**Advanced Bank Management**

In the courseware on Advanced Bank Management, under Module D (Credit Management), the types of borrowers are mentioned in Unit 26. Candidates need to have a broader understanding of the types of borrowers who may be availing credit facilities from banks. While the details regarding companies are covered in the courseware on Accounting & Finance for Bankers (JAIIB), the salient features of Partnership accounts and Joint Ventures are given below. Salient features of Consignment Accounts, Leasing and Single Entry System are also mentioned.

**PARTNERSHIP ACCOUNTS**

**INTRODUCTION TO PARTNERSHIP**

Section 4 of the Indian Partnership Act, 1932 defines partnership as ‘The relation between persons who have agreed to share the profits of a business carried on by all or anyone of them acting for all.’

According to the above definition, the main features of partnership are as under:

(i) It is the relationship between persons, which means that there should be at least two persons to form a partnership.

(ii) A partnership is the result of an agreement, which may be written, or oral.

(iii) The agreement is to share the profits of the business. This means that profits have to be shared by all though loss may be borne by only one partner, a few partners or all the partners.

(iv) The business must be carried by one or more than one or all, on behalf of all. This means that one partner can act on behalf of the other partners. This is known as the principle of agency.

When all these four characteristics are fulfilled, the relationship between the persons is known as the ‘Partnership’. Persons who have entered into partnership with one another are individually called ‘partners’ and collectively ‘a firm’. The name under which the business is carried on is called the ‘firm name’ and it constitutes a separate entity for its activities/operations and subsequent accounting treatment thereof.

According to the Indian Partnership Act, there is no maximum limit of partners in the partnership, but according to the Companies Act 2013; the maximum number of partners is ten in case of banking business and hundred in case of other business operations. The Companies (Amendment) Bill 2003 permits the formation of partnership consisting of professionals up to fifty partners. An association of persons of more than the said limit is an illegal association.

The document, which contains the partnership agreement, is known as ‘Partnership Deed’. Legally, it is not compulsory for any partnership firm to have a written partnership deed but it is always advisable to have a written partnership deed to be referred to in future in the event of any disputes between partners. Sometimes, even if there is a partnership deed, it may be silent on certain points. In such cases, the relevant provisions of the Partnership Act will apply.

Some of the important clauses of a partnership deed (particularly those affecting accounts and consequent accounting treatment) are as follows:

1. Name of the firm and the partnership business.

2. Commencement and duration of business.

3. Amount of capital to be contributed by each partner.

4. Rate of interest to be allowed to each partner on his capital and on his loan to the firm.

5. Disposal of profits, particularly the ratio in which profits or losses is to be shared.

6. Amount to be allowed to each partner as drawings and the timings of such drawings and interest chargeable, if any.

7. Whether a partner will be allowed to draw a salary.

8. Any variations in the mutual rights and duties of partners.

9. Method by which the goodwill is to be calculated on the admission, retirement or death of a partner.

10. Procedure by which a partner may retire and the method of payment of his dues.

11. Basis of determination of the executors of a deceased partner and the method of payment.

12. Treatment of losses arising out of the insolvency of a partner.

13. Procedure to be followed for settlement of disputes among partners.

14. Preparation of accounts and their audit.

In the absence of any partnership deed or where a deed is silent in respect of the above-mentioned points, the following rules of the Partnership Act will have to be observed:

1. The partners are entitled to share profits or losses equally.

2. The partners are not entitled to any interest on capital nor any interest is to be charged by the firm on drawings.

3. The partners are entitled to interest at 6 per cent per annum on loans given by them to the firm.

4. The partners are not entitled to any salary, remuneration or commission for any extra work done.

**DISTINCTION BETWEEN PARTNERSHIP AND OTHER FORMS OF BUSINESS**

The distinction between partnership accounts and other forms of business is depicted in the Table below:

|  |  |  |  |
| --- | --- | --- | --- |
| Points of  Distinction | Proprietary | Partnership | Company and other forms which are separate legal entitles (Artificial Judicial persons) |
| Legal Status | Individual, i.e. one single person. | Partners and partnership firm is one entity. All partners are jointly and severally liable for acts of the firm. | They are separate legal entities. |
| Ownership | Owned by a single person. | Owned jointly by all the partners. | Members of the Company, i.e. Shareholders are the owners. |
| Share of Profit | Entire profits belong to the proprietor. | All the partners share the profits in  some agreed proportion. | Members, i.e. shareholders enjoy the profit in the form of dividends. |
| Management of  Business | Business in most cases is run by single person. | Business may be run by one or some or all the partners acting for all. | Board of Directors who are professionals and may also be shareholders manages business. |

Proprietorship and partnership are two forms of business organisation in which there is not much difference between the accounts thereof. However, instead of one capital account in a proprietary concern, there will be as many capital accounts as there are partners in a partnership firm. Moreover, there are certain transactions applicable only to a partnership firm such as interest on capital and drawings of the partners, salary and commission and interest on loan payable to a partner. All these items are shown separately in the profit and loss appropriation account and profits and losses are distributed among the partners in their respective profit sharing ratio after such adjustments as stated above. Partners’ capital accounts are separately shown on the liabilities side of the balance sheet (assuming credit balances in the accounts in normal circumstances).

Sometimes, a new partner is admitted to the firm or an old partner retires or is expelled or dies. In such events, special adjustments are required to be made (explained in detail later). For dissolution of a firm also, special accounting procedure for realising the firm’s assets, settling the liabilities and partners’ dues is required to be adopted.

**PARTNERS’ CAPITAL AND LOAN ACCOUNTS**

**A. Methods of Maintaining Capital Accounts**

The Partners’ capital accounts may be maintained by two methods, viz., Fixed Capital Method and Fluctuating Capital Method. Generally, the partnership deed mentions the method of maintaining capital accounts. If a particular method is stated in the partnership deed then the firm has to maintain the capital accounts only by that method. However, if there is no mention about the method of maintaining capital accounts in the partnership deed, the capital accounts are maintained as per the Fluctuating Capital Method.

(a) *Fixed Capital Method*

Under this method, for each partner two accounts are maintained. One is called the partner’s capital account and the other is called partner’s current account. Partner’s capital account is credited with the amount of capital contributed by the partner. All the adjustments regarding interest on capital, interest on drawings and share in profit or loss are recorded in the current account.

(b) *Fluctuating Capital Method*

Under this method, all the transactions relating to a partner are entered in only one capital account maintained for him. No current account is opened as in the Fixed Capital Method. Capital account is credited, not only with the amount contributed by him/her as capital, but other transactions, such as interest on capital, drawings and share of profits, are also recorded in the same capital account.

**B. Partners’ Loan Accounts**

Loans given by the partners, exclusive and independent of contributions by way of capital, are recorded in separate accounts called Partners’ Loan Accounts, keeping the Capital Accounts undisturbed.

**C. Interest on Capital, Drawings and Loans from Partners**

If there is an agreement to allow interest on capital, loan and drawings, interest is calculated at a rate specified in the agreement. In the absence of any such provision in the agreement, no interest will be allowed/charged on the capital and drawings and interest at the rate of 6 per cent per annum will be allowed on the partners’ loans to the firm. It may further be noted that, in the absence of any agreement to the contrary, interest to partners, on the capital account, will be paid only if there is a profit. However, interest on a loan, given by the partners, has to be allowed, irrespective of the fact that there is no profit.

**GOODWILL AND METHOD OF ITS VALUATION**

Goodwill is the value of an established business over and above the value represented by its tangible assets. It is the reputation that the firm has built up in the course of its business. It is also the value attached to the super profit earning capacity of a business arising from its wide connections and long standing in the business. Goodwill is the value of the good name of a firm, which attracts more customers and helps it earn more profits. It is an intangible fixed asset built up slowly by the owners of the business over a period of time and is very often recorded in the books of account. Unlike a fictitious asset, which has no realisable value, Goodwill has a realisable value and can be bought and sold in the market.

*Necessity:* The necessity for valuation of goodwill in a firm arises in the following cases:

1. Change in profit sharing ratio.

2. Admission of a new partner.

3. Retirement, expulsion or death of a partner

4. Sale of business

There are mainly three methods of valuation of goodwill, viz. (i) Average Profit Method

(ii) Super Profit Method

(iii) Capitalisation of Profit Method

(i) **Average Profit Method**

In this method, goodwill is valued on the basis of the average profits of past few years (normally abnormal increase or decrease in profit is left out). Average profit (simple or weighted), so arrived at, is multiplied by an agreed multiplier factor (called number of years’ purchase) and the amount so arrived is taken as the amount of goodwill.

(ii) **Super Profit Method**

Under this method, goodwill is calculated on the basis of the number of years’ purchase of Super Profits. Super Profit is the difference between the Actual Profit and the normal expected profit in the trade.

Super profit is multiplied by a certain multiplier, as in the simple average method.

(iii) **Capitalisation of Profit Method**

Under this method, value of goodwill is arrived at after capitalising the normal profit at a given reasonable or normal rate of return. Profit, when divided by the normal rate of return, gives the amount, which should have been invested in the business of the firm in the form of capital. This value is compared with the net assets of the firm. The value of goodwill is the excess of capitalised value over the net assets of the firm.

**ADMISSION OF A PARTNER**

A new partner may be admitted into an existing partnership for the purpose of securing additional capital or additional skill or for any other purpose. When a new partner is admitted in an existing firm, the new partner will get certain benefits such as:

• Share in the assets and liabilities of the firm.

• Share in the profit/loss of the firm.

• Share in the goodwill enjoyed by the firm.

All *these* advantages are derived by the new partner at the initial sacrifice of the old partners. Thus, at the time of admission of a new partner, the following steps are required to be taken by the firm:

1. Revaluation of assets and liabilities

2. Treatment of goodwill

3. Decision regarding amount of capital to be brought in by the new partner

4. Adjustment regarding accumulated losses and reserves

5. Capital accounts of the partner.

**1. Revaluation of Assets and Liabilities**

A *new* partner, admitted into a partnership, gets a share in the profits as well as the assets of the business. On the date of admission of the new partner, the real value of assets of the firm may be more or less than the value appearing in the books of account. This increase or decrease in value belongs entirely to the old partners and hence, has to be adjusted before the admission of the new partner. Similarly, the liabilities existing on the date of admission of the new partner may also need revision.

When the asset value increases, there is a profit and when it goes down, there is a loss. When liabilities increase, there is a loss and when liabilities decrease, there is a profit. This increase or decrease in assets and liabilities is adjusted to the accounts of the old partners through an account called the

**‘Revaluation Account’** or ‘**Profit and loss Adjustment Account’**. The entries recorded in this account are on the principle that when there is a loss, debit profit and loss adjustment account and when there is a gain, credit profit and loss adjustment account. The difference in the two sides of this account will show either profit or loss, which is transferred to the accounts of the old partners in old profit sharing ratio.

**2. Treatment of Goodwill**

A. Admission of a Partner

When a new partner is admitted to partnership, adjustments of goodwill is necessary because goodwill has been built up by the old partners over a period of years for which they have worked hard and they would not like to just pass on a part of it to the new partner. The new partner also gets a share in profits of the firm from the date of his admission, which is sacrificed by the existing partners. The existing partners would not like to just pass on this benefit to the new partner without a consideration.

**B. Retirement or Death of a Partner**

On retirement or death of any partner, the portion of goodwill of the firm belonging to the retiring partner or the partner who died, has to be paid by the continuing/surviving partners, to the retiring partner or the heirs of the deceased partner, as the case may be. As the continuing/surviving partners gain in terms of increase in share of profits due to death/retirement of a partner, they bear this amount of goodwill paid, in the gain ratio.

**3. Capital to be brought in by a New Partner**

The new partner brings in capital, in addition to goodwill, to get a share in the firm’s assets, liabilities and profits. It can be in the form of cash or assets.

**4. Adjustment Regarding Accumulated Losses and Reserves**

Normally, the profits of the partnership are divided between the partners at the end of each year. In case, a part of the profits is kept in reserve, to take advantage of it in bad times, then the old partners would not like the newly admitted partner to share the benefit of this reserve or undistributed profits. Therefore, the said amount is divided by the old partners amongst themselves in the old profit sharing ratio.

Sometimes, losses of the earlier years are carried by the partnership under the head profit and loss account. They also belong entirely to the old partners and the new partner would definitely not bear this loss.

**5. Adjustment of Capital Accounts of Partners**

Sometimes, it may be decided that after the admission of a new partner, the old partners’ capitals should also be adjusted according to the new profit sharing ratio. This is because old partners’ capital balances may have changed considerably due to revaluation of assets and liabilities, transfer of reserves, adjustment of goodwill, etc. For this purpose, generally, the new partner’s capital and his share of profit are taken as the basis for calculation and the old partners’ capitals are ascertained according to the future profit sharing ratio. The amounts so arrived at are compared with the capitals standing to the credit of their capital accounts. Excess may be paid off by the firm to the old partners and deficiency, if any, may be required to be made up by them by bringing in additional cash.

**RETIREMENT AND DEATH OF A PARTNER**

**A. Retirement of a Partner**

Retirement of a partner means that the partner breaks off his/her relations with all other partners and withdraws himself/herself from the firm.

*Reasons of Retirement*

(a) Due to old age

(b) Retiring partner may not have faith in the future prospects of the firm or in other partners

(c) Difference of opinion with other partners

(d) Retiring partner may migrate or shift from the place of business

(e) Voluntarily decides to retire

(f) As per terms of partnership deed.

According to Section 32 of the Indian Partnership Act, 1932, a partner may retire: (a) with the consent of all the partners,

(b) in accordance with the terms of the partnership agreement, or

(c) by giving a notice to all the partners of his intention to retire, when the partnership is ‘At Will’.

In case of retirement, a retiring partner is interested in collecting his share in the various activities of the business of which he was a part owner till the date of his retirement.

**B. Death of a Partner**

In retirement, a partner breaks off his/her relation with the firm voluntarily, i.e. on his own. Death of a partner automatically terminates such relationship. Unlike retirement, which is on a specific convenient date mutually agreed upon with other partners, death of a partner can occur at any time during the accounting year.

**C. New Profit Sharing Ratio of Continuing Partners**

After retirement or death of a particular partner, the continuing partners may agree to share the profits in the same old ratio or in a new agreed ratio. The ratio in which the continuing partners gain or benefit from the share of the retiring or dead partner is called the ‘Gaining ratio’. Gaining ratio is equal to the new ratio minus the old ratio.

**D. Joint Life Policy**

In order to provide for the cash in contingency like the death of a partner, etc., a firm may decide to take a joint life policy on the lives of partners so that the proceeds received from the insurance company may be utilised to make payments of the dues of a deceased partner and the firm is saved from financial hardship.

**SLEEPING PARTNER AND QUASI PARTNER**

**Sleeping Partner**

In a partnership, very often, some partners agree to work while others are interested in merely investing the capital and getting a share of profits. Such partners are normally not interested in the day-to-day working of the partnership and are called sleeping partners. The other partners who work for the business of the firm are called working partners or active partners. However, it must be noted that law makes no difference between a sleeping partner and a working partner and the sleeping partner will be equally responsible to the third parties for all acts or omissions of a working partner.

**Quasi or Nominal Partner**

Sometimes, some prominent persons lend their names to a firm in order to allow the firm to enjoy their goodwill in furtherance of its business. Likewise, in some cases, a person’s name may be used by the partnership firm showing him/her to be a partner, whereas the person is, in fact, not a partner in the firm. In such cases, although no relationship of partnership exists, the law stops a person from disclaiming his/her status as partner vis-à-vis third parties, if he/she keeps quiet, in spite of being fully aware of the fact that his/her name is utilised as partner. Such a quasi-partnership protects the third parties who may make a non-partner liable in these circumstances.

**Joint Ventures**

**INTRODUCTION**

Where a businessman finds it difficult to undertake any business work or a venture alone, he /she may associate with other businessman/ businesswoman. Such an association of persons is for a short period or for a particular venture and is known as ‘Joint Venture’. It is regarded as a temporary partnership without a firm name and it ceases with the completion of the task undertaken. Persons, who have come together, are called co-venturers and not partners. The co-venturers enter into a contract with each other, deciding about their capital contribution and share of profit. In the absence of any agreement, profit and losses are shared equally by the co-venturers.

**DEFINITION**

A dictionary for accountants, by Eric L. Kohler, defines joint venture as under:

‘A commercial undertaking by two or more persons, differing from a partnership in that relate to disposition of a single lot of goods or the completion of a single project. Its duration is limited to the period in which goods are sold or the project is carried on.’

**FEATURES**

The essential features of a joint venture agreement are: (1) It is an agreement between two or more persons. (2) The agreement is made to carry on a specific job.

(3) The agreement is over as soon as the venture is completed.

(4) It is a temporary partnership without any firm’s name.

**DISTINCTION BETWEEN JOINT VENTURE AND PARTNERSHIP**

(1) A partnership has a firm name while a joint venture does not possess such a common name. (2) A partnership is a continuing business whereas a joint venture is purely temporary in nature.

(3) The persons who enter into joint venture are called co-venturers while in case of a partnership,

such persons are called partners.

(4) Partners have joint and several liabilities while in a joint venture it depends on the mode of contract.

(5) Separate set of books is maintained in case of a partnership firm whereas the same is not a must in case of a joint venture.

(6) In a partnership firm, accrual basis of accounting is followed whereas in a joint venture cash basis of accounting is usually followed.

(7) In a partnership, profit or loss is ascertained at the end of the year whereas in a joint venture it is ascertained on completion of each venture.

**DISTINCTION BETWEEN JOINT VENTURE AND CONSIGNMENT**

(1) In a joint venture, the venturers contribute capital and share the profit or losses according to an agreed ratio, whereas, in a consignment, the consignee does not contribute any capital and he is not entitled to the profit or loss but he gets a commission at an agreed rate.

(2) In a joint venture, each co-venturer can take part in the management of the venture, whereas in consignment, neither the consignor nor the consignee can take part in the other’s business.

(3) A joint venture is governed by the Partnership Act and by the terms of contract between the co- venturers but a consignment is governed by the law relating to ‘Agency’ and the terms of contract between parties to the contract.

(4) A joint venture may be regarded as a temporary partnership whereas consignment is not similar to joint venture since the relationship between consignor and consignee is that of the ‘Principal’ and

‘Agent’

**Consignment Account**

**MEANING**

A consignment is the dispatch of goods by its owner to his agent for the purpose of selling. The former is called the ‘Principal’ or ‘Consignor’ and the latter is called ‘Agent’ or ‘Consignee’. The goods so dispatched or sent by the consignor is regarded as ‘Consignment Outward’ in the books of consignor, whereas the goods so received by the consignee is treated as ‘Consignment Inward’ in his books.

**DIFFERENCE BETWEEN CONSIGNMENT AND SALE**

The following points may be noted.

(a) According to Sale of Goods Act, where the property in the goods is transferred from the seller to the buyer, the contract is called a ‘sale’. But in consignment, the ownership of the goods is not transferred to the consignee.

(b) In actual sale, the purchaser can dispose off the goods according to his own choice and desire since he is the owner of such goods. But in a consignment, the consignee cannot do so since he is not the owner of the goods and at the same time, he is bound to sell the same prescribed by the consignor.

(c) In case of sale, risk is transferred from the seller to the buyer as soon as the transaction takes place. Therefore, any loss, if incurred, is to be borne by the purchaser. But in case of consignment, loss is to be borne by the consignor and not by the consignee since he is only the agent.

(d) In a contract of sale, the purchaser cannot return the goods to the seller, but in consignment, the consignee can do so if he thinks that the goods are not marketable.

**PROFORMA INVOICE**

It is an invoice sent by consignor to the consignee stating full details of the goods consigned, such as quantity, grade, value, etc. Since transfer of goods to consignee is not a sale, the invoice is called ‘Pro forma Invoice’.

**ACCOUNT SALE**

Consignor, who is a manufacturer or wholesaler, sends the consignment to his agent, consignee, for selling the goods on his behalf at the best available price. The consignor, reimburses all legitimate expenses incurred by the consignee for selling these goods. Such expenses include rental of shop, salary and commission to salesmen, etc. The consignee is given a fixed rate of commission over and above the reimbursement of expenses. The consignee is required to submit to the consignor a statement, showing details of goods sold, expenses incurred, commission due to him and how the balance payable to consignor is settled. This statement is called ‘Account Sale’

**VALUATION OF CLOSING STOCK**

Unsold stock of goods with the consignee must be valued properly. The stock is valued at cost plus the proportionate expenses incurred by the consignor and the consignee. In case of the consignor, all expenses incurred for sending goods to the consignee are to be considered. But in case of consignee, only non- recurring or direct expenses, incurred by him are taken into account.

**CONSIGNING GOODS AT A HIGHER PRICE**

When the consignor thinks that the consignee should have no knowledge of the cost of goods consigned, he prepares a pro forma invoice at a higher price. Another object of preparing the pro forma invoice at a higher price is to keep the consignee in the dark about the actual amount of profit earned. The excess amount, over the cost price, is called ‘Loading’. When goods are consigned at the ‘Invoice Price’ (Loaded Price), the consignment account is debited with the loaded price and immediately the excess over the cost is credited to consignment account so that the element of the unrealized profit is removed. Similarly, while valuing closing stocks, goods are valued first at the invoice price and the excess included in the stocks is transferred to consignment stock revenue by debiting consignment account.

**COMMISSION PAYABLE TO CONSIGNEE**

Over and above the reimbursement of expenses incurred by the consignee, he is paid a commission at a fixed rate on the sales by him. Commission payable to the consignee is of two types, i.e.

(1) Ordinary and

(2) Del Credere.

Ordinary commission is paid at a fixed rate on all sales made by him, cash as well as credit. Collection charges, loss due to bad debts must be borne by the consignor.

Del Credere commission is an extra commission, over and above the normal, paid to the consignee for selling goods on credit. Under these circumstances, all losses due to bad debts, collection charges and discount must be borne by the consignee. This is calculated on total sales.

**NORMAL LOSS**

If some loss is unavoidable (e.g, leakage) it would be spread over the entire consignment while valuing stock. The total cost plus expenses incurred should be divided by the quantity available after the normal loss to ascertain the cost per unit.

**ABNORMAL LOSS**

If any accidental or unnecessary loss occurs then such loss is ascertained and transferred to the profit and loss account.

**LEASING**

**Definition**

Leasing can be described as a contract between two parties, whereby the owner of an asset transfers his right of use to some other party on payment of a fixed periodical rent.

**Essential features of a lease contract**

There are two parties to a lease transaction, the owner of the asset known as the lessor and the user of the asset as the lessee. By virtue of the lease agreement, the lessee gets the right of uninterrupted use of the asset provided he makes the payment of lease rentals regularly. During the entire period of currency of the contract, the ownership of the asset remains with the lessor only. The contract is usually for a specific period, normally five years and on the expiry of the same, it can be renewed or terminated or the asset can be purchased by the lessee depending upon the terms of the contract.

**Advantages**

Leasing, as a means of organising industrial production capacity, has become very popular in India in the last few years. The leasing is beneficial both to the lessor as well as the lessee.

**Advantages to Lessor**

1*. Expansion of business:* Manufacturers of plant and machinery with high prices may find it difficult to expand their sales if they insist on selling their products on an outright ownership basis. Owing to recession in the economy, the growth of capital goods industry is affected to a considerable extent. In this situation, leasing is increasingly used to revive the demand for capital goods. The manufacturers of the capital goods have benefited immensely by adopting leasing arrangements.

2*. Tool of tax planning:* If a manufacturer or a dealer sells capital goods, it increases his profits and as a result, he will pay more income tax. Larger the sales, higher is the profit and consequently higher the tax liability. Instead of selling the capital goods, if the manufacturer or dealer leases them out, the lease rent becomes receivable over a long period. Thus, with the help of leasing, manufacturer or a dealer or lessor reduces his tax liability. In this way, leasing can be used as

a tax-planning tool.

**Advantages to Lessee**

1*. Reduction in capital investment:* Instead of purchasing the capital goods, if the same are taken on lease, the manufacturer can reduce the capital investment in the project. Entrepreneurs with lower financial capacity can start a venture without investing huge funds. Leasing also saves the interest

burden on funds which the lessee would have paid on the borrowed fund for purchasing the assets.

2. *Elimination of risk of obsolescence:* With fast developing technology, the owner of an asset has to bear the risk of his asset becoming obsolete or outdated. Since the lessee is not the owner of the asset, he does not have to bear this risk. If the lease period is short, on expiry of the lease period, the lessee can take on lease another capital asset having the most advanced technology.

3. *Increase in borrowing capacity:* If the capital goods are purchased with borrowed funds, the asset, as well as the borrowed funds, appear in the balance sheet; this reduces further borrowing capacity of the business – although leasing of capital assets involves substantial payments over a long period. In future, such liability need not be shown in the balance sheet. From the point of view of the lenders of the long-term loans, the borrower’s borrowing capacity increases with no past borrowings. Thus, the lessee can borrow more funds from the financial institutions without much difficulty.

4. *Reduction in tax liability:* Lease rent payable by the lessee is treated as revenue expenditure in his hand which is fully debited to profit and loss account before calculating the taxable profit of the lessee. This will reduce his tax liability.

5*. Application of certain laws:* The provisions of the Monopolies and Restrictive Trade Practices

Act can be avoided by keeping the capital investment at a lower level.

6. *Interference of financial institutions:* Leasing reduces the dependence on the financial institutions and banks for borrowing huge sums for long-term or medium term. Thus, the lessee can avoid interference of these institutions in the day-to-day management of his organisation.

**Limitations**

1. Lease rent may be quite burdensome to the lessee as it has to cover the cost of depreciation, cost of finance and administrative expenses of the lessor.

2. When the lessor has acquired the leased assets by borrowing funds against the hypothecation of the leased assets, any default on the part of the lessor may adversely affect the operations of the lessee.

3. Leasing only shifts the need for borrowing from the lessee to the lessor. Thus, for the banks and the financial institutions, the demand for the finance remains the same.

4. Leased assets are not eligible for capital subsidies available for projects in backward areas.

5. Generally, lease rental structures do not provide for a moratorium period as available in respect of finance from banks/financial institutions. Thus, leasing is considered unattractive for projects with a long gestation period.

6. The disadvantage to the lessee in cases of financial lease is that he is not entitled to the protection of warranties from the supplier of the equipments as the same are purchased by lessor. He has to pay lease rentals in spite of loss, destruction or defects in the leased assets.

**Types of Leases**

Lease is mainly of four types:

1. Finance or Capital lease

2. Operating lease

3. Service lease

4. Leveraged lease

**1. Finance or Capital Lease**

This is the most popular type of lease. It is fairly long-term in nature. Generally, the entire economic life of the asset is agreed to be transferred for use by the lessee, though the ownership remains with the lessor. Lessee agrees to pay the fixed instalments (lease rentals) which, in total, exceed the cost of equipment. Normally, such a contract is non-cancellable in nature during the primary period. Lessee bears the risk of obsolescence and under utilisation, if any. The lease is generally spread into two periods:

(a) Primary Period: Normally, for equipment, the period is five years. The lessor recovers the cost of the asset and interest thereon during this period.

(b) Secondary Period: It starts after the primary period is over. The lease is continued on a very nominal rental.

**2. Operating Lease**

Operating lease is a lease which is not ‘Finance’ or a ‘Capital’ lease. It does not transfer any of the rewards and risks of ownership of the leased property to the lessee. The contract is, usually, cancellable and of lower maturity period than in the case of financial lease. Normally, the period of lease is much less compared to the economic life of the asset. Leasing of telephones, vehicles, computers, etc., are some of the examples of operating lease. The lease period is normally for a short period and may stretch from a day to about three years.

**3. Service Lease**

It is a lease agreement effected by manufacturers or dealers of capital goods (like machinery) or consumer durables (like Air-conditioners, etc.) in which they deal. Service lease covers the cost of maintenance and servicing the assets for a short period. The lease payment covers cost of servicing and not the capital outlay. Sometimes, the lessee may be given an option to retain the asset on the expiry of the lease period.

**4. Leveraged Lease**

In this type of lease, there are three parties to the lease agreement. In addition to the lessor and the lessee, the third party is the financier to lessor. Hence, the lease is also known as a ‘Third Party Lease’. Under this lease, the third party provides the finance to the lessor. Leasing has nowadays become a specialised service industry. Many leasing companies have been formed to purchase assets and give them on lease to the lessees. The leasing companies give plant and machinery, factory buildings, worth crore of rupees, on lease. In order to lease such assets involving huge capital outlays, even leasing companies have to borrow huge funds. When a business uses borrowed funds, having low costs, to maximise its profits, it is said in the financial management that the business has used financial leverage. Since the leasing companies (i.e. the lessors) use borrowed funds to finance their leasing activities, such lease is known as ‘Leveraged Lease’.

**HIRE PURCHASE AND INSTALMENT SALE**

**Meaning**

In a hire purchase and in instalment sale, a buyer purchases goods but pays the price of the goods not in one lump sum but in various instalments. The buyer takes possession of the goods and enjoys them as if he is the sole owner of the goods, although, the price for the goods is not fully paid.

The person who purchases goods on hire purchase basis is called ‘hirer’; while the seller is called ‘hire purchase seller ’, ‘hire purchase vendor’ or ‘owner’. The hire purchase agreement must be in writing. It includes the description of the goods, cash price, interest to be charged, number of instalments and so on. The hire purchase price consists of two elements:

(1) Cash price and

(2) Interest for delayed payments.

Normally, a certain amount is paid immediately at the time of signing the agreement. This is called

‘Down’ payment.

**Distinction Between Hire Purchase and Instalment Sale**

|  |  |
| --- | --- |
| **Hire Purchase** | **Instalment Sale** |
| **1. Ownership**  The agreement mentions the date on which ownership in the goods passes  to the buyer. Usually, it passes on payment of the last instalment. | Ownership passes to the buyer as soon as the transaction of instalment sale is completed. |
| **2. Default in payment of instalment**  In case of a default, the seller can take back the possession of the goods and he is not bound to return the amount already received. | The seller cannot take back the goods. He can sue the buyer for non-payment of instalment. |
| **3. Buyer’s right to terminate contract** The buyer has an option to terminate the contract and return the goods. | The buyer has no right to terminate the contract. |
| **4. Buyer’s right to dispose of goods** He cannot dispose of the goods as ownership has not passed on to him. | Since the buyer is the sole owner of the goods, he can dispose of these goods in any manner he likes. |
| **5. Loss of Goods**  Loss of goods has to be borne by the seller provided the buyer has taken reasonable care of the goods. | As he is the sole owner, any loss of goods has to be borne by him. |

**ACCOUNTING FROM INCOMPLETE RECORDS (SINGLE ENTRY SYSTEM)**

‘Single Entry System’ may be defined as any system which is not exactly the double entry system. In other words, Single entry system may consist of:

(i) Double entry in respect of certain transactions such as cash received from debtors, cash paid to creditors, etc.

(ii) Single entry in respect of certain transactions such as cash purchases, cash sales, expenses made, fixed assets purchased, etc.

(iii) No entry in respect of certain such as depreciation, bad debts,etc.

Thus, a business is said to be using single entry system if it is not following completely the principles of double entry system of bookkeeping. Kohler defines the single entry system as, ‘A system of book- keeping in which, as a rule, only records of cash and of personal accounts are maintained, it is always incomplete double entry, varying with the circumstances.’

**SALIENT FEATURES**

The salient features of the single entry system are as follows:

**(i) Maintenance of personal accounts**

Usually under this system personal accounts are maintained while real and nominal accounts are avoided. On account of this reason some accountants define it as a system where only personal accounts are maintained.

**(ii) Maintenance of cash book**

A cash book is maintained, which usually mixes up both the personal transactions and the business transactions.

**(iii) Dependence on original vouchers**

In order to collect the necessary information one has to depend on original vouchers. For example, the figure of credit purchases may not be readily available; it may have to be found out on the basis of the original invoices received from the suppliers. Similarly, the total figure of sales at the end of a particular period may have to be found out on the basis of the invoices which have been issued by the business from time to time.

**(iv) No uniformity**

The system may differ from firm to firm as per their individual requirements and conveniences.

**(v) Suitability**

The system is suitable in case of small proprietary or partnership concerns. Limited companies cannot adopt this system on account of legal requirements.

**LIMITATIONS**

The system suffers from the following limitations:

**(i) Arithmetical accuracy cannot be checked**

In case of double entry system of bookkeeping, Trial balance is prepared to check the arithmetical accuracy of the books of accounts. This is possible because every transaction is recorded at two places. In case of the single entry system, this is not done. Hence, trial balance cannot be prepared and the arithmetical accuracy of the books of accounts cannot be checked. This increases the possibility of more frauds and misappropriations, as compared to the double entry system of bookkeeping.

**(ii) True profits cannot be known**

In the absence of complete information for sales, purchases and other expenses, it is not possible to draw the profit and loss account. Hence, the true profit or loss, made or suffered by the business, cannot be known.

**(iii) Financial position of the business cannot be judged**

In the absence of a true figure of profit and correct information about the assets and liabilities of the business, the balance sheet cannot be drawn up to give a correct picture of the financial position of the business on a particular date.

**(iv) Makes planning and decision-making difficult**

The system does not provide accurate figures about the performance of the business and its financial position. For example, separate figures of gross profit, net profit and sales are not available. Thus, the ratio of gross profit to sales or net profit to sales cannot be found out. Similarly in the absence of any information about the cost of goods sold, the proportion of different elements of cost of sales cannot be found out. In the absence of such information, it becomes difficult for the proprietor of the business to know the reasons of his improving or deteriorating profitability and financial position. Thus, he is not in a position to compare, plan and take sound decision for the prosperity of the business. Moreover, it may be difficult for him to find the real value of his business in the event of his deciding to sell the business.

**COMPUTATION OF PROFITS UNDER SINGLE ENTRY SYSTEM**

The profit or loss in case of business maintaining accounts according to single entry system can be computed by two methods:

(i) Net Worth method, and

(ii) Conversion method.

**Net Worth Method**

According to this method, the profit or loss made by the business is computed by comparing the net worth (or capital) of the business on two different dates.

Following adjustments are required for determination of the profit in case of this method:

(i) *Adjustment for drawings:*The proprietor may withdraw money from the business for his personal use. In the absence of any such withdrawal, the capital at the end of accounting period would have been more by the amount of money withdrawn by him. Thus, the amount of drawings should be added back to the capital at the end of the accounting period to find out his true profit for that period.

*Adjustment for capital introduced:*The proprietor may introduce further capital in the business during the course of the accounting year. This will increase the capital of the proprietor at the end of the accounting year. It is, therefore, necessary to reduce the amount of capital, by the amount of capital introduced by the proprietor during the year, in order to ascertain the profit earned by him during the course of the accounting year.

**Conversion Method**

The Net Worth method, explained above, does not provide a clear picture of the operational results of a business. It does not give information about sales, purchases, gross profit, operating expenses, etc. of the business. As a result, neither a meaningful analysis of the financial statements can be done nor can effective steps be taken to improve the financial position of the business. It will, therefore, be better to collect all such information from the books of accounts, and other sources, which is necessary for preparing a ‘Trial Balance’ of the business. This is done by preparing a total debtors account, a total creditor’s account, a bills receivable account and a bills payable account and receipts and payments accounts etc. on the basis of double entry. Accounts relating to different expenses, incomes, fixed assets and fixed liabilities, and outstanding, are also prepared with the help of receipts and payments accounts and additional information available. Thus, the closing balances of different accounts are found out and a trial balance prepared. Final accounts can then be prepared in the usual way. Such a method of collecting information as per the requirements of the double entry system of bookkeeping is termed as the ‘Conversion Method’.

In practice, usually, an abridged conversion method is followed. Under this method, nominal accounts are not opened in the ledger, nor is a trial balance prepared. Only such information is collected which is required for preparing the trading and profit and loss account, and balance sheet of the business.

**PREPARATION OF STATEMENT OF AFFAIRS UNDER SINGLE ENTRY SYSTEM**

Statement of affairs is a statement giving the assets and liabilities of the business on a particular date. It is virtually the Balance Sheet of the business. However, the term Balance Sheet is used for the statement of assets and liabilities in the double entry system of bookkeeping where balances are taken from the ledger. In case of single entry system, all the assets and liabilities, which appear in the statement of affairs, are not necessarily taken from the ledger accounts, on account of incomplete recording of the transactions. Moreover, the term Balance Sheet is used for statement which shows the correct financial position of the business. In case of the single entry system, it may not be possible to prepare a statement which shows the correct financial position of the business, since the information from different sources, which may include not only the books of accounts, but other sources, which may not be hundred per cent reliable. For example, estimate about drawings may have to be made on the basis of the estimated living expenses of the proprietor of the business and also other estimated payments which might have been paid on his behalf.

**Steps for preparing Statement of Affairs**

The following steps may be taken for preparing the statement of affairs:

(i) In most cases in single entry system, a cash book is maintained. In case, this has been done, the cash and the bank balances can be taken from the cash book. In the absence of a proper cash book, cash balance may have to be found out by preparing a receipts and payments account on the basis of information, collected from the proprietor of the business, and the statement of accounts, which might have been received or sent by the proprietor from/to his debtors and creditors. Information regarding other business expenses can be collected from the salaries register of his employees, petty cash book, if any, maintained by him, etc. and the actual cash balance available with the business. The balance at the bank can be verified from the bank pass book or statement of account from the bank.

(ii) A list of sundry debtors and creditors should be prepared. This may not be difficult because in most cases, a record of personal accounts is maintained under the single entry system.

(iii) The value of the fixed assets like building, plant, furniture, etc. should be ascertained from vouchers or other documents available with the business. A reasonable charge for depreciation should also be made and the assets should be shown in the statement of affairs after charging depreciation.

(iv) A physical verification of the stock should be taken and the value of the stock should be ascertained on the basis of the different invoices received from suppliers from time to time, in respect of the goods purchased.

(v) The amount of outstanding expenses and the accrued income should also be determined. Last year’s figures about these items may be of considerable help in this respect.

(vi) The excess of assets over liabilities should be found out and this will denote the net worth or the capital of the business on the date on which the Statement of Affairs has been prepared.