FINANCIAL ACCOUNTING

Partnership – Death of a partner – Treatment of Joint Life Policy

A Joint Life Policy (JLP) is an insurance policy which is taken out by the partnership firm on the joint lives of all the partners. The amount of policy is payable by the Insurance Company either on the death or on maturity of policy, whichever is earlier. The firm pays annual premium to the insurer against the policy. Joint Life Policy will be an asset of the firm and deceased partner has a right to share any profit or loss on such policy. So, any claim which is received by the firm on the death of a partner is divided among the partners and credited to their capital accounts in their profit sharing ratio.

ACCOUNTING TREATMENT OF JOINT LIFE POLICY
The accounting treatment of JLP can be understood from the following table:

(A) Premium Paid is Treated as Expense	Journal Entry(s)
1. The premiums are treated as expense and debited to P & L A/c.	*On payment of premium*: Insurance Premium A/c Dr To Bank
2. No Joint Life Policy Account is maintained.	*On premium charged to P & l A/c*: Profit & Loss A/c Dr To Insurance Premium A/c
3. At the time of maturity of policy, the amount received will be credited to the capital accounts of all the partners (including the deceased partner) in their profit sharing ratio.	*On maturity of policy:* Insurance Company A/c Dr To Partners' Capital A/c

4. Surrender value is not considered under this method.	*On receipt of amount from the Insurance Co.:*
	Bank A/c Dr
	    To Insurance Company A/c
	
	On t/f of the balance in JLP a/c:
	Joint Life Policy A/c Dr
	    To All Partners' Capital A/c

(B) Premium Paid is Treated as an Asset	**Journal Entry(s)**
1. Joint Life Policy is shown at its surrender value in the Balance Sheet	*On payment of premium:* Joint Life Policy A/c Dr To Bank A/c
2. Surrender Value is the amount that the insurer would be willing to pay on the basis of number of premiums paid. At the end of the year, the amount which is in excess (i.e. Joint Life Policy A/c balance – Its	*On t/f of balance exceeding surrender value:* Profit & Loss A/c Dr To Joint Life Policy A/c

surrender value) is transferred to the P/L A/c as a loss.	
3. From the 2nd yr and onwards, the 1st and 2nd entry shall be repeated until the last year. In the last yr, i.e., the yr of death, 1st entry will be recorded only if death takes place after the due date of premium and 2nd entry will not be recorded at all. On maturity of policy or in the event of death, the claim to be registered with the insurance company.	*On maturity:* Insurance Company A/c Dr To Joint Life Policy A/c

4. Joint Life Policy Account is maintained to which the premium paid shall be debited and the amount received from the insurance company shall be credited.	*On receipt of amount from the Insurance Co.:*
	Bank A/c Dr
	    To Insurance Company
	
	On t/f of the balance in JLP a/c:
	Joint Life Policy A/c Dr
	    To All Partners' Capital A/c

(C) Premium Paid is Treated as an Asset and Reserve is Maintained	**Journal Entry(s)**

1. An amount equal to the premium is debited to the Profit & Loss Appropriation A/c and credited to the Joint Life Policy Reserve A/c.	*On payment of premium:*
	Joint Life Policy A/c Dr
	    To Bank A/c
	
	On Appropriation of reserve:
	Profit & Loss Appropriation A/c Dr
	    To Joint Life Policy Reserve A/c

2. The JLP A/c and the JLP Reserve A/c are mutually adjusted to leave in each account a balance equal to the surrender value of the policy.	*On t/f of balance exceeding surrender value:* Joint Life Policy Reserve A/c Dr To Joint Life Policy A/c The entries for maturity of policy, receipt of the policy amount and t/f of balance in JLP A/c are same as above.
	On t/f of the balance in JLP Reserve A/c: Joint Life Policy Reserve A/c Dr To Joint Life Policy A/c
(D) Individual Life Insurance Policy	**Accounting Treatment/ Remarks**
1. It is a life policy which covers the life of a partner individually. 2. The firm charges the premium paid on the individual lives of the partners to the Profit and	*On the retirement of a partner:* Retiring partner entitled to his share in the surrender values of unmatured policies of <u>all</u> the partners on the date of retirement.

Loss A/c	*On the death of the partner:* Executors are entitled to (i) insurance claim and (ii) share in the surrender value of unmatured policies of <u>other</u> partners.		

Note: Joint Life Policy Account is shown at the assets side of the Balance Sheet and the Joint Life Policy Reserve Account is shown at the liabilities side of the Balance Sheet.

CALCULATION OF THE BALANCE EXCEEDING THE SURRENDER VALUE

Annual Premium charged to the Profit & Loss A/c.
Add: Surrender Value of Policy in the previous year.
Less: Surrender Value of Policy in the current year.
= Balance exceeding the surrender value.

Illustration : A and B sharing profits and losses in the ratio of 2:3 took out a Joint Life Policy on 1st January 2010 for ` 10,000 for 10 years. The premium for the whole year is ` 1,000. B died on 1st March 2013 and the claim was received on 1st May 2013. The books of the firm are closed on 31st December each year. The surrender values of the policy at the end of 2010, 2011, 2012 and 2013 were NIL, ` 200, ` 600 and ` 1,200 respectively. Give the necessary journal entries when Joint Life Policy is recorded under Surrender Value Method (i.e. when premium paid is treated as asset)

Solution   Journal Entries

Date	Particulars	Dr. (`)	Cr. (`)
01.01.2010	Joint Life Policy A/c Dr. To Bank A/c (Being payment of premium)	1,000	1,000
31.12.2010	Profit and Loss A/c Dr. To Joint Life Policy A/c (Being the amount in excess of surrender value written off to the P & L A/c)	1,000	1,000
01.01.2011	Joint Life Policy A/c Dr To Bank A/c. Being payment of premium)	1,000	1,000
31.12.2012	Profit and Loss A/c Dr. To Joint Life Policy A/c (Being the amount in excess of surrender value written off to the P & L A/c)	800	800
01.01.2013	Joint Life Policy A/c Dr. To Bank A/c (Being payment of premium)	1,000	1,000
31.12.2013	Profit and Loss A/c Dr. To Joint Life Policy A/c (Being the amount in excess of surrender value written off to the P & L A/c)	600	600
01.01.2014	Joint Life Policy A/c Dr. To Bank A/c (Being payment of premium)	1,000	1,000
01.03.2014	Insurance Company's A/c Dr To Joint Life Policy A/c.	10,000	10,000

Date	Particulars	Dr.	Cr.
	(Being the claim due on B's death)		
01.05.2014	Bank A/c Dr. To Insurance Company's A/c (Being the claim received from Insurance Company)	10,000	10,000
01.05.2014	Joint Life Policy A/c Dr. To A's Capital A/c To B's Capital A/c (Being the transfer of balance in Joint Life Policy A/c to the partners' capital accounts in the ratio of 2:3)	8,400	3,360 5,040

DIRECT TAXATION

Capital Assets: One of the Conditions for Chargeability of Capital Gains

Chargeability [Section 45(1) of Income-tax Act]: Any profits or gains arising from transfer of any capital asset shall be chargeable to Income-tax as Capital Gains and shall be deemed to be the income of the previous year in which the transfer took place.

Meaning of Capital Asset [Section 2(14)]: ***The term "capital asset" means property of any kind held by an assessee, whether or not connected with his business or profession. It includes movable assets, immovable assets, tangible/intangible assets, incorporeal rights, and chooses in action. Property transferred must be a capital asset on the date of transfer. It is not necessary that it should have been capital asset also on the date of its acquisition by the assessee.***

However, the following assets are excluded from the definition of "capital assets":

E X C L U S I O N S

- Any stock-in-trade, consumable stores or raw material held for the purposes of business or profession.
- Personal effects of the assessee, that is to say, movable property including wearing apparel and furniture held for his personal use or for the use of any member of his family dependent upon him
- Agricultural land in India provided it is not situated—
  a. in any area within the territorial jurisdiction of a municipality or a cantonment board, having a population of 10,000 or more ; or
  b. in any area notified by the Government outside the local limits of above municipality (but within 8 kilometres). *[See amendment]
- 6¹/² per cent Gold Bonds, 1977 or 7 per cent Gold Bonds, 1980 or National Defence Gold Bonds, 1980 issued by the Central Government.
- Special Bearer Bonds, 1991
- Gold Deposit Bonds issued under Gold Deposit Scheme, 1999

Amendment from the assessment year 2014-15 regarding agricultural land situated in rural area is not a capital asset:

Rural area for the above purpose is as follows:

Any area which is outside the jurisdiction of a municipality or cantonment board having a population of 10,000 or more and also which does not fall within distance (to be measured aerially) given below –

2 kilometres from the local limits of municipality/ cantonment board	*If the population of the municipality/cantonment board is more than 10,000 but not more than 1 lakh*
6 kilometres from the local limits of municipality/ cantonment board	*If the population of the municipality/cantonment board is more than 1 lakh but not more than 10 lakh*
8 kilometres from the local limits of municipality/ cantonment board	*If the population of the municipality/cantonment board is more than 10 lakh*

*Types of capital assets: **There are two types of capital assets—long-term capital asset and short-term capital asset.***

"Short-term capital asset" means a capital asset held by an assessee for not more than 36 months, immediately prior to its date of transfer. In other words, if a capital asset is held by an assessee for more than 36 months, then it is known as "long-term capital asset".

In the following cases, an asset, held for not more than 12 months, is treated as short-term capital asset—

Equity or preference shares in a company [Shares may or may not be quoted]
Securities (like debentures, Government securities) [Should be quoted in a recognised stock exchange in India]

Units of UTI [Units may or may not be quoted]
Units of a mutual fund specified under section 10(23D) [Units may or may not be quoted]
Zero coupon bonds [Bonds may or may not be quoted]

Illustration:

State, giving reason, whether the asset is short-term or long-term in the cases given below—
1. T purchases a house property on March 10, 2011 and transfers it on June 6, 2013.
2. P purchases shares in an Indian company on March 10, 2011 and transfers it on June 6, 2013.
3. Z acquires units of a mutual fund on July 7, 2012 and he transfers these units on July 10, 2013.
4. A purchases diamonds on September 12, 2010 and gifts the same to his friend B on December 31, 2011. B transfers the asset on October 20, 2013.
5. B purchases shares in a company through a NSE broker (date of purchase by the broker: November 21, 2012; the company transfers shares in the name of B: January 5, 2013). These shares are transferred by B on December 20, 2013.

Solution:

Tax payer	Asset	Minimum period to become long-term capital asset	Short-term or long-term
T	House property	More than 36 months	Short-term
P	Shares	More than 12 months	Long-term
Z	Units of a mutual fund	More than 12 months	Long-term
B	Diamonds	More than 36 months	Long-term
B	Shares	More than 12 months	Long-term

Notes:

1. If an asset is acquired by gift, will, etc., then the period of holding of the previous owner is also taken into consideration.
2. In the case of shares, the purchase date by the broker is taken as the date of acquisition.

Activity Based Costing

Activity based costing (ABC) assigns manufacturing overhead costs to products 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.
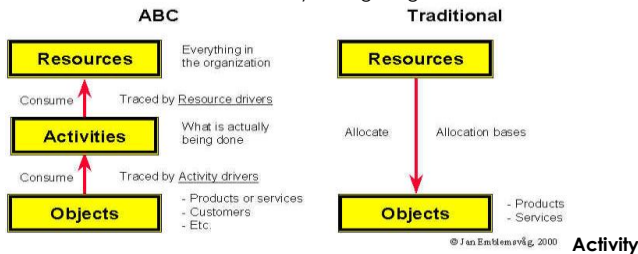
Objective of Activity Based Costing

Remove manufacturing costs from product costing

↓

Determine the single best measure for allocating all overhead costs to products or services

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Fully cost products for external reporting purposes.

↓

Understand overhead and the profitability of products, services, and customers.
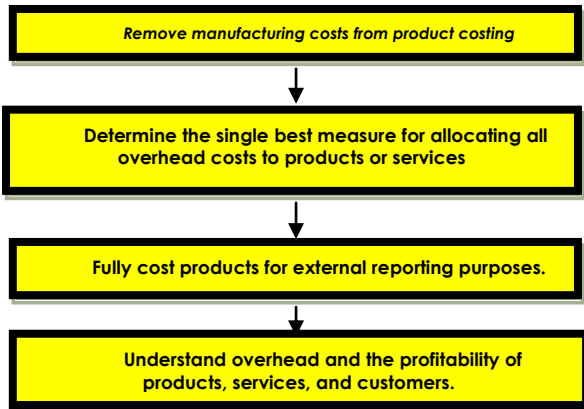
Steps in Activity Based Costing

Understanding and analyzing manufacturing

↓

Studies of the activities involved

↓

Activity Cost Pool

↓

Cost Drivers

↓

Identification of costs with the products
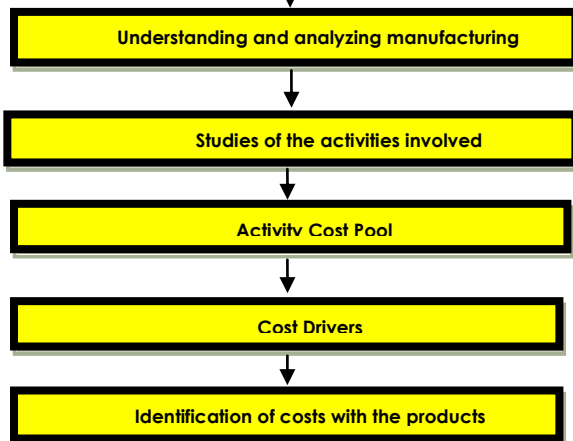
ABC brings detailed information from the processes up to assess costs and manage capacity on many levels whereas traditional cost accounting methods simply allocate costs, or capacity to be correct, down onto the cost objects without considering any 'cause and effect' relations. This can be understood by the figure given below:

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Activity Based Costing with Two Activities

Let's illustrate the concept of activity based costing by looking at two common manufacturing activities: (1) the setting up of a production machine for running batches of products, and (2) the actual production of the units of product.

We will assume that a company has annual manufacturing overhead costs of $2,000,000—of which $200,000 is directly involved in setting up the production machines. During the year the company expects to perform 400 machine setups. Let's also assume that the batch sizes vary considerably, but the setup efforts for each machine are similar. The cost per setup is calculated to be $500 ($200,000 of cost per year divided by 400 setups per year). Under activity based costing, $200,000 of

the overhead will be viewed as a batch-level cost. This means that $200,000 will first be allocated to batches of products to be manufactured, and then be assigned to the units of product in each batch. For example, if Batch X consists of 5,000 units of product, the setup cost per unit is $0.10 ($500 divided by 5,000 units). If Batch Y is 50,000 units, the cost per unit for setup will be $0.01 ($500 divided by 50,000 units). For simplicity, let's assume that the remaining $1,800,000 of manufacturing overhead is caused by the production activities that correlate with the company's 100,000 machine hours.

For our simple two-activity example, let's see how the rates for allocating the manufacturing overhead would look with activity based costing and without activity based costing:

	With ABC	Without ABC
Mfg overhead costs assigned to setups	$200,000	$-0-
Number of setups	400	Not applicable
Mfg overhead cost per setup	**$500**	**$-0-**
Total manufacturing overhead costs	$2,000,000	$2,000,000
Less: Cost traced to machine setups	**200,000**	**-0-**
Mfg O/H costs allocated on machine hours	$1,800,000	$2,000,000
Machine hours (MH)	100,000	100,000
Mfg overhead costs per MH	**$18**	**$20**
Mfg overhead cost allocations	**$500 setup cost per batch + $18 per MH**	**$20 per MH**

Next, let's see what impact these different allocation techniques and overhead rates would have on the per unit cost of a specific unit of output. Assume that a company manufactures a batch of 5,000 units and it produces 50 units per machine hour, here is how the cost assigned to the units with activity based costing and without activity based costing compares:

	With ABC	Without ABC
Mfg overhead for setting up machine	$500	$-0-
No. of units in batch	**5,000**	**Not applicable**
Mfg O/H caused by Setup - Per Unit	**$0.10**	**Not applicable**
Mfg overhead costs per machine hour	$18	$20
No. of units produced per machine hour	50	50
Mfg O/H caused by Production - Per Unit	**$0.36**	**$0.40**
Total Mfg O/H Allocated - Per Unit	**$0.46**	**$0.40**

If a company manufactures a batch of **50,000** units and produces 50 units per machine hour, here is how the cost assigned to the units with ABC and without ABC compares:

	With ABC	Without ABC
Mfg overhead for setting up machine	$500	$-0-
No. of units in batch	**50,000**	**Not applicable**
Mfg O/H caused by Setup - Per Unit	**$0.01**	**Not applicable**
Mfg overhead costs per machine hour	$18	$20
No. of units produced per machine hour	50	50
Mfg O/H caused by Production - Per Unit	**$0.36**	**$0.40**
Total Mfg O/H Allocated - Per Unit	**$0.37**	**$0.40**

As the tables above illustrate, with activity based costing the cost per unit decreases from $0.46 to $0.37 because the cost of the setup activity is spread over 50,000 units instead of 5,000 units. Without ABC, the cost per unit is $0.40 regardless of the number of units in each batch. If companies base their selling prices on costs, a company not using an ABC approach might lose the large batch work to a competitor who bids a lower price based on the lower, more accurate overhead cost of $0.37. It's also possible that a company not using ABC may find itself being the low bidder for manufacturing small batches of product, since its $0.40 is lower than the ABC model of $0.46 for a batch size of 5,000 units. With its bid price based on manufacturing overhead of $0.40—but a true cost of $0.46—the company may end up doing lots of production for little or no profit.

Our example with just two activities (production and setup) illustrates how the cost per unit using the activity based costing method is more accurate in reflecting the actual efforts associated with production.

Information System

Digital Signature: A Mode of Authentication in E-commerce

Digital signature means authentication of any electronic record by a subscriber by means of an electronic method or procedure. Digital signatures are based on asymmetric, or public key cryptography and are capable of fulfilling the demand of burgeoning E-commerce by not only providing message authentication, integrity and non-repudiation function but also making it highly scalable.

Technology Used in a Digital Signature: A digital signature is not a digitized image of a handwritten signature. It is a block of data at the end of an electronic message that attests to the authenticity of the said message. Digital signatures are an actual transformation of an electronic message using public key cryptography. It requires a key pair (private key for encryption and public key for decryption) and a hash function.

Digital Signature is a two way process, involving two parties: signer (creator of digital signature) and the recipient (verifier of the digital signature). A digital signature is complete only when the recipient verifies it successfully.

Terms Used in Digital Signature:
Public Key: It is meant for public consumption.
Private Key: It is to be kept confidential.
Hash Function: It is used in both creating and verifying a digital signature. It is an algorithm which creates a digital representation or "fingerprint" in the form of a "hash value" or "hash result" of a standard length which is usually much smaller than the message but nevertheless substantially unique to it.

Creation of a Digital Signature:

Step 1: Signer demarcates what is to be signed. This delimited information to be signed is termed as the "message".

Step 2: A hash function in the signer's software computes a hash result (message digest or digital fingerprint) unique to the message.

Step 3: The signer's software then transforms (encrypts) the hash result into a digital signature using the signer's private key. The resulting digital signature b thus unique to both the message and the private key used to create it.

Step 4: The digital signature (a digitally signed hash result of the message) is attached to its message and stored or transmitted with its message. Since a digital signature is unique to its message, it is useful if it maintains a reliable association with its message.
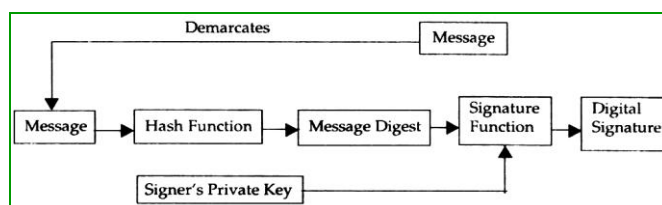
Verifying a Digital Signature:

Recipient:
Step 1: receives digital signature and the message
Step 2: applies signer's public key on the digital signature
Step 3: recovers the hash result (message digest) from the digital signature
Step 4: computes a new hash result of the original message by means of the hash function used by the signer to create the digital signature
Step 5: compares the hash results recovered in Step 3 and Step 4.

If the hash result computed by the verifier is *identical* to the hash result extracted from the digital signature during the verification process, it indicates the message remained unaltered. If they are not equal, it would mean that message either originated elsewhere or was altered after it was signed, and recipient can reject the message.

Digital Signature Certificate (DSC): A digital signature certificate is a mechanism for authenticating and securing the information that is transmitted between the two parties. It is an authoritative identification about a person or a company. It identifies the subscriber, certification authority, and its operational period and contains the subscriber public key. It is like an electronic passport that authenticates identity of an entity.

Case Scenario:
Usage of Digital Signatures in Uttar Pradesh

In Uttar Pradesh, Digital Signatures are being extensively used in various projects right from delivery of citizen centric services through eDistrict to online application for tendering system. Many of the manual processes have been converted to electronic workflow systems and the DSCs are being effectively used by the Government Officials in digitally signing the documents. These processes have made the service delivery faster and have almost brought an end to the physical movement of files and papers which used to cause delays and hold-ups. This has increased the authenticity of documents and reduced the chances of issuance of bogus and fake certificates.

Some of the successful implementation of Digital Signatures in Uttar Pradesh includes (upto December, 2010)—

Project	Use of Digital Signatures	No of DSC issued
eDistrict — implemented in six pilot districts. More than 18 lakh Digitally Signed Certificates/ Service	Digital Signatures are being used for electronically signing the Certificates being issued through eDistrict Centres / CSCs etc. The approving authority puts his Digital Signatures at the time of approving the certificate and the related information is printed on the certificate	500 to various Govt. district Functionaries such as DM, SDM, Tehsildar, DSO, DSWO etc. for

already delivered to citizens	also. This not only ensures that the details of the signing authority is displayed, even the DSC of the signatory can be verified over the Internet.	issuance of services
Online Counselling for admission to more than 1 lakh seats of Engineering, Medical, Polytechnic & B.Ed. courses.	The Digital Signatures are being used by the Counselling In-charge for document verification, fee submission, registration & for choice locking opted by the candidates who are finally locked by the invigilators using DSC. Class II DSC is being used for these activities. In case of any modification in the student record, the same can be carried out only through digital signatures in order to ensure the same is recorded in the database.	B. Ed – 438 UPTU - 433 Medical — 433 Polytechnic – 220