Referencer for Quick Revision

Foundation Course Paper-1: Principles and Practice of Accounting

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CA FOUNDATION PAPER 1: PRINCIPLES AND PRACTICE OF ACCOUNTING

The objective of Paper 1 "Principles and Practice of Accounting" at Foundation level is to develop an understanding of the basic concepts and principles of Accounting and apply the same in preparing financial statements. It has always been the endeavor of Board of Studies to provide quality academic inputs to the students. Considering this objective, it has been decided to bring forth a crisp and concise capsule on the topic of Depreciation covered in the syllabus of this paper.
The concepts involved in this chapter have been presented through infographics in this capsule, which will help students in grasping the intricate practical aspects. This Capsule is meant to enable students in undergoing quick revision of the chapter Concept and Accounting of Depreciation. Under no circumstances, can such revision substitute the detailed study of the material provided by the Board of Studies. Students are advised to refer Chapter 5 of the Study Material for comprehensive study.

CHAPTER 5: CONCEPT AND ACCOUNTING OF DEPRECIATION

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Thus it is not necessary that an asset must be used to be depreciated. There is decrease in value of assets due to normal wear and tear even when these are not physically used. Accordingly, value of such wear and tear should be estimated and accounted for.

Meaning of depreciation

As per Schedule II under the Companies Act, 2013,	• Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. • The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. • The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

Concept of PPE

Property, plant and equipment (PPE) are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months.

Reasons for decreases in value of an asset

Value of an assets decreases with passage of time mainly due to following reasons.

1. Wear and tear due to its use in business.
2. Efflux of time even when it is not being used.
3. Obsolescence due to technological or other changes.
4. Decrease in market value.
5. Depletion mainly in case of mines and other natural reserves.

Factors affecting the amount of depreciation

- Estimated life of asset
- Cost of the asset
- Residual value of the asset at the end of the of its estimated useful life

Objectives of providing depreciation

Objectives of providing depreciation

Correct income measurement:

Depreciation should be charged for proper estimation of periodic profit or loss. In case an enterprise does not account for depreciation on Property, Plant & Equipment, it will not be considering loss in value of property, plant & equipment due to their use in production or operations of the enterprise and will not result in true profit or loss for the period.

True position statement:

Value of the Property, Plant & Equipment should be adjusted for depreciation charged in order to depict the actual financial position. In case depreciation is not accounted for appropriately, the property, plant and equipment would be disclosed in financial statements at a value higher than their true value.

Funds for replacement:

Generation of adequate funds in the hands of the business for replacement of the asset at the end of its useful life. Depreciation is a good indication of the amount an enterprise should set aside to replace a fixed asset after its economic useful life is over. However, the replacement cost of a fixed asset may be impacted by inflation or other technological changes.

Ascertainment of true cost of production:

For ascertaining the cost of the production, it is necessary to charge depreciation as an item of cost of production. Further depreciation is a non-cash expense and unlike other normal expenditure (e.g. wages, rent, etc.) does not result in any cash outflow.

Further depreciation by itself does not create funds it merely draws attention to the fact that out of gross revenue receipts, a certain amount should be retained for replacement of assets used for carrying on operation.

Depreciation on components of an assets

It may be noted that Accounting Standards as well as the Companies Act, 2013 requires

depreciation to be charged

on a component basis.

Each part of an item of Property, Plant and Equipment

with a cost that is significant in relation to the total cost of the item

should be depreciated separately.

An enterprise should allocate

the amount initially recognised in respect of an item of property, plant and equipment

to its significant parts/components and

should depreciate each such part separately

based on the useful life and residual value of each particular component.

Here it is important to note that a part of Property, Plant & Equipment to be identified as a separate component should have both:

(a) significant cost when compared to overall cost of item of property, plant and equipment and

(b) and estimated useful life or depreciation method different from rest of the parts of the property, plant and equipment

A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

'Useful Life'

'Useful Life' is either	(i) the period over which a depreciable asset is expected to be used by the enterprise or
	(ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

Determination of the useful life

is a matter of estimation and

is normally based on various factors

- including experience with similar type of assets.
- Several other factors like estimated working hours, production capacity, repairs and renewals, etc.

Determination of the residual value

Residual value

- If such value is considered as insignificant, → it is normally regarded as nil.
- If the residual value is considered significant, → it is estimated at the time of acquisition/ installation, or at the time of subsequent revaluation of asset.

Depreciable amount

Depreciable amount of a depreciable asset → is its historical cost or → other amount substituted for historical cost → in the financial statements, → less → the estimated residual value.

Cost of Property, Plant and Equipment

(a) its purchase price, including non-refundable import duties and purchase taxes, after deducting trade discounts and rebates.
+
(b) any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise.
+
(c) the initial estimate of the costs of dismantling, removing, the item and restoring the site on which an asset is located.
=
Cost of Property, Plant and Equipment

Examples of directly attributable costs are

Directly attributable costs include

- (a) cost of employee benefits arising directly from acquisition or construction of an item of property, plant and equipment.
- (b) cost of site preparation
- (c) initial delivery and handling costs
- (d) installation and assembly costs
- (e) cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling the items produced while testing (such as samples produced while testing)
- (f) professional fees e.g. engineers hired for helping in installation of a machine

Thus all the expenses which are necessary for asset to bring it in condition and location of desired use will become part of cost of the asset

Expenses should not become part of cost of asset

- (a) costs of opening new facility or business, such as inauguration costs;
- (b) cost of introducing new product or service (for example cost of advertisement or promotional activities).
- (c) cost of conducting business in a new location or with a new class of customer (including cost of staff training); and
- (d) administration and other general overhead costs

Once an asset has been brought to its intended condition and location of use, no cost should recognized as part of cost of the asset unless there is major repair or addition which increases the useful life of the asset or improves the production capacity of the asset. Accordingly, cost incurred while an item is capable of operating in intended manner but it is not yet put to use or is used at less than full capacity should not be capitalized as part of cost of the asset.

Similarly, cost of relocation of an asset should not be capitalized. Any additions made to a particular item of property, plant and equipment after it is initially put to use are depreciated over the remaining useful life of the asset. Therefore, it is important to maintain an asset register capturing asset wise details of cost, rate of depreciation, date of capitalization etc. All these details need to be captured for any additions to existing assets as well. In the absence of the adequate information, it will be very difficult to compute depreciation expense year on year. Also, at the time of disposal or discard of a particular asset, it will not be possible to compute gain or loss on such disposal/ discard.

Methods for providing depreciation

Generally, methods for providing depreciation are based on formula, developed on a study of the behavior of the assets over a period of years for readily computing the amount of depreciation suffered by different forms of assets. Each of the methods, however, should be applied only after carefully considering nature of the asset and the conditions under which it is being used.

Methods of Depreciation

Straight-line Method	Diminishing Balance Method	Units of Production Method
Results in a constant charge over the useful life if the residual value of the asset does not change	Results in a decreasing charge over the useful life	Results in a charge based on the expected use or output

Straight Line Method

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to nil or its residual value at the end of its useful life.

The advantage of this method is that it is simple to apply and gives accurate results especially in case of leases, and also in case of plant and machinery.

This method is also known as Fixed Installment Method.

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to nil or its residual value at the end of its useful life.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful life}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight Line Depreciation}}{\text{Cost of Asset}} \times 100$$

The underlying assumption of this method is that the particular tangible asset generates equal utility during its lifetime. But this cannot be true under all circumstances.

The expenditure incurred on repairs and maintenance will be low in earlier years, whereas the same will be high as the asset becomes old.

Apart from this the asset may also have varying capacities over the years, indicating logic for unequal depreciation provision.

However, many assets have insignificant repairs and maintenance expenditures for which straight line method can be applied.

While using this method the period of use of an asset in a particular year should also be considered. In the year of purchase of an asset it may have been available for use for part of the year only, accordingly depreciation should be proportioned to reflect the period for which it was available for use.

Reducing or Diminishing Balance Method

Under this system, a fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its residual value at the end of its life.

Repairs and small renewals are charged to revenue.

This method is commonly used for plant, fixtures, etc. Under this method, the annual charge for depreciation decreases from year to year, so that the earlier years suffer to the benefit of the later years.

Also, under this method, the value of asset can never be completely extinguished, which happens in the earlier explained Straight Line Method.

However, it is very simple to operate.

This method is based on the assumption that cost of repairs will increase as the asset get old, therefore, depreciation in earlier year should be high when the repair cost is expected to be low and depreciation in later years should be low when the repair cost is expected to be high.

Therefore, this method will result in almost equal burden in all the years of use of the asset as depreciation will reduce with increase in repair costs will increase with every passing year.

On the other hand, under the Straight Line Method, the charge for depreciation is constant, while repairs tend to increase with the life of the asset.

Among the disadvantages of this method is the danger that too low a percentage may be adopted as depreciation with the result that over the life of the asset full depreciation may not be provided; also if assets are grouped in such a way that individual assets are difficult to identify, the residue of an asset may lie in the asset account even after the asset has been scrapped.

The last mentioned difficulty could be, however, overcome if a Plant register is maintained. The rate of depreciation under this method may be determined by the following formula:

$$1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of asset}}} \times 100$$

where, n = useful life

Similar to straight line method, in this method also period of use in a particular year e.g. year of purchase or sale an item of property plant and equipment needs to be considered while computing the depreciation amount.

Accounting Entries under Straight Line and Reducing Balance Methods:

There are two alternative approaches for recording accounting entries for depreciation.

First Alternative

A provision for depreciation account is opened to accumulate the balance of depreciation and the assets are carried at historical cost.

Accounting entries:

Depreciation Account	Dr.
To Provision for Depreciation Account	
Profit and Loss Account	Dr.
To Depreciation Account	

Second Alternative

Amount of Depreciation is credited to the Asset Account every year and the Asset Account is carried at historical cost less depreciation.

Accounting entries:

Depreciation Account	Dr.
To Asset Account	
Profit and Loss Account	Dr.
To Depreciation Account	

Sum of Years of Digits Method

It is variation of the "Reducing Balance Method"

In this case, the annual depreciation is calculated by multiplying the original cost of the asset less its estimated scrap value by the fraction represented by:

- The number of years (including the present year) of remaining life of the asset / Total of all digits of the life of the asset (in years)

Machine Hour Method

Where it is practicable to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked.

The machine hour rate of the depreciation, is calculated after estimating the total number of hours that machine would work during its whole life; however, it may have to be varied from time to time, on a consideration of the changes in the economic and technological conditions which might take place, to ensure that the amount provided for depreciation corresponds to that considered appropriate in the changed circumstances.

It would be observed that the method is only a slight variation of the Straight Line Method under which depreciation is calculated per year.

Under this method it is calculated for each hour the machine works. Schedule II to the Companies Act 2013, prescribes estimated useful life of different assets for companies, also recognizes this method to some extent.

It prescribes that depreciation should be charged using estimate useful life suggested in it, however, in certain category of plant and machinery it prescribes to charge higher amount of depreciation if these assets are used for 2 shifts or 3 shifts. In a way, schedule II combines straight line method and machine hour method.

Production Units Method

Depreciation of the asset is determined by comparing the annual production with the estimated total production.

$$\text{Depreciation for the period} = \text{Depreciable Amount} \times \frac{\text{Production during the period}}{\text{Estimated total production}}$$

The method is applicable to machines producing product of uniform specifications.

Depletion Method

This method is used in case of mines, quarries etc. containing only a certain quantity of product.

The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.

Annual depreciation will be the quantity extracted multiplied by the rate per unit.

Profit or Loss on the Sale /Disposal of Property, Plant and equipment

Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has

been used in the sale year.

The written down value after charging such depreciation is used for calculating the profit or loss on the sale of that asset.

The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account.

Change in the method of depreciation

The depreciation method applied to an asset should be reviewed,

at least at each financial year-end and,

if there has been a significant change,

in the expected pattern of consumption of the future economic benefits embodied in the asset,

the method should be changed to reflect the changed pattern.

Whenever any change in depreciation method is made such change in method is treated as change in accounting estimate as per Accounting Standards.

Its effect needs to be quantified and disclosed.

Revision of the Estimated Useful Life of Property, Plant and equipment

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.

Whenever there is a revision in the estimated useful life of the asset,

the unamortised depreciable amount

should be charged over the

revised remaining estimated useful life of the asset.

EXAMPLE:

A Machine costing ₹6,00,000 is depreciated on straight line basis having useful life of 10 years and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years. In this case, Depreciation per year will be = ₹60,000 (₹6,00,000 / 10)

Depreciation on SLM charged for three years = ₹60,000 × 3 years = ₹1,80,000

Book value of the computer at the end of third year = ₹6,00,000 – ₹1,80,000 = ₹4,20,000.

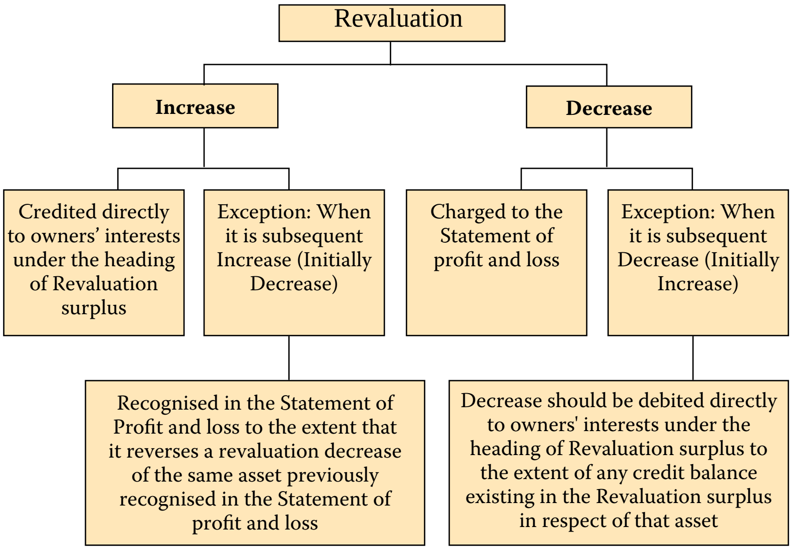
Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation from the fourth year onwards = ₹4,20,000 / 5 = ₹84,000 per annum

Revaluation of property, plant and equipment

If there is an upward revision in the value of asset for the first time, then the amount of appreciation is debited to Asset Account and credited to Revaluation Reserve Account. If there is downward revision in the value of asset then Profit and Loss Account is debited and Asset Account is credited. If an asset was earlier revalued downward and later on revalued upward then the appreciation to the extent of earlier downfall is credited to profit and loss account. If an asset was earlier revalued upward and then later on it was revalued downward then the downfall to the extent of earlier appreciation is debited to Revaluation Reserve Account. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.



EXAMPLE:

A machine of cost ₹12,00,000 is depreciated straight-line having useful life of 10 years and zero residual value for three years. At the end of third year, the machine was revalued upwards by ₹60,000 the remaining useful life was reassessed at 9 years. In this case,

Depreciation per year charged for three years = ₹12,00,000 / 10 = ₹1,20,000

WDV of the machine at the end of third year = ₹12,00,000 – ₹1,20,000 × 3 = ₹8,40,000.

Depreciable amount after revaluation = ₹8,40,000 + ₹60,000 = ₹9,00,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

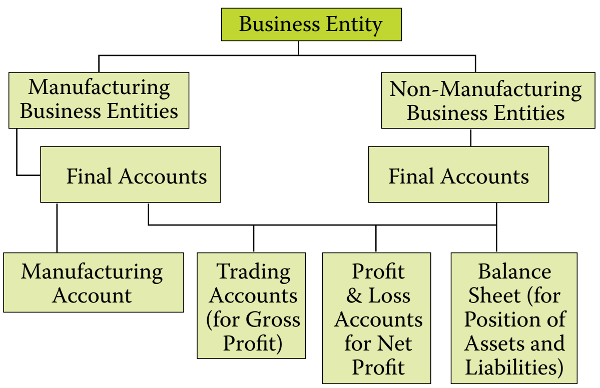
Depreciation for the fourth year onwards = ₹9,00,000 / 9 = ₹1,00,000.

PRINCIPLES AND PRACTICE OF ACCOUNTING: A CAPSULE FOR QUICK RECAP

The objective of Paper 1 "Principles and Practice of Accounting" at Foundation level is to develop an understanding of the basic concepts and principles of Accounting and apply the same in preparing financial statements and simple problem solving. It has always been the endeavour of Board of Studies to provide quality academic inputs to the students. Keeping with this objective, it has been decided to bring forth a crisp and concise capsule on the topics of Preparation of Final Accounts of Sole Proprietors and Partnership Accounts covered in this paper. At Foundation level, both these topics largely involve understanding the types of Business entities, manufacturing expenses, overhead expenses and preparation of final accounts and accounts of partnership firm, Features of a partnership, number of Partners, Limited Liability Partnership, clauses required in a partnership deed, Powers of partners, Fixed and Fluctuating Capital, Interest on capital, Interest on drawings, valuation of goodwill,admission, retirement and death of a partner. The concepts involved in each sub-topic have been gathered and presented through pictorial presentations in this capsule which will help the students in grasping the intricate practical aspects. This Capsule facilitates the students in undergoing quick revision of Chapters 7 and 8 of the study material, under no circumstances, such revision can substitute the detailed study of the material provided by the Board of Studies. Students are advised to refer the March, 2019 Edition of the Study Material for comprehensive study.

FINAL ACCOUNTS OF SOLE PROPRIETORS

BUSINESS ENTITIES



MANUFACTURING ENTITIES

The manufacturing entities generally prepare a separate Manufacturing Account as a part of Final accounts in addition to Trading Account, Profit and Loss Account and Balance Sheet. The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities. Manufacturing costs of finished goods are then transferred from the Manufacturing Account to Trading Account.

(a) Trading account shows Gross Profit while Manufacturing Account shows cost of goods sold which includes direct expenses.
(b) Manufacturing account deals with the raw material, and work in progress while the trading account would deal with finished goods only.

Manufacturing account serves the following functions:

(1) It shows the total cost of manufacturing the finished products and sets out in detail, with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly on manufacture.

(2) It provides details of factory cost and facilitates reconciliation of financial books with cost records and also serves as a basis of comparison of manufacturing operations from year to year.

(3) The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it discloses the profit or loss on manufacture. Similarly, it may also be used to fix the amount of production of profit sharing bonus when such schemes are in force.

MANUFACTURING COSTS

Manufacturing costs are classified into:

Raw Material Consumed	....
+Direct Manufacturing Wages	....
+Direct Manufacturing Expenses	....
Direct Manufacturing Cost	....
+Indirect Manufacturing expenses or	
Manufacturing Overhead	....
Total Manufacturing Cost	

DIRECT MANUFACTURING EXPENSES

Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.

Examples of direct manufacturing expenses are

(i) Royalties for using license or technology if based on units produced,

(ii) Hire charge of the plant and machinery used on hire, if based on units produced, etc.

INDIRECT MANUFACTURING EXPENSES OR OVERHEAD EXPENSES

These are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

Overhead = Indirect Material + Indirect Wages + Indirect Expenses

NON-MANUFACTURING ENTITIES

Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods.

At the end of the accounting year, the entity must be interested in knowing the results of the business so they prepare financial statements at the end of the year

INCOME STATEMENT	POSITION STATEMENTS
Profit or loss is disclosed in the Income Statement prepared at the close of the financial year	It exhibits assets and liabilities of the business as at the close of the financial year.
Income Statement is sub-divided into following two parts for a non-manufacturing concern: (i) Trading account; and (ii) Profit and Loss account	Apart from balance sheet to judge financial position of the business, sometimes additional statements are also prepared like cash flow statement, value added statement etc. which is not mandatory for non-corporate entities. These additional statements are prepared for the better understanding of the financial position of the business.
Income Statement discloses net profit of the business after adjusting from the income earned during the year, all the expenditures of the business incurred in that year.	Position statement discloses the assets and liabilities position as on a particular date.

PREPARATION OF FINAL ACCOUNTS

The **BASIC PRINCIPLES** in regard to accumulation of accounting period data are:

(i) a distinction should be made between capital and revenue receipts and payments;
(ii) also income and expenses relating to a period of account should be separated from those of another period.
(iii) different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities, which are outstanding for payment.

Having regard to these basic principles, the various matters to which attention should be paid for determining the different aspects of transactions, a record of which should be kept, and the different heads of account under which various items of income and expenditure should be accumulated, are stated below:

(a) **Distinction between personal and business income:-** Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.

(b) **Distinction between capital and revenue expenditure:-** A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet by following accounting principles and accounting standards. Likewise, a provision for income and expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

(c) **All material information to be disclosed:-** Every information, considered material for judging the profitability of the business or its financial position, should be disclosed. For example, when the labour charges have increased on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, if some of the items of inventory are not readily saleable, these should be valued at their approximate net realisable value and the basis of valuation and value of such inventory should be shown separately.

(d) **Record only current period transactions:-** Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.

(e) **Only transactions completed before close of accounts should be given effect:-** It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

MATCHING PRINCIPLE

This principle demands that expenses incurred to earn the revenue should be properly matched. This means the following:

(a) If a certain revenue and income is entered in the Trading / Profit and Loss Account all the expenses relating to it, whether or not payment has been actually made, should be debited to the Trading / Profit and Loss Account. This is why at the end of the year an entry is passed to bring into account the outstanding expenses. That is also the reason why the opening inventory of goods is debited to the Trading Account since the relevant sale is credited in the same account.

(b)If some expense has been incurred but against it sale will take place in the next year or income will be received next year, the expense should not be debited to the current year's Profit and Loss Account but should be carried forward as an asset and shown in the Balance Sheet. It will be debited to the Profit and Loss Account only when the relevant income will also be credited. The same reason applies to depreciation of assets also. The part of the cost which is used to earn current year revenue is debited in same year.

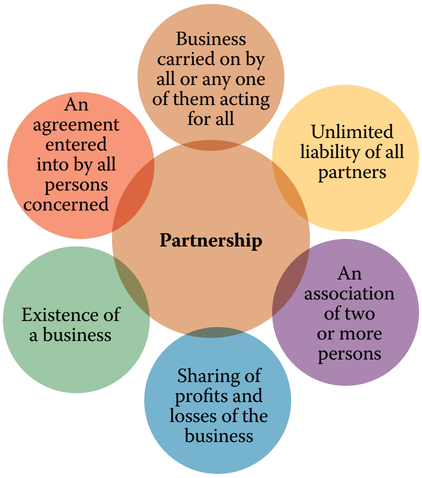
(c) If an income or revenue is received in the current year but the work against it has to be done and the cost in respect of it has to be incurred next year, i.e. income received in advance the income or the revenue is considered to be of next year. It should be shown in the Balance Sheet on the liabilities side as "income received in advance" and should be credited to the Profit and Loss Account of the next year. E.g. Newspapers or magazines usually receive subscriptions in advance for a year. The part of subscription that covers copies to be supplied in the next year is treated as income received in advance.

An exception: There appears to be one exception to the rule that only such costs as have yielded or is expected to yield revenue should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance. A loss, resulting from the fall of selling price below the cost or from some debts turning bad, must similarly be debited to the Profit and Loss Account. If this is not done the profit will be over-stated.

	Adjustment	Adjustment Entry		Treatment in Profit & Loss A/c		Treatment in Balance Sheet
1.	Closing Stock	Closing Stock A/c To Trading A/c	Dr.	Shown on the credit side		Shown on the assets side
2.	Goods sold but omitted to be recorded	Debtors A/c To Sales A/c	Dr.	Added to sales on the credit side		Added to Debtors on the assets side
3.	Goods purchased but omitted to be recorded	Purchases A/c To Creditors A/c	Dr.	Added to purchases on the debit side		Added to Creditors on the liabilities side
4.	Sale of goods on approval basis	(i) Sales A/c To Debtors A/c (Sale value of goods) (ii) Closing Stock A/c To Trading A/c (Cost price of goods)	Dr. Dr.	Deducted from sales on the credit side Added to closing stock on the credit side		Deducted from debtors on the assets side. Added to closing stock on the assets side.
5.	Goods distributed as free samples	Free samples A/c To Purchases A/c	Dr.	Deducted from purchases on the debit side	Shown on the debit side	
6.	Drawings in goods	Drawings A/c To Purchases A/c	Dr.	Deducted from purchases on the debit side		Deducted from capital on the liabilities side
7.	Depreciation	Depreciation A/c To Asset A/c	Dr.		Shown on the debit side	Deducted from the concerned asset on the assets side
8.	Provision for Doubtful debts	Profit & Loss A/c To Provision for Doubtful Debts A/c	Dr		Added to Bad-debts on the debit side	Deducted from Debtors on the assets side
9.	Provision for discount on Debtors	Profit & Loss A/c To Provision for Discount on Debtors A/c	Dr.		Shown on the debit side as a separate item	Deducted from Debtors on the assets side
10.	Further Bad-debts	Bad-debts A/c To Sundry Debtors A/c	Dr.		Added to Bad-debts (given in Trial Balance) on the debit side	Deducted from debtors on the assets side.
11.	Outstanding Expenses	Expenses A/c To Outstanding Expenses A/c	Dr	Added to the respective expense on the debit side	Added to the respective expense of the debit side	Shown on the liabilities side
12.	Prepaid or unexpired expenses	Prepaid Expenses A/c To Expenses A/c	Dr.	Deducted from the respective expense on the debit side	Deducted from the respective expense on the debit side	Shown on the assets side
13.	Accrued Income (Income earned but not received)	Accrued Income A/c To Income A/c	Dr.		Added to the respective income on the credit side	Shown on the assets side
14	Unearned Income (Income received in advance)	Income A/c To Unearned Income A/c	Dr		Deducted from the respective income on the credit side	Shown on the liabilities side
15.	Interest on capital	Interest on capital A/c To Capital A/c	Dr.		Shown on the debit side	Added to the capital on the liabilities side
16	Interest on Drawings	Interest on Drawings A/c To Interest on Drawings A/c	Dr.		Shown on the credit side	Added to the drawings and then deducted from Capital
17.	Interest on Loan (taken from someone)	Interest on Loan A/c To Loan A/c	Dr.		Shown on the debit side	Added to the loan on the liabilities side
18.	Abnormal loss of stock	Insurance Company A/c Profit & Loss A/c To Purchases A/c	Dr. Dr.	Total amount of loss is deducted from purchases on the debit side	Amount not recovered from the insurance company is shown on the debit side	Amount recovered from the insurance company is shown on the assets side.
19	Charity in the form of goods	Charity A/c To Purchases A/c	Dr.	Deducted from purchases on the debit side	Shown on the debit side	
20	Manager's Commission	Manager's Commission A/c To Outstanding Commission A/c	Dr.		Shown on the debit side	Shown on the liabilities side

PARTNERSHIP ACCOUNTS

INTRODUCTION TO PARTNERSHIP ACCOUNTS



DEFINITION OF PARTNERSHIP

As per Section 4 of the Partnership Act, 1932: Partnership is the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.

ACCOUNTS OF PARTNERSHIP FIRM

- Trading and Profit and Loss Account and Balance Sheet
- Profit and Loss Appropriation Account
- Capital accounts of partners: fixed capital method or fluctuating capital method

FEATURES OF A PARTNERSHIP

Existence of an agreement	The relation of partnership arises from contract between parties and not from status as it happens in case of HUF (Hindu Undivided Family). **A formal or written agreement is not necessary to create a partnership.**
Business	A partnership can exist only for business. **Section 2 (b) of Indian Partnership Act, 1932 states that business includes every trade, occupation and profession.**
Sharing of profit	**The** persons concerned must agree to **share the profits of the business. Section 4 of Indian Partnership Act, 1932** does not insist upon sharing of losses. Thus, a provision for sharing of loss is not necessary.
Mutual agency	It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

NUMBER OF PARTNERS

Number of Partners
- Minimum Partners: Two
- Maximum Partners: 50*

* As per Section 464 of the Companies Act, 2013, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. Rule 10 of Companies (incorporation) Rules 2014 specifies the limit as 50 .Thus, maximum number of members in a partnership firm are 50.

LIMITED LIABILITY PARTNERSHIP

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business proposal that provides the benefits of limited liability but allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a mutually arrived agreement.

The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.

No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct.

The liabilities of the LLP and partners who are found to have acted with intent to defraud Creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability.

An LLP has the special characteristic of being a separate legal personality distinct from its partners. The LLP is a body corporate in nature.

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships.

DEFINITION OF LLP

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines

Limited liability partnership as a partnership formed and registered under this Act; and limited **liability partnership agreement** means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

MINIMUM NUMBER OF PARTNERS IN CASE OF LLP

As per the LLP Act, any individual or body corporate may be a partner in a limited liability partnership; provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;	he is an undischarged insolvent; or	he has applied to be adjudicated as an insolvent and his application is pending.

Every limited liability partnership shall have atleast two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

Distinction between an ordinary partnership firm and an LLP

	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go
7	Number of Partners	Minimum 2 and Maximum 50	Minimum 2 but no maximum limit
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

MAIN CLAUSES REQUIRED IN A PARTNERSHIP DEED

1. Name of the firm and the partners;
2. Commencement and duration of business;
3. Amount of capital to be contributed by each partner;
4. Amount to be allowed to each partner as drawings and the timings of such drawings;
5. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
6. The ratio in which profits or losses are to be shared;
7. Whether a partner will be allowed to draw any salary;
8. Any variations in the mutual rights and duties of partners;
9. Method of valuing goodwill on the occasions of changes in the constitution of the firm;
10. Procedure by which a partner may retire and the method of payment of his dues;
11. Basis of the 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 allowed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

RULES IN THE ABSENCE OF PARTNERSHIP DEED

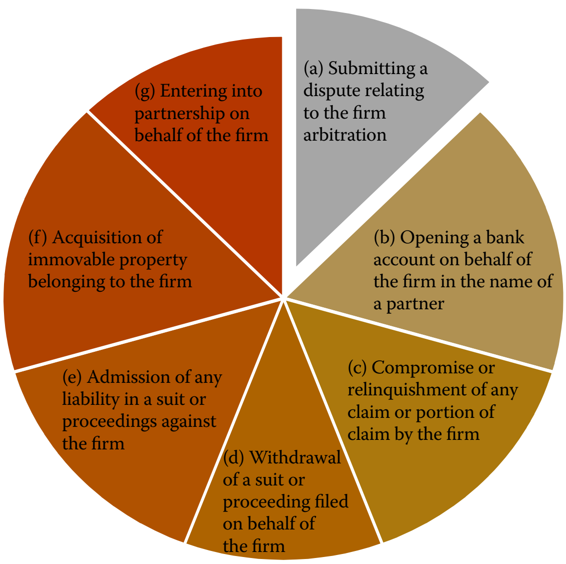
1. No partner has the right to a salary
2. No interest is to be allowed on capital
3. No interest is to be charged on the drawings
4. Interest at the rate of 6% p.a is to be allowed on a partner's loan to the firm
5. Profits and losses are to be shared equally

Note: In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

POWERS OF PARTNERS

- (a) Buying and selling of goods
- (b) Receiving payments on behalf of the firm and giving valid receipt
- (c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm
- (d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade
- (e) Engaging servants for the business of the firm

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are:



The rights, duties and power of partners can be changed by mutual consent.

ACCOUNTS

Partnership Act doesn't specifiy any format for preparation of accounts of Partnership Firm and thus accounts are prepared as per Basic rules of Partnership accounts.

There is not much difference between the accounts of a partnership firm and that of sole proprietorship (provided there is no change in the firm itself).

The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners.

When a partner takes money out of the firms for his domestic purpose, either his Capital Account can be debited or a separate account, named as Drawings Account, can be opened in his name and the account may be debited.

In a Trial Balance of a partnership firm, one may find Capital Accounts of partners as well as Drawings Accounts

Finally the Drawings Account of a partner may be transferred to his Capital Account so that a net figure is available.

Generally the Drawings Account or Current Account (as it is usually called) remains separate.

PROFIT AND LOSS APPROPRIATION ACCOUNT

During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.

The final accounts of a sole proprietorship concern will not differ from the accounts of a partnership firm.

The Profit and Loss Account will show the profit earned by the firm or loss suffered by it.

This profit or loss has to be transferred to the Capital Accounts of partners according to the terms of the Partnership Deed or according to the provisions of the Indian Partnership Act (if there is no Partnership Deed or if the Deed is silent on a particular point).

Two methods of accounting

Fluctuating capital method

No current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So, in fixed capital method, a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

Fixed capital method

Generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts. Unless a decision is taken to change it, initial capital account balance is not changed.

INTEREST ON CAPITAL

The amount of interest is debited to interest on capital accounts and credited to the capital accounts, if capitals are fluctuating and current accounts, if capitals are fixed. Interest on capital account is then closed by transfer to profit and loss appropriation account.

Alternatively, credit the capital (or current) account of the partner concerned and debit the profit and loss appropriation account.

FOR ALLOWING INTEREST ON CAPITAL

Profit and Loss Appropriation Account Dr.
To (Individual) Capital (or Current) Accounts of Partners

Net loss and Interest on Capital

Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e. net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.

INTEREST ON DRAWINGS

Calculation of Interest on Drawings: Total Drawings x Interest Rate x Multiplication Factor
(a) Fixed Amount is drawn:

Time of drawings	Multiplication Factor	Time of drawings	Multiplication factor
Beginning of every month	6.5/12	Beginning of each quarter	7.5/12
Middle of every month	6/12	Middle of each quarter	6/12
End of every month	5.5/12	End of each quarter	4.5/12

Note: Where the date of drawings not given then interest on drawing is always calculated for 6 months /multiplication factor will be 6/12

(b) Different amount is withdrawn at various dates: use product method
For charging interest on drawings
(Individual) Capital (or Current) Accounts of Partners Dr.
To Profit and Loss Appropriation Account

GUARANTEE OF MINIMUM PROFIT

Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement.

In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit.

However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- Excess is payable by one of the remaining partners.
- Excess is payable by at least two or all the partners in an agreed ratio.
- Excess is payable by remaining partners in their mutual profit sharing ratio.

If the question is silent about the nature of guarantee, the burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

CAPITAL RATIO

Partners may agree to share profits and losses in the capital ratio.

Capital ratio

If capitals are fixed

profits will be shared in the ratio of given capitals

If capitals are fluctuating and partners introduce or withdraw capitals during the year

the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method

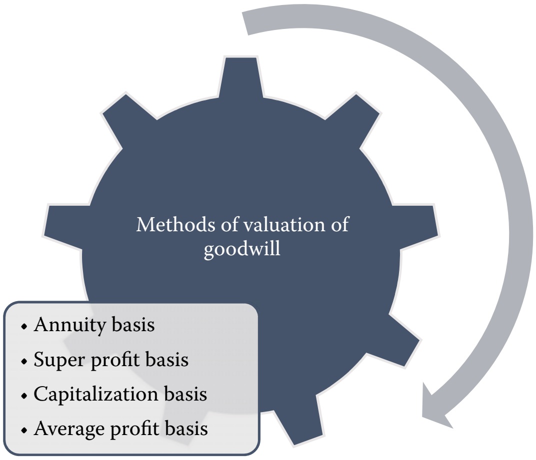
VALUATION OF GOODWILL

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.

Necessity for valuation of goodwill

Necessity for valuation of goodwill			
Change in profit sharing ratio	Admission of partner	Retirement or death of partner	When business is dissolved or sold*

* This situation is not covered at Foundation level.



Average profit basis

- Average Profit = Total profit/ Number of years
- Goodwill = Average Profit x No. of Years' purchased
- The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors.

Super profit basis

- Calculate Capital Employed
- Assets ....
- Less: Liability ....
- Capital Employed ....
    - Find the normal Rate of Return(NRR)
    - Find Normal Profit=Capital Employed X Normal rate of Return
    - Find Average Actual Profit
    - Find Super Profit=Average Actual Profit-Normal Profit
    - Find Goodwill=Super Profit X Number of Years Purchased

Annuity basis

- Goodwill=Super Profit x Annuity Number

Capitalization basis

- Goodwill = Super Profit / Normal Rate of Return

ADMISSION OF A NEW PARTNER

New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm.

Admission of partner

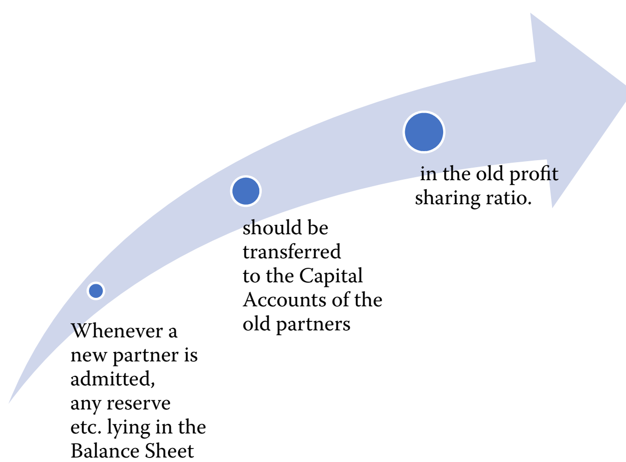
- Revaluation Account or Profit and Loss Adjustment Account for revaluation of assets and liabilities
- Adjustment of goodwill amongst the old partners in their scarificing gaining ratio
- Profit/loss on revaluation account is transfer to old partners in their old profit sharing ratio
- Reserve lying in the balance sheet transfered to the capital accounts of old partners in their old profit sharing ratio

Revaluation Account or Profit and Loss Adjustment Account

- When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose.
- This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities.
- The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.

ACCOUNTING ENTRIES

1	Revaluation Account	Dr.	
	To Assets Account		with the reduction in the value of the assets
	(Individually which show a decrease)		
	To the Liabilities Accounts		with the increase in the liabilities.
	(Individually which have to be Increased)		
2	Assets Account (Individually)	Dr.	with the increase in the value of the of assets
	Liabilities Accounts	Dr.	with the reduction in the amount liabilities
	To Revaluation Account		
3	Revaluation Account	Dr.	with the profit in the old profit sharing ratio.
	To Capital A/cs of the old partners		
	Or		
	Capital A/cs of the old partners	Dr.	with the loss in old profit sharing ratio.
	To Revaluation Account		



GAINING PARTNERS

The partners whose profit shares have increased as a result of change are known as gaining partners.

GAINING RATIO

The ratio in which the partners | have agreed to gain their shares | in profit from | the other partner or partners.

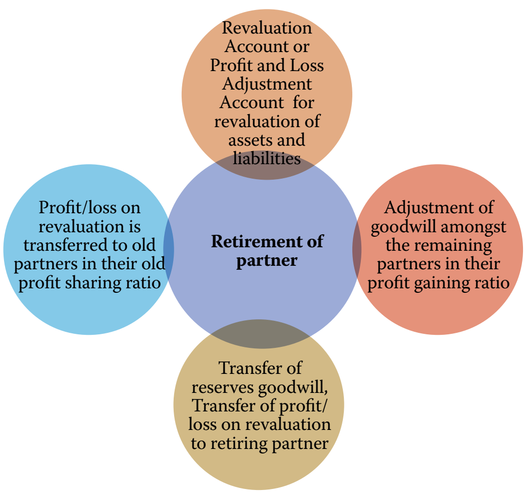
Gaining ratio = difference between new profit shares and old profit shares

HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred as follows:

Particulars	
Incoming partner's capital x Reciprocal of share of incoming partner	xxx
Less: Total capital after taking into consideration the capital brought in by incoming partner	xxx
Value of Goodwill	xxx

RETIREMENT OF A PARTNER



REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities.

To arrive at profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened.

Profit or loss on revaluation , such profit or loss should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.

Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.

If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed with the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain.

RESERVES

On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio.

Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

FINAL PAYMENT TO A RETIRING PARTNER

The following adjustments are necessary in the Capital A/c:

(i) Transfer of reserve

(ii) Transfer of goodwill

(iii) Transfer of profit/loss on revaluation

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will be

Retiring Partner's Capital A/c Dr.
To Bank A/c

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be

Retiring partner's Capital A/c Dr.
To Retiring Partner's Loan A/c
To Bank A/c

As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

(a) Repayment may be made in instalments over a period of time and the interest is paid on outstanding balance which will be treated as a loan of the outgoing partner.

(b) The amount due may be treated as a loan to the firm and in return the firm will either pay interest at a fixed rate or share of the profit of the firm.

(c) An annuity may be paid to a retired partner for life or for an agreed number of years for the life of some dependent.

PAYING A PARTNER'S LOAN IN INSTALMENT

Paying a partner's loan is only a matter of arranging finance.

Sometimes it is stated that the loan is to be paid off in equal instalments and that the balance is to carry interest.

In such case, loan should be divided into equal parts.

The interest for the period should be calculated and The payment should consist of the instalment on account of the loan plus interest for the period.

DEATH OF A PARTNER

When the partner dies the amount payable to him/her is paid to his/her legal representatives.

Right of outgoing partner in certain cases to share subsequent profits

As per provisions of Section 37 of the Indian Partnership Act., Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary.

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

The representatives of dead partners are entitled to

- (a) The amount standing to the credit to the capital account of the deceased partner
- (b) Interest on capital, if provided in the partnership deed upto the date of death
- (c) Share of goodwill of the firm
- (d) Share of undistributed profit or reserves
- (e) Share of profit on the revaluation of assets and liabilities
- (f) Share of profit upto the date of death
- (g) Share of Joint Life Policy.

CALCULATION OF PROFIT UPTO THE DATE OF DEATH OF A PARTNER

Such Profit is calculated through P&L Suspense account. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits* earned till the date of his/her death.

*Such profit is ascertained by either of the following methods

Time Basis

It is assumed that profit has been earned uniformly throughout the year

Turnover or Sales Basis

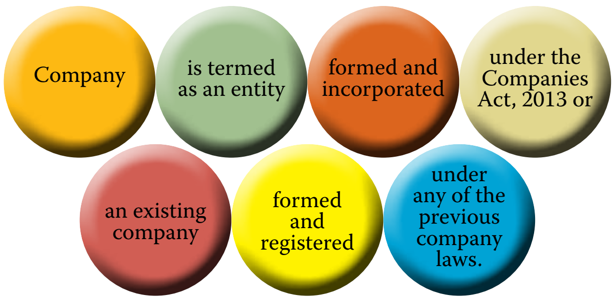
We have to take into consideration the profit and the total sales of the last year. Thereafter the profit up to the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Foundation Paper 1 - Principles and Practice of Accounting: A Capsule for Quick Recap

At Foundation level, the Company Accounts portion of the subject "Principles and Practice of Accounting" largely involves understanding the nature and types of companies, salient features of a company, accounting treatment of shares and the purpose of preparing the financial statements. This Capsule is intended to assist you in the process of revision of the concepts discussed in Unit 1 and Unit 2 of Chapter 10 of the Study Material.

Company Accounts

Meaning of a Company

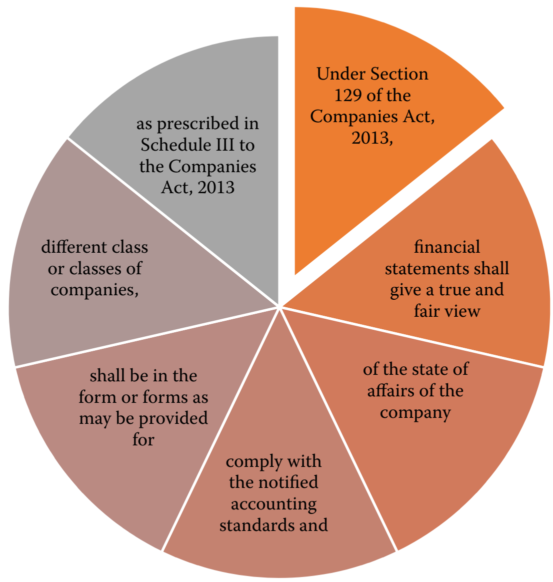


Types of Companies

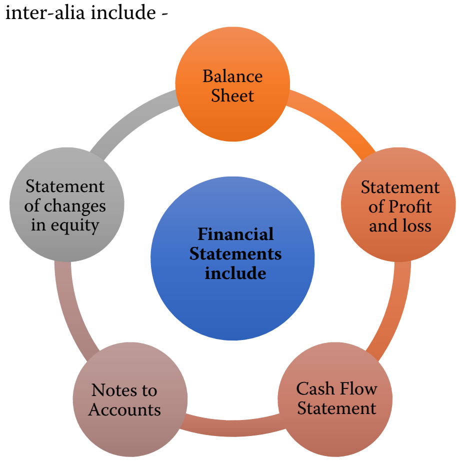
Types of Companies
- Government Company
- Foreign Company
- Private Company
- Public Company
- One Person Company
- Small Company
- Listed Company
- Unlimited Company
- Company limited by Shares
- Company limited by Guarantee
- Holding Company
- Subsidiary Company

Salient Features of a company

Preparation of Financial Statements



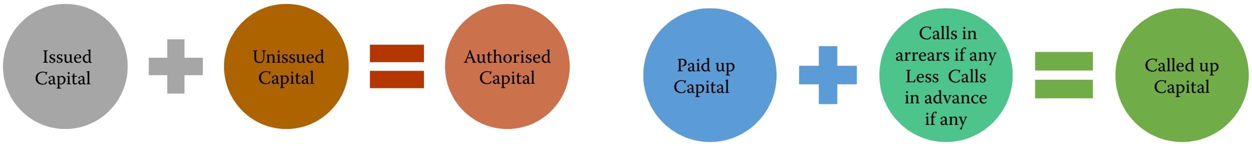
Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -



Share Capital

The total *capital* of the company is divided into shares, the capital of the company is called 'Share Capital'.

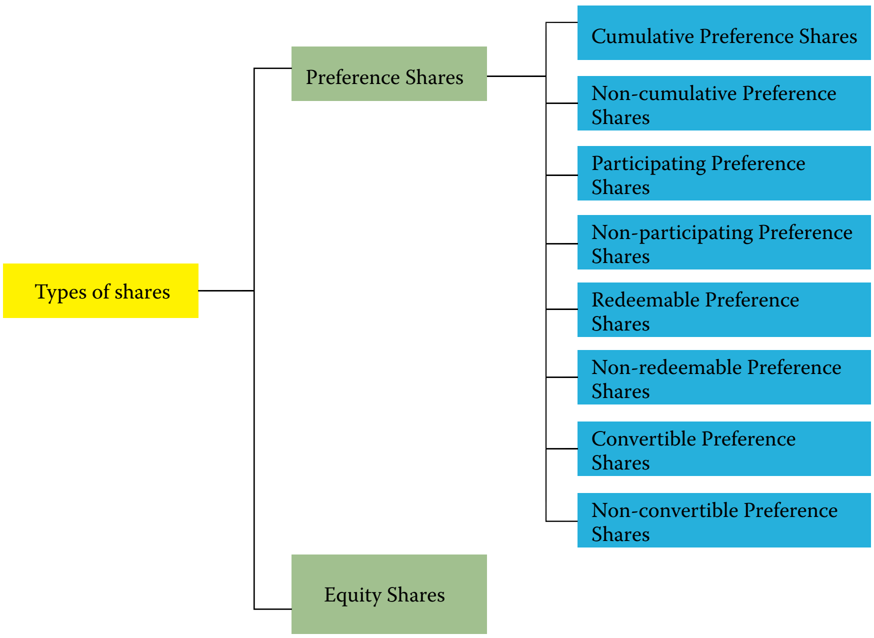
Share capital of a company is divided into various categories
- Authorised Share Capital or Nominal Capital
- Issued Share Capital
- Subscribed Share Capital
- Called-up Share Capital
- Paid-up Share Capital
- Reserve Share Capital



Subscribed Capital can be equal to or greater than or less than Issued Capital resulting in 3 situations respectively: Fully Subscribed; Over Subscribed and Under Subscribed.

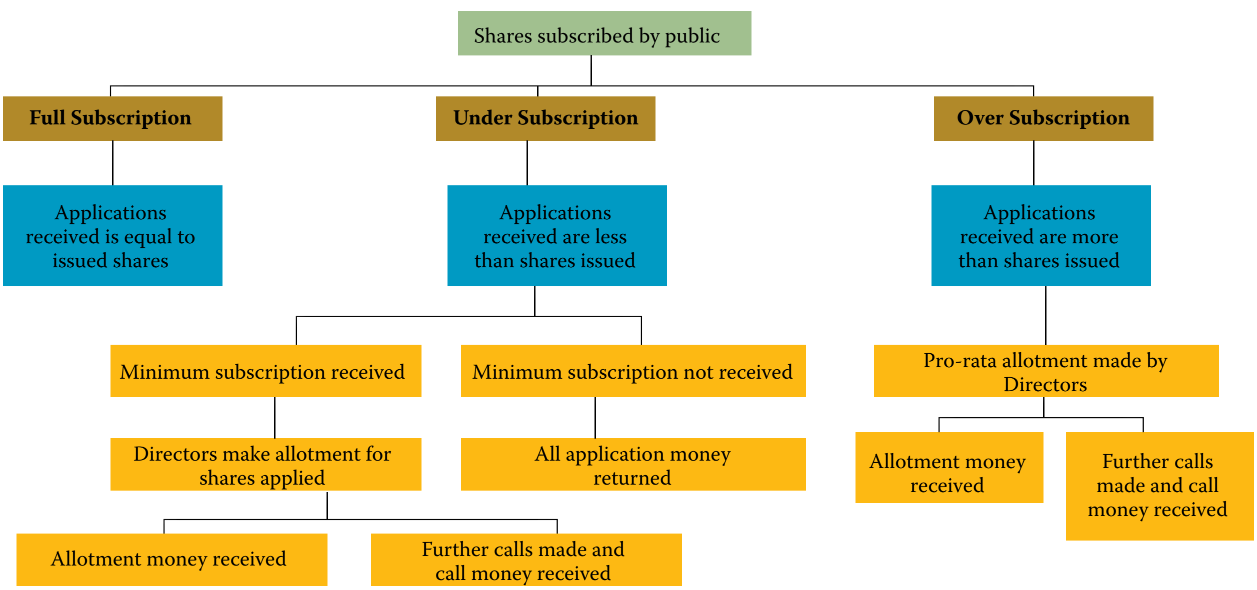
Types of Shares

Share issued by a company can be divided into following categories:



Subscription of Shares

Accounting for issue of shares depends upon the type of subscription. Whenever a company decides to issue shares to public, it invites applications for subscription by issuing a prospectus. It is not necessary that company receives applications for the exact number of shares to be issued by it. There may be three possibilities:



Issue of Shares

Shares issued at

- Discount
  - Issue price is less than the nominal or par value of shares
  - Issue of shares at discount shall be void except in the case of issue of sweat equity shares (issued to employees and directors).
- Premium
  - Issue price is more than the face value
  - Premium amount is credited to a separate account called *"Securities Premium Account.*

Accounting Treatment of Securities premium

Securities Premium is not a part of share capital. It represents a gain of capital nature to the company.

Being a credit balance, Securities premium Account is shown under the heading, "Reserves and Surplus". However, 'Reserves and Surplus' is shown as 'shareholders funds' in the Balance Sheet as per Schedule III.

According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company

- For the purchase of own shares or other securities.
- Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.
- *To write off preliminary expenses of the company.
- To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.
- *To provide for premium on the redemption of redeemable preference shares or debentures of the company.

** Companies whose financial statements comply with AS prescribed under Section 133 cannot use Securities premium for this purpose.*

Calls-in-Arrears and Calls-in-Advance

Receipt of value of shares in instalments (calls)

- Share installment money received in full
  - "Bank A/c" is debited with full money received
- Calls-in-arrears i.e. money received is less than due
  - "Calls-in-arrears A/c" and Bank A/c (money received) is debited
- Calls-in-advance i.e. money of future installments received before hand
  - "Calls-in-advance A/c" is credited and Bank A/c is debited (money received)

Interest on Calls-in-Arrears and Calls-in-Advance

Interest on calls in arrears	Interest on Calls in advance
It is payable by shareholders to company on the calls due but remaining unpaid.	It is payable by the Company to Shareholders on the call money received in advance but not yet due.
As per Table F maximum prescribed rate is 10%.	As per Table F maximum prescribed rate is 12%.
Period considered: From the date call money was due to the date money is finally received.	Period Considered: From the date money was received to the day call was finally made due.
Directors have a right to waive off such interest in individual cases at their own discretion.	Shareholders are not entitled for any dividend on calls in advance.
It is a nominal account in nature and is credited to statement of profit and loss as an income.	It is a nominal account in nature with interest being an expense for the company.

Forfeiture of Shares

Forfeiture of shares is the action taken by a company to cancel the shares.

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares.

- When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him.
- The shareholder has no further claim on the company.
- The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be bona fide in the interests of the company.
- Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.

Forfeiture of Shares which were issued at Par

Share Capital Account Dr. [No. of shares x called-up value per share]

- To Forfeited Shares Account [Amount already received on forfeited shares]
- To Share Allotment Account [If amount due, but not paid]
- To Share First Call Account [If amount due, but not paid]
- To Share Final Call Account [If amount due, but not paid]

Where all amounts due on allotment, first call and final call have been transferred to Calls-in-Arrears Account, the entry will be :

Share Capital Account Dr. [No. of shares x called-up value per share]

- To Calls-in-Arrears Account [Total amount due, but not paid]
- To Forfeited Shares Account [Amount received]

Forfeiture of Shares which were issued at a Premium

If premium not received

Share capital A/c Dr. [Called-up value]

Securities Premium A/c Dr. [Amount of Security premium not received]

- To Share Allotment Account [If amount due, but not paid]
- To Share First Call Account [If amount due, but not paid]
- To Share Final Call Account [If amount due, but not paid]
- To Forfeited Shares Account [Amount received on forfeited shares]

If premium received

Share capital A/c Dr. [Called-up value]

- To Share Allotment Account [If amount due, but not paid]
- To Share First Call Account [If amount due, but not paid]
- To Share Final Call Account [If amount due, but not paid]
- To Forfeited Shares Account [Amount received on forfeited shares]

Forfeiture of Fully Paid-Up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.

Re-Issue of Forfeited Shares

A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale.

Points for Consideration

- Loss on re-issue should not exceed the forfeited amount.
- If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
- The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'
- When only a portion of the forfeited shares are re-issued, then the profit made on reissue of such portion of shares only must be transferred to Capital Reserve.
- When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".
- If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.
- If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.