ending the working life of any asset.
(iii) For these assets which have a fixed life this method is most suitable.

Demerits:

(i) the rate to depreciation remain same year to year.
(ii) In case of addition to asset, it is difficult to calculate depreciation.

- This method tends to repeat an increasing rate of return on investment in the asset amount due to the fact that the net balance of the asset amount is taken .

(B) Diminishing Balance Method:

Depreciation is calculated to a certain percentage each year on the balance of asset which is brought forward from the previous year. This method is justified in the case

- Where there is much uncertainty of revenue in later year.
- There is also increase in repairs and maintenance cost consequently decreasing efficiency and revenue in every succeeding period.

Merits:

- It tends to give a fairly even change of depreciation against revenue each year.
- Fresh calculations are not required at the time of additions are made.
- This method is recognized by income tax authorities in India.

Demerits:

- Assets can never be reduced to zero.
- This method does not take into consideration the asset as an investment and interest is not taken into consideration.
- As compared to the straight line method, it is difficult to determine the suitable rate of depreciation.

(C) Sum of Digits Method:-

This is a variant of the reducing instalment or diminishing balance method. Under this method depreciation is calculated by the following formula:

$$\text{Depreciation} = \text{Amount to be written off} \times \frac{\text{No. of years of remaining life of the asset including the current year.}}{\text{The total of all the digits representing the life of the asset (in years)}}$$

(D) Annuity Method :

Under this method, the amount spent on the purchase of an asset is regarded as an investment which is assumed to earn interest at a certain rate. Every year the asset account is debited with the amount of interest and credited with the amount of depreciation. The interest is calculated on the debit balance of the asset account on the beginning of the year.

(E) Depreciation Fund Method:-

Under all the above method ready cash may not be available when the time of replacement comes because the amount of depreciation is retained in the business itself in the form of assets (not separate from other asset) which cannot be readily sold.

The method implies that the amount written off as depreciation should be kept aside and invested in readily saleable securities. The securities accumulate and when the life of the asset expires, the securities are sold and with the sale proceeds a new account will be opened known as Depreciation funds A/c.

Journal Entries :

(i) For providing annual depreciation

Depreciation A/c -Dr

To Depreciation Fund A/c

(ii) For investing the amount of depreciation

Depreciation Funds Investment A/c -Dr

To Bank A/c

(iii) For transferring depreciation to Profit and Loss A/c

Profit and Loss A/c -Dr

To Depreciation A/c

Subsequent year:-

(i) For interest received as investment out of depreciation Fund.

Bank A/c -Dr

To Depreciation Funds A/c

(ii) For annual instalment of depreciation

Depreciation A/c -Dr

To Depreciation Fund A/c

(iii) For amount of depreciation and interest earned invested in securities

Depreciation A/c -Dr

To Bank A/c

(iv) For depreciation transferring of depreciation to Profit and Loss A/c

Profit and Loss A/c -Dr

To Bank A/c

Last year:-

(i) For Interest received on investment

Bank A/c -Dr

To Depreciation Fund A/c

(ii) For annual instalment of depreciation

Depreciation A/c -Dr

To Depreciation Fund A/c

(iii) For Ltd Depreciation to Profit and Loss A/c

Profit and Loss A/c -Dr

To Depreciation A/c

(iv) For sale of investment

Bank A/c -Dr

To Depreciation Fund Investment A/c

(v) For Profit and sale of securities

Depreciation fund Investment A/c -Dr

To Depreciation fund A/c

(D) Insurance Policy Method:

The method is similar to the depreciation fund method but instead of making investment arrangements are made with an insurance company which will receive premiums annually and pay at the end of the fixed period the required amount. Premiums have to be paid at the beginning of each year. This method along with the previous two methos can be adopted where

(i) the re pairs and mai nte nance cost are co nstant or decreasing over the life to the asset.

(ii) the revenue and operating efficiency are constant or increasing over the life of the asset.

Journal Entries:-

First year:

(i) For payment of premium at the beginning

Depreciation Insurance Policy A/c -Dr

To Bank A/c

(i) For providing the amount of premium at the end of the year out of profit and loss A/c in the form of depreciation Reserve.

Profit and Loss A/c -Dr

To depreciation Reserve A/c

(ii) For interest on balance of the policy together with amount of premium.

Depreciation Insurance Policy A/c -Dr

To Depreciation Reserve A/c

Last Year :

(iv) For the receipt of amount of policy - Dr

Bank A/c To Depreciation Insurance Policy A/c

(v) For writing off old asset

Depreciation Reserve A/c -Dr

To Asset A/c

(vi) Transfer Entry

Depreciation Insurance Policy A/c -Dr

To Depreciation Reserve A/c

(vii) For purchase of new asset.

New Asset A/c -Dr

To Bank A/c

G) Revaluation Method :

Under this method, the asset is revalued at the end of accounting year and this value is compared with value of asset on its beginning. The difference is called as depreciation. This method is used in case of bottles, corks, crates, loose tools, package etc.

H) Depletion Method :

This method is mostly used in case of mines, quarries etc. from which a certain quantity of output is expected to be obtained. When the whole quantity is taken the mine loses its value. The rate of depreciation is worked out only so much per tonne. Depreciation is obtained by dividing the cost of mine by the total quantity of mineral obtained from mine.

I) Machine Hour Rate Method :

This method is applicable in case of machine. The life of the machine is fixed in terms of hours. Hourly rate of depreciation is worked out by dividing the cost of the machine by the total number of hours for which the machine is expected to be used. Depreciation to be written off in a year will be ascertained by multiplying the hourly rate of depreciation by the no.of hours that the machine actually run in a year.

2.1.8 Change of Method :

Sometimes the method is changed from one method to another. If this change is from current year; then there will be no problem. But if the change is any other then first all value of asset on the beginning date from which date by existing as well as by the change method and the difference is adjusted in the current year's asset account by giving debit on credit to the profit and loss A/c.

2.1.9 self check exercise2

a) describe diminishing balance method of depreciation
b) describe annuity method of depreciation

2.1.10 summary

After going through this lesson students have learnt about meaning of depreciation, its definition and need for charging depreciation. In this lesson journal entries required to passed for recording depreciation are explained. There are eight methods of depreciation namely , fixed installment method, diminishing balance method, sum of digits methos, annuity method, depreciation fund method, insurance policy method, revaluation method, machine hour rate method, depletion method are explained in this lesson.

2.1.11 glossary

Fixed installment method – depreciation= cost price of asset- scrap/ estimated life of the asset.

Depreciation = fall in the value of the asset due to wear and tear

2.1.12 answers to self check exercise

1 a) see para 2.1.2

b) see para 2.1.4

2 a) see para2.1.7 (B)

b) see para 2.17 (D)

2.1.13 exercise

Short questions

Q.1 define depreciation
Q.2 what is the need of the depreciation
Q.3 explain fixed installment method of depreciation
Q.4what is machine hour rate?

Long questions:

Q.1 “ Depreciation Accounting is a process of allocation and not of valuation” Comment.

Q.2 A company has acquired a lease of a cinema building for a term of 5 year by payment of Rs.50,000. It is proposed to depreciate the lease by annuity method @ 5%. Show the ledger A/c of the asset during the period of the lease. Reference to the Annuity. Table shows that the amount for Rs.1 for 5 years at 5% is Rs.0.230975

2.1.14 suggested readings

1)	Financial Accounting	:	C. Mohan Juneja U.K. Jouri M.M. Gupta
2)	Financial Accounting	:	P.C. Tulsian

BBA Part-II | Paper : BBA-302
SEMESTER-III | BUSINESS ACCOUNTING

Lesson No. 2.2 | Author: Gurpreet Kaur and Mandeep Kaur

PARTNERSHIP ACCOUNTS-I

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2.2.2 Meaning of Partnership
2.2.3 Characteristics of Partnership
2.2.4 Partnership Deed
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2.2.14 Suggested Readings

2.2.0 objective

The objective of this lesson to explain

i. Meaning and characters of partnership
ii. Partnership deed
iii. Preparation of final accounts of partnership

2.2.1 Introduction :

Partnership form of business organization came into existence on account of limitations of sole proprietary concerns. The major limitation of sole proprietary concerns are those of shortage of funds uncertainty about existence, unlimited personal liability etc. In case of a partnership business two or more persons join hands together to do a business. Thus the risks, funds, responsibility all are shared the Indian Partnership Act, 1932 is applicable to contracts of Partnership.

2.2.2 Meaning of Partnership :

When two or more than two persons agreed to do some business to earn profits is called partnership. Collectively all individuals of partnership known as 'firm' and separately an individual known as 'partner'.

According to Indian Partnership Act 1932 section 4, "The relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

2.2.3 Characteristics of Partnership :

The essential features of partnership are as follows:-

1) Two or more persons : To form partnership there must be at least two

persons. There is a limit on the maximum number of persons who constitute partnership firm. It should not exceed 10 if the firm is carrying on banking business and 20 if it is engaged in any other business.

2) Agreement between the partners : A partnership is created by an agreement. It is neither created by operation of law as in the case of Hindu

Undivided Family (HUF) nor by status the agreement forms the basis of economic relationship amongst the partners. It can be oral or written.

3) Business : The agreement should be for carrying on some legal business. A joint ownership of some property by itself does not constitute partnership. However the joint ownership if the property may be used for forming the partnership in order to pursue the business objectives for which the partnership is formed.
4) Sharing of Profits : The agreement should be to share the profits of the business, if some persons join hands to carry on some charitable activity it will not be termed as partnership/
5) Business carried by all or any of them acting for all : The firm's business may be carried by all the partners or any one of them acting for all. This means that partnership is based on the concept of mutual agency relationship. A partner is both on agent (he can, by his acts, bind the other partners) and a principal (he is bound by the acts of other partners). Each partner is entitled to participate in the conduct of business.

2.2.4 Partnership Deed :

Partnership is created by an agreement, relations between partners will be governed by mutual agreement called 'Partnership Deed'. It can be oral or written.

2.2.4.1 Contents of the Deed

The deed usually contains the following information:-

1) Name of the firm.
2) Names of Partners.
3) Nature and place of business.
4) Date of commencement of partnership.
5) Duration of the firm.
6) Capital employed by different partners.
7) Profit Sharing ratio.
8) Rules to be followed in case of admission, retirement or death of a partner.
9) Salaries or commission if payable to partners.
10) Interest on partner's capital loans and drawings.
11) Settlement of accounts of dissolution of firm.
12) Arbitration clause.

2.2.4.2 self check exercise

a) partnership deed

b) features of partnership

2.2.5 Final Accounts

The same method is followed for preparing final accounts as in case of sole proprietary concerns. Some of the important points should be taken into account while preparing final accounts.

1. Capital Account : There will be separate capital account for each partner with their names such as A's capital A/c, B's capital A/c ets. Capital Accounts can be of two types:-

   1. Fixed Capital Account : In this account partner's capital has fixed balance for all the appropriations/adjustments of profits separate account is opened I.e. current A/c. Its balance can be either debit or credit.

   2. Fluctuating Capital Account : In case of fluctuating capital account there is only one account for each partner. This account is known as 'Capital Account', all entries relating to introduction of new capital, interest on drawings, interest on capital or loan, profit's share etc are made in this account, the balance of the capital account goes on fluctuating. That is it is called 'Fluctuating Capital Account'.

2.2.6 Profit and loss Appropriation Account :

This account is prepared to show the distribution of profits among the partners. Following appropreations/adjustments are to be made in this account.

(I) Interest on capital : Interest will be calculated on each partner's capital. The accounting entry for the following adjustment is:-

(i) Interest on capital A/c Dr
    To Partner's capital A/c

(ii) Profit and loss Appropriation A/c Dr
    To Partner's Capital A/c

(iii) Profit and loss appropriation A./c Dr
    To Interest on capital A/c

Example: P, Q and R are partner in a firm. Their capital A/cs as on 1.2.2011 were Rs. 2,00,000, Rs.1,00,000 and Rs. 60,000. They are sharing profits and losses equally. Interest on capital is allowed 12% p.a. P entitled salary of Rs. 1000 Pm for the year. Profit for the years Rs. 1,00,000 you are requested to prepare Profit and loss Appropriation A/c

Solution-

Profits and Loss Appropriation
For the year ending 31.12.2011

Particulars	Amount	Particulars	Amount
To Interest on capital		By Profit for the year	1,00,000
P 24000	43,800		
Q 12000	12000		
R 7800			
To Salary to P			
To Net Profit transferred to			
P's capital A/c	44,200		
14734			
Q's capital A/c			
14733			
R's capital A/c	1,00,000		
14733			1,00,000

Example 2: (Fixed and Fluctuating capital Account)
Amit and Sumit commenced business as partners on April 1, 2000. Amit contributed Rs. 40,000 and Sumit Rs. 25000 as their share of capital. The partners decided to share their profits in the ration of 2:1. Amit was entitled to a salary of Rs. 6,000 pa. Interest on capital was to be provided@ 6% pa. The drawings of Amit and Sumit far the year ending March 31, 2001 were Rs. 4000 and Rs. 8000 respectively. The profits of the firm providing Amit's salary and interest on capital accounts

(i) When capital are fluctuating
(ii) When capital are fixed

Solution:-

(i) When capital are fluctuating

Books of Amit and Sumit

Amit's Capital A/c

Dr. Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Drawings To Balance C/f		4000 52,400		By cash By Salary By Interest Loan Capital By Profit and Loss Appropriation A/c (share 2/3 of 12000)		40,000 6000 2400 8000
	Total		56400		Total		56400

Sumit's Capital A/c

Dr. Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Drawings To Balance C/f		8000 22500		By cash By Interest Loan Capital By Profit and Loss Appropriation A/c (share 2/3 of 12000)		25000 1500 4000
	Total		30500		Total		30500

(ii) When Capitals are fixed

Sumit's Capital A/c

Dr Cr

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Balance C/f		40000		By cash		40000
	Total		40000		Total		40000

Amit's Current Account

Dr Cr

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Drawings To Balance C/f		4000 40000		By Salary By Interest on Capital By P & L App A/c		6000 2400 8000
	Total		16400		Total		16400

Sumit's Capital A/c

Dr Cr

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Balance C/f		25000		By cash		25000
	Total		25000		Total		25000

Sumit's Current A/c

Dr Cr

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
	To Drawings		8000		By interest on capital By profit and app. A/c (1/3 of Rs 12000) By Balance C/f		1500 4000 2500
	Total		8000		Total		8000

2.2.7 JOINT LIFE POLICY

A joint life policy (JLP) is an insurance policy which is taken out by the partnership firm on the joint lives of all the partners. The amount of policy is payable by the insurance company on either the death or on maturity of the policy, w.e.f is earlier. The firm pays annual premium to the insurer against the policy. Joint life policy

will be an asset of the firm and deceased partner has a right to share any profit or loss on such policy. So any claim which is received by the firm on the death of a partner is divided among the partners and credited to their capital accounts in their capital accounts in their profit sharing ratio.

On the death of the partner the firm becomes liable to pay the executors of deceased partner his capital, interest on capital, his share of profit from the previous year to the date of death and his share of reserves, good will etc. The total amount thus becoming due to the executors is usually significant and immediate payment of such heavy amount out of firms resources is likely to affect firm's finances very adversely.

2.2.8 Accounting treatment of joint life policy :

1) When premium paid is treated as an expense : when premium paid is treated as an expense then it is closed every year by transferring to Profit and Loss account. In this case complete amount received from the insurance company either on a surrender of a policy or on the death of the partner becomes the gain.

Accounting entries are-:

a) On payment of premium-:

Joint life policy insurance premium A/C dr.
To bank A/C.

b) On charging to profit and loss account

Profit and loss account dr.
To joint life policy insurance premium A/c

c) On maturity of the policy

Insurance company bank A/C dr.
To partner's capital A/c [individually]
[Including the A/C of representative of deceased partner]

d) On receipt of amount from the insurance co:

Bank A/C dr.
To insurance company A/C.

2) When premium paid is treated as an assets : In this case insurance premium paid is first debited to life policy account and credited to bank account, at the end of the year the amount in excess of surrender value is treated as loss and is transferred to P/L Account . Surrender value is the amount that the insurer would be willing to pay on the number of premiums paid -:

a) On payment of premium:

Joint Life Policy A/c

To Bank A/c Dr

b) On transfer of balance exceeding surrender value:

Profit & Loss A/c Dr

To Joint Life Policy A/c

c) On maturity:

Insurance company a/c Dr

To joint life policy a/c

d) On receipt of amount from insurance co:

Bank a/c Dr

To insurance company

e) On transfer of the balance in JLP A/C:

Joint life policy A/C Dr

To all the partners capital account

3. When premium paid is treated as an assets and reserve is maintained.

a) On payment of premium:

Joint life policy a/c Dr

To bank a/c

b) On appropriation of reserve:

Profit & loss app. A/C Dr

To joint life policy reserve A/C

c) On t/f of balance exceeding surrender value-:

Joint life policy reserve a/c Dr

To joint life policy a/c

d) On t/f of the balance in JLP reserve a/c

Joint life policy reserve a/c Dr

To joint life policy a/c

Joint life policy a/c is shown at the asset side of the balance sheet and joint life policy reserve a/c is shown at the liabilities side of the balance sheet.

Adjustment at the time of the admission of partner -:

1. if joint life insurance policy is appearing is in the books: No journal entry is required book the old partners have already got the credit to their capital accounts with surrender value of life insurance policy.
2. If joint life insurance policy is appearing in the books, but all the partners including new one decide not to show joint life policy in the books of the new firm:

   All the partners' capital a/c _______Dr. (new ratio)

   To joint life policy

   [Being surrender value of policy written off in new ratio]

3. If joint life policy is not appearing in the books and all the partners including new one decide not to show the same in the books of new firm:

   1) Joint life policy a/c Dr.
      To old partners capital a/c [old ratio]
   [Being the surrender value of policy written off in new ratio]

4. If joint life insurance policy is not appearing in the books, but all of them decide to show in the new books :
   Joint life insurance policy a/c Dr.
      To old partners capitals a/c (old ratio)
   [Being the surrender value of insurance policy taken in to account]

5. If joint life insurance policy and joint life policy resrve both are appearing in the books and all the partners decide to show in the books:

   Joint life policy reserve a/c
      To old partners a/c (old ratio)
   [Being joint life policy reserve credited to old partners]
   By this entry joint life policy is seen in assets side of balance sheet.

6. if both joint life policy and joint life policy reserve are appearing in the books; but the partners decide not to show both of these in new books:
   I joint life policy reserve a/c Dr.
      To old partners capital a/c (old ratio)
   (Being reserve of life policy credited to old partners)
   Ii All the partners capital a/c Dr.
      To joint life policy
   [Being joint life policy debited to all partners in new ratio]

JLP is a policy taken by all the partner of the partnership firm for avoiding the disturbance in business due to the death or retirement of partners. So when a partner dies insurance company will pay the representatives of deceased partner otherwise the asset would have to be sold which can led to the disturbance of the business.

2.2.9 self check exercise

a) profit and loss appropriation account

b) joint life policy

2.2 .10summary

After going through this lesson students will be able to understand meaning partnership, characteristics of the partnership. Partnership deed, its content are explained in this lesson. Partnership deed is the written document which contains terms and conditions of the partnership. This lesson also explains preparation of final accounts of the partnership.

2.2.11 glossary

Partnership= when two or more persons agree to do business together for earning profit

Partnership deed= written document which contains terms and conditions of partnership

2.2.12 answer to self -check exercise

1 a) see para 2.2.2

b) see para 2.2.4.1

2 a) see para2.2.6

b) see para 2.2.7

2.2.13 exercise

Short questions

Q.1 what are the contents of the partnership deed?

Q.2 what is profit and loss appropriation account?

Long questios

Q.1 what do you mean by partnership? What are its characteristics?

Q.2 what are the final accounts prepared by partnership firm?

2.2.14 Suggested Readings

3) Financial Accounting : C. Mohan Juneja
U.K. Jouri
M.M. Gupta

4) Financial Accounting : P.C. Tulsian

B.B.A Part-II | Paper : BBA-302
SEMESTER-III | BUSINESS ACCOUNTING

Lesson No. 2.3 | Author: Mandeep Kaur

PARTNERSHIP ACCOUNTS-II

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2.3.1 Objective

The objective of this lesson to explain:

i. Meaning of goodwill
ii. Factors affecting goodwill
iii. Methods of valuation of goodwill
iv. Treatment of goodwill in partnership accounts in detail

2.3.2 Introduction

Goodwill is classified as an intangible assets on the balance sheet. However according to International Finance Reporting Standards, goodwill is never amortized. Instead, an management is responsible to value goodwill every year and to determine is impairment is required. If the Fair Market Value goes below historical cost (what good will was purchased for) impairment must be recorded to being it down to is FMV. This is a very valuable asset even if one can't touch or see it. The assets is intangible but not fictitious. This asset is known as goodwill and may be defined as the extra profit which firms not possessing equal reputation, do not earn

2.3.3 Meaning

Good will is generally known as good name or reputation. Good will is a type of intangible asset that arises when company acquires another company entirely. The price paid is often more than the total market value of the acquired company. This gap is referred to a “Good will”. Good will is the excess of purchase consideration (money paid to purchase an assets or business) over the total value assets and liabilities.

This reputation will not depend on:

A) The personal reputation of the owner/management.
B) The reputation of goods dealt in or the quality of the service rendered.
C) The peculiar advantage of the site of the business.
D) The peculiar advantage available to it as regard sales or supplies of the material.
E) The patents, copyrights or trademarks owned by the firm.

Those who purchase goodwill acquire the name of the firm and also the site. The patents and trade marks etc.

2.3.4 Factors affecting the Value of Goodwill : Value of goodwill depends upon the capacity of the business to earn excess profits. Thus, all such factors which help in increasing the profitability of the business, will also affect the value of goodwill. These factors are :

(i) Location
(ii) Time
(iii) Nature of business
(iv) Capital Required
(v) Types of customers
(vi) Reputation of management

2.3.5 Valuation of Goodwill : The need for valuation of goodwill in case of partnership firm asses in following circumstance :-

(i) Admission of partner
(ii) Retirement or death of a partner
(iii) Change in profit sharing ratio of partners
(iv) Amalgamation of a partnership firm with another firm.
(v) Sale of partnership business.

2.3.6 Methods of Valuation :-

1. Average Profit Method
    a. Average expected profits
    b. no. of years
2. Super Profit Methods
    a. Average capital employed in the business
    b. Normal Profit
    c. Average expected profit
    d. Super Profit
    e. No. of years
3. Capitalisation of Profit Method

2.3.6.1 Average profit method -: Under this method goodwill is calculated on the basis of the average of some agreed number of past years. The average is then multiplied by the agreed number of years. This is the simplest and most commonly

used method of the valuation of good will. The value of the good will depends on the two factors -:

a) Average expected profit -: These are calculated on the basis of past performance of the business adjusted in the eight of the future possibilities.

b) Number of years -: This denotes the average period which a new businessman would take in bringing a business to a stage where it will be in a position to give the average profits as indicated.

Before calculating the average profit the following adjustment should be made in the profit of firm:

i) Any abnormal profit should be deducted from the net profit of that year.
ii) Any abnormal loss should be added back to the net profit of that year
iii) Non operating income e.g. income from the investments etc. should be deducted from the net profit of that year.

Illustration – I Frezer purchased shyam's business we from 1st jaunary from 2014. The profit disclosed by shyam's business for the last three years were as follows -:

2011 - 40,000 (including an abnormal gain of 5000)
2012 - 50,000 (after charging an abnormal loss of 10,000
2013 - 45,000(excluding 5,000 as insurance premium on firm's property – now to be issued)

Calculate the value of firm's good will on the basis of 2 year purchase of the average profit for the last 3 years.

Solution -:

Average maintenance profit
Profits for 2011 (40,000-5,000) = 35,000
Profit for 2012 (50,000 + 10,000) = 60,000
Profit for 2013 (45, 00 – 5,000) =40,000

Total profit for 3 years = 1,35,000
Average profit = 1,35,000/3 = 45,000
Good will at 2yrs purchase of the average profit = 45,000*2=90,000

2.3.6.2 Super Profit Method :

Super Profit are the profit earned above the normal profits. Under this method good will is calculated on the basis of the super profits. Under this method good will is calculated on the basis of super profits i.e. the excess of actual profits over the average profits. For example if the normal rate of return in a particular type of business is 20% and your investment in the business is 1,000,000 than your normal profit should be 2,000,000. But if you earned net profit of 2,30,000 than this excess of profits earned over the normal profits I.e. 2,30,000-200,000= 30,000 are your super profit for calculating good will super profits are multiplied by agreed

number of years purchased. Goodwill valuation in such a case depends on the following factors -:

a) Average capital employed in the business -: This is the average of the capital employed in the beginning and the capital employed at the end of accounting period. The capital is employed calculated as follows -:

Assets-: (Other than good will, preliminary expenses or fictitious assets.) 1,50,000

Less -: Liabilities due to outsiders (such as creditors , bills payable , outstanding expenses etc.)50,000

b) Normal profit -: The normal profit is calculated on the basis of normal rate of return earned by similar business applied to the average capital employed in th business. Average Capital Employed x Normal Rate of Return. For example , if the average capital employed in the business is 1,00,000 and the normal rate of profit is 10% , the normal profit would amount to 10,000.

c) Average expected profit -: This is calculated on the basis of past profit adjusted in the Eight of future expectations.For example, if the average profit of the business for the last three years have been 15,000 and it is expected they will further go up by 10% on account of exploring new markets the average expected profit would amount to 16500(i.e. 15000+1500)

d) Super profit -: The difference between the average expected profit and normal profit is the amount of super profit.

e) No. of years -:The amount of super profits so calculated will be multiplied by the no of years for which the super profit is expected to continue. For example , if it estimated that the super profit will continue to the new buyer of the business for two years , the amount of good will be 13,000 (I.e. 6500*2)

Illustration: from the following particulars calculate the value of the good will on the basis of the three years purchase of super profits of the business:

i.	Capital employed		50,000
ii.	Trading profits	2010 profit	12,300
		2011 profit	15,000
		2012 profit	2,000
		2013 profit	21,000

iii Normal rate of return 20%

iv remuneration for alternative employment to the proprietor if not engaged in the business 5000

Solution -:

i) Average expected profit -: The year 2012 seems to be an abnormal year. The business in all other years is giving profits expect 2012. Hence this year should be ignored for calculating average expected profits

Year	profit
2010	1,23,00
2011	15,000
2013	21,000
Total profit -	48,300

Average expected profit – 48300/ 3 = 16,100

Les remuneration for alternative employment <u>5,000</u>

Expected profit <u>11,100</u>

ii) Normal profit : 5000*20/100 = 10,000

iii) Supper profit : average expected profit – normal profit

11,100 – 10,000

iv) Good will at 3 years purchase = 1,100* 3 = 3,300

2.3.6.3 <u>Capitalistaion of profit method</u> -: The capitalistaion of profit method values good will at the excess of the capital that should have been employed for earning the average profit over the capital which has been actually employed.

There are two ways of calculating good will under this method :

a) Capitalistaion of average profit method
b) Capitalistaion of super profit method

a) Capitalistaion of average profit methods :

- Capitalized value of average profits =
  Average profits *(100/ normal rate of return)

- Capital employed = assets – liabilities
- Good will = capitalized value of average profits – capital employed

b) Capitalistaion of super profits -:

- Good will = super profits * (100/normal rate of return)

Illustration -: A firm earns Rs40,000 as its average profits . The normal rate of return is 10%. Total assets of the firm are 1,000,000 and its total external liabilities are rs50, 000. To calculate the amount of good will :-

Total capitalized value of the firm = 40,000 * 100/10 = 4, 00,000

Capital employed = 100,000 – 500,000 = 5, 00,000

Good will = 5, 00,000 -4, 00,000 = 1, 00,000

Illustration: ABC ltd. earns a profit of RS50, 000 by employing a capital of RS 2, 00,000. The normal rate of return of a firm is 20% calculate goodwill,

Normal profits = 2, 00,000 – 20/100 = 40,000

Super profits = 50,000 – 40,000 = 10,000

Good will = 10,000*100/20 = RS50, 000

2.3.7 Self check exercise1

a) explain super profit method

b) what is goodwill

2.3.8 Profit Sharing Ratio :

Profit sharing is the ratio in which profits and losses of a firm are to be distributed among the partners. The ratio is ascertained on the basis of provision in the partnership deed but in the absence of partnership deed, it should be considered as equal share for all the partners.

A change in profit sharing ratio basically implies the purchase of share ratio basically implies the purchase of share of profit by one partner from another partner. If the partner of a firm decide to change their profit sharing ratio the gaining partner must compensate the sacrificing partner by paying the proportionate amount of good will. The P.S. ratio is changed at the time of admission, retirement or death of a partner or at the time of amalgamation.

The adjustment is made as any one of the following two ways -:

a) when gaining partner does not bring his share of good will in cash then entry is as -;

Gaining partners capital A/c dr.

To sacrificing partners capital A/c.

b) where gaining partners brings good will in cash

i) Bank A/c dr

to premium A/c

ii) Premium A/c dr.

To sacrificing partners capital account

2.3.8.1 Change in Profit Sharing Ratio at the Admission of a Partner :

It becomes necessary to calculate new profit sharing ratio at the time of admission of a new partner and new profit sharing ratio depends upon the agreement between the old and new partners.

Illustration -: A and B are partners sharing profits and losses in the ratio of 5:3. C was admitted as a new partner for 1/5 share in future profile calculate the new profit sharing ration of partner.

Solution -:

C's share 1/5

Remaining profit = 1-1/5 = 5-1/5 = 4/5

A's share is 5/8 of 4/5 i.e.5/8*4/5 = ½

B's share is 3/8 of 4/5 i.e. 3/8*4/5 = 3/10

C's share = 1/5

New profit sharing ratio is

5/10:3/10 :2/10 or 5:3:2

2.3.8.2 Change in profit sharing ratio at retirement and death of Partners :

Sec, 32 of the Partnership Act deals with the statutory provision relating to provision relating to retirement of a partner from partnership firm . on the retirement of a partner, the share of retiring partner will be taken over by continuing partners. The ratio in which continuing partners decide to share the future profits and loses is known as new profit sharing ratio.

Illustration -: A,B and C were partner sharing profits in the ratio of 1/3,1/2,1/6. Find the new ratio of the remaining partners if (i) A retires,(ii) B retires
(iii) C retires.

Solution -:

Profit sharing ratio of A,B, C is 1/3,1/2,1/6 i.e. , 2:3:1. If A retires, ratio of b and c is 3:1 i.e. ¾:1/4.

If B retires ratio of a and c is 2:3 i.e. 2/3:1/3

If C retires ratio between a and b is 2:3 or2/5:3/5

2.3.8.3 Calculation of Gaining Ratio :

When a partner retires it become necessary to calculate the ratio of gain at the Stime when a particular a partner retires from the partnership concern.
On the retirement of a partner the gain of the continuing partners can be calculated by deducting their old share of profits from new share.

Illustration -: A, B, C are partners sharing profits in the ratio of 4/9, 1/3 and ½ respectively A retires calculate the ratio of B and C.

Profit sharing ratio of A, B and C is:

4/9, 1/3and 2/9 i.e. 4:3:2

A retires then the ratio of b and c is 3:2

Gaining ratio = New share –Old share

B’s gain = 3/5-3/9 = 27-15/45 = 12/45

C’s gain = 2/5-2/9 = 18-10/45 = 8/45

Gaining ratio = 12/45:8/45= 3:2

2.3.8.4 Death of a Partner :

Death 0f a partner dissolves and the rights of the representative deceased partner would depend on the provision of the partnership deed. Usually surviving partners carry on the business, purchasing the share of deceased partner after determining the among due to him and then treating it as a loan to the firm. The partnership dead usually states how this share is to be determined. In absent of any agreement or division by arbitration, accounts will have to be prepared as on the death and the profit or loss ascertained.

Illustration -: A, B and C are sharing profits in the ratio of 2:2:1. C dies on 1 April, 2013. The profit for the RS16, 000. Calculate the share deceased partner in profit of the firm.

Solution -: Profit for the year is RS16,000

Profit 1st Jan to 1st April 2013 i.e. for 3 months = 16,000*1/4=4000

C's share will be 4000x1/5 = 800.

2.3.9 Self check exercise

a) what is profit sharing ratio

b) how gaining ratio is calculated?

2.3.10 Summary

After going through this chapter students will be able to understand meaning of goodwill and factors affecting goodwill. Methods of valuation of goodwill are explained in this chapter. There are three methods of valuation of goodwill namely, average profit method, super profit method and capitalization of super profits. Changes in the profit sharing ratio on the event of admission of partner, retirement and death of partner are also explained in detail in this chapter.

2.3.11 Glossary

Gaining ratio = New share –Old share

Good will = capitalized value of average profits – capital employed

2.3.12 Answers to self check exercise

1. a) see para2.3.6.2
   b) see para 2.3.3
2. a) see para 2.3.8
   b) see para 2.3.8.3

2.3.13 Exercise

Long questions

Q.1 what do you mean by goodwill? Explain valuation of goodwill.

Q.2 what is goodwill? What is the treatment of goodwill in the events of admission, retirement and death of partner?

Short questions

Q.1 explain average profit method of goodwill valuation.

Q.2 how gaining ratio is calculated?

2.3.14 Suggested Readings :

Advanced Accounts M.C .Shukla, T.S Grewal& S.C Gupta

Financial Accounting

S.N Maheshwari [Vikas publication]

Suneel k.maheshwari [Vikas publication]

Sharda Maheshwari [Vikas publication]

Financial Accounting [kalyani publication]

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BBA PART-II (SEMESTER-III) BUSINESS ACCOUNTING

LESSON NO. 1.1-2.3

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Time Allowed : 1 Hour Max. Marks : 40

Attempt any two questions :

Q.1 Define Double Entry System. Give its advantages and disadvantages.

Q.2 Is Trail Balance a conclusive proof of accuracy ? Explain.

Q.3 What do mean by Depreciation. Give various reasons of Depreciation.

Q.4 Define Journal. Give the proforma of Journal and explain it.

Q.5 Write Notes :

(i) Matching Concept

(ii) Opening Entry

(iii) Diminishing Balance Method of Depreciation

(iv) Compensating Errors

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