UNIVERSITY GRANTS COMMISSION

COMMERCE **CODE: 08**

UNIT: 2 Accounting and auditing

Syllabus

SECTION – 1: Unit at a Glance

Sub Unit-1: Basic accounting Principles; Concepts and Postulates

Accounting and Book Keeping

Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes recording, classifying, summarizing, analysing, and reporting these transactions to those who are associated with the business.

Book keeping is the process of recording financial transactions on a daily basis. With the help of book keeping business entity is able to track all transaction related information relating to operating, investing and financial activities.

Objectives of accounting

- To maintain full and systematic records of business transactions
- To ascertain profit or loss of the business.
- To depict financial position of the business.
- To provide accounting information to the interested parties.

Classification of Accounting

- Financial accounting
- Cost accounting
- Management Accounting

Accounting Principles

Accounting principles are the general rules and guidelines that companies are required to follow at the time of preparing and reporting financial statement to the users of accounting information.

GAAP

GAAP (Generally Accepted Accounting Principles): It is a Technical concept that describes the basic rules, concepts, conventions and procedures that represent accepted accounting practices at a particular time.

Accounting Principles can be classified as

a) **Accounting Concept**

- Separate entity concept
- Going concern Concept
- Dual Concept
- Money Measurement Concept
- Cost Concept or Historical cost concept
- Accounting period concept
- Realisation Concept
- Matching Concept
- Accrual Concept

b) **Accounting Conventions**

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws.

- Convention of Consistency
- Convention of full disclosure
- Convention of Conservatism
- Convention of Materiality

Financial statement

Financial statements are written records that convey the business activities and the financial performance of a company.

Users of Financial Statement

- Creditors;
- Debtors;
- Potential Investors;
- Employees;
- Lenders;
- Government.

Components of Financial statement

- Income Statement or Profit & Loss account
- Balance Sheet or The Position Statement
- Statement of Changes in Financial Position (Cash flow statement.)

Sub Unit: 2 Partnership Accounts: Admission, Retirement, Death, Dissolution and Insolvency of partnership firms

Partnership

The term **partnership** is used to mean a business structure wherein **two or more individuals,** come together for undertaking a **lawful business** and have agreed to **share the profits and losses** arising from it. The **management and operation** of the business should be performed either by **all the partners or any of them, acting for all the partners.**

Partnership Deed

A Partnership Deed is a written agreement or document among the partners specifying rules and regulations and is signed by all the partners and stamped as per the Stamp Act with an aim to prevent possible disputes & disagreements among the partners at a future date. The registration of Deed of Partnership is made under the Indian Registration Act, 1908. In absence of partnership deed partnership Act is applied.

Content of Partnership Deed

- The name of the firm
- Names and addresses of the partners
- Nature of business
- Date of commencement
- Duration/Period
- The amount of capital to be brought in by each partner

- The amount of drawings that may be permitted in anticipation of profits and the manner of withdrawal.
- Sharing of profit or loss
- Rate of interest on capital
- Rate of interest on drawings
- Salary payable to the partners

Types of Partner

- Active Partner
- Sleeping or Dormant Partner
- Nominal partner
- Partners in Profits only
- Minor partner
- Partners by Estoppel or Holding Out

Dissolution and Insolvency of Partnership firms

Dissolving a partnership firm means discontinuing the business under the name of said partnership firm.

Dissolving a partnership firm is different from dissolving a partnership. In the former case, the firm ends its name and hence cannot do business in the future. But in case of dissolving a partnership, the existing partnership is dissolved– by consent or on happening of a certain event, but the firm can retain its existence if remaining partners enter into a new partnership agreement.

Modes of Dissolution of a firm

- Dissolution without the Intervention of Court
- Dissolution by court

Sub Unit: 3 Corporate Accounting: Issue, forfeiture and reissue of shares; Liquidation of companies; Acquisition, merger, amalgamation and reconstruction of companies

Company

A company is a legal entity formed by a group of individuals to engage in and operate a business enterprise in a commercial or industrial capacity. Companies may be either public or private; the former issues equity to shareholders on an exchange, while the latter is privately-owned and not regulated.

Share

A share is a single unit of ownership in a company or financial asset. It is essentially an exchangeable piece of value of a company which can fluctuate up or down, depending on several different market factors. So, share is nothing but the small unit of the total capital of the company.

Share capital

Total amount raised by the company by issuing shares is known as the share capital and the subscriber of the share is popularly known as shareholders.

Types of share

- Equity share
- Preference share

Types of share capital

- Authorised or Registered or Nominal capital
- Issued Capital
- Subscribed capital
- Called up capital
- Paid up capital

Subscription of share

- Full Subscription
- Under subscription
- Over subscription

Valuation of shares

Before investing in any company, it is important for us to understand the real worth of its shares. This will be possible if we can calculate the intrinsic value of the share. The process of calculating this intrinsic value is known as share valuation.

Methods of valuation of shares

- Assets-Backing Method or Intrinsic Value Method
- Yield-Basis Method
- Fair Value Method

Forfeiture of shares

If a shareholder, who is called upon to pay any call fails to pay the amount, even after sending several reminders, the company may forfeit his shares.

What is Re-issue of shares?

Re-issue of forfeited shares is a mere sale of shares for the company. Such shares may be re-issued at par, at a premium or even at a discount. So, re issue of shares is nothing but issue of forfeited shares as fresh issue.

Liquidation of company

The winding up or liquidation of a company means the termination of the legal existence of a company by stopping its business, collecting its assets and distributing the assets among creditors and shareholders in the manner laid down in the Act.

At the end of the winding up the company will have no assets or liabilities and will be a formal step for it to be dissolved. ***So winding up and dissolution are not same. Winding up is a process and dissolution is the end result.***

An administer , called ***" liquidator"*** is appointed who takes control of the company and he is responsible for collecting the assets and pays its debts and finally distributes any surplus among the members in accordance with their rights.

Liquidator is ***appointed*** by the Tribunal in case of winding up by the Tribunal and company or creditors in case of voluntary winding up.

Modes of liquidation of company

Section 270(1) of the Companies Act, 2013 deals with the types of winding up of a company. As per this section there are two modes of winding up of a company namely-

i) Compulsory winding up u/s 271 by the Tribunal and,

ii) Voluntary winding Up, u/s 304 by passing an appropriate resolution at a general meeting of members.

Acquisition of company

An acquisition refers to a corporate transaction wherein a company purchases a portion or entire shares/assets of another company. A new company does not emerge from an acquisition; rather, the smaller company is often consumed and ceases to exist, and its assets become part of the larger company.

Purchase consideration

Purchase Consideration refers to the consideration payable by the purchasing company to the vendor company for taking over the assets and liabilities of Vendor Company.

Methods of calculating purchase consideration

- Lump sum method
- Net Assets method
- Net Payment Method

Merger

Two or more companies are combined to form an altogether new entity; or one or more target companies get absorbed into an existing company i.e. merged company.

Amalgamation

Amalgamation is the combination of one or more companies into a new entity. In an amalgamation a new company is mandatorily formed to house the assets and liabilities of the combined companies. The amalgamating companies cease to exist.

Reconstruction

Reconstruction is an exercise of restating assets & liabilities by company / entity whose financial position as reflected by its balance sheet is not healthy but future is promising.

Types of reconstruction

- Internal reconstruction
- External reconstruction

Sub Unit: 4 Holding Company accounts

Holding company

Section 2(46) of the Companies Act, 2013 defines Holding Company. The company is said to be the holding company if that particular company holds/owns at least 50% of the other companies and has the authority to make management decisions, influences and controls the company's board of directors

Types of holding companies

- Parent holding company:
- Offspring company:
- Pure holding company:
- Proprietary holding company:
- Intermediate holding company:
- Finance holding company:
- Investment holding company:
- Primary holding company:
- Mixed holding company:

Subsidiary company

Section 2(87) of the Companies Act, 2013 defines the Subsidiary Company. The subsidiary company is the company that is controlled by the holding or parent company. It is defined as a company/body corporate where the holding company controls the composition of the Board of Directors. As per the Companies Amendment Act, 2017, Section 2(87)(ii), if the holding company have control over more than one-half of the voting power of another company, that particular company will be identified as the subsidiary company.

Minority Interest

A minority interest is ownership or interest of less than 50% of an enterprise.

A minority interest can either be passive or active.

Sub Unit : 5 Cost and Management Accounting: Marginal costing and Break-even analysis; Standard costing; Budgetary control; Process costing; Activity Based Costing (ABC); Costing for decision-making; Life cycle costing, Target costing, Kaizen costing and JIT

Uses of Marginal Costing:

- Business is calculating the break-even level of output.
- Business is considering whether to make or buy a product.
- Business is choosing between two or more alternatives.
- Business is costing a project to determine the minimum possible price to be quoted.
- Business is devising a price strategy.
- Business is abandoning a line of business.
- Business is facing a limiting factor and is deciding about optimum production mix.

Standard cost

The term **'standard cost'** can be defined as the expected cost per unit of the products produced during a period, which is based on various factors.

Standard costing

Standard Costing is a costing method that is used to compare the standard costs and revenues with the actual results, in order to arrive at the variances along with its causes, to inform the management about the deviations and take corrective measures, for its improvement.

Process of standard costing

- Ascertainment and use of Standard Costs;
- Recording the actual costs;
- Comparison of actual costs with standard costs in order to find out the variance;
- Analysis of variance; and
- After analysing the variance, appropriate action may be taken where necessary.

Types of standard

- Idle standard
- Normal standard
- Basic Standard
- Current standard
- Expected or Attainable standard

Variance analysis

Variance analysis is the procedure of computing the differences between standard costs and actual costs and recognizing the causes of those differences. Studies indicated that variance is the difference between standard performance and actual performance.

Budget

A budget may be defined as a financial and/or quantitative statement, prepared and approved prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective.

Budgetary control

It is a continuous process of determining the standard for future period of time and comparing the standard with the actual for identifying the deviation for taking corrective measures.

Flexible budget

It is a budget which is flexible and can be revised time to time considering current situation and conditions.

Process costing

Process costing is a technique and is applied where an unit passes through different processes for completion of its process and the processes are easily distinguishable then the cost of the unit will be cost of process that it goes through

Industries where process costing technique is applied

- Sugar Manufacturing Industries
- Brick Industries
- Petroleum Industries
- Steel Industries

Activity based costing

Activity based costing (ABC) is a method that assigns manufacturing overhead costs to products or process that consume cost in a more logical manner than the traditional approach of simply allocating costs on the basis of machine hours. Activity based costing first assigns costs to the activities that are the real cause of the overhead. It then assigns the cost of those activities only to the products that are actually demanding the activities. So in Activity Based costing the main focus is on the identifying the activities that are used to produce the product.

Costing for decision making

- Key factor or limiting factor
- Fixation of selling price
- Determination of product mix
- Make or buy decision
- Discontinuation of product line
- Profit planning

Life cycle costing

Product life cycle costing involves tracing of costs and revenues of a product over several calendar periods throughout its life cycle. So Life Cycle Costing is a method of identifying the cost and revenue of a product over several calendar years from the product invention to abandonment

Target costing

Target costing is a cost accounting approach in which companies set targets for costs based on the price prevalent in the market and the profit margin they want to earn. Keeping its costs below the relevant targets helps the companies to generate profit.

Target cost = Selling Price – Profit Margin

Kaizen costing

Kaizen costing is a technique of controlling the cost incurred over unproductive activities and resources which does not add any value to the organization. In simple words, it is a practical approach to solving cost-related problems to improve the overall efficiency of the organization.

5’s in Kaizen costing

- **Short**
- **Straighten**
- **Shine**
- **Standardize**
- **Sustain**

Stages of Kaizen Costing

Involve your employee→ Find problems→ Think and find →Solutions→ Implement→ Check→ Standardize→ Repeat.

Just-In-Time (JIT)

Just-in –Time is an inventory management method whereby materials is scheduled to arrive or be replenished exactly when needed in the production process. The Just-in-time system is adopted by the firms, to reduce the unnecessary burden of inventory management, in case the demand is less than the inventory raised.

Sub Unit: 6 Financial Statements Analysis: Ratio analysis; Funds flow Analysis; Cash flow analysis

Financial statement analysis

Financial Statement Analysis is nothing but the analysis of the financial statement by using different analytical and financial tools to make different business decision. There are three types of analysis namely vertical analysis, horizontal analysis and ratio analysis. Each one of these tools gives decision makers a little more insight into how well the company is performing.

Components of financial statement

1. Balance Sheet
2. Income Statement or Profit or Loss account.
3. Cash Flow Statement
4. Statement of Changes in Owners' Equity

Financial ratio

Financial Ratio is a quantitative relationship between two variables taken from the financial statement. This ratio is a very useful tool for analysing financial health of an organisation.

Classification of Ratio

- Liquidity Ratio
- Profitability Ratio
- Solvency Ratio
- Activity Ratio
- Income Statement Ratio
- Balance Sheet ratio
- Composite or Mixed Ratio
- Primary Ratio
- Secondary Ratio

Inter firm comparison

Inter firm comparison means a **comparison of two or more similar business units** with the objective of finding the competitive position to improve the profitability and productivity of those business units. Thus, inter firm comparison is a **tool used by the management of a company** to compare its operating performance and financial results with those of similar companies engaged in the same industry.

Fund

In narrow sense fund means **cash**. In broader sense fund means **all the financial resources** used in the business. In popular sense funds means **working capital**.

Fund flow statement

The fund flow statement is a statement which indicates various means by which the funds have been obtained during a specific period and the ways to which these funds have been used during that period. The term flow means movement and includes both inflows and outflows of resources.

Cash flow statement

A cash flow statement is a statement which shows the inflow and outflow of **cash and cash equivalent** during a specific accounting period. A cash flow statement is prepared by classifying all the activities into cash flow from operating activities, cash flow from financing activities and cash flow from investing activities. **Cash equivalents include bank accounts and marketable securities, which are debt securities with maturities of less than 90 days.**

Sub Unit: 7 Human Resources Accounting; Inflation Accounting; Environmental Accounting

Human Resource Accounting (HRM)

The American Accounting Society Committee on Human Resource Accounting defines it as follows –

"Human Resource Accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties."

Methods of Human Resource Accounting

- Replacement Cost Model
- Opportunity cost Model
- Capitalization of Historical cost Model
- Economic Value Model
- **Flamholtz model**

Inflation Accounting

Inflation accounting refers to the adjustment of the financial statements during the inflationary periods. It involves the recording of the income and expenditure of the business at the current prices and reinstating all the three statements of the company and analyse the cost and the trend of the current company.

Methods of Inflation Accounting

- Current Purchasing Power Method
- Current Cost Accounting
- Current value

Environmental Accounting

Environmental accounting is the practice of using traditional accounting and finance principles to calculate the costs that business decisions will have on the environment. Environmental accounting is the practice of incorporating principles of environmental management and conservation into reporting practices and cost/benefit analyses.

Sub Unit: 8 Indian Accounting Standards and IFRS

Accounting Standard (AS)

An accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies, accounting standards basically provide framework and standard accounting policies so that financial statements of different enterprise become comparable.

International Financial reporting Standard (IFRS)

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB). The goal of IFRS is to provide a global framework for how public companies prepare and disclose their financial statements. IFRS provides general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting. IFRS were established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country.

Advantages of IFRS

- Greater comparability
- Benefits to new and small investors
- More flexibility

Disadvantages of IFRS

- High costs of Implementation
- Prone to manipulation
- It is not globally accepted.

Sub Unit: 9 Auditing: Independent financial audit; Vouching; Verification ad valuation of assets and liabilities; Audit of financial statements and audit report; Cost audit

Auditing

The primary purpose of the audit is to confirm the authenticity of books of accounts prepared by an accountant. The audit is an intelligent and critical examination of the books of accounts of the business.

Independent financial audit

A **financial audit** is an independent, objective evaluation of an organization's financial reports and financial reporting processes. The primary purpose for financial audits is to give regulators, investors, directors, and managers' **reasonable assurance** that financial statements are accurate and complete.

Vouching

The act of examining documentary evidence in order to ascertain the accuracy of entries in the account books is called "Vouching". Vouching means a careful examination of all original evidence i.e invoices, statements, receipts, correspondence, minutes and contracts etc. with a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible, that no entries have been omitted in the books of accounts. Therefore, vouching is the act of testing the truth of entries appearing in the primary books of accounts.

Voucher

Voucher is known as the evident for the support of a transaction in the books of account. It may be bill, receipts, requisition form, agreement, decision, bank paying slip etc. The *voucher* is an internal *accounting* control, which ensures that every payment is properly authorized.

Types of voucher

- Receipt or Credit Voucher
- Payment or Debit Voucher
- Transfer or Journal voucher or Non-cash Voucher
- Supporting Voucher
- Primary Voucher
- Collateral Voucher

Verification

Verification means the act of assuring the correctness of value of assets and liabilities in the organization. It refers to the examination of proof of title and their existence or confirmation of assets and liabilities on the date of Balance Sheet

Verification and vouching

Vouching relates to confirmation of the correctness and authenticity of accounting entries as appeared in the books of accounts whereas verification confirms the existence, ownership and valuation of assets as appears in the balance sheet.

Valuation of assets and Liabilities

Valuation means finding out correct value of the assets on a particular date.

Vouching, Verification and Valuation

- In vouching, accounting entries are checked with the bona-fide vouchers.
- Verification proves the **existence, ownership** and **title** of assets.
- Valuation certifies the **correct value of asset**.
- Vouching is done after **original entry** in the books of accounts.
- Verification and valuation are done at the **end of the financial year**.
- Vouching is done by **Senior Auditor** and **Audit Clerk**.
- Verification and valuation are done by the **Auditor** himself.
- Bona-fide vouchers are sufficient **evidence** for vouching
- For Valuation Auditor has to depend upon **certification** from owner/partner/director.
- Verification is done by physical verification, title deeds and receipt of payment, etc.

Audit report

Lancaster has defined a report as "a report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of subject matter of the report."

Types of audit report

- Clean or Unqualified Report
- Qualified Report
- Adverse or Negative Report
- Disclaimer Report

Cost audit

Cost audit may be defined as "the verification of cost records and accounts and a check on the adherence to the prescribed cost accounting procedures and the continuing relevance of such procedures."

Circumstances under Which Cost Audit is Desirable

The following are the circumstances under which cost audit is ordered:

- Price Fixation.
- Cost variation within the industry.
- Inefficient Management.
- Tax Assessment.
- Trade Disputes.

Types of Cost Audit

- Efficiency Audit
- Propriety Audit
- Statutory Audit

Sub Unit: 10 Recent Trends in Auditing: Management audit; Energy audit; Environment audit; Systems audit; Safety audit

Management audit

Management audit is a method of independent and systematic evaluation of the management activities at all levels of management to ascertain the functions, efficiency and achievement of' the management (policies, programs, procedures) as compared to standards set by the company.

Energy audit

Energy Audit attempts to balance the total energy inputs with its use and serves to identify all the energy streams in the systems and quantifies energy usages according to its discrete function. Energy Audit helps in energy cost optimization, pollution control, safety aspects and suggests the methods to improve the operating & maintenance practices of the system. Energy audit helps to assess present pattern of energy consumption in different cost centres of operations and it also helps to highlight the wastage of energy in major areas.

Stages of energy audit

Data Collection→ Field work→ Analysis of energy consumption and performance of energy accounting→ Analysis and development of energy saving measures→ Energy Audit Report

Environmental audit

Environmental auditing involves examination of interaction between business and surroundings and ensures how organisation, management and equipment are functioning to protect environment.

System audit

A system audit is a disciplined approach to evaluate and improve the effectiveness of a system. Audits are carried out in order to verify that the individual elements within the system are effective and suitable in achieving the stated objectives.

Safety audit

It is an audit where information is collected about one or more aspects of the workplace in order to evaluate the risk levels for health or safety issues.

SECTION – 2: KEY STATEMENTS

Every candidates appearing for NET/SET examination should follow these key (main) points those can help them a better understanding regarding this unit very quickly.

Basic Key Statements: Accounting (2.1.1), Book Keeping (2.1.1), Accounting Principles (2.1.2), **GAAP** (2.1.2), Accounting Concept (2.1.2), Accounting Conventions (2.1.2), Capital expenditure (2.1.3), Deferred Revenue Expenditure(2.1.3), Financial statement (2.1.4), Partnership Deed (2.2.1.1), Merger (2.3.6), amalgamation (2.3.7), reconstruction (2.3.8), holding company (2.4.1), Marginal cost(2.5.2.2), Profit volume ratio (2.5.2.2), flexible budget (2.5.4.4), Kaizen costing (2.5.10), Just-In-Time (JIT)(2.5.11), components of financial statement (2.6.1.1), financial ratio (2.6.2.1), Inter firm comparison (2.6.2.6), Cash equivalents (2.6.4), Human Resource Accounting (2.7.1), Inflation Accounting (2.7.2), Methods of Inflation Accounting (2.7.2.1), Environmental Accounting (2.7.3), Independent financial audit (2.9.2), vouching (2.9.3). Types of voucher (2.9.3.3), Verification (2.9.4), valuation of assets and liabilities (2.9.5.1), audit report (2.9.6), Types of audit report (2.9.6.1), Cost audit (2.9.7),

Standard Key Statements: Types of Partners (2.1.4), Dissolution of a firm(2.2.5.1), Garner vs Murray (2.2.5.4), Fixed Capital vs Fluctuating Capital (2.2.5.5), Forfeiture of shares (2.3.3), liquidation of company (2.3.4), Types of standard (2.5.3.4), activity based costing (2.5.6), Key factor(2.5.7) Life cycle costing (2.5.8), Target costing (2.5.9), Types of Cost Audit(2.9.7.3), management audit(2.10.1), energy audit(2.10.2), environmental audit(2.10.3), system audit(2.10.4), safety audit(2.10.5).

Advanced Key Statements: Subscription of share (2.3.1.4), Types of share capital(2.3.1.3), Pro rata allotment(2.3.1.5), Valuation of shares(2.3.1.6), Re-issue of shares (8.3.2), purchase consideration (2.3.5.1), Types of holding companies (2.4.1.1), subsidiary company (2.4.1.2), Minority Interest (2.4.1.6), Cash break-even point(2.5.2.2), Margin of Safety(2.5.2.2), standard cost(2.5.3), 5's in Kaizen costing(2.5.10.1), Accounting Standard(2.8.1), International Financial reporting Standard(2.8.2), Indian Accounting Standards(Ind As)(2.8.3).

[N.B. – Values in parenthesis are the reference number]

SECTION – 3: KEY FACTS AND FIGURES

Sub Unit-1: Basic accounting Principles; Concepts and Postulates

Sl. No.	Topics
1	2.1.1Accounting and Book Keeping
2	2.1.1.1 Objectives of accounting
3	2.1.1.2 Classification of Accounting
4	2.1.2 Accounting Principles
5	2.1.3 Capital and Revenue Items
6	2.1.4 Financial statement
7	2.1.4.1 Objectives of Financial Statements
8	2.1.4.2 Users of Financial Statement
9	2.1.4.3 Components of Financial statement

2.1.1 Accounting and Book Keeping

Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes recording, classifying, summarizing, analysing, and reporting these transactions to those who are associated with the business. Accounting can be classified as financial accounting, cost accounting and management accounting.

Book keeping is the process of recording financial transactions on a daily basis. With the help of book keeping business entity is able to track all transaction related information relating to operating, investing and financial activities.

Distinguish between Book Keeping and Accounting

Book Keeping	Accounting
Bookkeeping is mainly related to identifying, measuring, and recording, financial transactions	Bookkeeping is mainly related to identifying, measuring, and recording, financial transactions
Management can't take a decision based on the data provided by bookkeeping	Management can't take a decision based on the data provided by bookkeeping
The objective of bookkeeping is to keep the records of all financial transactions proper and systematic	The objective of bookkeeping is to keep the records of all financial transactions proper and systematic
Financial statements are not prepared as a part of this process	Financial statements are not prepared as a part of this process
Bookkeeping doesn't require any special skill sets	Bookkeeping doesn't require any special skill sets

2.1.1.1 Objectives of accounting

- To maintain full and systematic records of business transactions
- To ascertain profit or loss of the business.
- To depict financial position of the business.
- To provide accounting information to the interested parties.

2.1.1.2 Classification of Accounting

a) Financial accounting

Financial accounting is the process of preparing financial statements that companies' use to show their financial performance and position to people outside the company, Including investors, creditors, suppliers, and customers.

b) Cost accounting

Cost accounting is the process of determining the costs of goods and services to be produced by an organisation. It involves the recording, classification, allocation of various expenditures. This data is generally used in financial accounting. Cost accounting is basically associated with the estimation of cost of a product and services.

c) Management Accounting

Management accounting is the presentation of financial data and business activities for the internal management of the organization. Management accounting basically present the business financial data and information to the internal management of the company in such a manner that it can be used by the management for taking different managerial decisions.

2.1.2 Accounting Principles

Accounting principles are the general rules and guidelines that companies are required to follow at the time of preparing and reporting financial statement to the users of accounting information.

What is GAAP?

GAAP (Generally Accepted Accounting Principles): It is a Technical concept that describes the basic rules, concepts, conventions and procedures that represent accepted accounting practices at a particular time.

Accounting Principles can be classified as

a) **Accounting Concept**

The term concept includes those basic assumptions, conditions and ideas upon which the science of accounting is based.

- **Separate entity concept**

  The separate entity concept suggests that the financial transactions and balances of a business entity are to be accounted for distinctly from those of its owner. Therefore, when it comes to accounting, a business entity is entirely separated from its owner. That is why an owner's equity is placed on the liability side of a balance sheet. So as per this concept business and owner of the business is separate person. The proprietor is treated as a creditor to the extent of his capital.

- **Going concern Concept**

According to this concept an enterprise will continue to function in the coming future without the need of the entity to be liquidated emerging or to cut down on its operational activities. So as per this concept it is assume that business will remain in operation for the foreseeable future.

- **Dual Concept**

According to this concept every transaction has two sides i.e. debit and credit. If one account is debited, another account must be credited. Every business transaction involves duality of effects. (i) Yielding of that benefit (ii) The giving of that benefit.

- **Money Measurement Concept**

Money measurement concept of accounting defines and states that financial accounting is concerned only with the items which can be quantified and expressed in monetary terms.

- **Cost Concept or Historical cost concept**

According to this concept the assets should be recorded at the cash amount (or the equivalent) at the time that an asset is acquired. Further, the amount recorded will not be increased for inflation or improvements in market value.

- **Accounting period concept**

Accounting is a continuous process in any business undertaking. Every businessman wants to know the result of his investment and efforts at frequent intervals. Accountants choose some shorter period to measure the result. Therefore, one year has been, generally, accepted as the accounting period. This period is called accounting period. Financial period chosen, in this regard, should be neither too long nor too short.

- **Realisation Concept**

According to realisation concept, which is also known as the “revenue recognition concept”, revenue is considered as being earned on the date on which it is realized, i.e., the date on which goods and services are transferred to customers either for cash or for credit. “Credit transactions create debtors and the promise of debtors to make payment is sufficient for the purpose of realising revenue. The realisation concept is important in ascertaining the exact profit earned during a period in a business concern. This concept is very important as it prevents firms from inflating their profits by recording sales and incomes that are likely to accrue.

- **Matching Concept**

Matching concept of accounting defines and states that “while preparing the income statement, revenue and profits are matched with the related expenses incurred in generating them”. So as per matching concept in determining the net profit from business operations all cost which is applicable to revenue of the period should be charged against that.

- **Accrual Concept**

According to this concept all the transactions should be recorded in the same accounting periods when they actually occur, rather than in the periods when there are actual cash outflow for the transaction.

b) **Accounting Conventions**

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws.

- **Convention of Consistency**

The consistency principle states that once you decide on an accounting method or principle to use in your business, you need to stick with and follow this method throughout your accounting periods.

- **Convention of full disclosure**

According to this convention all the information that has an impact on business's financial statements should be disclosed or included alongside to the statement. So as per this convention all the information whether it is significant or not has to be disclose fully.

- **Convention of Conservatism**

According to this approach probable losses has to be accounted but probable gains should not be included in financial statement. So, this concept allows accountants to anticipate future losses, rather than future gains.

- **Convention of Materiality**

This convention is contrary to the convention of full disclosure. As per convention of full disclosure all the information whether it is significant or insignificant should be disclosed fully in financial statement but as per materiality only the material facts or significant information should be disclosed in financial statement and financial statement should not be disclosed insignificant information.

2.1.3 Capital and Revenue Items

Capital expenditure

Capital expenditure refers to the investment used by a business to acquire, maintain, and upgrade fixed assets i.e. to expand business and to generate additional profits.

Examples: Purchase of plant and Machinery, motor car, furniture, addition to office building etc.

Revenue Expenditure

Revenue expenditure refers to the expenses incurred for day-to-day activities and are not capitalized because they do not provide benefits extending beyond the current year.

Examples: Payment of salaries, rent, commission etc.

Deferred Revenue Expenditure

It can be defined as the expenditure which is revenue in nature and incurred in one accounting period but its benefits are to be derived in multiple future accounting periods. These expenses are unusually large in amount and, essentially, the benefits are not consumed within the same accounting period. These expenses are large in amount and, essentially, the benefits are not consumed within the same accounting period. Part of the amount which is charged to profit and loss account in the current accounting period is reduced from total expenditure and rest is shown in the Balance Sheet as a fictitious asset.

Example: Advertisement Expense

Revenue Profit

It is nothing but the positive difference between revenue and the operating expenses.
(Revenue> Operating expenses)

Revenue Loss

It is nothing but the negative difference between revenue and the operating expenses.
(Revenue< Operating expenses). Revenue losses on normal business activity are part of the profit and loss account.

Capital loss
Discount on issue of shares and losses on sale of fixed assets are the capital loss and would be set off against the capital profits only.

Capital profit
The premium received on issue of shares, and the profits on sale of fixed assets are the major examples of capital profit .Capital profit should be transferred to the capital reserve account, which is used to set off capital losses in future if any

Revenue Receipt
Sale of stock, commission received, and interest on investment received are the main examples of revenue receipts. Revenue receipts will be credited to the profit and loss account.

Capital Receipts
Sale of fixed assets, capital employed or invested, and loans are the example of capital receipts. Capital receipts will affect the Balance-sheet.

2.1.4 Financial statement

Financial statements are written records that convey the business activities and the financial performance of a company. Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing, or investing purposes. These statements are prepared to give users outside of the company, like investors and creditors, more information about the company's financial positions. Publicly traded companies are also required to present these statements along with others to regulatory agencies in a timely manner. Financial statement not only represents the profit and loss of the business but also the assets and liabilities of the business.

2.1.4.1 Objectives of Financial Statements

(i) It provides necessary information about the financial activities to the interested parties.
(ii) It provides necessary information about the efficiency or otherwise of the management, regarding the proper utilisation of the scarce resources.
(iii) It help to evaluate the earning capacity of the firm by supplying a statement of financial position, a statement of periodical earnings together with a statement of financial activities to the various interested persons.
(iv) It provides necessary data to the government for taking proper decisions relating to duties, taxes and price control, etc. and for some legal and control purposes.
(v) It also provides necessary data and information to the managers for internal reporting and formulation of overall policies.
(vi) It also helps to safeguard the interest of shareholders who are not allowed to go through the day-to-day affairs of the firm.

2.1.4.2 Users of Financial Statement

Financial statement is used by the following parties that are associated with the business organisation-

i) Creditors;
ii) Debtors;
iii) Potential Investors;
iv) Employees;
v) Lenders;
vi) Government.

2.1.4.3 Components of Financial statement

Financial statement includes the following three components-

i) Income Statement or Profit & Loss account
ii) Balance Sheet or The Position Statement
iii) Statement of Changes in Financial Position (Cash flow statement.)

Previous Year Questions

Sub Unit – 2.1

July- 2018

1. **Assertion (A)** : Personal transactions of the owners of the business are not recorded in the books.

Reasoning (R) : According to the business entity concept, each business enterprise is Considered as an accounting unit separate from owners.

Code :

(1) Both (A) and (R) are correct and (R) is the correct explanation of (A).
(2) Both (A) and (R) are correct but (R) is not the correct explanation of (A).
(3) (A) is correct but (R) is not correct.
(4) (A) is wrong but (R) is correct.

2. Which one of the following statements is not true?

(1) An expenditure intended to benefit current year is revenue expenditure.
(2) Amount paid for acquiring goodwill is capital expenditure.
(3) Wages paid for installation of a new machine is usually debited to wages account.
(4) Revenue expenditure is not intended to benefit future period.

Answer with Reference

SL. NO.	QUESTION NO.	ANSWER	REFERENCE NO.
1.	8	1	2.1.2
2.	11	3	2.1.3

Jan.- 2017

1. Which one of the following receipts is of revenue nature?
(1) Amount realised from the sale of investments
(2) Dividend received on investment
(3) Amount borrowed from a bank
(4) Compensation received from municipal corporation for the acquisition of land for the construction of road.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.1.3

July 2016

1. Which of the following is deferred revenue expenditure?
(1) Legal expenses incurred on the purchase of land.
(2) Expenses on a mega advertisement campaign while launching a new product.
(3) Expenses incurred on installation of a new machine.
(4) Wages paid for construction of an additional room in the building.

2. The amount of depreciation charged to Profit and Loss Account varies every year under:
(1) Fixed instalment method
(2) Annuity method
(3) Diminishing balance method
(4) Insurance policy method

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.1.3
2.	3	2.1.3

Sept. 2016

1. Capital in the business is treated as a liability due to
(1) Dual aspect concept
(2) Business entity concept
(3) Going concern concept
(4) Accrual concept

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.1.2
2.	3	2.1.3

June 2015

1. **In what order, the following assets are shown in the balance sheet of a company?**

(i) Trade receivables
(ii) Cash
(iii) Furniture and fittings
(iv) Investment in shares and debentures

Codes:

1. (ii), (i), (iv), (iii)
2. (i), (ii), (iii), (iv)
3. (iii), (iv), (i), (ii)
4. (iv), (iii), (ii), (i)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.1.4

Dec. 2015

1. Interest on loan taken for the purchase of fixed assets is a
1) Revenue expenditure
2) Capital expenditure
3) Deferred Revenue Expenditure
4) Capital loss

2. Dual Aspect concept results in the following accounting equation
1) Revenue=Expenses
2) Capital +Profit= Assets+ Expenses
3) Capital +Liabilities=Assets
4) Capital+ Drawings=Owner's Equity

3. Match the items in column -1 with the items in Column -2:

Column -1	**Column-2**
A) Materiality concept	i) The same accounting method used by a firm From one period to another
B) Going Concern Concept	ii) An inappropriate assumption of a firm being bankrupt
C) Historical Cost Concept	iii) A normal basis used for accounting assets
D) Consistency concept	iv) Relates to the importance of an item or event

Codes:

	A	B	C	D
1)	(iv)	(ii)	(iii)	(i)
2)	(i)	(ii)	(iii)	(iv)
3)	(ii)	(iii)	(iv)	(i)
4)	(iv)	(ii)	(i)	(iii)

4. Which of the following statements are correct?
(a) Analysis and interpretation of financial statements, is a function of accounting.
(b) Profit and Loss account is prepared for ascertaining financial position of a firm.
(c) Goodwill is a wasting asset.
(d) Balance Sheet is prepared for ascertaining financial position of a firm.
Select the correct answer using the codes given below:
A. (a) and (b)
B. (a) and (c)
C. (a) and (d)
D. (b) and (c)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.1.3
2.	3	2.1.2
3.	1	2.1.2
4.	A	2.1.4

Sub Unit: 2 Partnership Accounts: Admission, Retirement, Death, Dissolution and Insolvency of partnership firms

Sl. No	Topics
10	2.2.1 What is Partnership?
11	2.2.1.1 What is Partnership Deed?
12	2.2.1.2 Content of Partnership Deed
13	2.2.1.3 Provisions affecting Accounting Treatment in Absence of a partnership deed
14	2.2.1.4 Types of Partners
15	2.2.2 Admission of a Partner
16	2.2.2.1 Adjustment to be made on Admission
17	2.2.3 Retirement
18	2.2.4 Death
19	2.2.5 Dissolution and Insolvency of Partnership firms
20	2.2.5.1 Modes of Dissolution of a firm
21	2.2.5.2 Accounts to be open for dissolution of partnership firm
22	2.2.5.3 Decision in Garner vs Murray

2.2.1 What is Partnership?

The term **partnership** is used to mean a business structure wherein **two or more individuals,** come together for undertaking a **lawful business** and have agreed to **share the profits and losses** arising from it. The **management and operation** of the business should be performed either by **all the partners or any of them, acting for all the partners.**

2.2.1.1 What is Partnership Deed?

A Partnership Deed is a written agreement or document among the partners specifying rules and regulations and is signed by all the partners and stamped as per the Stamp Act with an aim to prevent possible disputes & disagreements among the partners at a future date. The registration of Deed of Partnership is made under the Indian Registration Act, 1908. In absence of partnership deed partnership Act is applied.

2.2.1.2 Content of Partnership Deed

Partnership deed includes the following-

- The name of the firm
- Names and addresses of the partners
- Nature of business
- Date of commencement
- Duration/Period
- The amount of capital to be brought in by each partner
- The amount of drawings that may be permitted in anticipation of profits and the manner of withdrawal.
- Sharing of profit or loss
- Rate of interest on capital
- Rate of interest on drawings
- Salary payable to the partners

2.2.1.3 Provisions affecting Accounting Treatment in Absence of a partnership deed

Profit Sharing:

It will be distributed equally among the partners.

Right to Remuneration

No partners will be allowed any remuneration.

Interest on Capital

No interest on partners' capital will be allowed

Interest on Drawings

No interest on Partners Drawings will be allowed.

Interest on Loans or advances

Interest on loan or advance will be allowed at 6% P.a.

2.2.1.4 Types of Partners

Active Partner

A person who takes active interest in the conduct and management of the business of the firm is known as active or managing partner.

Sleeping or Dormant Partner

A sleeping partner is a partner who 'sleeps', that is, he does not take active part in the management of the business. Such a partner only contributes to the share capital of the firm, is bound by the activities of other partners, and shares the profits and losses of the business.

Nominal partner

A nominal partner is one who does not have any real interest in the business but lends his name to the firm, without any capital contributions, and doesn't share the profits of the business.

Partners in Profits only

When a partner agrees with the others that he would only share the profits of the firm and would not be liable for its losses, he is in own as partner in profits only.

Minor partner

A partnership is created by an agreement. And if a partner is incapable of entering into a contract, he cannot become a partner. Thus, at the time of creation of a firm a minor (i.e., a person who has not attained the age of 18 years) cannot be one of the parties to the contract. But under section 30 of the Indian Partnership Act, 1932, a minor 'can be admitted to the benefits of partnership', with the consent of all partners. A minor partner is entitled to his share of profits and to have access to the accounts of the firm for purposes of inspection and copy.

Partners by Estoppel or Holding Out

If a person, by his words or conduct, holds out to another that he is a partner, he will be stopped from denying that he is not a partner. The person who thus becomes liable to third parties to pay the debts of the firm is known as a holding out partner

2.2.2 Admission of a Partner

As per the 'Indian partner Act 1932', a person may be admitted as partner in the firm either with consent of all existing partner or in an accordance with the contract already made between the existing partners in the firm for the admission of new partners in the business concern.

2.2.2.1 Adjustment to be made on Admission

a) Adjustment in the profit sharing ratio

New Profit Sharing Ratio

The ratio at which the partners decide to share profits/losses in future is called new profit sharing ratio.

Calculation of new profit sharing ratio

It is necessary to determine the new profit sharing ratio at the time of admission of a partner because the new partner is entitled to share the future profits of the firm. New profit sharing ratio is the agreed proportion in which future profit will be distributed to all the partners including the new partner. If the new profit sharing ratio is not agreed, the partners will share the profits and losses equally.

(a) When share sacrificed is given

When new profit sharing ratio is not given, but the share sacrificed by the old partner(s) is given, new profit sharing ratio is calculated as follows:

New share of old partner= Old share- share sacrificed

Share of new partner=Sum of shares sacrificed by the old partners

(b) When proportion of share sacrificed is given

(i) When share sacrificed is given as a proportion on old partners' share

When new profit sharing ratio is not given, but the share sacrificed is given as a proportion on old partners' share, new profit sharing ratio is calculated as follows:

Share sacrificed by old partner = Old share x Proportion of share sacrificed

New share of old partner = Old share - Share sacrificed

Share of new partner = Sum of shares sacrificed by old partners

(ii) When proportion of share sacrificed on new partner's share is given

When new profit sharing ratio is not given, but the proportion of share sacrificed on new partner's share is given, new profit sharing ratio is calculated as follows:

New share of old partner = Old share - Share sacrificed

Share sacrificed = New partner's share × Proportion of share sacrificed

(c) When share sacrificed and proportion of share sacrificed is not given

When new profit sharing ratio, share sacrificed and the proportion of share sacrificed is not given, but only the share of new partner is given, new profit sharing ratio is calculated by assuming that the share sacrificed is the proportion of old share. New profit sharing ratio is calculated as follows:

Share sacrificed = New partner's share x Old share

New share of old partner = Old share - Share sacrificed

Sacrificing Ratio

The ratio in which the partners have agreed to sacrifice their share of profit in favour of other partners is called sacrificing ratio.

Sacrificing ratio = Old Ratio – New Ratio

Gaining Ratio

The ratio in which the partners have agreed to gain their share of profit from other partners is called gaining ratio.

Gaining ratio= New ratio- Old ratio

b) Adjustment for Goodwill

At the time of admission of a partner, the existing partners sacrifice part of their share of profit in favour of the new partner. Hence, to compensate the sacrifice made by the existing partners, goodwill of the firm has to be valued and adjusted. In addition to capital, the new partner may contribute towards goodwill. This goodwill is distributed in the sacrificing ratio to the old partners who sacrifice.

1. Accounting treatment for goodwill

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

1. When new partner brings cash towards goodwill
2. When the new partner does not bring goodwill in cash or in kind
3. When the new partner brings only a part of the goodwill in cash or in kind
4. Existing goodwill

1. When new partner brings cash towards goodwill
When the new partner brings cash towards goodwill in addition to the amount of capital, it is distributed to the existing partners in the sacrificing ratio.
(i) For the goodwill brought in cash credited to old partners' capital account
Cash/Bank a/c ……Dr.
To, Old partners' capital A/c
(ii) For the goodwill brought in kind (in the form of assets) credited to old partners' capital account
Respective assets A/c …Dr.
To, Old partners' capital a/c
(iii) For withdrawal of cash received for goodwill by the old partners
Old partners' capital a/c……. Dr.
To, Cash /Bank a/c
2. When the new partner does not bring goodwill in cash or in kind
If the new partner does not bring goodwill in cash or in kind, his share of goodwill must be adjusted through the capital accounts of the partners. The following journal entry is passed.
New partners' capital a/c ………Dr.
To Old partners' capital a/c
3. When the new partner brings only a part of the goodwill in cash or in kind
Sometimes the new partner may bring only a part of the goodwill in cash or assets. In such a case, for the cash or the assets brought, the respective account is debited and for the amount not brought in cash or kind, the new partner's capital account is debited. The following journal entry is passed.
Cash/Bank a/c……………. Dr.
New partners' Capital a/c ………..Dr.
To, Old partners' capital a/c
4. Existing goodwill
If goodwill already appears in the books of accounts, at the time of admission if the partners decide, it can be written off by transferring it to the existing partners' capital account / current account in the old profit sharing ratio. The following journal entry is to be passed:
Old Partners capital a/c………….. Dr.
To, Goodwill a/c
2.2.3 Retirement
When one or more partner (s) leaves the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Retirement may happen due to old age of the partners, old age etc. On the event of 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.

Adjustment to be made on Retiring Partner

a) Adjustment in Profit sharing ratio

1. New profit sharing ratio

It is necessary to determine the new profit sharing ratio at the time of retirement of a partner because the continuing partners acquire the retiring partner's share of profit. New profit sharing ratio is the agreed proportion in which future profit will be distributed to the continuing partners. If the new profit sharing ratio is not agreed, the continuing partners will share the profits and losses equally.

2. Gaining ratio

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

Share gained = New share – Old share

Gaining ratio = Ratio of share gained by the continuing partners

Calculation of gaining ratio and new profit sharing ratio under different situations

1. When new profit sharing ratio is given

When new profit sharing ratio is given, only gaining ratio has to be calculated as follows:

Gaining ratio = Ratio of share gained by the continuing partners

Share gained = New share – Old share

2. When new profit sharing ratio is not given

(a) Only one partner gains the retiring partner's share

When new profit sharing ratio is not given and only one continuing partner gains the entire share of the retiring partner, new profit sharing ratio is calculated as follows:

New share of continuing partner = Old share + Share gained

(b) More than one partner gains the retiring partner's share

(i) Proportion of share gained on retiring partner's share is given

When new profit sharing ratio is not given, but the proportion of share gained on retiring partner's share is given, new profit sharing ratio is calculated as follows:

New share of continuing partners = Old share + Share gained

Share gained = Retiring partner's share × Proportion of share gained

(ii) Proportion of share gained is not given

When new profit sharing ratio, share gained and the proportion of share gained is not given, the new share is calculated by assuming that share gained is the proportion of the old share. Therefore, the new profit sharing ratio and the gaining ratio among the continuing partners is their old profit sharing ratio between them.

b) Adjustment for Goodwill

Goodwill and its types

Goodwill is an intangible asset associated with the purchase of one company by another. Specifically, goodwill is recorded in a situation in which the purchase price is higher than the sum of the fair value of all visible solid assets and intangible assets purchased in the acquisition and the liabilities assumed in the process. The value of a company's brand name, solid customer base, good customer relations, good employee relations, and any patents or proprietary technology represent some examples of goodwill.

It is very interesting to study the classification of Goodwill based on consumer behavior. This theory was first coined by P.D. Leake in 1921. He also defines goodwill as follows: "the right which grows out of all kinds of past effort in seeking profit, an increase of value or other advantages".

DOG GOODWILL

Dog is an animal that develops a fondness for its owner and not the place where he resides. When the owner moves, the dog also follows. Similar behaviour is portrayed by consumers of an entity with dog goodwill. The customers rely on the management and leadership of the company. They see value in the company because of the people chairing its positions. Such consumers will be likely to move their preferences to the location of the company leaders. Thus, the leadership of a business drives the dog goodwill.

For example, Warren Buffet is the heart and soul of Berkshire Hathaway Inc. The share value will spiral down were Buffet to step down or move. People will then choose to reallocate their funds to Buffets new address

CAT GOODWILL

A cat is often pictured as a self-sufficient animal with a "couldn't-care-less" personality. It does not care where the fish is coming from as long as it is coming every day. Think of an alley where you will always notice the same group of cats. Thus, cat goodwill customers are more loyal to a brand or the company name. The management and leadership team of the entity does not concern them. They are highly invested in the "brand equity" of the product and will hardly switch their preference.

The Apple iPhone users are the best example of cat goodwill. They are so highly drawn to the brand that no amount of better deals, price cuts or fancy features can lure them away. Steve Jobs and Wozniak can come and go. But the Apple users are here to stay.

RAT GOODWILL

Rat is a scurried animal rushing over to wherever the next piece of cheese is. It does not care "who" is putting out the cheese or "where" is it coming from. In other words, such consumers do not play favourites either in management personnel or in the brand. For this reason, it is also known as fugitive goodwill and is valueless. It is fickle and vulnerable. Therefore, it cannot be translated to generate any value.

1. Adjustment for goodwill

Reputation built up by a firm has an impact on the present and future profit to be earned by the firm. At the time of retirement of a partner, the continuing partners gain part of retiring partner's share of profit. Hence, the retiring partner's share of goodwill is to be valued and adjusted through the capital accounts of the gaining partners. The following journal entry is passed.

Continuing partners' capital a/c …Dr.(in gaining ratio)

To, Retiring partners capital a/c

2. Existing goodwill

If goodwill already appears in the balance sheet, at the time of retirement if the partners decide, it can be written off by transferring it to all the partners' capital account / current account in the old profit sharing ratio. The following journal entry is to be passed:

All partners' capital a/c ….Dr. (in old ratio)

To, Goodwill a/c

2.2.4 Death

2.2.5 Dissolution and Insolvency of Partnership firms

Dissolving a partnership firm means discontinuing the business under the name of said partnership firm. In this case, all liabilities are finally settled by selling off assets or transferring them to a particular partner, settling all accounts existed with the partnership firm. Any profit/ loss is transferred to partners in their profit sharing ratio as agreed by them in the partnership deed.

Dissolving a partnership firm is different from dissolving a partnership. In the former case, the firm ends its name and hence cannot do business in the future. But in case of dissolving a partnership, the existing partnership is dissolved– by consent or on happening of a certain event, but the firm can retain its existence if remaining partners enter into a new partnership agreement.

2.2.5.1 Modes of Dissolution of a firm

a) Dissolution without the Intervention of Court

i) Compulsory dissolution

A firm may need to be dissolved compulsorily if:

All partners or all partners except one partner are declared insolvent

The firm is carrying unlawful activities like dealing in drugs or other illegal products or doing business with alien countries or other countries that may harm the interest of India or doing other such activities.

ii) Dissolution depending on certain contingent events

Upon happening of certain events, a firm may be required to get dissolved:

Expiry of fixed-term– Partnership formed for a fixed term will get dissolved once the term gets over.

Completion of task– Sometimes, a partnership is formed for a certain task or objective. Once the task is completed, the partnership will automatically get dissolved.

Death of the partner– If there are only two partners and one of the partner dies, the partnership firm will automatically dissolve. If there are more than two partners, other partners may continue to run the firm. In such case, only the partnership will get dissolved, and other partners will enter into a new agreement.

iii)Dissolution by notice

If a partnership business is at will, any partner can dissolve the partnership by giving an advanced notice. Notice will contain a date from which dissolution will be effective.

iv) When partners are mutually agreed

It is the easiest way to dissolve a partnership firm since all partners have mutually agreed upon closing the partnership firm. Partners can give a mutual consent or may enter into an agreement for the dissolve.

b) Dissolution by court

When a partner files a suit in the court, the court may order the dissolution of the firm on the basis of the following grounds:

- In the case where a partner becomes insane
- In the case where a partner becomes permanently incapable of performing his duties.
- When a partner becomes guilty of misconduct and it affects the firm's business adversely.
- When a partner continuously commits a breach of the partnership agreement.
- In a case where a partner transfers the whole of his interest in the partnership firm to a third party.
- In a case where the business cannot be carried on except loss.
- When the court regards the dissolution of the firm to be just and equitable on any ground.

2.2.5.2 Accounts to be open for dissolution of partnership firm

a) Realisation a/c
b) Partners capital a/c
c) Bank/ cash a/c

2.2.5.3 Decision in Garner vs Murray

When there is nothing mentioned about the treatment of deficiency of insolvent partner, the judgement of leading case of Garner vs. Murry (1903) is followed.

As per this case the deficiency of insolvent partner must be borne by the other solvent partners in proportion to their capital, after each solvent partner has brought in cash equal to his own share of loss on realisation. To apply this decision, three conditions must be fulfilled

a) There are two or more than two solvent partners
b) One or more of partners are solvent
c) The capitals are not in profit sharing ratio.

Previous Year Question
Sub Unit – 2.2
June- 2019

1. Which of the following types of goodwill is considered to be the best?
1. Dog goodwill
2. Cat goodwill
3. Rat goodwill
4. Cow goodwill

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.2.3

July- 2018

1. X and Y sharing profits in the ratio of 7 : 3, admit Z for 3/7 share in the new firm in which he takes 2/7 from X and 1/7 from Y. The new ratio of X, Y and Z will be:

(1) 7 : 3 : 3
(2) 4 : 2 : 3
(3) 14 : 6 : 15
(4) 29 : 11 : 30

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	4	2.2.2.1

Nov.- 2017

1. Goodwill of a firm of X and Y is valued at Rs. 30,000. It is appearing in the books at Rs. 12,000. Z is admitted for 1/4 share. What amount he is supposed to bring for goodwill?

(1) Rs.3,000
(2) Rs.4,500
(3) Rs. 7,500
(4) Rs.10,500

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.2.2.1

July 2016

1. Ram and Shyam are partners in a firm with capital of Rs. 4,80,000 and Rs. 3,10,000, respectively. They admitted Ganesh as a partner with1/4th share of profit. Ganesh brings Rs. 3, 00,000 as his capital. Ganesh's share of goodwill will be-

(1) Rs. 1,10,000
(2) Rs. 27,500
(3) Rs. 17,500
(4) Rs. 70,000

2. A, B and C are partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2. They agreed to take D into partnership and gave him1/8th share. What will be their new profit sharing ratio?

(1) 4 : 3 : 2 : 1
(2) 28 : 21 : 14 : 9
(3) 28 : 21 : 14 : 8
(4) 4 : 1 : 2 : 1

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.2.2.1
2.	2	2.2.2.1

Sept. 2016

1. X, Y and Z are partners in a firm sharing profits and losses equally. They decided to share profits in ratio of 2 : 1 : 2 respectively. The gaining ratio of X and Z will be-
(1) 1 : 2
(2) 2 : 1
(3) 1 : 1
(4) 3 : 2

2. A and B are partners in a firm who share profits and losses equally. They admitted C on the following terms:
C should bring _ 12,000 as capital and _ 8,000 as goodwill. New profit sharing ratio of A, B and C will be 2 : 1 : 2, respectively. A and B will share the goodwill in which of the following ratios?
(1) 3 : 4
(2) 2 : 3
(3) 2 : 1
(4) 1 : 3

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.2.2.1
2.	4	2.2.2.1

June 2015

1. **A retiring partner continues to be liable for obligations incurred after his retirement:**

1. If unpaid amount is transferred to his loan account
2. If he does not give public notice.
3. If he starts a similar business elsewhere.
2. In all the situations till he survives.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.2.3

Sub Unit: 3 Corporate Accounting: Issue, forfeiture and reissue of shares; Liquidation of companies; Acquisition, merger, amalgamation and reconstruction of companies

2.3.1 Definition of Company

A company is a legal entity formed by a group of individuals to engage in and operate a business enterprise in a commercial or industrial capacity. Companies may be either public or private; the former issues equity to shareholders on an exchange, while the latter is privately-owned and not regulated.

2.3.1.1 Issue of shares

A company can raise its long term sources of finance by issuing share capital. By the term share capital we generally mean equity share capital. Equity share capital represents the ownership capital of the company. There are several methods of issuing share in the financial market.

What is Share?

A share is a single unit of ownership in a company or financial asset. It is essentially an exchangeable piece of value of a company which can fluctuate up or down, depending on several different market factors. So, share is nothing but the small unit of the total capital of the company.

What is share capital?

Total amount raised by the company by issuing shares is known as the share capital and the subscriber of the share is popularly known as shareholders.

2.3.1.2 Types of share

Shares of a company may be divided according to the rights and privileges attached to them into the following two categories-

Preference share

It means that part of the capital of the company which:

(a) Carries a preferential right as to payment of dividend at fixed rate during the life time of the company.

(b) Carries, on the winding up of the company, a preferential right to be repaid the amount of the capital paid up.

** In case of redemption of preference share out of any profits, available for dividends, an equal amount must be transferred to a reserve known as "***Capital redemption Reserve***". Capital redemption reserve can only be utilized for issuing fully paid bonus share to the equity shareholders.

Equity Share

It means with reference to a company, limited by shares, all share capital which is not preference share capital. Equity shareholders participate in divisible profits just after the claims of preference shareholders have been met. They have voting right.

2.3.1.3 Types of share capital

i) Authorised or Registered or Nominal capital

This is the amount of capital with which the company intends to get itself registered. This is the amount of share capital which a company is authorized to issue.

ii) Issued Capital

It is that part of the nominal capital which is actually issued by the company for public subscription.

iv) Subscribed capital

It is that amount of the nominal value of shares which have actually been taken up by the public.

v) Called up capital

Called up capital is that amount of the nominal value of shares subscribed for which the company has asked its shareholders to pay by means of calls or otherwise.

vi) Paid up capital

Paid up capital represents the total payments made by the shareholders to the company in response to the calls made by the company. Paid up capital of the company is calculated by deducting the calls in arrears from the called up capital.

2.3.1.4 Subscription of share

Full Subscription

When the number of shares applied for, is equal to the number of shares offered for subscription, the share are said to be fully subscribed.

Under subscription

It is a situation where the number of shares applied for is less than the number of shares offered for subscription.

Over subscription

It is a situation where the number of shares applied for is more than the number of shares offered for subscription. In this case excess application is refunded or pro rata allotment is made.

2.3.1.5 Some important concept related to issue of shares

Calls in advance

A shareholder can pay the whole or part of the amount remaining unpaid on his shares even before the call is made. This is only a voluntary payment and is known as **calls in advance.** The amount paid in advance can be adjusted when the calls are actually made. An interest can also be paid if the Articles so authorize.

Calls in arrear

When one or more shareholders fail to pay the amount due from them towards allotment and/or calls, such dues are called calls-in-arrears. An interest can also be charged if the Articles so authorize.

Pro rata allotment

Pro- rata allotment is made in case of oversubscription of shares. It can be defined as the process of issuing of shares in proportion of the shares applied for.

In case of pro-rata allotment excess application money received is transferred to share allotment and while receiving allotment money excess application money received is adjusted towards allotment account.

Examples:

A company which issued 10000 shares, received application of 12900 shares. It decides to make full rejection of applications against 900 shares and allot 10000 shares against the remaining applications for 12000 shares. In this case excess application money on 2000 shares will be transferred to the share allotment account and the ratio of allotment will be 5:6 i.e. pro-rata allotment.

Uses of Security Premium Account

Section 52(2) of Companies Act, 2013 basically talks about usage of premium, i.e. the areas where the premium amount can be applied, the purpose that can be resolved using this premium amount lying in your Balance Sheet

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68 (Buy Back of Securities)

2.3.1.6 Valuation of shares

Before investing in any company, it is important for us to understand the real worth of its shares. This will be possible if we can calculate the intrinsic value of the share. The process of calculating this intrinsic value is known as share valuation.

Need for valuation of shares

- When a business is being sold to another business;
- When a business offers its shares as security to get a loan;
- When companies undergoes mergers, demergers, acquisitions or reconstruction;
- When a company is implementing an Employee Stock Option Plan (ESOP); and/or
- When a company plans to convert its shares from preference to equity shares.

Methods of valuation of shares

There are three methods of valuation of shares namely-

i) Assets-Backing Method or Intrinsic Value Method

Under this method, the net values of assets of the company are divided by the number of shares to arrive at the value of each share. For the determination of net value of assets, it is necessary to estimate the worth of the assets and liabilities. The goodwill as well as non-trading assets should also be included in total assets. The following points should be considered while valuing of shares according to this method:

* Goodwill must be properly valued
* The fictitious assets such as preliminary expenses, discount on issue of shares and debentures, accumulated losses etc. should be eliminated.
* The fixed assets should be taken at their realizable value.
* Provision for bad debts, depreciation etc. must be considered.
* All unrecorded assets and liabilities (if any) should be considered.
* Floating assets should be taken at market value.
* The external liabilities such as sundry creditors, bills payable, loan, debentures etc. should be deducted from the value of assets for the determination of net value.

The net value of assets, determined so has to be divided by number of equity shares for finding out the value of share. Thus the value per share can be determined by using the following formula:

Value Per Share$=\frac{\textbf{Net Assets}-\textbf{Preference Share Capital}}{\textit{No.of Equity Shares}}$

ii) Yield-Basis Method

The expected rate of return in investment is denoted by yield. The term "rate of return" refers to the return which a shareholder earns on his investment. Further it can be classified as (a) Rate of earning and (b) Rate of dividend. In other words, yield may be earning yield and dividend yield.

a. Earning Yield

Under this method, shares are valued on the basis of expected earning and normal rate of return. The value per share is calculated by applying following formula:

Value Per Share = (Expected rate of earning/Normal rate of return) X Paid up value of equity share

Expected rate of earning = (Profit after tax/paid up value of equity share) X 100

b. Dividend Yield

Under this method, shares are valued on the basis of expected dividend and normal rate of return. The value per share is calculated by applying following formula:

Expected rate of dividend = (profit available for dividend/paid up equity share capital) X 100

Value per share = (Expected rate of dividend/normal rate of return) X 100

iii)Fair Value Method

Value per share$=\frac{Intrinsic\ value+Yield\ value}{2}$

2.3.2 What is Forfeiture of shares?

If a shareholder, who is called upon to pay any call fails to pay the amount, even after sending several reminders, the company may forfeit his shares. Forfeiture of shares results in a permanent reduction of the share capital. Before such forfeiture is done a notice must be given to the shareholder. The notice must provide the shareholder with a minimum of 14 days to make the payment due, or his shares will be forfeited. Even after such notice if the shareholder does not pay, then the shares will be cancelled.

2.3.2.1 Accounting treatment of forfeiture of share

a) Forfeiture of share, issued at par

Share Capital A/c …Dr(called up amount)
To Share allotment a/c(Amount not received on allotment)
To, Share Call a/c (amount not received on call)
To Share forfeiture a/c (amount received so far)

b) Forfeiture of share, issued at premium

Share Capital A/c …Dr(called up amount)
Securities premium a/c Dr. (premium amount on called up)
To Share allotment a/c(Amount not received on allotment)
To, Share Call a/c (amount not received on call)
To Share forfeiture a/c (amount received so far)

2.3.3 What is Re-issue of shares?

Forfeited shares are available with the company for sale. After the forfeiture of shares, the company is under an obligation to dispose off the forfeited shares. The company requires to pass a resolution in its Board Meeting for the re-issue of forfeited shares. Re-issue of forfeited shares is a mere sale of shares for the company. Such shares may be re-issued at par, at a premium or even at a discount. So, re issue of shares is nothing but issue of forfeited shares as fresh issue.

2.3.3.1 Accounting treatment of Re-issue of shares

a) For forfeited shares reissued at par

Bank a/c …………………Dr.
To, share Capital a/c

b) For forfeited shares reissued at premium

Bank a/c …………………Dr.
To, share Capital a/c
To, Securities Premium a/c

C) **For forfeited shares reissued at discount**

Bank a/c …………………Dr.
Share Forfeiture a/c…….Dr. (amount of discount)
To, share Capital a/c

After any forfeited share has been re-issued, any balance left in forfeited share account represents a capital profit. It is transferred to Capital reserve Account .When all forfeited shares have been issued, the credit balance left on the share forfeiture account is transferred to capital reserve account. But, if all the forfeited shares are not re-issued, the proportionate profit is to be calculated only on the re-issued shares. Only that profit can be transferred.

Share forfeiture a/c…..Dr.
To, Capital reserve a/c

2.3.4 What is liquidation of company?

The winding up or liquidation of a company means the termination of the legal existence of a company by stopping its business, collecting its assets and distributing the assets among creditors and shareholders in the manner laid down in the Act.

At the end of the winding up the company will have no assets or liabilities and will be a formal step for it to be dissolved. ***So winding up and dissolution are not same. Winding up is a process and dissolution is the end result.***

An administer , called ***" liquidator"*** is appointed who takes control of the company and he is responsible for collecting the assets and pays its debts and finally distributes any surplus among the members in accordance with their rights.

Liquidator is ***appointed*** by the Tribunal in case of winding up by the Tribunal and company or creditors in case of voluntary winding up.

2.3.4.1 Distinguish between Liquidation and Dissolution

Winding up	Dissolution
Winding up is one of the methods by which dissolution of a company is brought about.	Dissolution is the end result of winding up.
Legal entity of the company continues at the commencement of the winding up.	Dissolution brings about an end to the legal entity of the company
A company may be allowed to continue its business as far it is necessary for the beneficial winding up of the company	Company ceases to exist on its dissolution.

2.3.4.2 Modes of liquidation of company

Section 270(1) of the Companies Act, 2013 deals with the types of winding up of a company. As per this section there are two modes of winding up of a company namely-

i) Compulsory winding up u/s 271 by the Tribunal and,

ii) Voluntary winding Up, u/s 304 by passing an appropriate resolution at a general meeting of members.

Compulsory liquidation of company

According to sec. 271(1) a company may be wound up by the Tribunal

- If the company unable to pay its debts;
- If the company has by special resolution resolved that the company be wound up by the tribunal.
- If the company has acted against the interest of the integrity or morality of India, security of the state, or has spoiled any kind of friendly relations with foreign or neighbouring countries.
- If the company has not filled its financial statements or annual returns for preceding 5 consecutive financial years.

- If the tribunal by any means finds that it is just & equitable that the company should be wound up.
- If the company in any way is indulged in fraudulent activities or any other unlawful business, or any person or management connected with the formation of company is found guilty of fraud, or any kind of misconduct.

Voluntary liquidation of company

Winding up by the creditors or members without any intervention of the court is termed as voluntary winding up

The company can be wound up voluntarily by the mutual decision of members of the company, if:

- The company passes a Special Resolution stating about the winding up of the company.
- The company in its general meeting passes a resolution for winding up as a result of expiry of the period of its duration as fixed by its Articles of Association or at the occurrence of any such event where the articles provide for dissolution of company.

2.3.5 What is acquisition of company?

An acquisition refers to a corporate transaction wherein a company purchases a portion or entire shares/assets of another company. A new company does not emerge from an acquisition; rather, the smaller company is often consumed and ceases to exist, and its assets become part of the larger company.

2.3.5.1 What is purchase consideration?

Purchase Consideration refers to the consideration payable by the purchasing company to the vendor company for taking over the assets and liabilities of Vendor Company.

Accounting Standard – 14 defines the term purchase consideration as the "aggregate of the shares and other securities issued and the payment made in the form of ach or other assets by the transferee company to the shareholders of the transferor company". Although, purchase consideration refers to total payment made by purchasing company to the shareholders of Vendor Company, its calculation could be in different methods, as explained below:

A. Lump sum method

B. Net Assets method

C. Net Payment Method

2.3.6 What is Merger?

Merger is a form of corporate restructuring that involves the following:

Two or more companies are combined to form an altogether new entity; or one or more target companies get absorbed into an existing company i.e. merged company.

A merger helps companies to enlarge their reach, obtain increased market shares, and diversify their services. The combined business, through structural and operational advantages secured by the merger, can cut costs and increase profits, boosting shareholder values for both groups of shareholders.

A merger can be horizontal, vertical, or conglomerate. A horizontal merger is entered into for the purpose of reducing or eliminating one or several competing companies in the market. A vertical merger is where one company provides raw materials or services to the business or businesses it is acquiring. A conglomerate merger is taken with an aim of diversifying the business activities.

2.3.7 What is amalgamation?

Amalgamation is the combination of one or more companies into a new entity. In an amalgamation a new company is mandatorily formed to house the assets and liabilities of the combined companies. The amalgamating companies cease to exist. An amalgamation is distinct from a merger because neither of the combining companies survives as a legal entity. Rather, a completely new entity is formed to house the combined assets and liabilities of both companies. The main objective of amalgamation is to achieve synergetic benefits which arise, when two companies can achieve more in combination than when they are individual entities. The other objectives of amalgamation are: (i) To reap economies of scale (ii) To eliminate competition (iii) To build up goodwill (iv) To reduce the degree of risk through diversification (v) Managerial effectiveness.

2.3.7.1Amalgamation in the nature of Merger

According to AS-14 on Accounting for Amalgamation, the following conditions must be satisfied for an amalgamation in the nature of merger:

A. After amalgamation, all the assets and liabilities of the transferor company becomes the assets and liabilities of the transferee company.

B. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company become the equity shareholders of the transferee company by virtue of amalgamation.

C. The business of the transferor company is intended to be carried on after the amalgamation by the transferee company.

D. Purchase consideration should be discharged only by issue of equity shares in the transferee company except that cash may be paid in respect of any fractional shares.

E. No adjustments are required to be made in the book values of the assets and liabilities of the transferor company, when they are incorporated in the financial statements of the transferee company. If any one of the condition is not satisfied in a process of amalgamation, it will not be considered as amalgamation in the nature of merger.

2.3.7.2 Amalgamation in the nature of purchase

An amalgamation will be treated as “Amalgamation in the nature of purchase” if any of the above mentioned conditions is not satisfied.

2.3.7.3 Distinguish between amalgamation and acquisition

- When a company takes over control of another company establishing itself as the owner, the transaction or process is termed as acquisition
- When two or more companies decide to join hands to consolidate and form a new company in an effort to have a larger customer base, larger market and possibly more profits, the process is termed as amalgamation.

- Amalgamation is often between equals whereas acquisition is between companies of unequal sizes
- Amalgamation is horizontal expansion whereas acquisition is a vertical expansion

2.3.8 What is reconstruction?

Reconstruction is an exercise of restating assets & liabilities by company / entity whose financial position as reflected by its balance sheet is not healthy but future is promising. This exercise is done to gain the confidence of different stakeholders (creditors, lenders, customers, shareholders etc) whose support is required for revival of the operations.

2.3.8.1 Objectives:

1. To generate surplus for writing off accumulated losses & writing down overstated assets.
2. To generate cash for working capital needs, replacement of assets, to add balancing equipment, modernise plant & machinery etc.

2.3.8.2 Types of reconstruction

i) Internal reconstruction

Internal reconstruction means a recourse undertaken to make necessary changes in the capital structure of a company without liquidating the existing company. In internal reconstruction neither the existing company is liquidated, nor is a new company incorporated. It is a scheme in which efforts are made to bail out the company from losses and put it in profitable position. Internal reconstruction of a company is done through the reorganization of its share capital. It is a scheme of reorganization in which all interested parties in the capital structure volunteer to sacrifice. They are the company's shareholders, debenture holders, creditors etc. Under internal reconstruction, the accumulated trading losses and fictitious assets are written off against the sacrifice made by these interest holders in the form of reduction of paid up value of their interest.

ii) External reconstruction

The term 'External Reconstruction' means the winding up of an existing company and registering itself into a new one after a rearrangement of its financial position. Thus, there are two aspects of 'External Reconstruction', one, winding up of an existing company and the other, rearrangement of the company's financial position. Such arrangement shall be approved by its shareholders and creditors and shall be sanctioned by the National Company Law Tribunal (NCLT). Such a step usually involves the writing off of a debit balance on Profit and Loss Account, elimination of all fictitious assets if any from the Balance Sheet, and the consequent readjustment of share capital.

2.3.8.3 Distinguish between internal and external reconstruction

Internal Reconstruction	External Reconstruction
No new company is formed in case of Internal Reconstruction.	A new company is formed in case of External Reconstruction.
In case of Internal Reconstruction, no company is liquidated.	In case of External Reconstruction one company is liquidated
Internal Reconstruction requires court’s confirmation.	But External Reconstruction can be affected without court’s confirmation
Internal Reconstruction is a slow and tedious process.	But External Reconstruction can be carried out easily
In the case of Internal Reconstruction, the company is able to set off its past losses against future profits.	In the case of External Reconstruction, the past losses of the old company can’t be set off against the future profits of the new company.

Previous Year Question

Sub Unit – 2.3

June 2019

1. Redeemable preference shares of ₹2,00,000 are to be redeemed at par for which fresh equity shares of ₹80,000 are issued at a discount of 10%. What amount should be transferred to Capital Redemption Reserve Account?

1. ₹ 2,00,000
2. ₹ 1,20,000
3. ₹ 1,28,000
4. ₹ 72,000

2. **As per Section 52 of the companies Act, 2013, the balance in the Security Premium Account cannot be utilized for:**

1. Payment of dividend
2. Writing off discount on issue of shares
3. Issue of fully paid-up bonus share
4. Capital losses

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.5.1.2
2.	1	2.3.1.5

July- 2018

1. X Ltd. forfeited 20 shares of Rs. 10 each, Rs. 8 called up, on which John had paid application and allotment money of Rs. 5 per share, of these, 15 shares were reissued to Parker as fully paid up for Rs. 6 per share. What is the balance in the share Forfeiture Account after the relevant amount has been transferred to Capital Reserve Account?

(1) NIL
(2) Rs. 5
(3) Rs. 25
(4) Rs. 100

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.3.3.1

Nov.- 2017

1. Under the yield method of valuation of equity share capital, if for an equity share of Rs. 50, the normal rate of return is 10% and expected rate of return is 5%, then the value of an equity share will be

(1) Rs. 25
(2) Rs. 40
(3) Rs. 50
(4) Rs.100

2. Which one of the following statements is not true?
(1) When there is one liquidation and one formation it is known as external construction.
(2) Goodwill or Capital reserve arises only when the amalgamation is in the nature of Merger.
(3) Under the pooling of interest method, the transferee company incorporates the assets and liabilities of the transferor company at book value.
(4) The vendor company transfers preliminary expenses (at the time of absorption) to equity shareholders' account.

3. Which of the following are the motives of mergers? Indicate the correct code.
(a) To gain the economies of scale.
(b) To utilise under - utilised resources.
(c) To break the monopoly.
(d) To reduce the tax liability.
Code :
(1) (a), (c) and (d)
(2) (a), (b) and (d)
(3) (b), (c) and (d)
(4) (a), (b) and (c)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.3.1.6
2.	2	2.3.8
3.	2	2.3.6

Jan. -2017

1. A Ltd. issued a prospectus inviting applications for 2,000 shares. Applications were received for 3,000 shares and pro-rata allotment was made on the applications of 2,400 shares. If A has been allotted 40 shares, how many shares he must have applied for?

(1) 40
(2) 44
(3) 48
(4) 52

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.3.1.5

<u>Sept. 2016</u>

1. The directors of X Ltd. resolved to forfeit 2000 equity shares of Rs. 10 each. On these shares Rs.7.50 per share was paid up, but final call of Rs. 2.50 per share was unpaid. 1,000 of the forfeited shares were reissued at Rs. 7 per share. Capital Reserve Account will be credited by

(1) Rs. 4,500
(2) Rs. 7,500
(3) Rs. 2,500
(4) Rs.5,000

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.3.3.1

Dec. 2015

1. When a business is purchased, any amount paid in excess of the total of assets, minus the liabilities taken, is called:

a) Share premium
b) Goodwill
c) Working capital
d) Capital employed

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	b	2.3.7

Sub Unit: 4 Holding Company accounts

2.4.1 What is holding company?

Section 2(46) of the Companies Act, 2013 defines Holding Company. The company is said to be the holding company if that particular company holds/owns at least 50% of the other companies and has the authority to make management decisions, influences and controls the company's board of directors. A holding company may exist for the sole purpose of controlling and managing subsidiary companies.

2.4.1.1 Types of holding companies

The following are the different types of holding companies:

1. **Parent holding company**: It comes into existence when an organization in existence acquires controlling stake in existing companies or starts new companies under its control. For e.g. Tata Tea has acquired controlling stake in Tetley, a UK tea company. In this case, Tata Tea is the parent holding company.
2. **Offspring company**: A new company started by some existing company with the objective of exercising control. For example, ECC (Engineering Construction Corporation Ltd.,) was set up by L&T (Larsen & Toubro Ltd.,) as its subsidiary. L&T is the parent holding company and ECC is the offspring company.
3. **Pure holding company**: A company which is established primarily for uniting and controlling the subsidiaries. For e.g. in the Tata group, Tata Sons Ltd., was established for uniting and controlling the various subsidiaries. TV Sundaram Iyengar and Sons is the holding company of the TVS group.
4. **Proprietary holding company**: A company which holds the entire stock issued by its subsidiaries.
5. **Intermediate holding company**: A holding company of a subsidiary, but is itself controlled by another holding Company.
6. **Finance holding company:** It does not control the affairs of other companies. It earns profits by financing the operations of other firms.
7. **Investment holding company**: It does not control the affairs of other companies. It invests in the securities of a number of companies. Its members derive the benefit of diversified investment.
8. **Primary holding company**: A holding company which is not a subsidiary of any other company. For example, Unilever Ltd., set.up HLL (Hindustan Lever Limited) as its subsidiary. Unilever Ltd., which is the holding company is not a subsidiary of any other company and is therefore a primary holding company
9. **Mixed holding company**: A holding company which runs its own business and also controls the business of its subsidiaries. For e.g. ICI Ltd., set up Indian Explosive as its subsidiary. ICI Ltd., runs its own business and also controls the business of Indian Explosives.

2.4.1.2 What is subsidiary company?

Section 2(87) of the Companies Act, 2013 defines the Subsidiary Company. The subsidiary company is the company that is controlled by the holding or parent company. It is defined as a company/body corporate where the holding company controls the composition of the Board of Directors. As per the Companies Amendment Act, 2017, Section 2(87)(ii), if the holding company have control over more than one-half of the voting power of another company, that particular company will be identified as the subsidiary company.

2.4.1.3 Consolidation of financial statement

AS-21 came into effect in respect of accounting periods commencing on or after 1st April 2002.The AS-21 is applicable to all the enterprises that prepare consolidated financial statement. It is mandatory for listed companies and banking companies.

2.4.1.4 Advantages of holding company

- Ease of operation
- Polling of large Capital
- Competition avoidance
- Economies of large scale operation
- Secrecy maintained
- Reduction of tax
- Assets protection

2.4.1.5 Disadvantages of holding company

- Misuse of power
- Overcapitalisation
- Exploitation of subsidiaries
- Concentration of economic power
- Secret monopoly
- Reduce transparency
- Excessive legal compliance

2.4.1.6 Minority Interest

A minority interest is ownership or interest of less than 50% of an enterprise.

A minority interest can either be passive or active. **Passive minority interests**, where a company owns 20% or less, are those in which a company has no material influence on the company in which it maintains a minority interest. In accounting terms, only the dividends received from the minority interest are recorded for those with minority passive interests.

Active minority interests—owning 21% to 49%—are those in which a company has the ability to materially influence the company in which it holds a minority interest. Unlike passive interests, dividends received and a percentage of income is recorded for those with active minority interests.

Previous Year Question

Sub Unit – 2.4

July 2016

1. X Ltd. purchased 70 percent of the shares of Y Ltd. at a price of Rs. 1,00,000. Share capital of Y Ltd. was of Rs. 70,000 and its accumulated profits amounted to Rs.90, 000. What would be the amount of Minority Interest in the consolidated Balance Sheet?

(1) Rs.25,000
(2) Rs.70,000
(3) Rs. 1,00,000
(4) Rs. 40,000

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	***	

Nov. -2017

1. Consolidated financial statements are prepared on the principle

(1) In form the companies are one entity, in substance they are separate.
(2) In form companies are separate, in substance they are one.
(3) In form and substance the companies are one entity.
(4) In form and substance the companies are separate.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.4.1

June -2015

1. Preparation of consolidated statement of accounts as per AS - 21 is:

a. Optional

b. Mandatory for Private Ltd. Companies

c. Mandatory for Listed Companies

d. Mandatory for all Companies

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	c	2.4.1.3

Sub Unit : 5 Cost and Management Accounting: Marginal costing and Break-even analysis; Standard costing; Budgetary control; Process costing; Activity Based Costing (ABC); Costing for decision-making; Life cycle costing, Target costing, Kaizen costing and JIT

Sl. No.	Topics
55	2.5.1 Some Important concept related to cost accountancy
56	2.5.2 Uses of Marginal Costing
57	2.5.2.1 What is Cost-Volume-profit (CVP) analysis?
58	2.5.2.2 Some Important terms
59	2.5.2.3 Advantages of marginal costing
60	2.5.2.4 Limitations of marginal costing
61	2.5.3 What is standard cost?
62	2.5.3.1 What is standard costing?
63	2.5.3.2 Objectives of standard costing
64	2.5.3.3 Process of standard costing
65	2.5.3.4 Types of standard
66	2.5.3.5 Variance analysis
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68	2.5.4.1 What is budgetary control?
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82	2.5.10 what is Kaizen costing?
83	2.5.10.1 5’s in Kaizen costing
84	2.5.10.2 Stages of Kaizen Costing
85	2.5.11 Just-In-Time (JIT)

2.5.1 Some Important concept related to cost accountancy

What is cost?

Cost is commonly defined as 'sacrificed resource' for a particular thing.

What is costing?

It is a process for determining the cost. It may be called a technique for ascertaining the cost of production of any product or service in the business organization.

What is cost accounting?

Cost Accounting is basically the next step to costing. Cost accounting involves analyzing relevant costing data, interpret it and present various management problems to management.

What is Cost Accountancy?

It is subject which provides the knowledge of costing and cost accounting. Cost Accountancy facilitates management with cost control initiatives, ascertainment of profitability and informed decision making. It also includes determination of selling price for the products, division and unit wise profitability. Forecasting of expenses and future probable incomes is also a part of the practice of Cost Accountancy.

Objectives of cost accounting

- To ascertain the cost per unit of the different products manufactured by a business concern;
- To provide requisite data and serve as a guide for fixing prices of products manufactured or services rendered;
- To ascertain the profitability of each of the products and advise management as to how these profits can be maximised;
- To help in the preparation of budgets and implementation of budgetary control;
- To exercise effective control if stocks of raw materials, work-in-progress, consumable stores and finished goods in order to minimise the capital locked up in these stocks;
- To supply useful data to management for taking various financial decisions such as introduction of new products, replacement of labour by machine etc.

What is Management accounting?

Management accounting is the presentation of financial data and business activities for the internal management of the organization. Management accounting basically present the business financial data and information to the internal management of the company in such a manner that it can be used by the management for taking different managerial decisions.

Objectives of management accounting

- **Helping out in planning and formulating the policies**
- **Proper interpretation of the financial status**
- **Effective Communication**
- **Solving critical business problems**
- Facilitates Control over the organisational activities
- **Evaluate policy efficiency**
- Helping in qualitative decision-making

2.5.2 Uses of Marginal Costing:

Marginal costing is used for short run decision making, when:

- Business is calculating the break-even level of output.
- Business is considering whether to make or buy a product.
- Business is choosing between two or more alternatives.
- Business is costing a project to determine the minimum possible price to be quoted.
- Business is devising a price strategy.
- Business is abandoning a line of business.
- Business is facing a limiting factor and is deciding about optimum production mix.

2.5.2.1 What is Cost-Volume-profit (CVP) analysis?

Cost- Volume- Profit (CVP) analysis is a technique for studying the relationship between cost, volume and profit. The CVP relationship is an important tool used for the profit planning of a business.

2.5.2.2 Some Important terms:

Marginal cost

Marginal cost is the additional cost incurred for the production of an additional unit of output. The formula is calculated by dividing the change in the total cost by the change in the product output. Decision relating to additional production of output should be taken on the basis of the marginal cost with the marginal revenue that will be realized by an additional unit of output.

Contribution

The *term contribution* represents the difference between sales price and variable cost. Contribution means, "contribution towards absorption of fixed costs and profits".

Formula for contribution:

**** Sales**	****
Less, Variable cost	***
Contribution	***
Less, Fixed Cost	***
Profit	***

a) Contribution= Sales- variable cost

b) Contribution= Fixed cost+ Profit

c) Contribution= sales*P/V ratio

So, Variable cost= Sales*(1-P/V ratio)

Again, Sales- variable cost= Fixed cost+ Profit= Contribution

Breakeven point

BEP is that level of output at which total cost is equal to the total revenue. So at BEP the organisation earns zero profit and Zero loss. BEP may also refer to the revenues that are needed to be reached in order to compensate for the expenses incurred during a specific period. So it is a situation where there is no profit, no loss to the company. Break-Even Point tells about the volume of sales needed to cover all operating expenses. If sales equals to Break-even point then the company neither earns profit nor suffers from loss. If company cannot achieve BEP, the company suffers from loss.

A) B/E(in units)=$\frac{Fixed\ Cost}{Contribution\ per\ unit}$

B) B/E (in sales value)= $\frac{Fixed\ Cost}{\frac{P}{V}ratio}$

Profit volume ratio

P/V Ratio (Profit Volume Ratio) is the ratio of contribution to sales which indicates the contribution earned with respect to one rupee of sales. It also measures the rate of change of profit due to change in volume of sales. Its fundamental property is that if per unit sales price and variable cost are constant then P/V Ratio will be constant at all the levels of activities. A change is fixed cost does not affect P/V Ratio. A high P/V Ratio indicates that a slight increase in sales without increase in fixed costs will result in higher profits. A low P/V ratio which indicates low profitability can be improved by increasing selling price, reducing marginal costs or selling products having high P/V ratio.

a) P/V ratio= $\frac{Contribution}{Sales}$

b) P/V ratio= $\frac{Contribution\ per\ unit}{Selling\ price\ per\ unit}$

c) P/V ratio= $\frac{Change\ in\ contribution}{Change\ in\ sales}$

d) P/V ratio= $\frac{Change\ in\ profit}{Change\ in\ sales}$

e) P/V ratio= $\frac{Profit}{Margin\ of\ safety\ ratio}$

Cash break-even point

Breakeven point implies the amount of sales which is required to cover all operating expenses. But, fixed costs include certain non-cash expenses like depreciation and amortization of expenses, for which no cash is needed in short-run. Therefore, company can exclude depreciation and other non-cash expenses in the short-run. If only the cash costs are included in fixed costs we get cash BEP.

Cash BEP (in units)= $\frac{Cash\ Fixed\ cost}{Cash\ contribution\ per\ unit}$

Cash fixed cost**= Fixed costs- Non-cash expenses**

Margin of Safety

Margin of safety is the amount of actual sales beyond Break Even sales are known as Margin of Safety. Margin of safety determines that how much extent sales can decrease before the business will move out of profit and into a loss making situation. It gives an indication of the vulnerability of profit to reduction in demand and is frequently used as a risk measure. It is useful to determine financial soundness of business enterprise. If margin of safety is high, then the financial position of the enterprise is sound.

a) Margin of safety=Total Sales- B/E Sales

b) Margin of safety= $\frac{Total\ sales - \frac{B}{E}Sales}{Total\ sales} \times 100$

2.5.2.3 Advantages of marginal costing

- Effective cost control – It divides cost into fixed and variable. Fixed cost is excluded from product. As such, management can control marginal cost effectively.
- Helpful to management – It enables the management to start a new line of production which is advantageous. It is helpful in determining which is profitable whether to buy or manufacture a product. The management can take decision regarding pricing and tendering.
- Helps in production planning – It shows the amount of profit at every level of output with the help of cost volume profit relationship. Here the break-even chart is made use of.
- Better results – When used with standard costing, it gives better results.
- Fixation of selling price – The differentiation between fixed costs and variable costs is very helpful in determining the selling price of the products or services. Sometimes, different prices are charged for the same article in different markets to meet varying degrees of competition.
- Helpful in budgetary control – The classification of expenses is very helpful in budgeting and flexible budget for various levels of activities.
- Preparing tenders – Many business enterprises have to compete in the market in quoting the lowest price. Total variable cost, when separately calculated, becomes the 'floor price'. Any price above this floor price may be quoted to increase the total contribution.
- "Make or Buy" decision – Sometimes a decision has to be made whether to manufacture a component or a product or to buy it ready-made from the market. The decision to purchase it would be taken if the price paid recovers some of the fixed expenses.

2.5.2.4 Limitations of marginal costing

- Difficulty to analyse overhead – Separation of costs into fixed and variable is a difficult problem. In marginal costing, semi-variable or semi-fixed costs are not considered.
- Time element ignored – Fixed costs and variable costs are different in the short run; but in the long run, all costs are variable. In the long run all costs change at varying levels of operation. When new plants and equipment are introduced, fixed costs and variable costs will vary.
- Problem of variable overheads – Marginal costing overcomes the problem of over and under-absorption of fixed overheads. Yet there is the problem in the case of variable overheads.
- Sales-oriented – Successful business has to go in a balanced way in respect of selling production functions. But marginal costing is criticised on account of its attaching over-importance to selling function. Thus it is said to be sales-oriented. Production function is given less importance.

2.5.3 What is standard cost?

The term **'standard cost'** can be defined as the expected cost per unit of the products produced during a period, which is based on various factors. Standard costs are based on scientific analysis and engineering studies while estimated costs are based on historical basis.

2.5.3.1 What is standard costing?

Standard Costing is a costing method that is used to compare the standard costs and revenues with the actual results, in order to arrive at the variances along with its causes, to inform the management about the deviations and take corrective measures, for its improvement.

2.5.3.2 Objectives of standard costing

- To provide a formal basis for assessing performance and efficiency.
- To control costs by establishing standards and analysis of variances.
- To assist in setting budgets.
- It supplies the ways to utilise properly material, labour and also overhead which will be economic in character.
- To assist in assigning responsibility for nonstandard performance in order to correct deficiencies or to capitalise on benefits.
- To motivate staff and management.
- To provide a basis for estimating.
- It also helps to motivate the employees of a firm to improve their performance by setting up a 'standard'.
- It also helps the management to take various corrective decisions viz., fixation of price, make-or-buy decisions etc. which will be more beneficial to the firm.

2.5.3.3 Process of standard costing

- Ascertainment and use of Standard Costs;
- Recording the actual costs;
- Comparison of actual costs with standard costs in order to find out the variance;
- Analysis of variance; and
- After analysing the variance, appropriate action may be taken where necessary.

2.5.3.4 Types of standard:

Idle standard

Ideal standards are the standards which can be attained under the most favourable conditions possible.

Normal standard

Normal standards are the average standards which can be attained during a future period of time.

Basic Standard

Basic standard can be defined as the standard which is unaltered and is used over for a longer period of time and do not reflect current conditions. It is also known as the fixed or static standard,

Current standard

It is the standard set for shorter period of time and can easily adapt to the current conditions.

Expected or Attainable standard

It compromises between the extreme of normal standard and idle standard. So it is the standard which can be attained at current conditions and set up.

2.5.3.5 Variance analysis

Variance analysis is the procedure of computing the differences between standard costs and actual costs and recognizing the causes of those differences. Studies indicated that variance is the difference between standard performance and actual performance. It is the process of scrutinizing variance by subdividing the total variance in such a way that management can assign responsibility for off-Standard Performance.

Formula for Calculating Variance

Material Variance

a) Material Price Variance = (Standard Price – Actual Price) x Actual Quantity

b) Material Usage Variance = (Standard Quantity for actual output – Actual Quantity) x Standard Price

Labour Variance

a) Labour rate variance

= (Standard Rate Per Hour – Actual Rate Per Hour) x Actual Hours

b) Labour Efficiency Variance = (Standard Hours for Actual Out Put – Actual Hours) x Standard Rate

Variable Overheads variance

a) Variable overhead efficiency variance = (Actual Output – Standard Output) x Standard Rate

b) Variable overhead expenditure variance = (Standard Output x Standard Rate) – (Actual Output x Actual Rate)

Fixed overhead variance

a) Fixed overhead expenditure variance = Standard Fixed Overhead – Actual Fixed Overhead

b) Fixed overhead volume variance = (Actual Output x Standard Rate per unit) – Standard Fixed Overhead

Sales Variance

a) Sales volume variance = (Budgeted Quantity – Actual Quantity) x Budgeted Price

b) Sales price variance = (Budgeted Price – Actual Price) x Actual Quantity

2.5.4 What is Budget?

A budget may be defined as a financial and/or quantitative statement, prepared and approved prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective. So budget is nothing but the quantitative or numeric expression of planning.

2.5.4.1 What is budgetary control?

It is a continuous process of determining the standard for future period of time and comparing the standard with the actual for identifying the deviation for taking corrective measures. Chartered Institute of Management Accountants explained Budgetary Control as "the establishment of the budgets relating to the responsibilities of the executive to meet the objective of an organization and the continuous comparison of actual with budgeted estimates so that if remedial is necessary it may be taken at an early stage".

2.5.4.2 Process of budgetary control

The process of controlling budgets can be broken down into several steps:

- Establishing actual position
- Comparing actual with budget
- Calculating variances
- Establishing reasons for variances
- Taking action to exert control

2.5.4.3 Advantages of budgetary control

Control: It facilitates management to control each function, sector, ministry or department in order to accomplish the best possible result.
Coordination: It supports and encourages synchronization between departments of activities for the accomplishment of the overall progress of the organization/institution
Cost reduction: It makes management to become more cost conscious and reduce waste and inefficiency in its operations.
Management by exception: It is a time saving device, as attention is directed to areas of more serious needs.
Performance appraisal: It leads to measure the employee's performance in an efficient way.
It increases the operational efficiency of various business actions.
It assists in effective utilization of resources of organization.
It leads to maximization of profit of the organisation.

2.5.4.4 What is flexible budget?

It is a budget which is flexible and can be revised time to time considering current situation and conditions.

2.5.4.5 Distinguish between fixed budget and flexible budget

Fixed Budget	Flexible Budget
A fixed budget is a budget that doesn't change due to any change in activity level or output level.	The flexible budget is a budget that changes as per the activity level or production of units.
The fixed budget is static and doesn't change at all.	Flexible budget, on the other hand, is adjustable as per the necessity of the business.
The fixed budget is very simplistic	A flexible budget is pretty complex.
A fixed budget is estimated on the past data and the anticipation of management regarding future events.	Flexible budget, on the other hand, is estimated on the basis of realistic situations.

2.5.5 What is Process costing?

Process costing is a technique and is applied where an unit passes through different processes for completion of its process and the processes are easily distinguishable then the cost of the unit will be cost of process that it goes through. In process costing a separate account is opened for every process and on completion of the process the cost is transferred to the next process. In process costing output of one process is used as input for another process.

2.5.5.1 Industries where process costing technique is applied

- Sugar Manufacturing Industries
- Brick Industries
- Petroleum Industries
- Steel Industries

2.5.5.2 Some important concept related to process costing

Normal loss

Normal loss means that loss which is inherent in the processing operations. It can be expected or anticipated in advance i.e. at the time of estimation. The cost of the normal loss is considered as the part of the cost of production. Realisable scrap value of normal loss is credited to the process account.

Abnormal loss

The loss which is over and above the normal loss and occurred due to unexpected situation or abnormal conditions is called as abnormal loss. Process account is credited by abnormal loss with the cost of materials, labour and overhead equivalent to good unit and the loss arises to abnormal loss is transferred to costing profit & loss account.

Abnormal gain

If the actual loss of a process is less than the expected loss of that particular process the difference is popularly known as abnormal gain. The value of abnormal gain is transferred to the debit of process account and the abnormal gain is ultimately closed by crediting it to the costing profit & loss account.

2.5.6 What is activity based costing?

Activity based costing (ABC) is a method that assigns manufacturing overhead costs to products or process that consume cost in a more logical manner than the traditional approach of simply allocating costs on the basis of machine hours. Activity based costing first assigns costs to the activities that are the real cause of the overhead. It then assigns the cost of those activities only to the products that are actually demanding the activities. So in Activity Based costing the main focus is on the identifying the activities that are used to produce the product.

2.5.6.1 Objectives of Activity Based Costing

- To rectify the inaccurate cost information.
- To allocate the overheads on activity basis.
- To help the management in taking quality and timely decision.

2.5.6.2 Process of Activity Based Costing

Implementation of Activity Based Costing (ABC) involves the following steps-

Step 1.Identify the activities which is required to complete products.

Step 2. Assign overhead costs to the activities identified in step 1.

Step 3.Identify the cost driver for each activity.

Step 4.Calculate a predetermined overhead rate for each activity.

Step 5.Allocate overhead costs to products.

2.5.7 Costing for decision making

Key factor or limiting factor

Limiting factors also known as key factors or principle budget factors or governing factors which put a limit to the capacity of an organization and stand in the way of accomplishing a desired objective or prevent indefinite expansion or unlimited profits.

Examples of key factors:

Shortage of materials, Shortage of labour, Shortage of plant capacity, shortage of demand, shortage of factory space, etc.

Fixation of selling price

Fixation of selling price is one of the important functions of management. Prices are generally determined by market conditions and other economic factors. Cost-Volume-Profit analysis assists the management in the fixation of selling prices under various circumstances.

Determination of product mix

The most-profitable product mix can be determined by applying marginal costing technique. Fixed cost remaining constant, the most profitable product-mix is determined on the basis of contribution only. That product-mix which gives maximum contribution is to be considered as best product mix.

Make or buy decision

A company may have idle capacity which may be utilised for making a component or a product, instead of buying them from outside sources. In taking such ‘make-or-buy’ decision, a comparison should be made between the variable (or marginal) cost of manufacture of the product and the supplier’s price for it.

Discontinuation of product line

Marginal cost will help the management in taking a decision regarding continuance of a product from the market. Besides marginal cost, the other expenses are selling expenses, salesman commission, distribution expenses, advertisement etc. The selling price may differ from market to market. Discontinuance of a market will eliminate variable expenses but selling and distribution expenses are to be compared with the fixed expenses. Till any market yields contribution, it should not be discontinued.

Profit planning

Profit planning is the planning of future operations to attain maximum profit. Under the technique of marginal costing, the contribution ratio, i.e., the ratio of marginal contribution to sales, indicates the relative profitability of the different products of the business whenever there is any change in volume of sales, marginal cost per unit, total fixed costs, selling price, and sales-mix etc.

2.5.8 Life cycle costing

Product life cycle costing involves tracing of costs and revenues of a product over several calendar periods throughout its life cycle. So Life Cycle Costing is a method of identifying the cost and revenue of a product over several calendar years from the product invention to abandonment

Life Cycle cost of an asset can be defined as "The total cost throughout its life including planning, design, acquisition and support costs and any other costs directly attributable to owning or using the asset".

2.5.9 Target costing

Target costing is a cost accounting approach in which companies set targets for costs based on the price prevalent in the market and the profit margin they want to earn. Keeping its costs below the relevant targets helps the companies to generate profit.

Target cost = Selling Price – Profit Margin

Profit margin may be based on cost or selling price. In target costing, companies leverage their ability to monitor and control their cost to generate a profit. Target costing is a more effective approach because it emphasizes efficiency in order to keep costs low. Target costing is particularly useful in industries that have low profit margins and high competition.

2.5.10 what is Kaizen costing?

Kaizen costing is a technique of controlling the cost incurred over unproductive activities and resources which does not add any value to the organization. In simple words, it is a practical approach to solving cost-related problems to improve the overall efficiency of the organization. Kaizen costing is implemented in business organizations to manage following types of costs in a business-cost of supply chain, cost of production of goods, legal formalities cost, redesigning of product cost, etc.

2.5.10.1 5's in Kaizen costing

Short-It is nothing but the categorization of items based on their necessity. The unnecessary items should be labelled as red and must be moved out from the organisation.

Straighten-It is the arranging of the essential items in orderly manner for simplifying the operation.

Shine- It relates to maintenance of cleanliness of the workplace.

Standardize- It relates to establishment of standards for cleanliness, usability and maintaining the placement of items in day to day business operations.

Sustain- It is to communicate and educate the employees about the changes made. Thus, developing a sense of self-control and discipline among them to maintain and follow the set standards.

2.5.10.2 Stages of Kaizen Costing

Kaizen costing involves the following steps-

Involve your employee→ Find problems→ Think and find →Solutions→ Implement→ Check→ Standardize→ Repeat.

2.5.11 Just-In-Time (JIT)

Just-in –Time is an inventory management method whereby materials is scheduled to arrive or be replenished exactly when needed in the production process. The Just-in-time system is adopted by the firms, to reduce the unnecessary burden of inventory management, in case the demand is less than the inventory raised. The objective of Just-in-time is to increase the inventory turnover and reduce the holding cost and any other costs associated with it. This concept is again popularized by the Japanese firms, who place an order for the material, the same day the product is to be produced.

Previous Year Question

Sub Unit – 2.5

June-2019

1. Product A requires 10 kg of material at the rate of ₹5 per kg. The actual consumption of material for the manufacturing of product A comes to 12 kg of material at the rate of ₹6 per kg. Direct material cost variance is:
1. ₹ 22 (favourable)
2. ₹ 22 (unfavourable)
3. ₹ 12 (favourable)
4. ₹ 12 (unfavourable)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.5.3.5

July- 2018

1. Which one of the following statements is true about estimated costs and standard costs?

(1) Standard costs are based on scientific analysis and engineering studies while estimated costs are based on historical basis.

(2) Standard cost emphasis is on "what cost will be" while estimated cost emphasis is on "what cost should be".

(3) Standard costs are more frequently revised compared to estimated cost.

(4) Estimated costs are more stable than standard costs.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.5.3

Nov. -2017

1. From the following two statements of Assertion (A) and Reason (R), indicate the correct code :

Assertion (A) : From the marginal costing approach point of view, the marginal cost is compared with the purchase price.

Reason (R) : If the marginal cost is less than the purchase price it should be purchased rather than manufactured.

Codes :

(1) (A) and (R) both are correct.
(2) (A) is correct, but (R) is not correct.
(3) (A) is not correct, but (R) is correct.
(4) (A) and (R) both are incorrect.

2. Which one of the following statements is true about standard labour time?

(1) Standard labour time indicates the time in hours needed for a specific process.
(2) It is standardized on the basis of past experience.
(3) In fixing standard time due allowance should not be given to fatigue and tool setting.
(4) The Production Manager does not provide any input in setting the labour time standards.

3. Which one of the following is not correct with reference to standard costing?

(1) Standard costing is a system where pre-determined costs are used for control of entire Organisation.
(2) Standard may be expressed in quantitative and monetary measures
(3) Only adverse variances are investigated intensively
(4) Standard is determined for each element of cost

4. Which one of the following is not correct?

1. (1) Margin of Safety= Profit/ P/V ratio
2. P/V Ratio= (Change in Contribution/ Change in sales)*100
3. Break-even point in units=Fixed cost/ Contribution per unit
4. Required sales to earn desired profits=Desired profit/ P/V ratio

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.5.2.2
2.	1	2.5.3.5
3.	3	2.5.3.5
4.	4	2.5.2.2

Sept. 2016

1. **Match the items of List – I with those of List – II and choose the correct code:**

List – I	List – II
a. Material Cost Variance	i. Actual Time (Standard Rate – Actual Rate)
b. Material Usage Variance	ii. Standard Price (Standard Quantity – Actual Quantity)
c. Labour Rate Variance	iii. Standard Material Cost – Actual Material Cost
d. Labour Efficiency Variance	iv. Standard Rate (Standard Time – Actual Time)

Codes:

	A	b	c	d
(1)	iii	i	ii	iv
(2)	ii	i	iv	iii
(3)	iii	ii	I	iv
(4)	iii	ii	iv	i

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.5.3.5

<u>July 2016</u>

1. From the following information, find out the number of units that must be sold by the firm to earn profit of RS. 80,000 per year.
Sales price : RS.25 per unit
Variable manufacturing costs – RS. 12 per unit
Variable selling costs – RS. 3 per unit
Fixed factory overheads – RS. 5,00,000
Fixed selling costs – RS. 3,00,000
(1) 60,000 units
(2) 88,000 units
(3) 98,000 units
(4) 1,00,000 units

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.5.2.2

June 2015

1.The basic difference between a static budget and flexible budget is that:

1. A flexible budget considers only variable costs but a static budget considers all costs
2. Flexible budgets allow management latitude in meeting goals, whereas static budget is based on fixed standards.
3. A flexible budget is applicable for a single department only but a static budget for entire production facility.
4. A flexible budget can be prepared for any production level within a relevant range but a static budget is based on one specific level of production.

2. Labour Rate of Pay Variance can be calculated by which one of the following equations?

A. Budgeted Labour Costs-Actual Labour Costs
B. (Standard Hours - Actual Hours) x Actual Wage Rate
C. (Standard Wage Rate-Actual Wage Rate) x Actual Hours Worked
D. (Standard Wage Rate-Actual Wage Rate) x Standard Hours Worked

3. Given:
Margin of Safety Rs. 80000
Profit Rs. 20000
Sales Rs. 300000
What is the amount of fixed cost?
a) Rs.100000 b) Rs.75000
c) Rs.55000 d) Rs.20000

4. Which one of the following is not true of cash Budget ?
a. The shortage or excess of cash would appear in a particular period.
b. All inflows would arise before outflows for those periods.
c. Only revenue nature cash flows are shown.
d. Proceeds from issue of share capital is shown as an inflow.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	**4**	2.5.4.5
2.	c	2.5.3.5
3.	c	2.5.2.2
4.	c	2.5.4

Sub Unit: 6 Financial Statements Analysis: Ratio analysis; Funds flow Analysis; Cash flow analysis

Sl. No.	Topics
86	2.6.1 What is financial statement analysis?
87	2.6.1.1 What are the components of financial statement?
88	2.6.2.1 What is Ratio?
89	2.6.2.2 Advantages of ratio analysis
90	2.6.2.3 Limitations of ratio analysis
91	2.6.2.4 Classification of Ratio
92	2.6.2.5 Horizontal comparison and vertical comparison
93	2.6.2.6 What is Inter firm comparison?
94	2.6.3 What is fund?
95	2.6.3.1 What is fund flow statement?
96	2.6.4 What is cash flow statement?
97	2.6.4.1 Uses of cash flow statement
98	2.6.4.2 Limitations of cash flow statement
99	2.6.4.3 Distinguish between fund flow and cash flow statement

2.6.1 What is financial statement analysis?

Financial Statement Analysis is nothing but the analysis of the financial statement by using different analytical and financial tools to make different business decision. There are three types of analysis namely vertical analysis, horizontal analysis and ratio analysis. Each one of these tools gives decision makers a little more insight into how well the company is performing.

2.6.1.1 What are the components of financial statement?

Following are the components of financial statements-
1. Balance Sheet
2. Income Statement or Profit or Loss account.
3. Cash Flow Statement
4. Statement of Changes in Owners' Equity

2.6.2.1 What is Ratio?

Ratio is a quantitative relationship between two variables. In mathematics, a ratio is a comparison of two or more numbers that indicates their sizes in relation to each other.

What is financial ratio?

Financial Ratio is a quantitative relationship between two variables taken from the financial statement. This ratio is a very useful tool for analysing financial health of an organisation. There are different ratios which are used for analysing financial statement of an organisation like- liquidity ratio, solvency ratio, profitability ratio, efficiency ratio, coverage ratio, etc.

2.6.2.2 Advantages of ratio analysis

- Financial ratio analysis helps to compare the financial statements of two or more companies.
- It also helps the company by evaluating the trend analysis of a single company over a specific period of time.
- It helps in forecasting future business activities and so the management can plan accordingly.
- Budgeting is one of the main objectives achieved by financial ratio analysis. Financial ratios are used to estimate company's budgeted figures.
- Financial ratio analysis plays a vital role in inter-firm comparison. This comparison is carried out by using different financial ratios.
- It indicates about the overall profitability of the firm and also its ability to meet the short-term and long-term obligations to its investors, creditors,
- It helps the users of financial statement to analyse the financial statement and take appropriate decision about their activities.

2.6.2.3 Limitations of ratio analysis

- It only explains information regarding the past and users are usually interested to know more about current and future situation.
- While computing the financial ratios, only quantitative analysis is highlighted while the qualitative factors are ignored.
- The calculation methodology of different ratios may differ from organisation to organisation.

- The limitations in the financial statements often affect the financial ratio analysis and it is one of its major disadvantages. For examples Window Dressing in Balance Sheet.
- Financial ratio analysis is useful only when comparison is made between two companies from the same industries. If comparison is not possible then no benefits will be received from ratio analysis.
- Price level changes is not considered in case of Ratio analysis
- It is always a challenging job to find an adequate standard. The conclusions drawn from the ratios can be no better than the standards against which they are compared.

2.6.2.4 Classification of Ratio

Classification on the basis of functions

1. Liquidity Ratio

a) Current ratio=$\frac{Current\ ratio}{Current\ Liabilities}$

b) Quick Ratio/Liquid Ratio/Acid test ratio=$\frac{Current\ assets-Stock}{Current\ liabilities-Bank\ Overdraft}$

c) Super quick ratio=$\frac{Cash+Marketable\ securities}{Current\ Liabilities}$

2. Profitability Ratio

a) Gross profit ratio = $\frac{Gross\ profit}{Net\ Sales}$

b) Net profit Ratio = $\frac{Net\ Profit}{Sales}$

c) Operating profit ratio =$\frac{Operating\ Profit}{Sales}$

*Operating Profit= Net profit+ Non-operating expenses- Non -operating income

d) Return on Assets =$\frac{Net\ profit\ after\ tax}{Total\ tangible\ assets}$

e) Return on capital employed = $\frac{Net\ profit\ after\ taxes}{Total\ Capital\ Employed}$

3. Solvency Ratio

a) Debt-equity ratio =$\frac{Long-Term\ Debt}{Shareholders\ equity}$ or, $\frac{Total\ debts}{Shareholders\ Equity}$

* Shareholders Equity= Preference Share capital+ Equity share capital Reserve-Accumulated losses-Fictitious assets or, Total Assets- Total Debts

b) Debt assets ratio = $\frac{Total\ debts}{Total\ Assets}$

c) Interest coverage ratio = $\frac{EBIT}{Interest\ Charges}$

c) Proprietary ratio = $\frac{Proprietor'sFund\ or\ Shareholders\ Fund}{Total\ Assets\ (Excluding\ fictitious\ assets)}$

4. Activity Ratio

a) Inventory turnover ratio =$\frac{Cost\ of\ Goods\ Sold}{Average\ Stock}$

* Average stock = $\frac{Opening\ Stock+Closing\ stock}{2}$

b) Debtors turnover ratio = $\frac{Net\ Credit\ Sales}{Average\ Debtors}$

*Average Debtors = $\frac{Opening\ Debtors+Closing\ debtors}{2}$=

c) Creditors turnover ratio = $\frac{Net\ Credit\ Purchase}{Average\ Creditors}$

*Average Creditors = $\frac{Opening\ Creditors+Closing\ Creditors}{2}$

d) Fixed assets turnover ratio =$\frac{Net\ sales}{Fixed\ assets}$ or, $\frac{Cost\ of\ Goods\ Sales}{Average\ Fixed\ Assets}$

e) Total assets turnover ratio = $\frac{Net\ sales}{Total\ assets}$

5. Valuation ratio

a) Book value per share = $\frac{Shareholders\ equity-Preferred\ shares\ at\ par}{No.of\ outstanding\ equity\ shares}$

b) Payment ratio =$\frac{Dividend\ on\ equity\ shares}{Net\ earnings\ after\ taxs}$

c) Price-earnings ratio =$\frac{\text{Market price per share}}{Earning\ per\ share}$

d) Market value to book value ratio =$\frac{Market\ value\ per\ share}{Book\ value\ per\ share}$

Classification on the basis of financial statement

1. Income Statement Ratio
2. Balance Sheet ratio
3. Composite or Mixed Ratio

Classification on the basis of Importance

1. Primary Ratio
2. Secondary Ratio

2.6.2.5 Horizontal comparison and vertical comparison

Horizontal analysis refers to the comparison of financial data of a company for several years. The figures of the various years are compared with standard or base year.

On the other hands vertical analysis refers to the study of relationship of various items in the financial statements of one accounting period.

2.6.2.6 What is Inter firm comparison?

Inter firm comparison means a **comparison of two or more similar business units** with the objective of finding the competitive position to improve the profitability and productivity of those business units. Thus, inter firm comparison is a **tool used by the management of a company** to compare its operating performance and financial results with those of similar companies engaged in the same industry.

2.6.3 What is fund?

In narrow sense fund means **cash**. In broader sense fund means **all the financial resources** used in the business. In popular sense funds means **working capital**.

2.6.3.1 What is f und flow statement?

The fund flow statement is a statement which indicates various means by which the funds have been obtained during a specific period and the ways to which these funds have been used during that period. The term flow means movement and includes both inflows and outflows of resources. So, fund flow statement is the statement which shows the inflow and outflow of funds from different sources.

2.6.4 What is cash flow statement?

A cash flow statement is a statement which shows the inflow and outflow of **cash and cash equivalent** during a specific accounting period. A cash flow statement is prepared by classifying all the activities into cash flow from operating activities, cash flow from financing activities and cash flow from investing activities. **Cash equivalents include bank accounts and marketable securities, which are debt securities with maturities of less than 90 days.**

Cash flow from operating activities

Net profit before tax and extraordinary item	*****	
Add:		
Depreciation		
Preliminary expenses/ discount on issue of shares and debenture written off		
Goodwill, patents and trademarks amortised		
Loss on sale of fixed assets		***
Less:		
Interest income		
Dividend income		
Rental income		
Profit on sale of fixed assets		***
Operating Profit before working capital changes		*****
Add: Decrease in current assets and increase in current liabilities		***
Less: Increase in current assets and decrease in current liabilities		***
Cash generated from operation		****
Less: Income tax paid		***
Net cash flow from operating activities		******

Cash flow from financing activities

Proceeds from issue of shares and debentures
Proceeds from other long term borrowings
(Final dividend paid)
(Interim dividend paid)
(Interest on debentures and loan paid)
(Repayment of loans)
(Redemption of debentures/Preference shares)

Cash flow from investing activities

Proceeds from sale of fixed assets
Proceeds from sale of investment
Proceeds from sale of intangible assets
Interest and dividend received
Rent received
(Purchase of fixed assets)
(Purchase of investment)
(Purchase of intangible assets like goodwill)

2.6.4.1 Uses of cash flow statement

- Cash flow statement helps in planning the repayment of loans, replacement of fixed assets and other similar long-term planning of cash.
- A comparison of the historical and projected cash flow statements can be made so as to find the variations and deficiency or otherwise in the performance so as to enable the firm to take immediate and effective action.
- Since a cash flow statement is based on the cash basis of accounting, it is very useful in the evaluation of cash position of a firm.

2.6.4.2 Limitations of cash flow statement

- Cash flow statement shows only cash inflow and cash outflow. But, the cash balance disclosed by the statement cannot reveal the true liquid position of the business.
- It does not give complete picture of the financial position of the business concern.
- The preparation of cash flow statement is only post-mortem analysis. There is no projection of cash in future in this method.
- The accuracy of cash flow statement is based on the balance sheet. If balance sheet is wrong, the cash flow statement is also wrong.
- It is not prepared on the basic accounting concept of accrual basis. Hence, the accuracy of cash flow statement is questionable.

2.6.4.3 Distinguish between fund flow and cash flow statement

Cash Flow Statement	Funds Flow Statement
Cash flow is based on a narrow concept called “cash”.	Fund flow is based on a wider concept called “working capital”.
The utility of the cash flow statement is to find out the net cash flow.	The utility of fund flow is to understand the financial position of the company.
The cash flow statement starts with opening balance and after adjustments come out with net cash inflow/outflow.	The fund flow statement calculates the difference between sources of funds and the application of funds.
It is part of the financial statement	It is not a part of the financial statement
It is used for cash budgeting	It is used for capital budgeting

Previous Year Question
Sub Unit – 2.6
July- 2018

1. Which one of the following is not an example of 'financing activities' with reference to cash flow statement?
(1) Repayment of bank loan
(2) Interest on debentures/Dividend paid
(3) Cash proceeds from public deposits
(4) Sale of fixed assets

2. **Assertion (A)** : A high operating ratio indicates a favourable position.
Reasoning (R) : A high operating ratio leaves a high margin to meet non-operating expenses.
Code :
(1) (A) and (R) both are correct and (R) correctly explains (A).
(2) Both (A) and (R) are correct but (R) does not explain (A).
(3) Both (A) and (R) are incorrect.
(4) (A) is correct but (R) is incorrect.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	4	2.6.4
2.	3	2.6.2.4

Jan.- 2017

1. **Assertion (A)** : Debt - equity ratio indicates the long term solvency of a company.
Reasoning (R) : It measures the ability of the company to pay off its long term liabilities.
Select the correct answer from the code given below:
(1) Both (A) and (R) are correct and (R) is the correct reason for (A).
(2) Both (A) and (R) are correct but (R) does not explain (A) correctly.
(3) (A) is correct but (R) is wrong.
(4) (A) is wrong but (R) is correct.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.6.2.4

Nov. -2017

1. Match the items of List-I with those of List-II and indicate the correct code:

List – I	**List – II**
a. Acid Test Ratio	i. Profitability analysis
b. Debt Service Coverage Ratio	ii. Activity analysis
c. Debt Equity Ratio	iii. Liquidity analysis
d. Stock Turnover Ratio	iv. Long-term solvency analysis

Codes:

	a	**b**	**c**	**d**
(1)	ii	i	iii	iv
(2)	ii	iii	iv	i
(3)	iii	iv	i	ii
(4)	iii	i	iv	ii

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	4	2.6.2.4

Sept. 2016

1. According to which of the following categories of activities, a cash flow statement should be prepared as per AS-3 ?

I. Cash flow from operating activities
II. Cash flow from investing activities
III. Cash flow from financing activities
IV. Cash flow from production activities
V. Cash flow from selling activities

Codes :

(1) I, II, III
(2) I, II, III, IV, V
(3) I, II, IV
(4) II, III, IV, V

2. While preparing the Cash Flow Statement, suggest the correct code for the items treated as cash and cash equivalents:

I. Balance in the current account with Allahabad Bank.
II. Investment in 5-years government bonds maturing after one week.
III. Investment in the shares of a subsidiary company.
IV. Investment in equity mutual funds.
V. Fixed deposits with State Bank of India maturing after one year.

Codes:

(1) I, II, III
(2) I, III, IV
(3) I, III
(4) I, II

3. Which of the following statements is true?

(1) Rate of return on capital is Acid Test Ratio.
(2) Equity capital to fixed interest- bearing securities is a turnover ratio.
(3) Capital gearing is the ratio of equity capital to fixed-interest bearing securities.
(4) Input and output ratio is a measure of profitability.

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.6.4
2.	2	2.6.4
3.	3	2.6.2.4

July 2016

1. Match the items in Column – I with the items in Column – II and indicate the correct code:

Column – I	**Column – II**
a. Debt-Equity Ratio	i. *Net Profit* before interest and tax/ Interest on long term loans
b. Proprietary Ratio	ii. Equity share capital + Reserves/ Preference share capital + Interest bearing finance
c. Interest coverage ratio	iii. Long term debts/ Shareholder's Funds
d. Capital gearing ratio	iv. Shareholder's Funds/ Total Assets

Codes:

	A	b	c	d
(1)	i	ii	iii	iv
(2)	iii	iv	i	ii
(3)	iii	iv	ii	i
(4)	ii	iii	iv	i

2. Which of the following is not a cash inflow?

(1) Decrease in creditors
(2) Decrease in debtors
(3) Issue of shares
(4) Sale of a fixed asset

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.6.2.4
2.	1	2.6.4

June 2015

1. When opening stock is Rs 50,000, closing stock is Rs 60,000 and the cost of goods sold is RS 2,20,000, the stock turnover ratio is:

1. 2 Times
2. 3 Times
3. 4Times
4. 5Times

2. **If: Stock turnover ratio is = 6 times**
Average stock = Rs 8,000
Selling price = 25% above cost
What is the amount of gross profit?

1) Rs.2000
2) Rs. 4000
3) Rs.10000
4) Rs.12000

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.6.2.4
2.	4	2.6.2.4

Dec. 2015

1. X Ltd. has a liquid ratio of 2:1. If its stock is Rs. 40000 and its current liabilities are of Rs. 1 lac, its current ratio will be:
1. 1.4 times
2. 2.4 times
3. 1.2 times
4. 3.4 times

2. Comparison of the financial statements of the current year with the performance of the previous years of the same firm is known as:
1) Trend analysis
2) Horizontal analysis
3) Intra-firm comparison
4) All of the above

3. Indicate the correct code as regards the sources of funds for a Funds Flow Statement from the following: (a) Increase in working capital (b) Decrease in working capital (c) Writing off the intangible/fictitious assets (d) Issuing equity shares for acquisition of a building for office (e) Charging depreciation on fixed assets
A. (a), (c), (d)
B. (b), (c), (e)
C. (a), (d), (e)
D. (b), (c), (d)

4. **Match the items of List - I with those of the List - II and indicate the correct code for the following:**

List - I	**List - II**
(a) Debtors Turnover Ratio	(i) Solvency Ratio
(b) Proprietary Ratio	(ii) Liquidity Ratio
(c) Operating Ratio	(iii) Activity Ratio
(d) Acid Test Ratio	(iv) Profitability Ratio

	a	b	c	d
A.	(ii)	(iv)	(iii)	(i)
B.	(iii)	(ii)	(i)	(iv)
C.	(iii)	(i)	(iv)	(ii)
D.	(iv)	(iii)	(ii)	(i)

5. **For the following two statements of Assertion (A) and Reasoning (R), indicate the correct code :**
Assertion (A) : Cash Flow Statement as per the financial statements as well is incapable in revealing the overall financial position of a firm.
Reasoning (R): Cash is an important constituent of the working capital based on the recorded facts only.
A. (A) and (R) both are correct and (R) is an explanation of (A).
B. (A) is correct but (R) is not correct.
C. (A) is not correct but (R) is correct
D. (A) and (R) both are incorrect

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2	2.6.2.4
2.	4	2.6.2.5
3.	B	2.6.3
4.	C	2.6.2.4
5.	A	2.6.4

Sub Unit: 7 Human Resources Accounting; Inflation Accounting; Environmental Accounting

2.7.1 What is Human Resource Accounting (HRM)?

The American Accounting Society Committee on Human Resource Accounting defines it as follows –

"Human Resource Accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties."

According to Flamholtz, "Human resources accounting means accounting for people as an organizational resource. It involves measuring the costs incurred by business firms and other organizations to recruit, select, hire, train and develop human assets. It also involves measuring the economic value of people to organization."

2.7.1.1 Objectives of Human Resource Accounting

- The main purpose of the Human Resource Accounting is to help human resource professionals and senior managers to use human resources of an organization efficiently and effectively.
- To help the management for making decision about acquiring, allocating, developing and maintaining human resources in order to keep control on human resource cost as one of the organizational objective.
- To provide information to the management regarding human resource cost and value.
- To see whether the human resources are effectively utilized or not.
- To see whether the human resources are producing a return on investment of the persons interested in the organization or not.
- HRA facilitates managing the people as one of the resources of the organization.

2.7.1.2 Limitations of Human Resource Accounting

- There is no specific guideline for measuring the cost and value of human resources.
- Tax laws do not recognize human assets and in that sense, it might be theoretically only.
- It is a difficult task to value human asset.
- Human Resource Accounting is full of measurement problems.
- The life of a human being is uncertain. So its value is also uncertain.

2.7.1.3 Methods of Human Resource Accounting

Replacement Cost Model

This approach was first developed by Rensis Likert on the basis of the concept of the replacement cost. This method measures the cost to replace an organization's existing human resource. It indicates what it would cost the concern to recruit, hire and train and develop human resources to match the present level of efficiency.

Opportunity cost Model

This method was first advocated by Hc Kiman and Jones for a company with several divisional heads bidding for the services of various people they need among themselves and then include the bid price in the investment cost. Opportunity cost is the value of an asset when there is an alternative use of it. There is no opportunity cost for those employees that are not scarce and also those at the top will not be available for auction. As such, only scarce people should comprise the value of human resources. This method can work for some of the people at shop floor and middle order management.

Capitalization of Historical cost Model

This approach was developed by William C. Pyle (and assisted by R. Lee Brummet & Eric G. Flamholtz) and R.G. Barry corporation, a leisure footwear manufacturer based on Columbus, Ohio (USA) in 1967. In this approach, actual cost incurred on recruiting, hiring, training and development the human resources of the organisation are capitalised and amortised over the expected useful life of the human resources. Thus a proper recording of the expenditure made on hiring, selecting, training and developing the employees is maintained and a proportion of it is written off to the income of the next few years during which human resources will provide service.

Economic Value Model

This method measures the value of human assets on the assumption that an individual generates value for an organization as he occupies and moves among organizational roles and renders services to the organization. The roles he will occupy depend probabilistically upon the roles previously occupied. Thus, the valuation process involves the use of probabilities of the employees change of position and of service to be derived.

Flamholtz model: According to Flamholtz, an individual's value to an organization can be measured by applying personnel evaluation methods like ranking. Individuals may be evaluated by their supervisors' subordinates, peers or independent experts. The economic value of an individual to the organization can be measured in terms of their net contribution to the organization, that is, their gross value, less the compensation and other costs associated with their utilization.

The Lev & Schwartz Model:-

The Lev and Schwartz model states that the human resource of a co is the summation of value of all the Net present value (NPV) of expenditure on employees. The human capital embodied in a person of age r is the present value of his earning from employment.

According to this model value of an individual human is determined applying the following formula

$$V_r = \frac{I(t)}{(1+r)^{(t-r)}}$$

Where, Vr = the value of an Individual r years old I (t) = the individual's annual earnings up to retirement t = retirement age r = a discount rate specific to the cost of capital to the company.

2.7.2 Inflation Accounting

Inflation accounting refers to the adjustment of the financial statements during the inflationary periods. This special accounting technique is only used in inflationary periods where the general level of prices is usually high for three consecutive quarters.

It involves the recording of the income and expenditure of the business at the current prices and reinstating all the three statements of the company and analyse the cost and the trend of the current company.

2.7.2.1 Methods of Inflation Accounting

Current Purchasing Power Method

This technique involves adjustment of the financial statements to the current price changes. It involves recalculating the historical financial figures of the company at the current purchasing power which is done by applying a certain conversion factor.

Current Cost Accounting

Under this method, the cost categories and the various cost items and the items in the balance sheet are shown at the current cost rather than the historical cost and the profit is determined under this method, the cost categories and the various cost items and the items in the balance sheet are shown at the current cost rather than the historical cost. Current cost accounting (CCA) method was proposed by the Sandilands Committee of UK.

Current value

Under this method, all assets and liabilities are measured and are reinstated at their current cost structure.

2.7.3 What is Environmental Accounting?

Environmental accounting is the practice of using traditional accounting and finance principles to calculate the costs that business decisions will have on the environment. Environmental accounting is the practice of incorporating principles of environmental management and conservation into reporting practices and cost/benefit analyses.

2.7.3.1 Advantages of Environmental Accounting

- It helps to measure the environmental problem impact of each and every process and operation on the air, water, soil, worker's health and safety and society at large.
- It helps to measure the organization environmental performance.
- It gives an indication of the effectiveness of the environmental management and suggests how it can be improved.
- The result of the environmental accounting system helps the management to develop its environment strategy for moving toward a greener corporate culture.
- Proper environmental accounting system facilitates proper reporting of the results of environment practices followed by the company. It facilitates communicating environmental performance towards stakeholder.

2.7.3.2 Limitations of Environmental Accounting

- There is no standard environmental accounting method.
- It basically considered the internal cost to the company and ignores cost to the society as a whole.
- Environmental accounting cannot work independently it should be integrated with financial accounting.
- Input for environmental accounting is not available as the cost and the benefits relevant to environment are not easily measurable.

Previous Year Question

Sub Unit – 2.7

Nov. -2017

1. Which one of the following methods of Inflation Accounting has been proposed by Sandilands Committee of U.K?

(1) General Price Level Method
(2) Specific Price Level Method
(3) Current Cost Accounting Method
(4) Generally Accepted Accounting Principles

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.7.2.1

Sept. 2016

1. 'Lev and Swartz Model' belongs to

(1) Social Accounting

(2) Depreciation Accounting

(3) Human Resource Accounting

(4) Inflation Accounting

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.7.1.3

Sub Unit: 8 Indian Accounting Standards and IFRS

2.8.1 What is Accounting Standard (AS)?

An accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies, accounting standards basically provide framework and standard accounting policies so that financial statements of different enterprise become comparable.

2.8.1.1 Process of issuing accounting standard in India

The Institute of Chartered Accountant of India (ICAI) through Accounting Standards Board (ASB) issues Accounting Standards in the following ways

Firstly, broad areas are identified by ASB for formulation of AS.

↓

Then a study group is constituted to consider these broad areas and prepare a preliminary draft which includes objective, scope of the standard and definitions of the terms. Then it's reviewed and revised after deliberations.

↓

Then this draft is circulated to the council members of ICAI, SEBI, CBDT, DCA for comments. There is also a meeting held with them to solicit their views on the proposed AS.

↓

Then the draft is finalized after inviting public comments.

↓

Then these comments are considered and the draft is finalized by the ASB for submission to the council of the ICAI for its consideration and approval for issuance. If there is any need of any modification in standard, necessary modifications are done by the council in consultation with ASB.

↓

The accounting standard on the relevant subject (for non-corporate entities) is issued by the ICAI.

↓

For corporate entities the AS are issued by the central government of India.

2.8.1.2 Write down the functions of Accounting Standard Board (ASB)

The Institute of Chartered Accountants of India, recognizing the need to harmonies the diverse accounting policies and practices at present in use in India, constituted an Accounting Standards Board (ASB) on 21st April, 1977.

- The main function of ASB is to formulate accounting standards so that such standards may be established by the Council of the Institute in India. While formulating the accounting standards, ASB will take into consideration the applicable laws, customs, usages and business environment.
- Maintain the standards up to date to reflect changes in the method of preparing the financial statements and in the economy
- Considering those specific areas which are insufficiency in the financial areas that might be improved through standard-setting; support international convergence of

Accounting Standard concurrent with improvement in the quality of financial reporting;
- Describing the usefulness of financial reporting by focusing on characteristics of reliability and relevance;
- ASB also explains the usefulness of financial reporting by focusing on consistency and comparability.

2.8.1.3 Advantages of Accounting Standard

Following are the main advantages of accounting standard

- By adoption the accounting standard confusing variations in the accounting treatment used to prepare financial statement is reduced.
- Accounting standard describe the accounting principles, the valuation techniques are the method of applying accounting principle so as to ensure true and fair view.
- Where important information is not statutorily required, accounting standards calls for its disclosure.
- Accounting standards facilitates comparison of financial statements of companies in the same industry situated in different parts of the world.
- Accounting standards helps in resolving conflicts of financial interest among various groups.
- Accounting standards helps the auditors in case of preparation of financial statement and any deviation can be disclosed in the reports so that the user is aware of such deviations.

2.8.1.4 Limitations of accounting Standard

- Every company has to follow the accounting principles continuously as prescribed by the respective accounting standard and there is no scope of changing principles as per organisations requirements. So accounting standard suffers from Rigidity and inflexibility of the principle of the standard.
- Involvement of high cost in implementing accounting standard.
- Choosing the best alternative options of accounting treatment among the different alternatives available in accounting standard is another limitation of accounting standard.

2.8.2 What is International Financial reporting Standard (IFRS)?

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB). The goal of IFRS is to provide a global framework for how public companies prepare and disclose their financial statements. IFRS provides general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting. IFRS were established in order to have a common accounting language, so business and accounts can be understood from company to company and country to country.

2.8.2.1 What are the advantages of IFRS?

- **Greater comparability**

Businesses using similar standards to prepare financial statements can more accurately compare with each other. This is very useful when comparing businesses that are based in different countries, as they may otherwise have different methodologies and rules in preparing these documents. This greater comparability has aided investors to better identify where their investments should go.

- **Benefits to new and small investors**

The IFRS can help new and small investors by making reporting standards to have better quality and become simpler, putting these investors in a similar position with professional investors, which was not feasible under previous standards. This also entails a reduced risk for these investors when they trade, as the professionals will not be able to take advantage because the nature of financial statements will just be simple to be understood by all.

- **More flexibility**

Using a philosophy that is based on principles, instead of rules, this set of standards will have the goal of arriving at a reasonable valuation with various ways to accomplish tasks. This would give businesses the freedom to adopt IFRS to their specific situations, which will result in financial statements that are more easily read and useful.

2.8.2.2 Disadvantages of IFRS

- **High costs of Implementation**

Whether large or small, all businesses would feel the impact if a country adopts IFRS. However, small companies would not have sufficient resources to implement the changes that come with it, not to mention that they would need to train staff or hire accountants or consultants for assistance. They would simply bear more financial burden than their larger counterparts.

- **Prone to manipulation**

As businesses can only use the methods that they wish, this would lead to financial statements show only desired results, which can lead to profit manipulation. While this new set of standards requires changes to how the rules should be applied to be justifiable, it is often possible for businesses to come up with reasons for making such changes. This means that stricter rules should be implemented to ensure all companies will value their statements in a similar fashion.

- It is not globally accepted.

2.8.3 Indian Accounting Standards

Indian Accounting Standards (Ind AS) are a set of accounting standards notified by the Ministry of Corporate Affairs (MCA), which are converged standards with IFRS (International Financial Reporting Standards). These are popularly known as Ind AS. Indian Accounting Standard provides principles for recognition, measurement, treatment, presentation and disclosures of accounting transactions in financial statements prepared as per Indian Accounting Standard. These standards are formulated by Accounting Standards Board of Institute of Chartered Accountants of India. For the purpose of ensuring that old Accounting Standards (AS) coverage more closely with International Financial Reporting Standards (IFRS), the Institute of Chartered Accountants in India (ICAI) set out to introduce a new system, called the Indian Accounting Standards (Ind AS).The first phase of Ind AS was implemented in April 2011 and introduced a total of 35 new accounting standards.. Subsequent phase were implemented in April 2013 and April 2014. On February 16, 2015, the Ministry of Corporate Affairs (MCA) released a roadmap for the next phase of implementation, to be active from April 1, 2016. The map is intended to bring both domestic and foreign companies with a minimum net worth of Rs. 500 crore into full compliance with Ind AS and therefore, into effective compliance with IFRS.

At present **there are two sets of accounting standards** in India:

- The existing accounting standards under Companies (Accounting Standard) Rules, 2006; and
- The IFRS converged Indian Accounting Standards (known as Ind AS)

2.8.3.1 List of Indian Accounting Standards along with comparative Accounting Standard (AS):

Ind AS	Objective/ Deals with	Relevant Accounting standard or Guidance note
New Converged Ind AS with IFRS (New SL no and this will continue in future)		
Ind AS 101 – First-time adoption of Ind AS	Its main objective is to prepare first financial statements as per Ind AS containing high quality information that is transparent, comparable and prepared at economical cost, suitable starting point for accounting in accordance with Ind AS.	N.A.
Ind AS 102 – Share Based payments	It deals with accounting of share-based payment transactions and reflects effect of such payment on profit or loss and financial statements of entity.	Guidance note on Employee Share Based Plans
Ind AS 103 – Business Combination	It applies to transaction or other event that meets the definition of a business combination. This standard helps in improving the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects.	AS 14
Ind AS 104 – Insurance Contracts	This standard specifies financial reporting for insurance contracts by insurer entity.	N.A.
Ind AS 105 – Non-Current Assets Held for Sale and Discontinued Operations	This standard specifies accounting for assets held for sale, and presentation and disclosure of discontinued operations.	AS 24

Ind AS 106 – Exploration for and Evaluation of Mineral Resources	This standard specifies financial reporting for exploration and evaluation of mineral resources.	N.A.
Ind AS 107 – Financial Instruments: Disclosures	This standard require entities to provide disclosures related to financial instruments that will enable users to evaluate significance of financial instruments for entity's financial position and performance and nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.	AS 32
Ind AS 108 – Operating Segments	This standard discloses information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.	AS 17
Ind AS 109 – Financial Instruments	This Standard establish principles for financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.	AS 30, AS 31 and Guidance note on derivative contract
Ind AS 110 – Consolidated Financial Statements	This standard establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.	AS 21
Ind AS 111 – Joint Arrangements	This standard establish principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (known as joint arrangements).	AS 27
Ind AS 112 – Disclosure of Interests in Other Entities	This standard requires an entity to disclose information that enable users of its financial statements nature risk and effect of such interest in other entities.	AS 21, AS 23 and AS 27
Ind AS 113 – Fair Value Measurement	This standard defines fair value, set outs framework for measuring fair value and disclosures about fair value measurements. Such fair measurement principle will apply when another Ind AS requires or permits use of fair value.	N.A.
Ind AS 114 – Regulatory Deferral Accounts	This Standard specifies financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods or services to customers at a price or rate that is subject to rate regulation.	Guidance note on accounting for rate regulated activities

Ind AS 115 – Revenue from Contracts with Customers	This Standard establishes principles that an entity shall apply to report useful information to users of financial statements about nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.	AS 7 & AS 9
Ind AS 116 – Leases	This standard prescribes appropriate accounting policies and principle for lessees and lessors.	AS 19
Old AS in India now Converged with Ind AS		
Ind AS 1 – Presentation of Financial Statements	This standard sets out overall requirements for presentation of financial statements, guidelines for their structure and minimum requirements for their content to ensure comparability.	AS 1
Ind AS 2 – Inventories Accounting	Its deals with accounting of inventories such as measurement of inventory, inclusions and exclusions in its cost, disclosure requirements, etc.	AS 2
Ind AS 3 –	Not exists	
Ind AS 4 –	Not exists	
Ind AS 5 –	Not exists	
Ind AS 6 –	Not exists	
Ind AS 7 – Statement of Cash Flows	It deals with cash received or paid during the period from operating, financing and investing activities. It also shows any change in the cash and cash equivalents of any entity.	AS 3
Ind AS 8 – Accounting Policies, Changes in Accounting Estimates and Errors	It prescribes criteria for selecting and changing accounting policies together with accounting treatments and disclosures.	AS 5
Ind AS 9 –	Not exists	
Ind AS 10 – Events after Reporting Period	It deals with any adjusting or non-adjusting event occurring after reporting date and	AS 4
Ind AS 11 –	Not exists	
Ind AS 12 – Income Taxes	This standard prescribes accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax	AS 22

Ind AS 13 to 15 –	Not exists	
Ind AS 16 – Property, Plant and Equipment	This standard prescribes accounting treatment for Property, Plant And Equipment (PPE) such as recognition of assets, determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.	AS 10
Ind AS 17 to 18 –	Not exists	
Ind AS 19 – Employee Benefits	This standard prescribes accounting and disclosure requirements relating to employee benefits.	AS 15
Ind AS 20 – Accounting for Government Grants and Disclosure of Government Assistance	This Standard shall be applied in accounting for and in disclosure of, government grants and in disclosure of other forms of government assistance.	AS 12
Ind AS 21 – The Effects of Changes in Foreign Exchange Rates	This Standard prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.	AS 11
Ind AS 22	Not exists	
Ind AS 23 – Borrowing Costs	It provides borrowing cost incurred on qualifying asset should form part of that asset, it also guides on which finance cost should be capitalised, conditions for capitalisation, time of commencement and cessation of capitalisation of borrowing cost.	AS 16
Ind AS 24 – Related Party Disclosures	This standard ensures that an entity's financial statements contains necessary disclosures to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances.	AS 18
Ind AS 25 & 26	Not exists	
Ind AS 27 – Separate Financial Statements	This Standard prescribes accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.	AS 13
Ind AS 28 – Investments in Associates and Joint Ventures	This standard prescribes accounting for investments in associates and to set out requirements for the application of equity method when accounting for investments in associates and joint ventures.	AS 23, AS 27

Ind AS 29 – Financial Reporting in Hyperinflationary Economies	This standard will gives inclusive list of characteristics that will categorise an economy as hyper inflationary and reporting of operating results and financial position.	N.A.
Ind AS 30 & 31 –	Not exists	
Ind AS 32 – Financial Instruments: Presentation	This Standard establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.	AS 32
Ind AS 33 – Earnings per Share	This Standard prescribe principles for the determination and presentation of earnings per share	AS 20
Ind AS 34 – Interim Financial Reporting	This Standard prescribes minimum content of an interim financial report and principles for recognition & measurement in complete or condensed financial statements for an interim period.	AS 25
Ind AS 35 –	Not exists	
Ind AS 36 – Impairment of Assets	This Standard prescribe procedures that an entity applies to ensure that an asset's carrying amount is not more than its recoverable amount.	AS 28
Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets	This Standard ensures that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and proper disclosures are made in the notes to enable users to understand their nature, timing and amount.	AS 29
Ind AS 38 – Intangible Assets	This Standard prescribes accounting treatment for intangible assets. It specifies conditions for recognition of intangible asset and how to measure carrying amount at which intangible asset should be recognised.	AS 26
Ind AS 39 –	Not exists	
Ind AS 40 – Investment Property	This Standard prescribes accounting treatment for investment property and related disclosure requirements.	AS 13
Ind AS 41 – Agriculture	This Standard prescribes accounting treatment and disclosures related to agricultural activity.	N.A.

Previous Year Question

Sub Unit – 2.2

June-2019

1. **Match List-I with List-II:**

List-I	**List-II**
(a) Ind AS-16	(i) Income tax
(b) Ind AS-38	(ii) Leasing
(c) Ind AS-17	(iii) Intangible assets
(d) Ind AS-12	(iv) Property, plant and equipment's

Choose the correct option from those given below:
1. (a)-(iv); (b)-(iii); (c)-(i); (d)-(ii)
2. (a)-(iv); (b)-(iii); (c)-(ii); (d)-(i)
3. (a)-(iii); (b)-(ii); (c)-(iv); (d)-(i)
4. (a)-(iv); (b)-(ii); (c)-(i); (d)-(iii)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	2(2)	2.8.3.1

Nov. -2017

1. Match the items of List - I with those of List - II and indicate the correct code:

List - I (Accounting standard)	**List - II (Relationship)**
(a) AS - 6	(i) Accounting for Consolidated Financial Statements
(b) AS – 3	(ii) Accounting for Fixed Assets
(c) AS – 10	(iii) Depreciation Accounting
(d) AS - 21	(iv) Accounting For Cash Flow Statement

Code:

	(a)	**(b)**	**(c)**	**(d)**
(1)	(ii)	(iv)	(iii)	(i)
(2)	(iii)	(iv)	(ii)	(i)
(3)	(iv)	(iii)	(i)	(ii)
(4)	(i)	(ii)	(iii)	(iv)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	1	2.8.3.1

Sub Unit: 9 Auditing: Independent financial audit; Vouching; Verification ad valuation of assets and liabilities; Audit of financial statements and audit report; Cost audit

2.9.1 What is auditing?

The primary purpose of the audit is to confirm the authenticity of books of accounts prepared by an accountant. The audit is an intelligent and critical examination of the books of accounts of the business.

Auditing is done by the independent person or body of persons qualified for the job with the help of statements, papers, information and comments received from the authorities so that the examiner can confirm the authenticity of financial accounts prepared for a fixed term and report that:

- The balance sheet exhibits an accurate and fair view of the state of affairs of concern;
- The profit and loss accounts reveal the right and balanced view of the profit and loss for the financial period;
- The accounts have been prepared in conformity with the law.

"An audit is an examination of accounting records undertaken with a view of establishing whether they correctly and completely reflect the transactions to which the purport to relate." –**Lawrence R. Dickey**

2.9.1.1 Objectives of auditing

- Examining the system of internal check.
- Checking arithmetical accuracy of books of accounts, verifying posting, casting, balancing, etc.
- Verifying the authenticity and validity of transactions.
- Checking the proper distinction between capital and revenue nature of transactions.
- Confirming the existence and value of assets and liabilities.
- Detection and prevention of errors.
- Detection and prevention of fraud.
- Under-or over-valuation of stock.

2.9.2 Independent financial audit

A **financial audit** is an independent, objective evaluation of an organization's financial reports and financial reporting processes. The primary purpose for financial audits is to give regulators, investors, directors, and managers' **reasonable assurance** that financial statements are accurate and complete.

2.9.2.1 Need for financial audit

- Examining the system of internal check.
- Checking arithmetical accuracy of books of accounts, verifying posting, casting, balancing, etc.
- Verifying the authenticity and validity of transactions.
- Checking the proper distinction between capital and revenue nature of transactions.
- Confirming the existence and value of assets and liabilities.
- Verifying whether all the statutory requirements are fulfilled or not.
- Proving true and fairness of operating results presented by income statement and financial position presented by the balance sheet.
- Detection of errors and frauds

2.9.3 What is vouching?

The act of examining documentary evidence in order to ascertain the accuracy of entries in the account books is called "Vouching". Vouching means a careful examination of all original evidence i.e invoices, statements, receipts, correspondence, minutes and contracts etc. with a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible, that no entries have been omitted in the books of accounts. Therefore, vouching is the act of testing the truth of entries appearing in the primary books of accounts.

2.9.3.1 Objectives of vouching

- To detect the errors and frauds.
- To know the truth of accounts.
- To find out the unrecorded transactions.
- To know about the authorisation of transactions.
- To make sure that only business transactions are recorded.

2.9.3.2 What is voucher?

Voucher is known as the evident for the support of a transaction in the books of account. It may be bill, receipts, requisition form, agreement, decision, bank paying slip etc. The *voucher* is an internal *accounting* control, which ensures that every payment is properly authorized.

2.9.3.3 Types of voucher

There are four types of vouchers namely-

Receipt or Credit Voucher-A Receipt voucher is used to record cash or bank receipt.

Payment or Debit Voucher-A Payment voucher is used to record a payment of cash or cheque.

Transfer or Journal voucher or Non-cash Voucher-Non-cash vouchers are used for non-cash transactions. They are basically used as documentary evidence.

Supporting Voucher-Supporting voucher serves as documentary evidence of the transactions happened in the past.

Again voucher can be classified on the basis of originality as **primary voucher and collateral voucher**

Primary Voucher − Original copy of written supporting document is called primary voucher. Like purchase Bill, cash memo, pay-in-slip, etc.

Collateral Voucher − Copies of supporting documents which are not available in original are collateral voucher like duplicate or carbon copy of sale invoice.

2.9.4 Verification

Verification means the act of assuring the correctness of value of assets and liabilities in the organization. It refers to the examination of proof of title and their existence or confirmation of assets and liabilities on the date of Balance Sheet. It usually indicates verification of assets of any organization, which can be done by examination of values, ownership, existence, possession of any assets and also ensures that the assets are free from any charge. In simple words, verification means, ‘proving the truth or confirmation’.

2.9.4.1 What is verification of assets and liabilities?

The Institute of Chartered Accountants of India defines verification as, " It aims at establishing a) existence, b) Ownership c) Possession, d) freedom from encumbrances e) proper recording, f) proper valuation".

2.9.4.2 Need for verification

- Confirm that the assets were in existence on the date of the balance sheet.
- Ascertain that the assets had been acquired for the purpose of the business and under proper authority.
- Confirm that owner ship of the asset rests with the organisation.
- Ascertain that no charge has been created on the asset.
- Ensure that the current book value of the asset is determined after providing correct amount of depreciation for various years.
- Ensure that values reflect current physical condition of the asset.
- Ensure that d
- isclosures regarding assets are adequate.
- Proof regarding proper valuation of assets.
- To confirm that assets are properly accounted for in the books of accounts.

2.9.4.3 Duties of an auditor in relation to verification

An auditor has to examine and ascertain the correctness of the money value of assets and liabilities appearing in the Balance Sheet and this examination is known as verification of assets and liabilities. Therefore, an auditor has to keep in mind the following points while verifying the assets:

- Ensuring the existence of assets.
- Acquiring the assets for business.
- Legal ownership and possession of the assets.
- Ensuring the proper valuation of assets.
- Ensuring that the assets are free from any charge.

2.9.4.4 Verification and vouching

Vouching relates to confirmation of the correctness and authenticity of accounting entries as appeared in the books of accounts whereas verification confirms the existence, ownership and valuation of assets as appears in the balance sheet.

2.9.5 Valuation of assets and Liabilities

Valuation means finding out correct value of the assets on a particular date. It is an act of determining the value of assets and critical examination of these values on the basis of normally accepted accounting standard. Valuation of assets is to be made by the authorized officer and the duty of auditor is to see whether they have been properly valued or not. For ensuring the proper valuation, auditor should obtain the certificates of professionals, approved values and other competent persons. Valuation is the primary duty of company officials. Auditor can rely upon the valuation of concerned officer but it must be clearly stated in the report because an auditor is not a technical person.

2.9.5.1 What is valuation of assets and liabilities?

R.Batliboi, "A company's Balance Sheet is not drawn for the purpose of showing what the capital would be worth if the assets were realized and liabilities paid -off, but to show how the capital stands invested".

2.9.5.2 Objectives of valuation

- To assess the correct financial position of the concern.
- To enquire about the mode of investment of the capital of the concern.
- To assess the goodwill of the concern.
- To evaluate the differences in the value of the asset as on the date of purchase and on the date of Balance Sheet.

2.9.5.3 Duties of an auditor in relation to valuation

It is not an auditor's duty to determine the values of various assets. It has been judicially held that he is not a valuer or a technical man to estimate the value of an asset. But he is definitely concerned with values set against the assets. He has to certify that the profit and loss account shows true profit or loss for the year and Balance Sheet shows a true and fair view of the state of affairs of the company at the close of the year. Therefore he should exercise reasonable care and skill, analyse all the figures critically, inquire into the basis of valuation from the technical experts and satisfy himself that the different classes of assets have been valued in accordance with the generally accepted assumptions and accounting principles. If the market value of the assets are available i.e., in the case of share investment then he should verify the market value with the stock exchange quotations. If there is any change in the mode of the valuation of an asset, he should seek proper explanation for it. If he is satisfied with the method of valuation of the assets he is free from his liability.

2.9.5.4 Vouching, Verification and Valuation

- In vouching, accounting entries are checked with the bona-fide vouchers.
- Verification proves the **existence, ownership** and **title** of assets.
- Valuation certifies the **correct value of asset**.
- Vouching is done after **original entry** in the books of accounts.
- Verification and valuation are done at the **end of the financial year**.
- Vouching is done by **Senior Auditor** and **Audit Clerk**.
- Verification and valuation are done by the **Auditor** himself.
- Bona-fide vouchers are sufficient **evidence** for vouching
- For Valuation Auditor has to depend upon **certification** from owner/partner/director.
- Verification is done by physical verification, title deeds and receipt of payment, etc.

2.9.6 What is audit report?

When financial statements are finalised, they usually must contain an evaluation – an auditor's report - from a licensed accountant or auditor. This report provides an overview of the evaluation of the validity and reliability of a company or organization's financial statements. The goal of an auditor's report is to document reasonable assurance that a company's financial statements are free from error. An audit report is a part of company statutory accounts. So, an auditor's report provides an opinion on the validity and reliability of a company's financial statements. **Lancaster** has defined a report as "a report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of subject matter of the report."

2.9.6.1 Types of audit report

Clean or Unqualified Report

Clean or Unqualified report will be given by the auditor if the auditor is satisfied that the accounts, Balance Sheet, Profit and Loss Account and Cash Flow statement do represent a true and fair view and they are prepared in conformity with the accounting principles and statutory requirements. This report shows that a business has followed the necessary practices and adhered to conditions set about by the UK GAAP. This is the best type of report a company can receive.

Qualified Report In qualified report the auditor believes that overall financial statements are not fairly stated. This report is generally positive because it indicates that the auditor has found nothing wrong in the financial documentation. The books of accounts, Profit & Loss account and Balance Sheet do not represent true and fair view of the state of affairs. In this report auditor gives an opinion subject to certain reservation. However, a qualified opinion means that the company audited has not adhered to the standards set by UK GAAP.

Adverse or Negative Report When there is sufficient basis for the auditor to form an opinion that the whole accounts and financial statements, do not present a true and fair view of the financial condition and results of operation, the adverse or negative opinion will be given. The adverse or negative report will be given on the following grounds:

- When the auditor is not satisfied with the truth and fairness of financial statements,
- Non conformity with the Generally Accepted Accounting Principles,
- Mistakes, discrepancies and material misstatement in the financial statements,
- Omission of a material disclosure.

Disclaimer Report The auditor may disclaim or refuse opinion on the accounts, Profit and Loss Account and the Balance Sheet, when he does not have sufficient information to base his opinion. In the scope and opinion paragraph, the auditor should give disclaimer information. This may happen on the following grounds:

- The auditor has not been able to obtain sufficient information to form his opinion,
- The audit examination is not adequate to form an opinion,
- There are some material un-determined item in audit examination.

2.9.6.2 Content of auditors report

- Answer, clarification and explanation of furnished questions are given by the concerned authority satisfactory or not.
- Income statement and balance sheet is prepared by the company in prescribed structure or not.
- Accounts are maintained as per the provision of laid down rules and regulations or not.
- Balance sheet of the company presents true and fair view of financial position or not.
- High ranking official, representatives and staffs of the company have performed work as per the provision of rules and regulations or not; they have committed fraud or not.
- Transactions of the company are satisfactory or not
- Auditor should provide suggestion if necessary.

2.9.7 What is cost audit?

Cost audit may be defined as "the verification of cost records and accounts and a check on the adherence to the prescribed cost accounting procedures and the continuing relevance of such procedures."

R.W. Dobson Smith and Day in their book Introduction to Cost Accountancy' defines it, "Cost audit is the verification of the correctness of cost accounts and the adherence to the cost accountancy plan."

2.9.7.1 Advantages of cost audit

- It provides necessary information for prompt decision decisions.
- It helps management to regulate production.
- Errors, omission, fraud, and mistakes can be detected and prevented due to the effective auditing of cost accounts.
- It reduces the cost of production through plugging loopholes relating to wastage of material, labour, and overheads.
- It can fix the responsibility of an individual wherever irregularities or wastage are found.
- It ensures that proper records are maintained as to purchases, utilization of materials and expenses incurred on various items i.e. wages and overheads, etc. It also makes sure that the industrial unit has been working efficiently and economically.
- It enables shareholders to determine whether or not they are getting a fair return on their investments. It reflects managerial efficiency or inefficiency.
- It ensures true picture of the company's state of affairs. It reveals whether resources like plant and machinery are being properly utilized or not.
- It creates an image of the creditworthiness of the concern.
- It tells the true cost of production. From this, the consumer may know whether the market price of the article is fair or not. The consumer is saved from exploitation.
- It improves the efficiency of industrial units and thereby assists in the economic progress of the nation.
- Since the price increase by the industry is not allowed without justification as to an increase in the cost of production, consumers can maintain their standard of living.
- It assists the tariff board in deciding whether tariff protection should be extended to a particular industry or not.
- It helps to ascertain whether any particular industry should be given any subsidy to develop that industry.
- It provides reliable data to the government for fixing up the selling prices of the various commodities.
- It helps in fixing contract prices in a cost-plus contract.
- It determines whether differential pricing within the industry is desirable.

2.9.7.2 Circumstances under Which Cost Audit is Desirable

The following are the circumstances under which cost audit is ordered:

- Price Fixation.
- Cost variation within the industry.
- Inefficient Management.
- Tax Assessment.
- Trade Disputes.

2.9.7.3 Types of Cost Audit

The following are the important types of Cost Audit:

Efficiency Audit-Efficiency Audit is directed towards the measurement of whether corporate plans have been effectively executed. It is concerned with the utilization of resources in an economic and most remunerative manner to achieve the objectives of the concern.

Propriety Audit-The propriety Audit is concerned with executive actions and plans bearing on the finance and expenditure of the company. The auditor has to judge whether the planned expenditure is designed to give optimum results.

Statutory Audit-It is the compulsory audit that required maintaining the related books and accounts of specified establishments. The chief aims of this type of audit are that the government wants to ascertain the relationship between costs and prices.

Previous Year Question

Sub Unit – 2.9

June- 2019

1. **Which of the following are the rights of a Statutory Auditor?**
(a) To receive remuneration
(b) To attend Board of Doctors' Meeting
(c) To attend the General Meeting
(d) To visit the branch office
Choose the correct answer from the following:
1. (a) and (b)
2. (a), (b) and (d)
3. (a), (c) and (d)
4. (a), (b), (c) and (d)

Answer with Reference

SL. NO.	ANSWER	REFERENCE NO.
1.	3	2.9.4.3

Sub Unit: 10 Recent Trends in Auditing: Management audit; Energy audit; Environment audit; Systems audit; Safety audit

Sl. No.	Topics
144	2.10.1 What is management audit?
145	2.10.1.1 Objectives of management audit
146	2.10.2 What is energy audit?
147	2.10.2.1 Stages of energy audit
148	2.10.3 What is environmental audit?
149	2.10.3.1 Objectives of environmental audit
150	2.10.4 What is system audit?
151	2.10.4.1 Objectives of system audit
152	2.10.5 What is safety audit?
153	2.10.5.1 Advantages of safety audit

2.10.1 What is management audit?

Management audit is a method of independent and systematic evaluation of the management activities at all levels of management to ascertain the functions, efficiency and achievement of' the management (policies, programs, procedures) as compared to standards set by the company. **"Management audit can be defined as an objective and independent appraisal of the effectiveness of managers and the effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organization and to recommend ways to rectify these weaknesses"**. – CIMA Official Terminology.

2.10.1.1 Objectives of management audit

- Management audit aims at to assess the efficiency at all levels of management and implementation of policies.
- Management audit examine and evaluates the plans and policies and judge whether planning and policies are properly implemented.
- To point out deficiencies in objectives, policies, procedures and planning.
- To suggest improved methods of operations.
- To point out weak links in organizational structure and in internal control system and suggesting improvements.
- To help management by providing early signals of sickness, ways and means to avoid the same; and
- To anticipate problems and suggest remedies to solve them in time.

2.10.2 What is energy audit?

Energy Audit attempts to balance the total energy inputs with its use and serves to identify all the energy streams in the systems and quantifies energy usages according to its discrete function. Energy Audit helps in energy cost optimization, pollution control, safety aspects and suggests the methods to improve the operating & maintenance practices of the system. Energy audit helps to assess present pattern of energy consumption in different cost centres of operations and it also helps to highlight the wastage of energy in major areas.

2.10.2.1 Stages of energy audit

Following are the steps of energy audit-

Data Collection→ Field work→ Analysis of energy consumption and performance of energy accounting→ Analysis and development of energy saving measures→ Energy Audit Report

2.10.3 What is environmental audit?

Environmental auditing involves examination of interaction between business and surroundings and ensures how organisation, management and equipment are functioning to protect environment. In this, measures of environment protection are also suggested. It is conducted by team of experts. In India it is not mandatory. An Environmental Audit can also be defined as an independent assessment performed to ensure that businesses and organizations are complying with environmental policies. It examines the amount of harm or risk of injury that may be posed by the assessed entity and determines the types of pollution being produced by looking at a broad range of locations, activities, and procedures. The information compiled from these factors to determine what changes would need to be installed for compliance.

2.10.3.1 Objectives of environmental audit

The overall objective of environmental auditing is to help safeguard the environment and minimize risks to human health. The key objectives of an environmental audit are:

- To determine how well the environmental management systems and equipment are performing.
- To verify compliance with the relevant national, local or other laws and regulations.
- To minimize human exposure to risks from environmental, health and safety problems.

2.10.4 What is system audit?

A system audit is a disciplined approach to evaluate and improve the effectiveness of a system. Audits are carried out in order to verify that the individual elements within the system are effective and suitable in achieving the stated objectives. The results of these audits can be used by the management for improving the performance of the organization. System audits are carried out by the trained auditors who can be organization own staff or staff of an external auditing agency or independent professional auditors. System audit is defined as "A systematic and independent examination to determine whether activities and related results comply with planned arrangements and whether these arrangements are implemented effectively and are suitable to achieve objectives."

2.10.4.1 Objectives of system audit

- To evaluate the organization system against a system standard.
- To determine the conformity or non-conformity of the system elements with the specified requirements.
- To determine the effectiveness of the implemented system in meeting the specified objectives.
- To offer an opportunity for improvement in the system.
- To meet statutory and regulatory requirements.

2.10.5 What is safety audit?

It is an audit where information is collected about one or more aspects of the workplace in order to evaluate the risk levels for health or safety issues. A safety audit is a structured process whereby information is collected relating to the efficiency, effectiveness, and reliability of a company's total health and safety management system.

2.10.5.1 Advantages of safety audit

Following are the advantages of safety audit:

- Promote constant review of systems to ensure that they do not become weakened by habit.
- Facilitate planned improvements to programs, policies, and procedures.
- Help to identify weaknesses in human resources departments.
- Help to demonstrate management's dedication to employee health and safety.