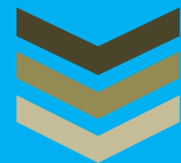
Referencer for Quick Revision



Foundation Course Paper-1: Principles and Practice of Accounting

A compendium of subject-wise capsules published in the monthly journal “The Chartered Accountant Student”

Board of Studies
(Academic)
ICAI

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CA FOUNDATION - PAPER I - PRINCIPLES AND PRACTICE OF ACCOUNTING

Accounting plays a vital role for developing a strong base for Chartered Accountants to enable them to understand how the accounting information can fit into the process of Financial Reporting. Considering this objective, it has been decided to bring forth a crisp and concise capsule on the topics of Subsidiary Books and Cash Book covered in the syllabus of Paper 1: Principles and Practice of Accounting. The purpose of above topics is to enable the students to record the transactions of a business entity in different books in line with the nature of transactions. The concepts involved in these topics have been gathered and presented through pictorial presentations in this capsule which will help the students for quick revision. 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 Study Material for comprehensive study.

CHAPTER 2 - ACCOUNTING PROCESS
UNIT 4 - SUBSIDIARY BOOKS

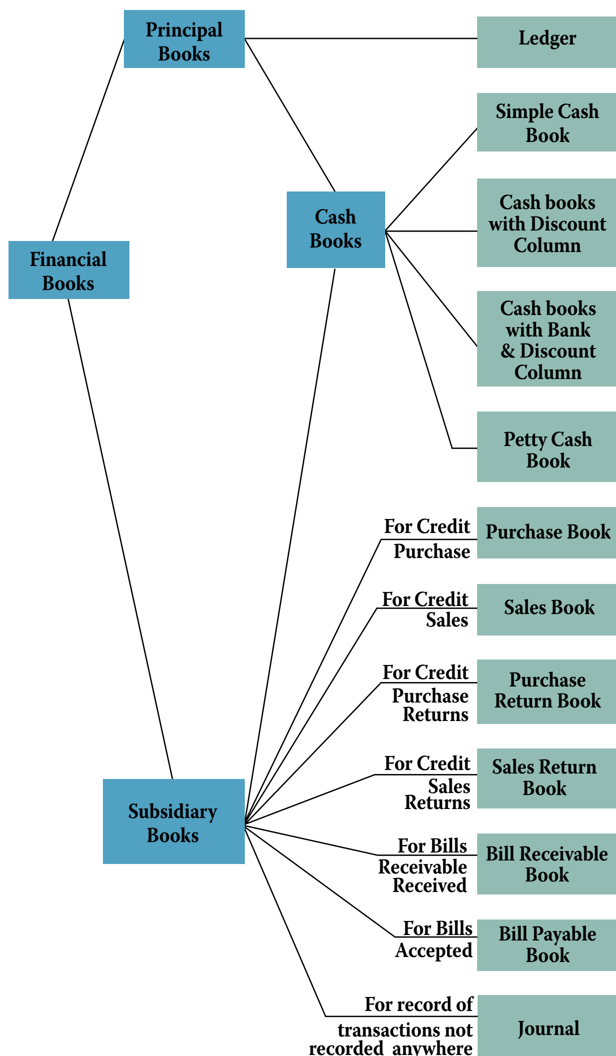
In a business, most of the transactions generally relate to receipts and payments of cash, purchases and sales of goods. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. Such register is called a book of original entry or prime entry.

The books of original or prime entry are also called **Subsidiary Books** since ledger accounts are prepared on the basis of these books and without ledger posting, a trial balance cannot be taken out.

Normally, the following subsidiary books are used in a business:

- **Cash Book** – to record cash receipts and payments, including receipts into and payments out of the bank.
- **Purchases Book** – to record credit purchases of goods dealt in or of the materials and stores required in the factory.
- **Purchase Returns Book** – to record the returns of goods and materials previously purchased.
- **Sales Book** – to record the sales of the goods dealt in by the firm.
- **Sale Returns Book** – to record the returns made by the customers.
- **Bills Receivable Book** – to record the receipts of promissory notes or hundies from various parties.
- **Bills Payable Book** – to record the issue of the promissory notes or hundies to other parties.
- **Journal** – to record the transactions which cannot be recorded in any of the above books mentioned above.

Distinction Between Subsidiary Books and Principal Books



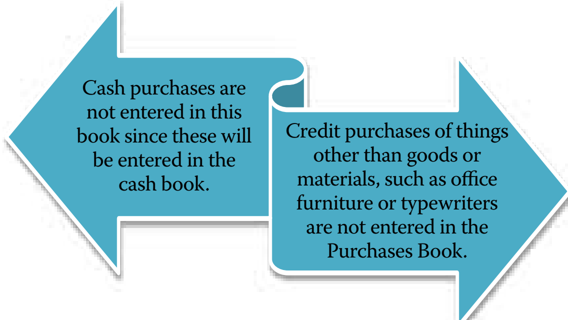
Advantages of Subsidiary Books

Division of work	Specialisation and efficiency	Saving of the time	Availability of information	Facility in checking
Since in the place of one journal there will be so many subsidiary books, the accounting work can be divided.	When the same work is allotted to a particular person over a period of time, he becomes efficient in handling it. Thus the accounting work will be done efficiently.	Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to completing the work quickly.	Since a separate register or book is kept for each class of transactions, the information relating to each transaction will be available at one place.	When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by various subsidiary books.

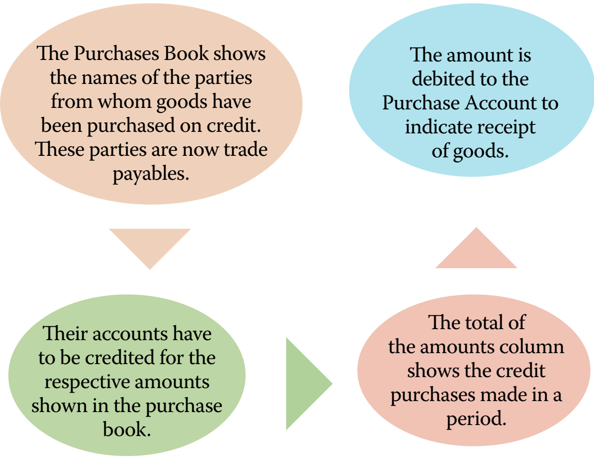
Purchase Book

To record the credit purchases of goods dealt in or materials used in the factory, a separate register called the Purchases Book or the Purchases Journal, is usually maintained by firms.

Points to Remember



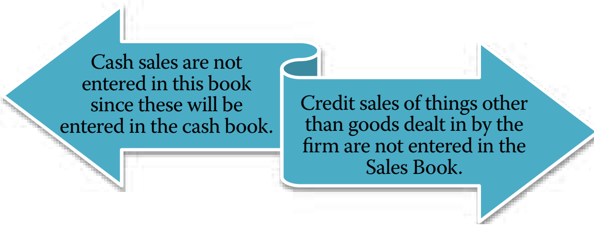
Posting the Purchase Book



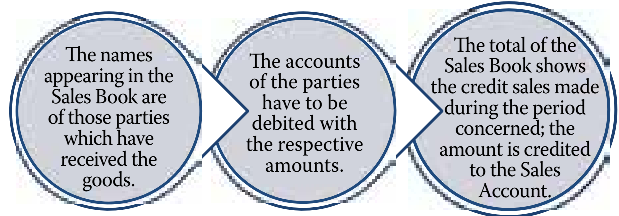
Sales Book

The Sales Book is a register specially kept to record credit sales of goods dealt in by the firm.

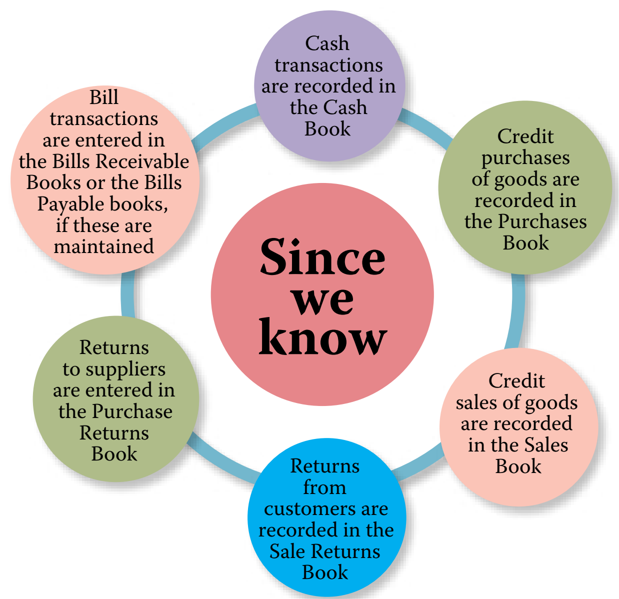
Points to Remember



Posting the Sales Book



Sales Return or Return Inward Book	Purchase Return or Return Outward Book	Bills Receivable and Bills Payable Book
If customers frequently return the goods sold to them, it would be convenient to record the returns in a separate book, which is named as the Sales Returns Book or the Returns Inward Book.	Such a book conveniently records return of goods or material purchased to the suppliers if however, the returns are not frequent, it may be sufficient to record the transaction in the journal.	If the firm usually receives /issues a number of promissory notes or hundies, it would be convenient to record the transaction in a separate book called the Bills Receivable/ Bills Payable Book.
This Book is similar to the Sales Book and entries are also made in the same manner.	This Book is similar to the Purchases Book and entries are also made in the same manner.	



Except the above transactions, there are some entries also which have to be recorded. For them the proper place is the journal. In fact, if there is no special book meant to record a transaction, it is recorded in the journal.

The role of the journal is thus restricted to the following types of entries:

Opening entries

When books are started for the new year, the opening balance of assets and liabilities are journalised.

Closing entries

At the end of the year the profit and loss account has to be prepared. For this purpose, the nominal accounts are transferred to this account. This is done through journal entries called closing entries.

Rectification entries

If an error has been committed, it is rectified through a journal entry.

Transfer entries

If some amount is to be transferred from one account to another, the transfer will be made through a journal entry.

Adjusting entries

At the end of the year, expenses or income may have to be adjusted for amounts received in advance or for amounts not yet settled in cash. Such adjustments are done through journal entries. Usually, the entries pertain to outstanding expenses, prepaid expenses, interest on capital and depreciation.

Entries on dishonour of Bills

If a promissory note (or bill) is dishonored on the due date, a journal entry will be necessary to record the non-payment or dishonour.

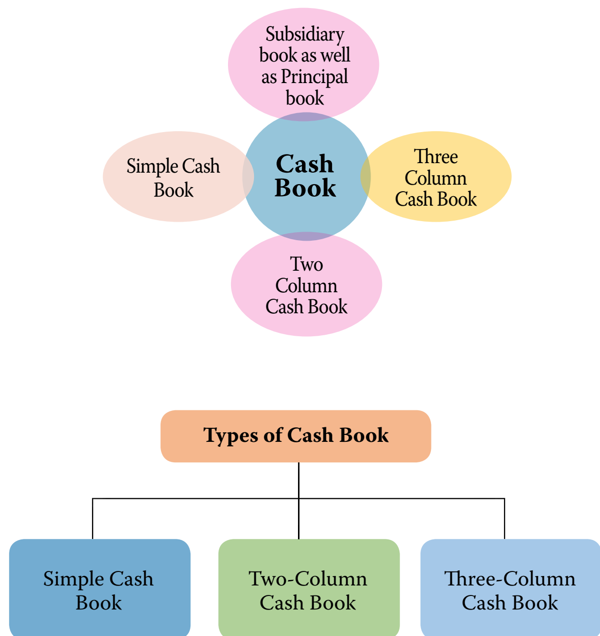
Apart from above few, other miscellaneous entries are also entered in Journal

Miscellaneous entries

- Credit purchase other than goods or materials required for production of goods. — e.g. credit purchase of furniture or machinery.
- An allowance given to the customers or a charge to be made to them after the issue of the invoice.
- Receipt or issue of promissory notes if separate bill books are not maintained.
- An amount becoming irrecoverable, say, because, customer becoming insolvent.
- Effects of accidents such as loss of property by fire.
- Transfer of net profit to capital account.

UNIT-5 CASH BOOK

Cash Book is a subsidiary book. All cash transactions are recorded in the Cash Book. It serves as basis for preparing ledger accounts. It acts as the cash account and the bank account; the balances are directly entered in the trial balance. The Cash Book, therefore, is part of the ledger also. Hence, it is also to be treated as the principal book. Thus Cash Book is both a subsidiary book and a principal book.

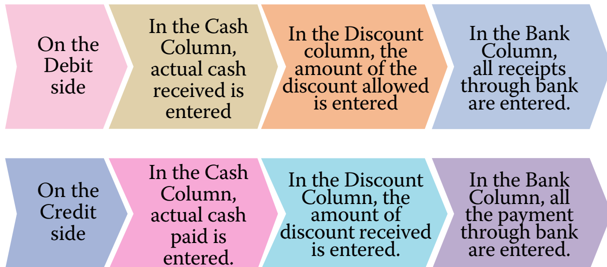


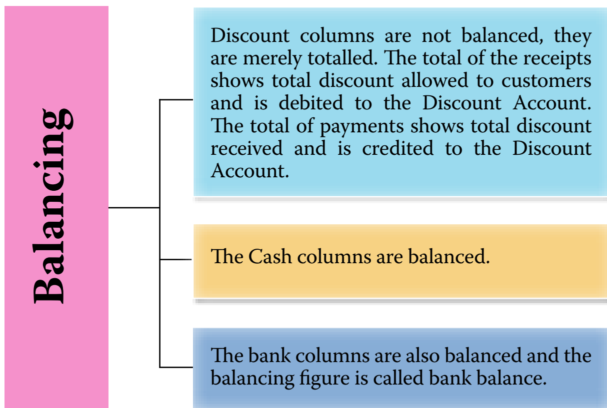
Simple Cash Book

- Only the cash receipts and cash payments are recorded.
- The left-hand side records receipts of cash and the right-hand side the payments.
- The total of Dr. side is always greater than the total of Cr. side since the payment cannot exceed the available cash.
- The simple cash book is like an ordinary account and is balanced in the same way as other accounts.
- The difference is written on the credit side as 'By balance c/d'.
- The totals are then entered in the two columns opposite to one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

Double Column Cash Book

If along with columns to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or another column is added on each side to record bank payments or the bank receipts. It is a double-column cash book.





Thus, a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

Three Column Cash Book

A firm normally keeps the bulk of its funds at a bank. Probably payments into and out of the bank are more numerous than strict cash transactions. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

For writing up the three-column cash book the following points should be noted:

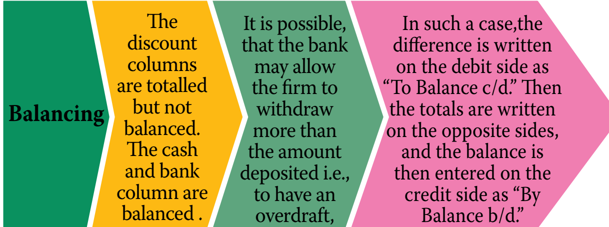
While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description "To Capital Account". If a new cash book is being started for an existing business, the opening balances are written as : "To Balance b/d".

All receipts are written on the receipts side, cash in the cash column and cheques in the bank column. Discount allowed in entered in the discount column.

All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column.Discount received is entered in the discount Column.

Often cash is withdrawn from bank for use in the office or cash is sent to the bank. In such a cases the entries entered with the letter "C" should be written in the L.F. column, to indicate that these are contra transaction and no further posting is required for them.

If cheque sent to the bank is dishonoured, it is entered in the bank column on the credit side with the name of the related party in the particulars column.



Balancing

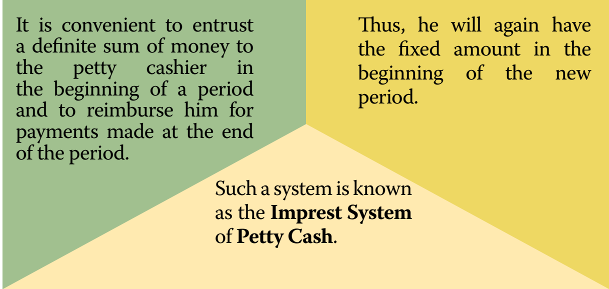
The discount columns are totalled but not balanced. The cash and bank column are balanced .

It is possible, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft,

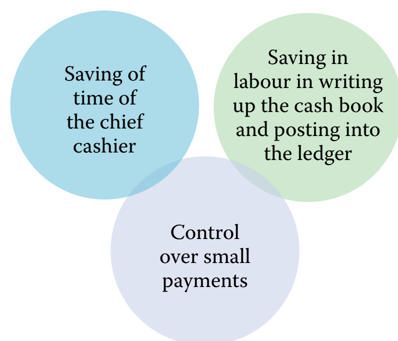
In such a case,the difference is written on the debit side as "To Balance c/d." Then the totals are written on the opposite sides, and the balance is then entered on the credit side as "By Balance b/d."

Petty Cash Book

In a business, a number of small payments, such as for conveyance, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below a definite amount to him. Later on, he will be reimbursed for the payments made and the respective account may be debited.



Advantages of Petty Cash Book



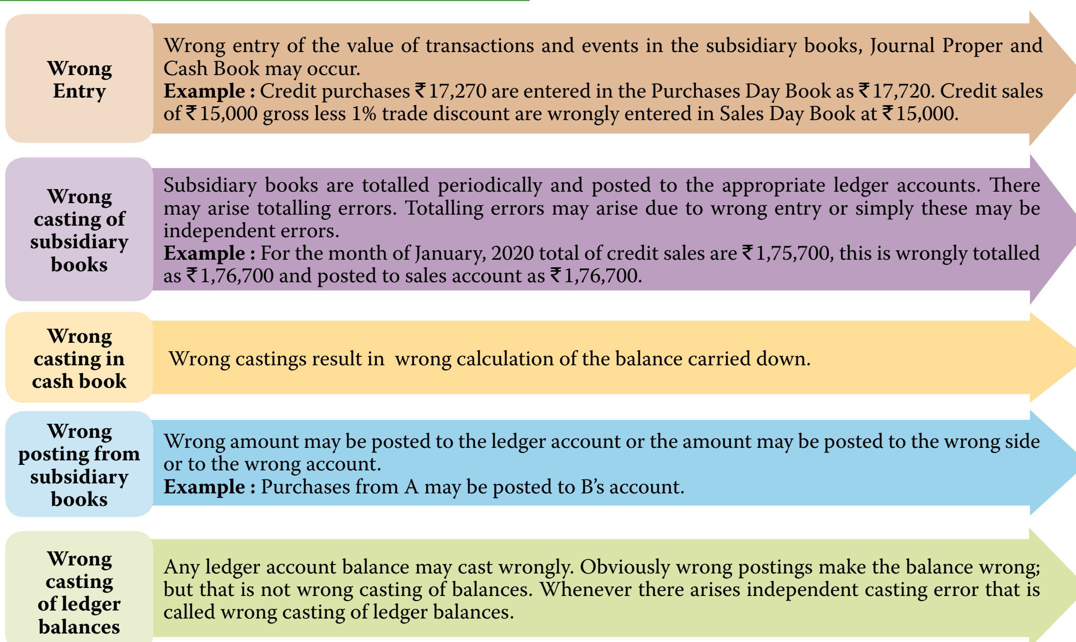
CA FOUNDATION - PAPER 1 - PRINCIPLES AND PRACTICE OF ACCOUNTING

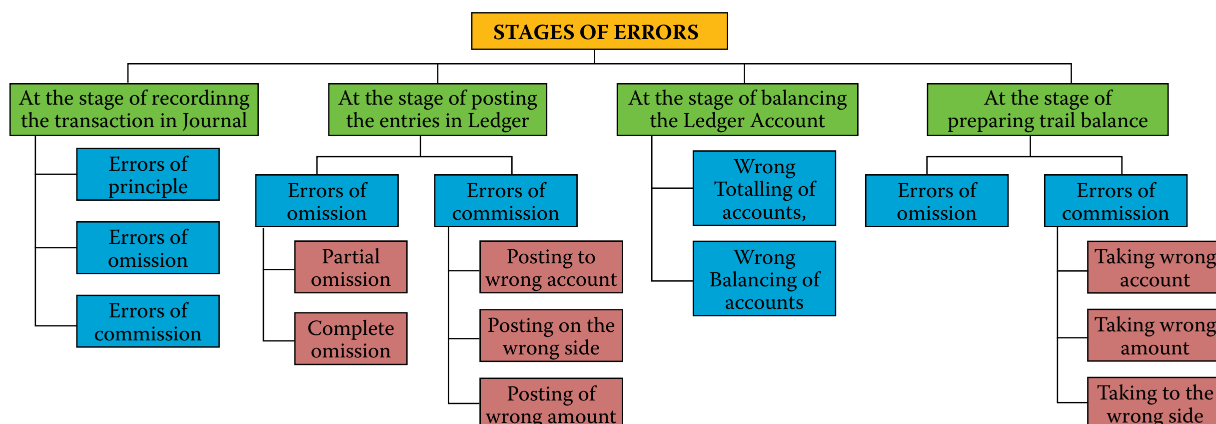
The objective of Paper 1 "Principles and Practice of Accounting" at Foundation level is to develop an understanding of the basic concepts and principles of accounting and apply the same in preparing financial statements and simple problem solving. It has always been the endeavour of Board of Studies 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 Rectification of Errors and Financial Statements of Not for Profit Organisations covered in this paper. At Foundation level, the topic of Rectification of errors largely involve understanding the types and stages of errors and how to rectify the errors whereas Financial Statements of Not for Profit Organisations deals with the preparation of final accounts through Receipt and Payment Account, Income and Expenditure Account and Balance Sheet for Not for profit organisations. The concepts involved in both these topics 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 Chapter 2 (Unit-6) and Chapter 9 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 Study Material for comprehensive study.

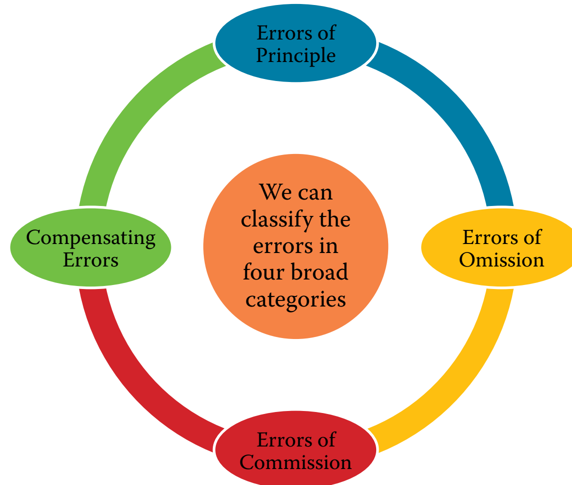
CHAPTER 2 UNIT 6: RECTIFICATION OF ERRORS

There are various unintentional errors that can be committed at the stage of collecting financial information/data on the basis of which financial statements are drawn or at the stage of recording this information. Also errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. If the trial balance does not tally, then it can be said that there are errors in the accounts which require rectification thereof. Some of these errors may affect the Trial Balance and some of these do not have any impact on the Trial Balance although such errors may affect the determination of profit or loss, assets and liabilities of the business.

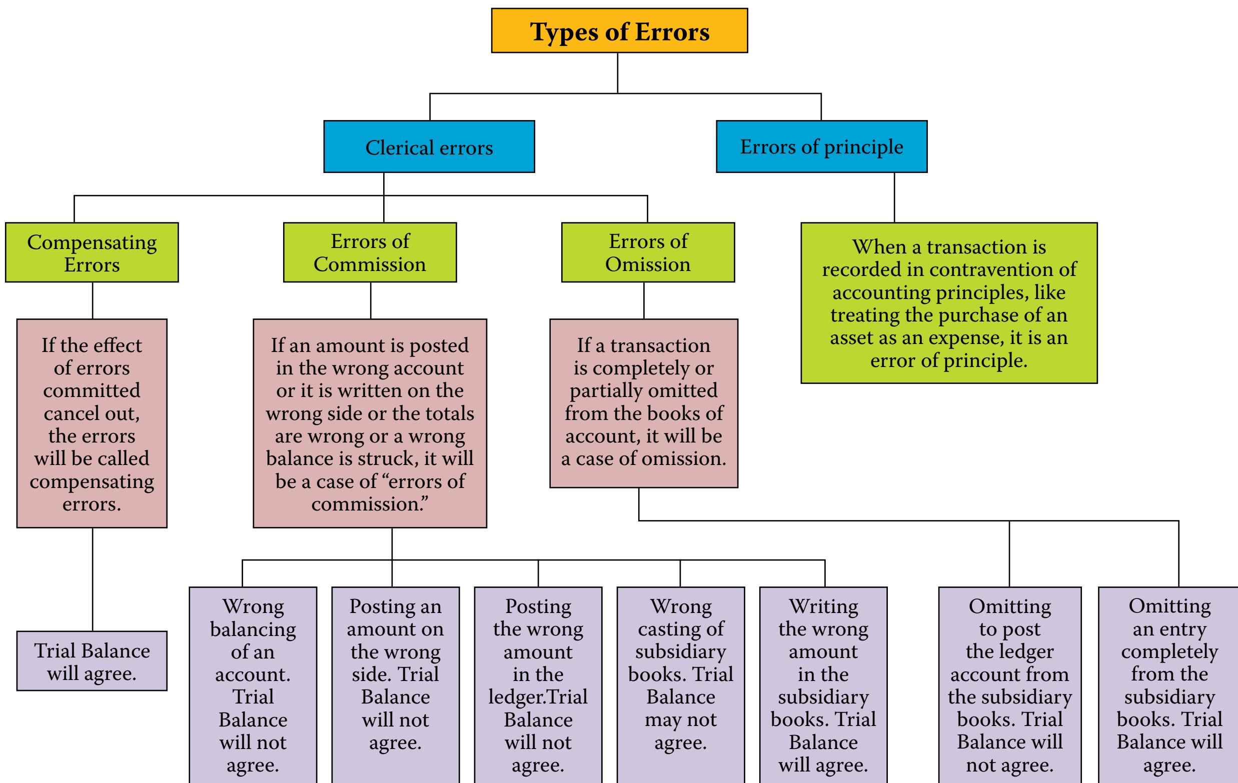
Illustrative Case of Errors and their Nature







Types of Errors



Steps to Locate errors

Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors. The following steps will be useful in locating errors :

The two columns of the trial balance should be totalled again. If in place of a number of accounts, only one amount has been written in the trial balance the list of such accounts should be checked and totalled again.

It should be seen that the cash and bank balances have been written in the trial balance.

The exact difference in the trial balance should be established. The ledger should be gone through; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in the wrong column.

The ledger accounts should be balanced again.

The casting of subsidiary books should be checked again, especially if the difference is Rs.100, Rs.1,000 etc.

If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially the cases should be seen; it is possible that an error has been committed.

Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.

If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.

Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry. If however the errors are located after some time, the correction should be made by making another suitable entry, called rectification entry. In fact the rectification of an error depends on the fact that at which stage it is detected. An error can be detected at any one of the following stages:

Errors before preparation of Trial Balance

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. It is important to note that such errors may involve only one account or more than one account. This can be explained with the help of following illustrations:

The sales book for November is undercast by Rs. 20,000. Only the Sales Accounts is to be corrected by making an entry for Rs. 20,000 on the credit side: "By undercasting of Sales Book for November Rs. 20,000.

While posting the discount column on the debit side of the cash book the discount of Rs. 1,000 allowed to Ramesh has not been posted. This is done by the entry "By omission of posting of discount ----- Rs.1,000".

Rs. 50,000 was received from Mahesh and entered on the debit side of the cash book but was not posted to his account. This error affects only the account of Mahesh by Rs. 50,000. The rectification will be by the entry. "By Omission of posting Rs. 50,000."

Thus, from the above illustrations it is observed that errors affecting two accounts can always be corrected by a journal entry is not always valid.

After Trial Balance but before Final Accounts

This method of correction of error is appropriate when the errors have been located before the end of the accounting period. Each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which complete journal entries were not possible in the earlier stage of rectification (i.e., before trial balance) can now be rectified by way of journal entry(s) with the help of suspense account.

Example: The sales book for November, 2020 is cast Rs.15,000 short; as a consequence the trial balance will not agree. To rectify the error the Sales Account will be credited. Since now one error remains, the Suspense Account must be used- it will be debiting the Suspense Account. The entry will be :

Suspense Account	Dr. Rs.15,000
To Sales Account	Rs. 15,000

(Correction of error of undercasting the sales book for Nov. 2020)

Correction in the next Accounting Period

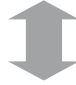
Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense Account or even transferring it to the Capital Account.

Example: The Purchase Book was cast short by Rs.1,000 in December, 2019 and a Suspense Account was opened with the difference in the trial balance. If the error is rectified next year and the entry passed is

Purchase Account Dr. Rs.1,000

To Suspense Account Rs.1,000

It will mean that the Purchases Account for year 2020 will be Rs.1,000 more than the actual amount relating to year 2020 and thus the profit that year 2020 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Profit and Loss Account.



To avoid the above correction of all amounts concerning nominal accounts, i.e., expenses and incomes should be through "Prior Period Items" or "Profit and Loss Adjustment Account". The balance in the account should be transferred to the Profit and Loss Account. However, these Prior Period Items should be charged after deriving net profit of the current year.

In brief the errors at this stage should be rectified in the same manner as we do in case of errors identified after the preparation of Trial Balance but before Final accounts.

The only difference is that all Nominal accounts in the rectification entries shall be substituted by Profit/Loss Adjustment account.

The balance of Profit and Loss Adjustment account will be transferred to capital account.

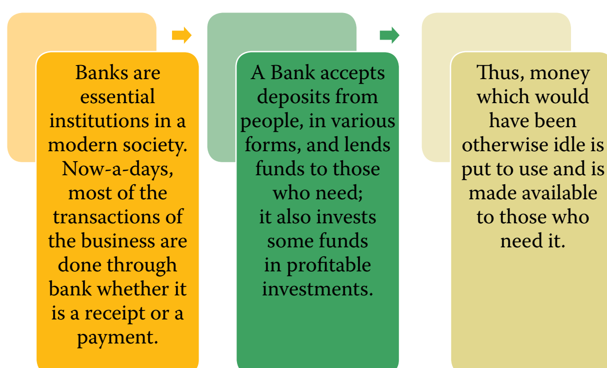
CA FOUNDATION - PAPER 1 - PRINCIPLES AND PRACTICE OF ACCOUNTING

Accounting plays a vital role of core competence for Chartered Accountants. It accelerates and develops the strong basics to understand the financials of business world in a better way. Considering this objective, it has been decided to bring forth a crisp and concise capsule on Bank Reconciliation Statement covered in the syllabus of Paper 1: Principles and Practice of Accounting. The concepts involved in this chapter has been gathered and presented through pictorial presentations which will help the students in grasping the intricate practical aspects for quick revision. 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 Study Material for comprehensive study.

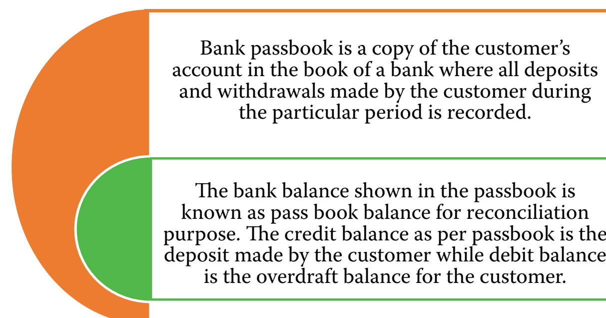
CHAPTER 3: BANK RECONCILIATION STATEMENT

Introduction

The objective of Bank Reconciliation statement is to understand passbook and cash book and reconciliation between the two. The reconciliation brings out any errors that may have been committed either in the cash book or in the passbook . A regular reconciliation discourages the accountant of the bank from embezzlement.



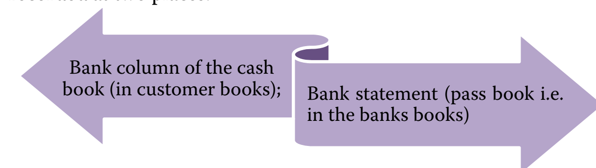
Bank Passbook

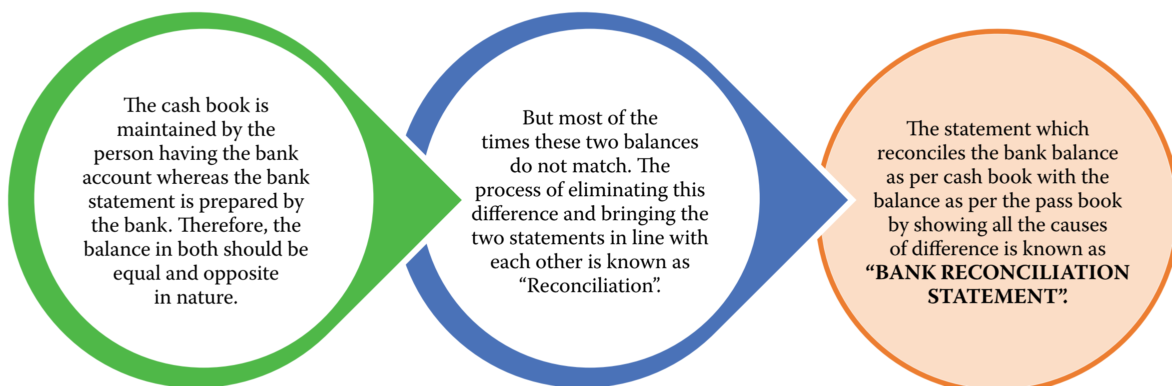


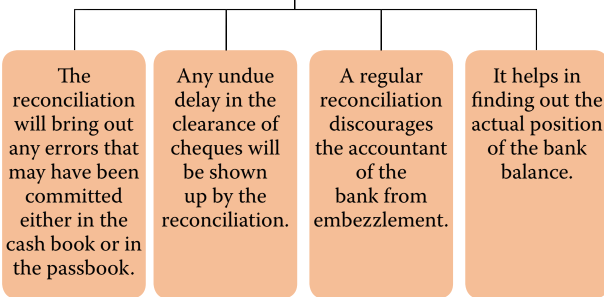
Bank Reconciliation Statement

To reconcile means to find out the difference between two and eliminating that difference.

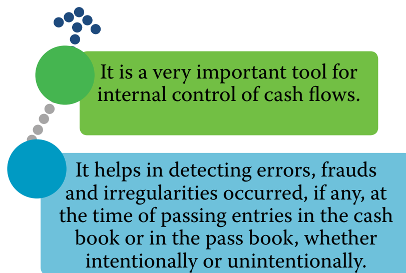
Whenever we deposit or withdraw money from banks, it is always recorded at two places:-







Importance of Bank Reconciliation Statement

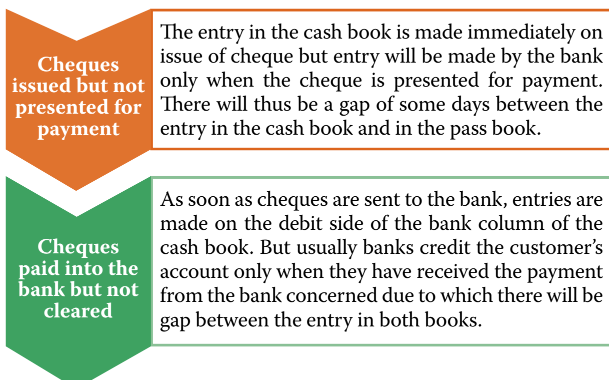


Causes of Difference

The difference in bank balance as per cash book and passbook may arise because of the following reasons:-

TIMING	TRANSACTIONS	ERRORS
Sometimes a transaction is recorded at two different times in cash book and the passbook.	There are various transactions which the bank carries out by itself without intimating the customer.	Mistakes or errors made in preparing the accounts either by the bank or the customer can also result in disagreement of the two statements. For this reason rectification of errors is required to be done in both the statements before preparing any Bank Reconciliation Statement.

Some of the items that frequently cause a difference are as follows :-



Interest allowed by bank: If the bank has allowed interest to the customer, the entry will normally be made in the customer's account and later shown in the pass book. The customer usually comes to know about the interest amount by pursuing the pass book and only then he makes relevant entry in the cash book.

Interest and expenses charged by the bank: Like (iii) above, the interest charged by the bank and the bank charges are entered in the customer account and later in the pass book. The customer makes the required entries only after he sees the pass book. These are debited to customer account by bank therefore, bank balance as per pass book is less than bank balance as per cash book.

Interest and dividends collected by the bank: Sometimes investments are left with the bank in the safe custody; the bank itself sees to it that the interest or the dividend is collected on the due dates.

Direct payments by the bank: The bank may be given standing instructions for certain payments for eg. insurance premium. In this case also, the customer may come to know of the payment only on seeing the pass book.

Direct payment into the bank by a customer: If such a payment is received by the bank, it will be entered in the customer's account and also in the pass book; the account holder may come to know of the amount only when he sees the pass book.

Dishonour of a bill discounted with the bank: If the bank is not able to receive payment on promissory notes discounted by it, it will debit the customer's account together with the charges it may have incurred. The customer will make the entry only when he sees the pass book.

Bills collected by the bank on behalf of the customer: If goods are sold, the documents may be sent through the bank. If the bank is able to collect the amount, it will credit the customer's account. The customer may make the entry only on receiving the pass book.

Errors: While recording the entries, error can occur in both cash book and pass book. A bank rarely makes any error but if does, the balance in the pass book will naturally differ from cash book.

Following is the table summarising in brief the timings of different transactions:

Sl. No.	Transaction	Time of recording in cash book	Time of recording in pass book
1.	Payment done by the account holder through issuing a cheque.	At the time of issuing the cheque.	At the time of presenting the cheque to the bank for payment.
2.	Receipt by the account holder through a cheque.	At the time of depositing the cheque into the bank.	At the time of collection of amount from the account of the issuing party.

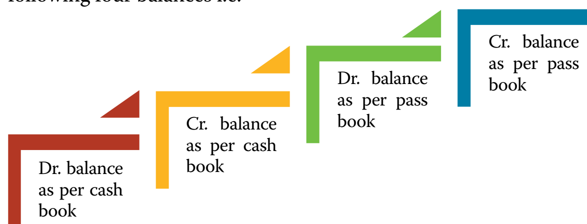
Sl. No.	Transaction	Time of recording in cash book	Time of recording in pass book
3.	Collection of bills/ cheque directly on behalf of the account holder.	When the entry is posted in the pass book.	When the amount is collected by the bank.
4.	Direct payment to the third party on behalf of the account holder.	When the entry is posted in the pass book.	When the amount is paid by the bank.
5.	Dishonour of cheque/ bills receivable.	When the entry is posted in the pass book.	When the cheque is dishonoured.
6.	Bank charges levied by the bank.	When the entry is posted in the pass book.	When charges are levied by the bank.
7.	Interest and dividend credited by the bank.	When the entry is posted in the pass book.	When interest or dividend is allowed or collected by the bank.
8.	Interest debited by the bank.	When the entry is posted in the pass book.	When interest is charged by the bank.

Procedure for Reconciling the Cash Book Balance with the Pass Book Balance

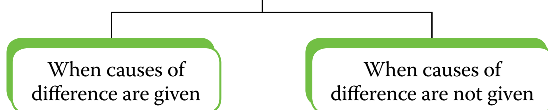
'Dr. balance as per cash book' means deposits in the bank or cash at bank or Cr. balance as per pass book.

Similarly 'Cr. balance as per cash book' means excess amount over deposits withdrawn by the account holder or overdraft balance or Dr. balance as per pass book.

It means that you can start bank reconciliation from any of the following four balances i.e.



TYPES OF PRACTICAL PROBLEMS



When causes of differences are given

Given the causes of disagreement, the balance of the other book can be either more or less. If the balance of the other book is more then add the amount and if the balance of the other book is less then subtract the amount.

If a reconciliation starts from debit balance of cash book and after all adjustments the balance arrived is positive then it is known as Cr. balance as per the pass book and if the balance is negative then it is said to be Dr. balance as per the pass book and vice-versa.

But if causes of differences are not given

Compare the debit entries of cash book with the credit entries of the pass-book and vice-versa. The entries, which do not tally, are the causes of difference in the balances of both the books. Once the causes are located, their effects on both the books are analysed and then reconciliation statement is prepared to arrive at the actual bank balance.

One should also take into care that whether opening balance of both the books at particular point of time from where the books are compared, tallies or not. If opening balances are not same then unticked items are divided into two categories i.e., one relating to reconciliation of opening balance and other relating to reconciliation of closing balance.

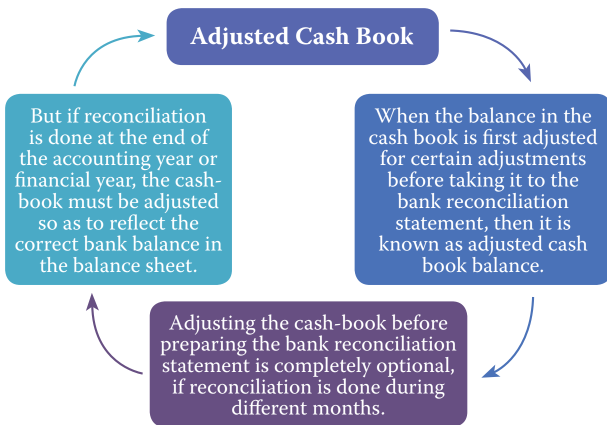
Methods of Bank Reconciliation

Bank Reconciliation Statement without the preparation of Adjusted Cashbook

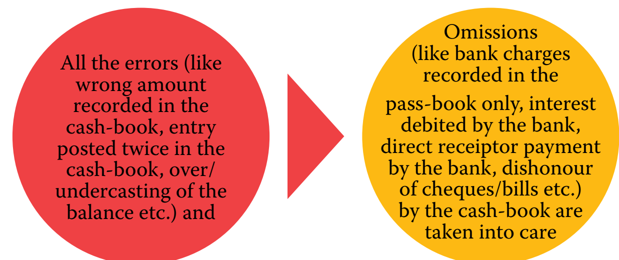
Causes of differences	Favourable balance (Dr.) as per cash- book	Unfavourable balance (Cr.) as per cash- book	Favourable balance (Cr.) as per pass- book	Unfavourable balance (Dr.) as per pass- book
Cheque deposited but not cleared	Subtract	Add	Add	Subtract
Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
Income (e.g., interest from UTI) directly received by bank	Add	Subtract	Subtract	Add
Expenses (e.g., telephone bills, Insurance charges) directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
Bank charges levied by bank	Subtract	Add	Add	Subtract
Locker rent levied by bank	Subtract	Add	Add	Subtract
Wrong debit in the cash book	Subtract	Add	Add	Subtract

Causes of differences	Favourable balance (Dr.) as per cash- book	Unfavourable balance (Cr.) as per cash- book	Favourable balance (Cr.) as per pass- book	Unfavourable balance (Dr.) as per pass- book
Wrong credit in the cash book	Add	Subtract	Subtract	Add
Wrong debit in the pass book	Subtract	Add	Add	Subtract
Wrong credit in pass book	Add	Subtract	Subtract	Add
Undercasting of Dr. side of bank account in the cash book	Add	Subtract	Subtract	Add
Overcasting of Dr. side of bank account in cash book	Subtract	Add	Add	Subtract
Undercasting of Cr. side of bank account in cash book	Subtract	Add	Add	Subtract
Overcasting of Cr. side of bank account in cash book	Add	Subtract	Subtract	Add
Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
Interest on bank overdraft charged	Subtract	Add	Add	Subtract
Final Balance	If answer is ***positive*** then favourable balance (Cr.) as per pass-book and if negative then unfavourable balance (Dr.) as per pass-book.	If answer is ***positive*** then unfavourable balance(Dr.) as per pass-book and if negative then favourable balance (Cr.) as per pass-book.	If answer is ***positive*** then favourable balance (Dr.) as per cash-book and if negative then unfavourable balance (Cr.) as per cash-book	If answer is ***positive*** then unfavourable balance (Cr.) as per cash book and if negative then favourable balance (Dr.) as per cash-book.

Bank Reconciliation Statement after the preparation of Adjusted Cashbook



While adjusting cash-book, the following adjustments are considered:-



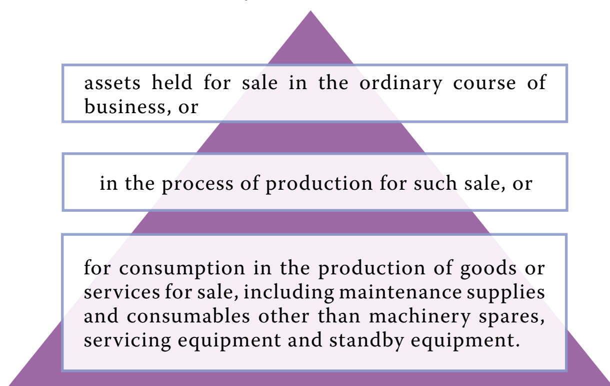
CA FOUNDATION - PAPER 1 - PRINCIPLES AND PRACTICE OF ACCOUNTING

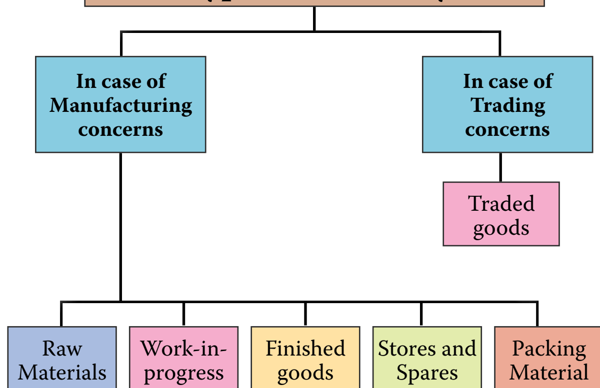
The objective of Paper 1 "Principles and Practice of Accounting" at Foundation level is to develop an understanding of the basic concepts and Principles of Accounting and apply the same in preparing financial statements. It has always been the endeavour of Board of Studies to provide quality academic inputs to the students. Considering this objective, it has been decided to bring forth a crisp and concise capsule on the topic of Inventory Valuation covered in the syllabus of this paper. The concepts involved in this chapter have been gathered and presented through pictorial presentations in this capsule which will help the students in grasping the intricate practical aspects for quick revision of this chapter. Under no circumstances, such revision can substitute the detailed study of the material provided by the Board of Studies. Students are advised to refer Chapter 4 of the Study Material for comprehensive study.

CHAPTER 4: INVENTORIES

Introduction

The chapter "Inventories" will help you to understand the term "Inventory" and the techniques of valuing the inventories. It will also enable you to comprehend the methods of inventory valuation for record keeping and intricacies related to book-keeping.





Inventory Valuation

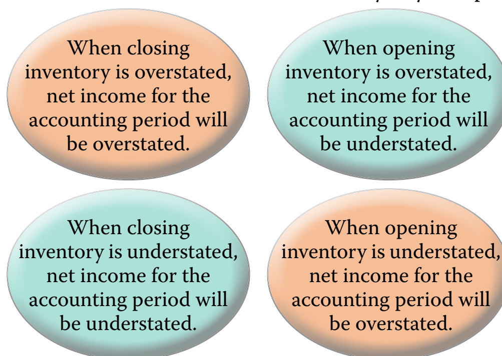
Inventory is generally the most significant component of the current assets held by a trading or manufacturing enterprise. Both excess of inventory and its shortage affects the production activity, and the profitability of the enterprise whether it is a manufacturing or a trading business.

The significance of inventory valuation arises due to various reasons as explained in the following points:

(i) Determination of Income

The valuation of inventory is necessary for determining the true income earned by a business entity during a particular period. To determine gross profit, cost of goods sold is matched with revenue of the accounting period.

The effect of over or understatement of inventory may be explained as:



(ii) Ascertainment of Financial Position

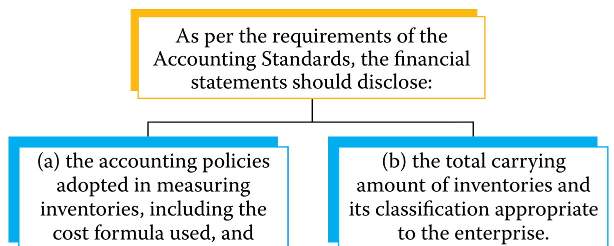
Inventories are classified as **current assets**. The value of inventory on the date of balance sheet is required to determine the financial position of the business. If inventory is not properly valued, the balance sheet will not disclose the truthful financial position of the business.

(iii) Liquidity Analysis

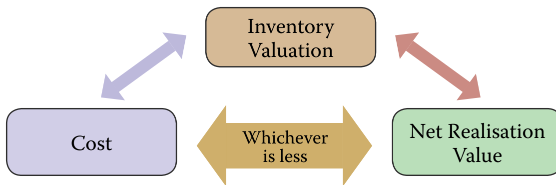
Inventory is classified as a current asset, it is one of the components of net working capital which reveals the liquidity position of the business. Current ratio which studies the relationship between current assets and current liabilities is significantly affected by the value of inventory.

(iv) Statutory Compliance

Schedule III to the Companies Act, 2013 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements.



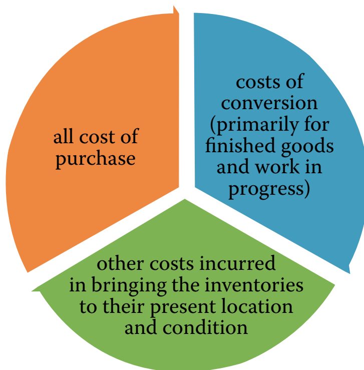
Basis of Inventory Valuation



The above principle is governed by 'Principle of Conservative Accounting' under which any expenses or losses from transactions entered or event occurred are to be recognized immediately, however, any gains or profits are recognized until it becomes due or are actually realized.

Cost

As per Accounting Standards, Cost of inventories should comprise



Cost of purchase	includes any amount paid to the seller reduced by any discounts/rebates given by the seller. Similarly, any duties paid to the supplier will be part of cost of the inventory unless the enterprises can recover these taxes duties from the authorities.
Costs of conversion	inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable overheads.
Other Costs	may include administrative overheads incurred to bring the inventory into present location and condition or any cost specifically incurred on inventory of a specified customer. Interest and other borrowing costs are generally not included in the cost of inventory.

Exclusions from cost of inventories

- abnormal amounts of wasted materials, labour or other production overheads;
- storage costs, unless those costs are necessary in the production process prior to further production stage;
- administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- selling and distribution costs.

Net Realisable Value

This is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

In case of raw materials	replacement cost is generally considered as net realisable value.
In case of work in progress	Net realisable value mean expenses and overheads required to be incurred to convert work in progress into finished goods and making it ready for sale as reduced from selling price.
In case of finished goods and traded goods	Net realisable value means selling price reduced by selling and distribution expenses.

Inventory Record System

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'. The periodic system is less expensive to use than the perpetual method. But the useful information obtained from perpetual system is more than cost incurred on it.

Periodic Inventory System

Periodic inventory system is a method of ascertaining inventory by taking an actual physical count (or measure or weight) of all the inventory items on hand at a particular date on which inventory is valued.

The cost of goods sold is determined as shown below:

opening inventory (Known) + Purchases (known) – closing inventory (physically counted) = Cost of goods sold.

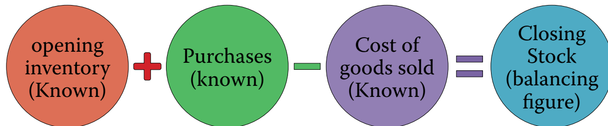
- Physical inventory taking is required more than once a year for preparation of quarterly or half yearly financial statements thereby making this system more expensive.
- Physical count of goods requires closure of normal operations of business.
- As cost of goods sold is taken as residual figure, it is not possible to identify loss of goods due to pilferage, damage or even fraud.
- Inventory control is not possible under this system.
- Books of accounts does not reflect inventory in hand and its value therefore, it is difficult to plan operations e.g. how much or when to order/manufacture.

This system is used by small enterprises where it is easy to control physical inventory. This system is not considered suitable for medium or larger enterprises which generally use Perpetual Inventory system.

Perpetual inventory system

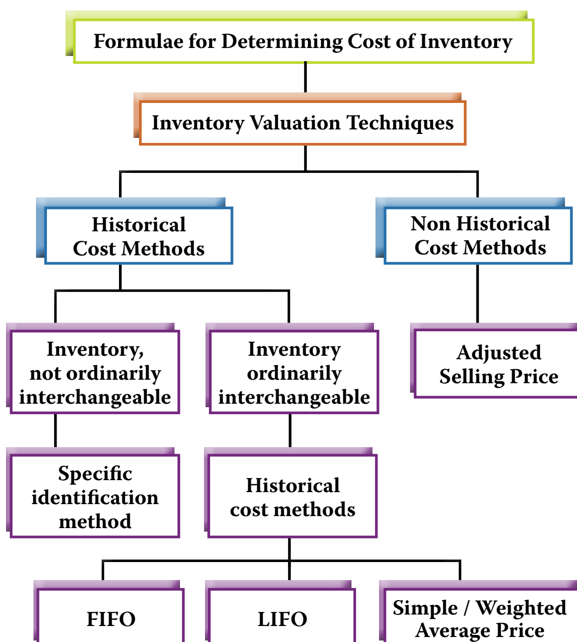
Perpetual inventory system is a system of **recording inventory balances after each receipt and issue**. In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined and inventory of goods is taken as residual figure with the help of inventory ledger in which flow of goods is recorded on continuous basis.

Closing inventory is determined as follows:



Sl. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.
4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
5.	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
6.	This system is simple and less expensive.	It is costlier method.
7.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.

Methods to Determine cost of Inventory



Historical Cost Methods

The different techniques for valuation of inventory have been discussed below:

(i) Specific Identification Method

- It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in inventories are left. The historical costs of such specific purpose inventories may be determined on the basis of their specific purchase price or production cost.
- This method is generally used to ascertain the cost of inventories of items that are not ordinarily interchangeable and their value is high like expensive medical equipments.

(ii) FIFO (First in first out) Method

- This method is based on the assumption that cost should be charged to revenue in the order in which they are incurred, that is, it is assumed that the issue of goods is usually from the earliest lot on hand. The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first and consequently items remaining in the inventory at the end of the period are those most recently purchased or produced.
- Thus, the closing inventory is valued at the price paid for latest consignments.

(iii) LIFO (Last in first out) Method

- The LIFO formula assigns to cost of goods sold, the cost of goods that have been purchased last though the actual issues may be made out of the earliest lot on hand to prevent unnecessary deterioration in value. Under this basis, goods issued are valued at the price paid for the latest lot of goods on hand which means inventory of goods in hand is valued at price paid for the earlier lot of goods.
- The price paid for the earliest consignments is used for valuing closing inventory.

(iv) Simple Average Price Method

- In Simple Average Price method, all the different prices are added together and then divided by the number of prices.
- The closing inventory is then valued according to the price ascertained.

(v) Weighted Average Price Method

- Under Weighted Average Price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit. Thus
- Weighted average price per unit = $\dfrac{\text{Total cost of goods available for sale during that period}}{\text{Total number of units available for sale during that period}}$
- Closing inventory = No. of units in inventory × Weighted average price per unit
- Cost of goods sold = No. of units sold × Weighted average price per unit.

Non Historical Cost Methods

(i) Adjusted selling price method

This method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The cost of the inventory is determined by reducing from the sales value of the inventory an appropriate percentage of gross margin. The percentage used takes into consideration inventory which has been marked below its original selling price. An average percentage for each retail department is often used.

(ii) Standard cost method

This method is used when there is frequent change in the price per unit of the goods and goods are purchased frequently by the business e.g. crude oil. Based on the experience a standard cost is determined on the basis of frequent changes in prices and inventory is valued on that price per unit.

Inventory Taking

Normally all operations are suspended for one or two days during the financial year and physical inventory is taken for everything in the godown or the store periodically. For the year-end inventory valuation, physical inventory taking is done during the last week of the financial year or during the first week of next financial year. If inventory taking is finished on 26th March, whereas accounting year ends on 31st March purchases and sales between 26th and 31st March are then separately adjusted. Later, a value is put on each item. The principle of cost or Net realizable value, whichever is lower, is applied either for the inventory as a whole or item by item.

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.

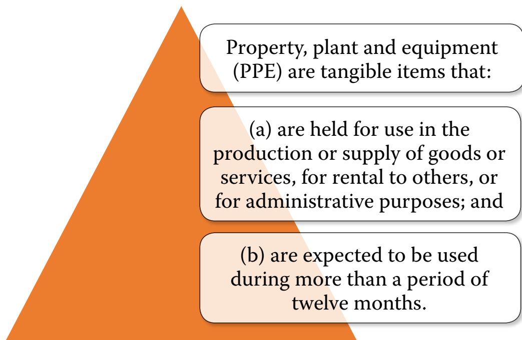
CHAPTER 5: CONCEPT AND ACCOUNTING OF DEPRECIATION

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

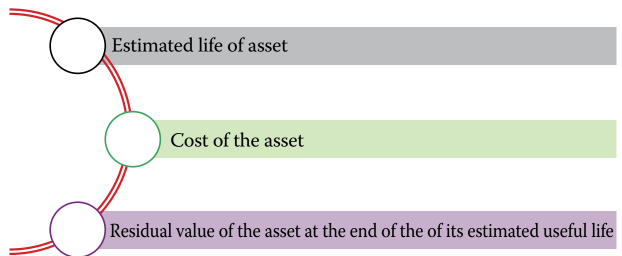


Reasons for decreases in value of an asset

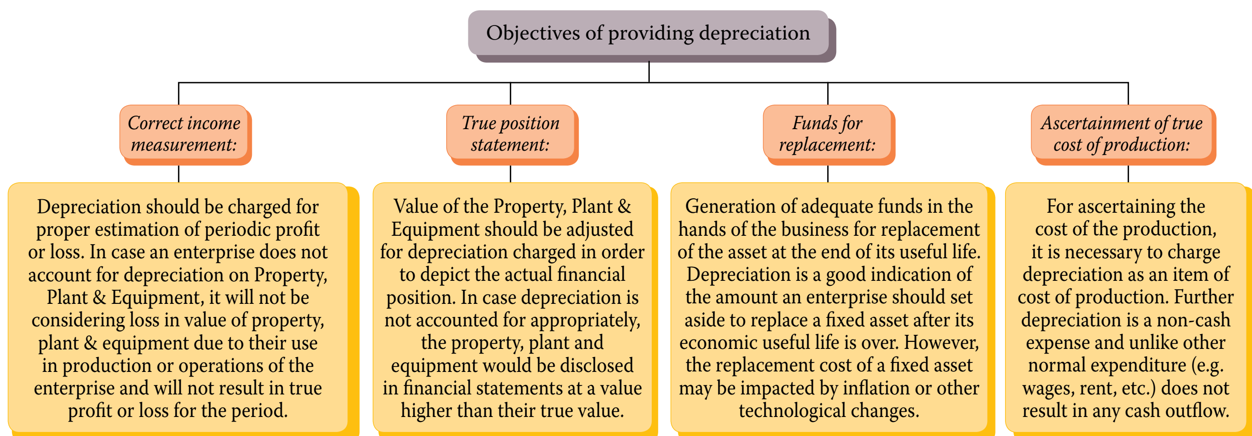
Value of an assets decreases with passage of time mainly due to following reasons.

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

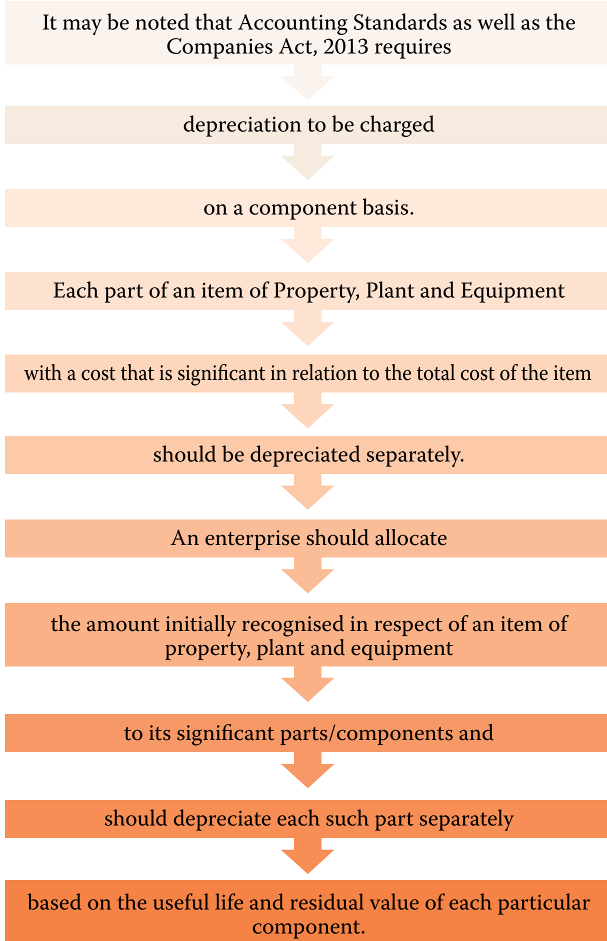


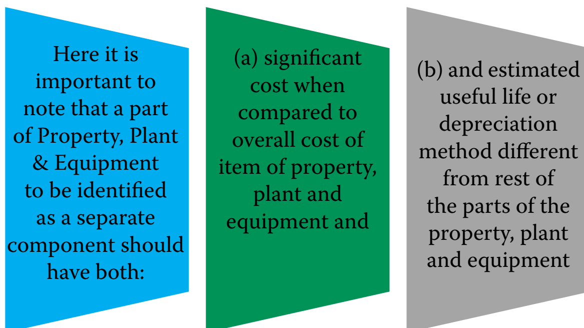
Objectives of providing depreciation



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





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.

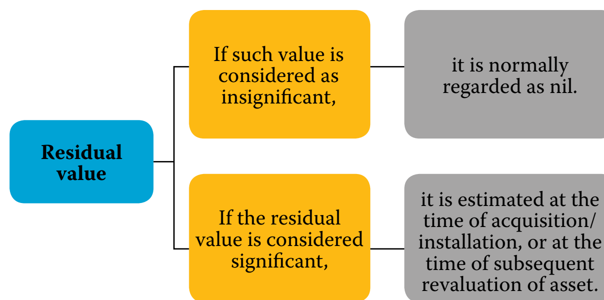
Determination of the useful life

is a matter of estimation and

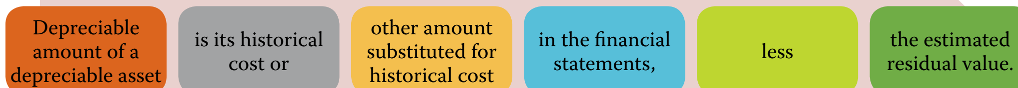
is normally based on various factors

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

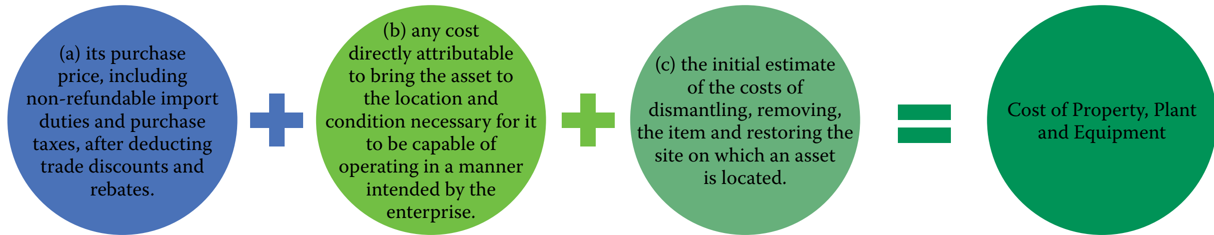
Determination of the residual value



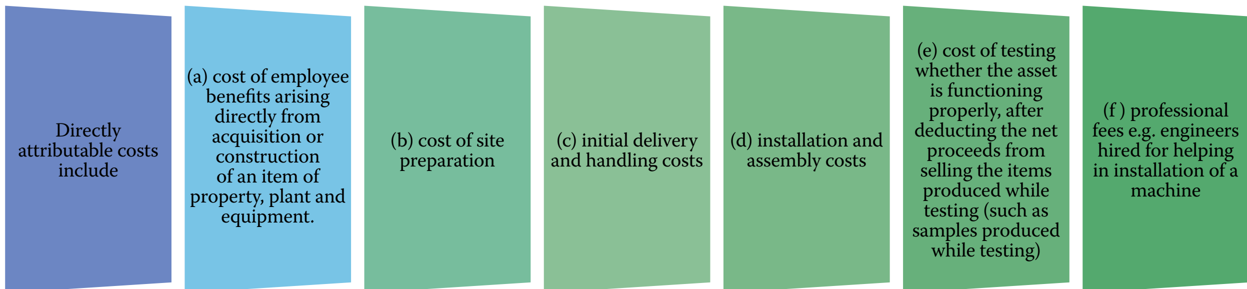
Depreciable amount



Cost of Property, Plant and Equipment

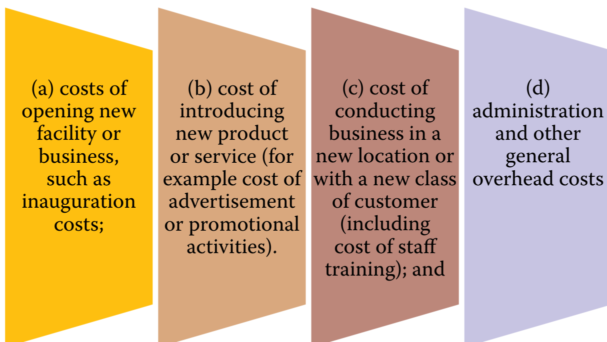


Examples of directly attributable costs are



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

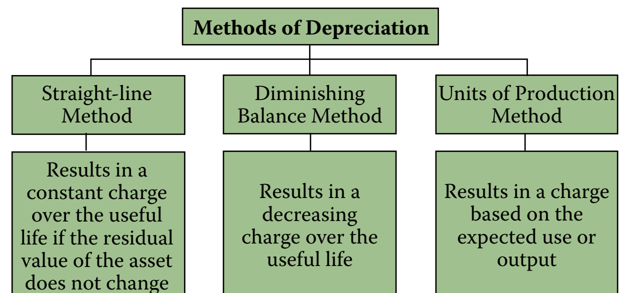


Once an asset has been brought to its intended condition and location of use, no cost should recognized as part of cost of the asset unless there is major repair or addition which increases the useful life of the asset or improves the production capacity of the asset. Accordingly, cost incurred while 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.



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.

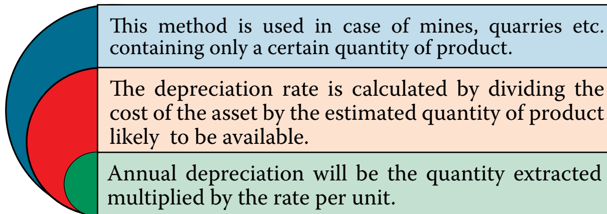
Production Units Method

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

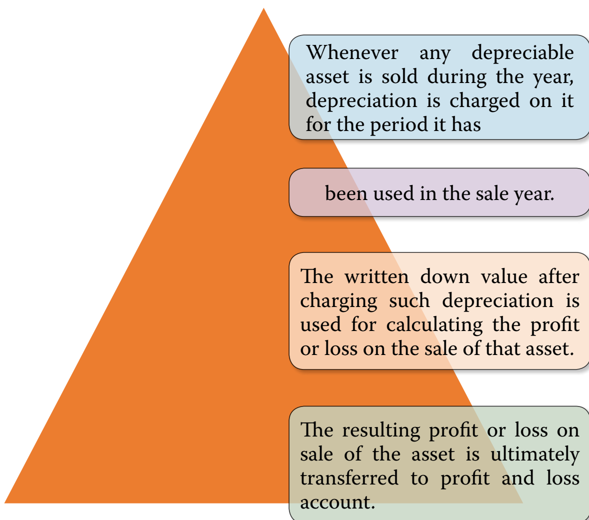
$$\text{Depreciation for the period} = \text{Depreciable Amount} \times \frac{\text{Production during the period}}{\text{Estimated total production}}$$

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

Depletion Method



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

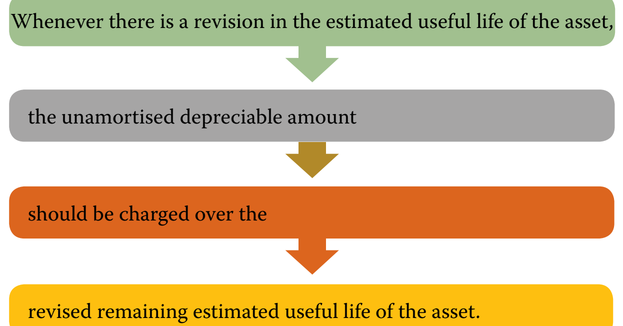


Change in the method of depreciation

- 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.



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.

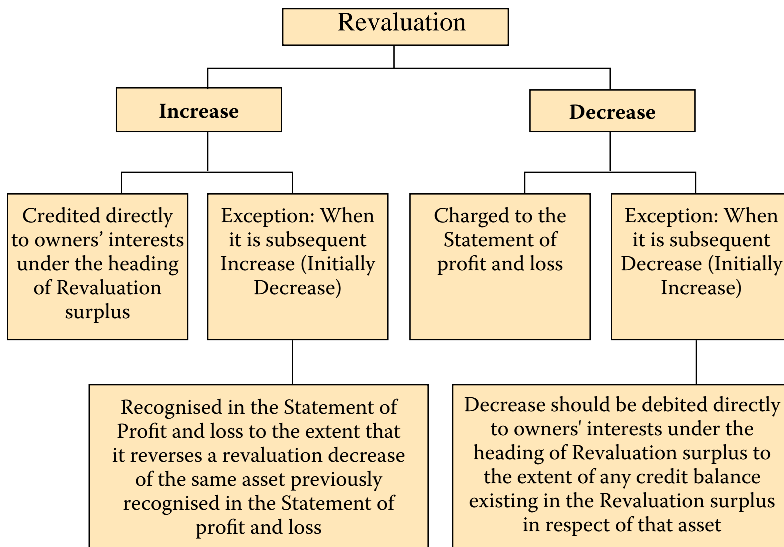
Remaining useful life as per previous estimate = 7 years

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

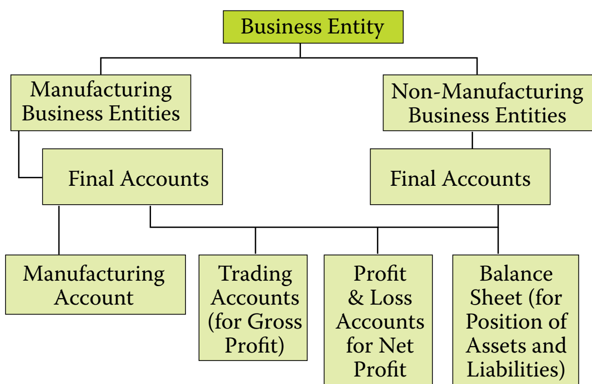
Depreciation for the fourth year onwards = ₹9,00,000 / 9 = ₹1,00,000.

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 Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
1.	Closing Stock	Closing Stock A/c To Trading A/c	Dr.	Shown on 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.

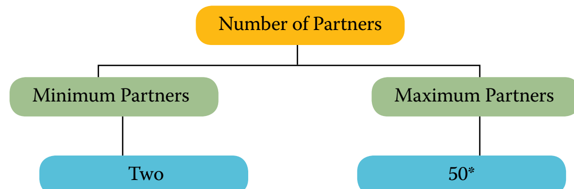
ACCOUNTS OF PARTNERSHIP FIRM

- 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



* 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

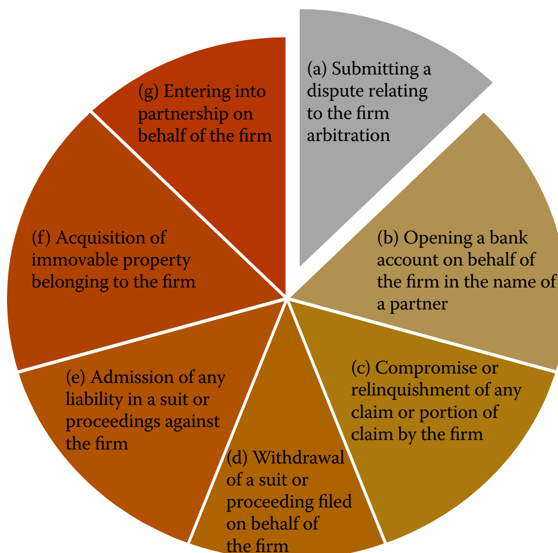
(b) Receiving payments on behalf of the firm and giving valid receipt

(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

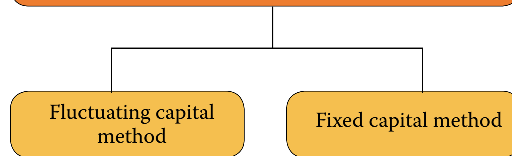
During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.

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.

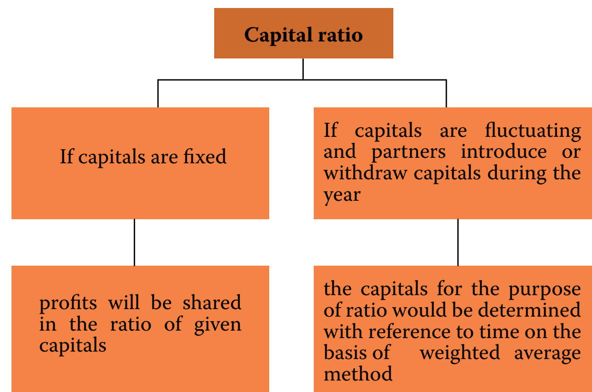
There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- 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.



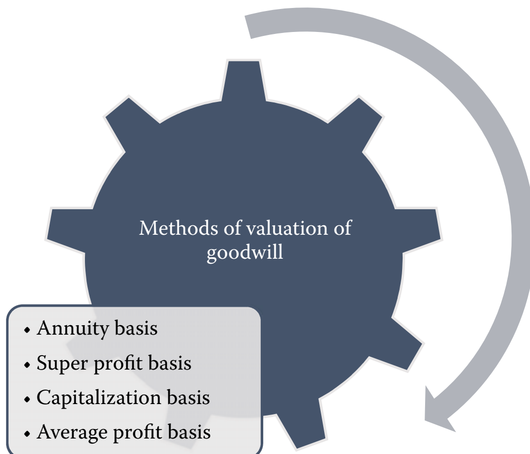
VALUATION OF GOODWILL

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

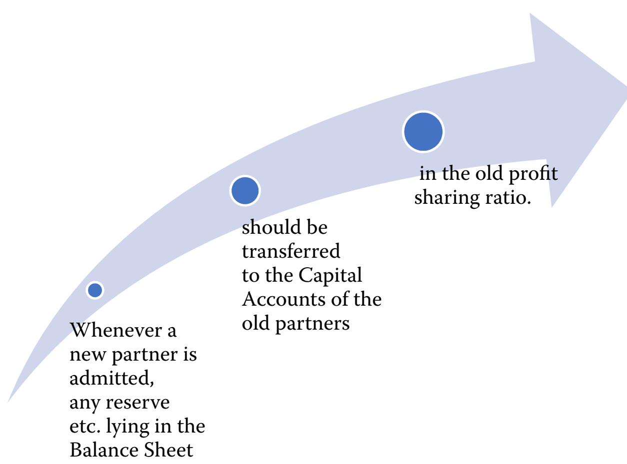
- Revaluation Account or Profit and Loss Adjustment Account for revaluation of assets and liabilities
- Adjustment of goodwill amongst the old partners in their scarificing gaining ratio
- Profit/loss on revaluation account is transfer to old partners in their old profit sharing ratio
- Reserve lying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

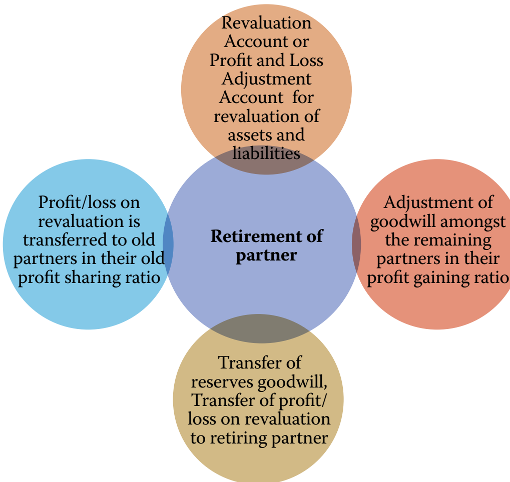
Gaining ratio = difference between new profit shares and old profit shares

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

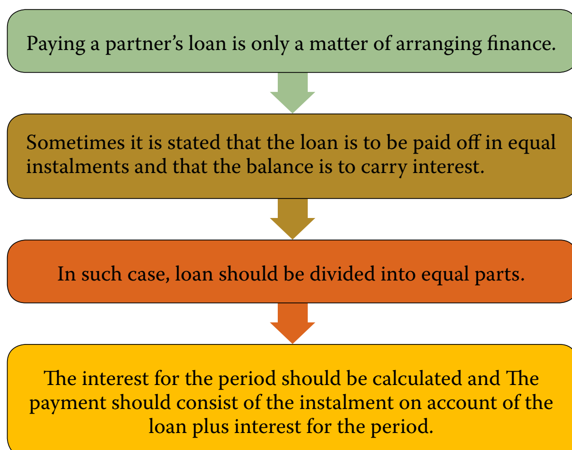
As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

(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.

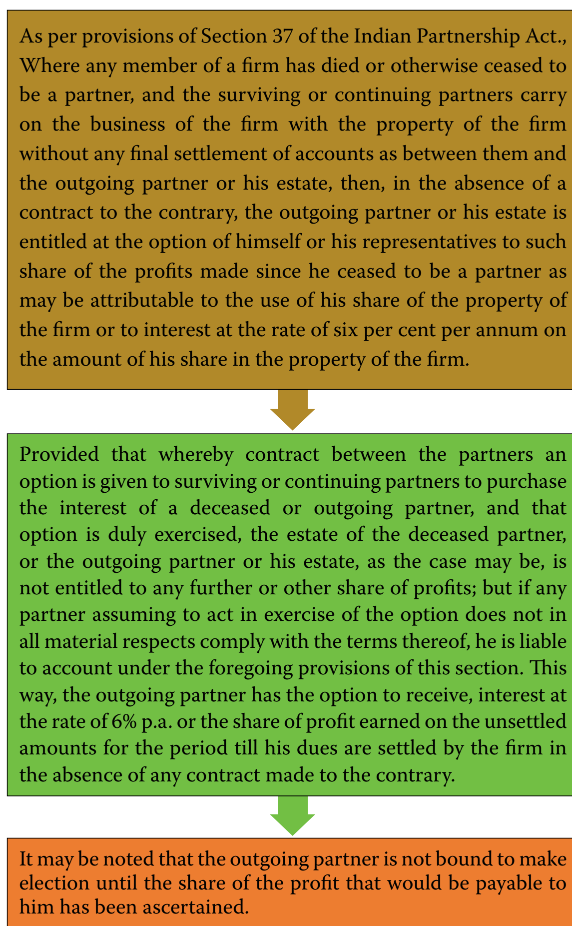
PAYING A PARTNER'S LOAN IN INSTALMENT



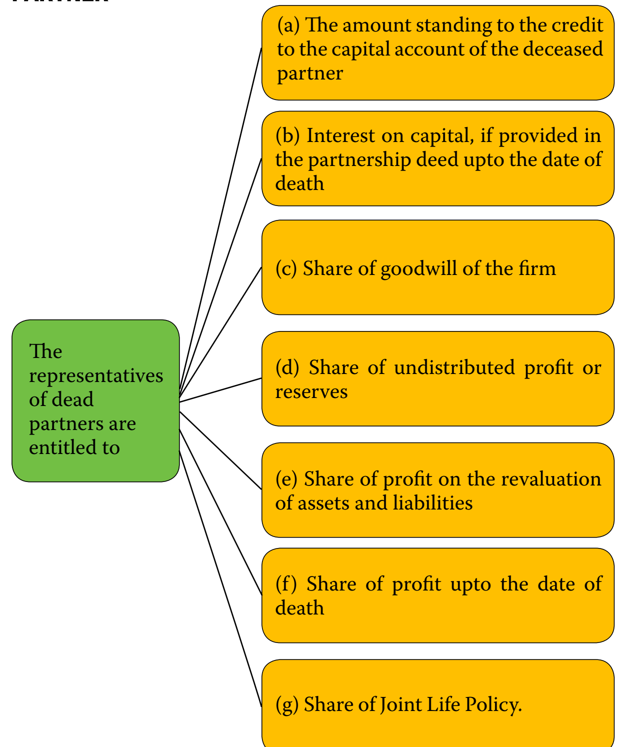
DEATH OF A PARTNER

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

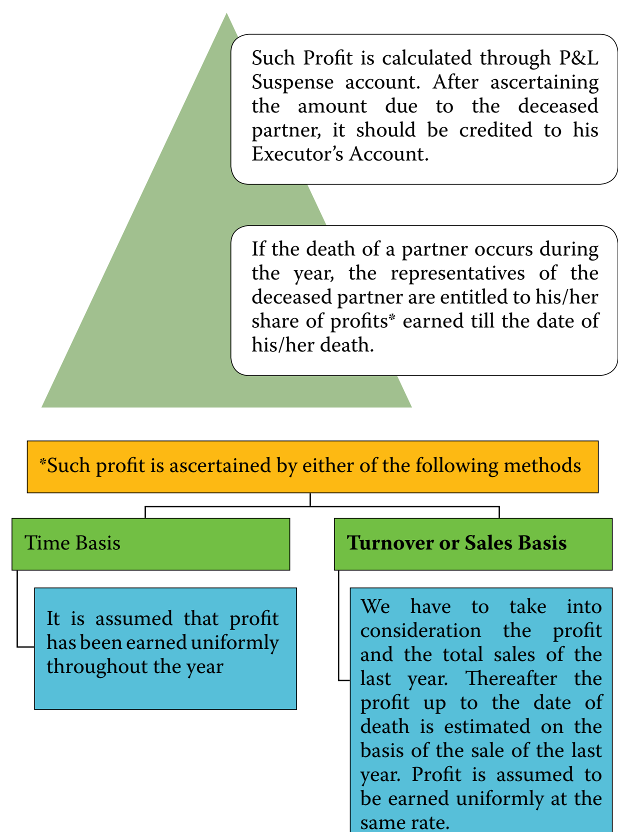
Right of outgoing partner in certain cases to share subsequent profits



AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

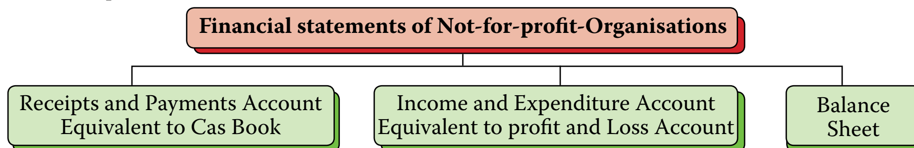


CALCULATION OF PROFIT UPTO THE DATE OF DEATH OF A PARTNER



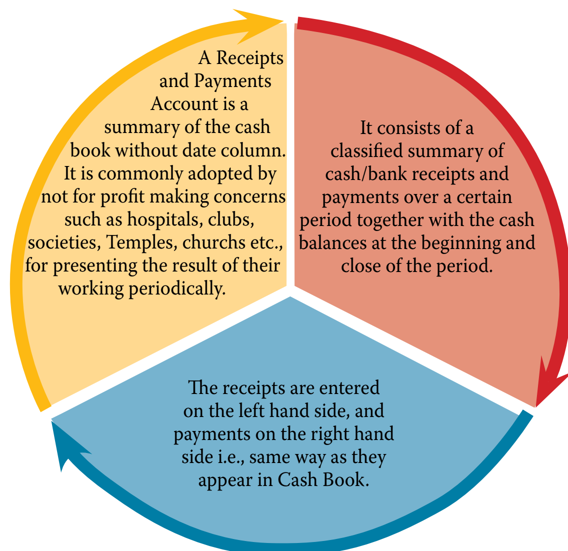
CHAPTER 9: FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANISATIONS

A non-profit organization is a legal accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. Non-profit making organisations such as public hospitals, public educational institutions, clubs, Temples, churches etc., as a part of their final accounts prepare Receipts and Payments Account and Income and Expenditure Account to show periodic performance and Balance Sheet to show financial position at the end of the period.

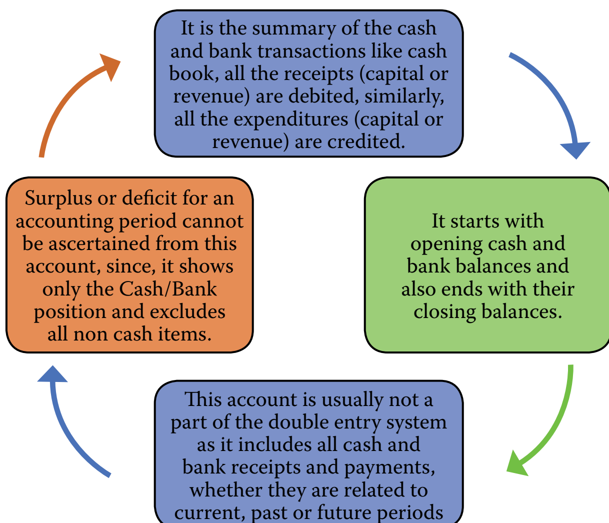


Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the sources of incomes for the non-profit organizations. These items have separate treatment, some being capitalized while others are treated on accrual basis.

Receipts and Payments Account



Features of Receipt and Payment Account



Limitations of Receipt and Payment Account

The increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year, since it does not consider outstanding subcription or subscription received in advance, etc.

Receipt and Payment account includes items relating to all the periods and all types whether capital or revenue. Hence, it does not ascertain whether for a current year income is sufficient to meet the current expenses.

Due to these drawbacks, the preparation of Receipts and Payments Account is not favoured except where the activities of the organization, the results of which are to be exhibited, are simple and modest.

Income and Expenditure Account

The income and expenditure account is **equivalent** to the Profit and Loss Account of a business enterprise. This account is prepared by following **accrual principle.**

Only items of revenue nature pertaining to the period of account are included therein. This requires adjustment in relevant accounts in respect of outstanding and advance items of Income and Expenditure Account.

It resembles a Profit and Loss Account and serves the same function in respect of a non-profit making concern. The only difference is profit is termed as surplus and loss is termed as deficit.

Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.

Features of Income and Expenditure Account

- It is a **revenue account** prepared at the end of the accounting period for finding out the surplus or deficit of that period.
- It is prepared by matching expenses against the revenue of that period concerned.
- Both cash and non-cash items, such as depreciation, are taken into consideration.
- All capital expenditures and incomes are excluded.
- Only **current years'** income and expenses are considered. The surplus/deficit is takan to the Balance Sheet and is added/deducted respectively with the capital fund.

Main Sources of Income

- These are subscriptions, ordinary donations, membership fees or entrances fees (if the amount is normal or provided according to bye-laws of the society), recurring grants from local authorities and income from investments, etc.
- Any amount raised for a special activity, e.g. on sale of match tickets, is deducted from the expenditure of that activity and net amount is shown in the income and expenditure account.
- Any receipt of capital nature shall not be shown as income but will be credited to the Capital Fund or special purpose fund.

It may be noted that after various accounts have been adjusted and all the revenue accounts have been closed off by transfer to the Income and Expenditure Account, there will still be a number of balances left over. These are included in the Balance Sheet.

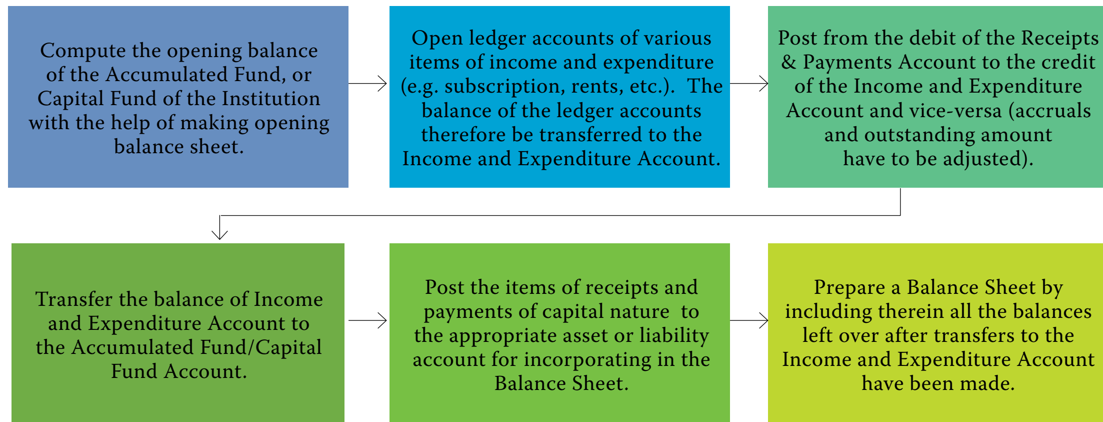
Distinction between Receipts and Payments Account and Income and Expenditure Account

The distinguishing features of Receipt and Payment Account and Income and Expenditure Account can be summarized as:

Receipt and Payment Account	Income and Expenditure Account
This account consist of a classified summary of cash receipts and payments over a certain period together with cash balances at the beginning and close of the period.	This Account **resembles a Profit and Loss Account** and serves the same function in respect of a non-profit making concern. Income and Expenditure Account is drawn up in the same form as the Profit and Loss Account.
Receipts and payments includes items relating to all the periods whether of revenue or capital nature.	Income and Expenditure Account contains all incomes and expenditures relevant to the current period only, whether received or paid out as well as that which have fallen due for recovery or payment. Capital Receipts, prepayments of income and capital expenditures, prepaid expenses are excluded.
The balance of the account at the end of a period represents the difference between the amount of cash received and paid up. It is always in debit since it is made up of cash in hand and at bank.	The closing balance represents the amount by which the income exceeds the expenditure only or vice versa.

Preparation of Income and Expenditure Account from Receipts and Payments Account

Situations may require compilation of Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account after making adjustments in respect of Income accrued but not collected and expenses outstanding. The preparation of Balance Sheet in such a case is also necessary since an Income and Expenditure Account must always be accompanied by a Balance Sheet. The procedure which should be followed in this regard is briefly outlined below.



Balance Sheet

A Balance Sheet is the statement of assets and liabilities of an accounting unit at a given date. It is classified summary of the ledger balances left over, after accounts of all the revenue items have been closed off by transfer to the Income and Expenditure Account.

In not for profit organizations, the excess of total assets over total outside liabilities is known as Capital Fund. The Capital fund represents the amount contributed by members, legacies, special donations, entrance fees and accumulated surplus over the years.

The surplus or deficit, if any, on the year's working as disclosed by the Income and Expenditure Account is shown either as an addition to or deduction from the Capital / Accumulated Fund brought forward from the previous period.

Preparation of Balance Sheet

Preparation of opening balance sheet and calculation of surplus	If capital fund or accumulated surplus in the beginning of the year is not given, it is calculated by deducting liabilities from assets in the beginning of year. While calculating opening capital fund, prepaid expenses and accrued incomes should be included as assets and outstanding expenses and advance incomes as liabilities. Any surplus earned / deficit suffered during the year is to be added to / deducted from the opening capital fund.
Cash and bank balance	Closing cash and bank balance is shown in the assets side of Balance Sheet. Bank overdraft is to be shown on the liabilities side of the balance sheet.
Fixed assets	Opening balances of Fixed Assets(Furniture, building, equipment, etc.) are increased by the amount of purchases and reduced by sales of the same and depreciation on the same.
Liabilities	Opening balances of liabilities should be adjusted for any increase or decrease in the same.

Accounting Treatment of Some Special Items

Donations

These may have been raised either for meeting some revenue or capital expenditure and are credited directly to the Income and Expenditure Account but if the donors have declared their specific intention, are credited to special fund account and in the absence thereof, to the Capital Fund Account.

Entrance and Admission Fees

Such fees which are payable by a member on admission to club or society are normally considered capital receipts and credited to Capital Fund. Where the amount is small, it could be treated as income and can be included in the Income and Expenditure Account. If the question is silent then always take it to be capital receipt.

Subscription

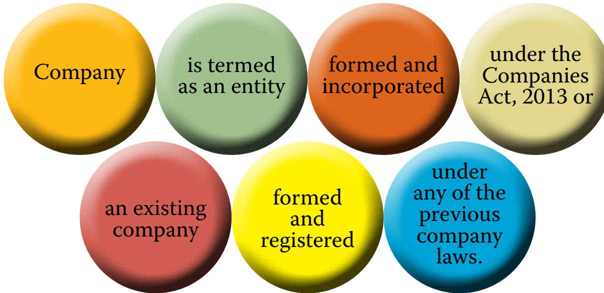
Subscriptions being an income should be allocated over the period of their accrual. If some subscriptions is received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount of subscription pertaining for the period for which accounts are being prepared.

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

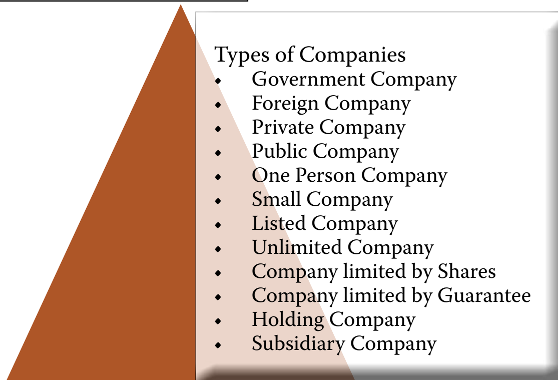
At Foundation level, the Company Accounts portion of the subject "Principles and Practice of Accounting" largely involves understanding the nature and types of companies, salient features of a company, accounting treatment of shares and the purpose of preparing the financial statements. This Capsule 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

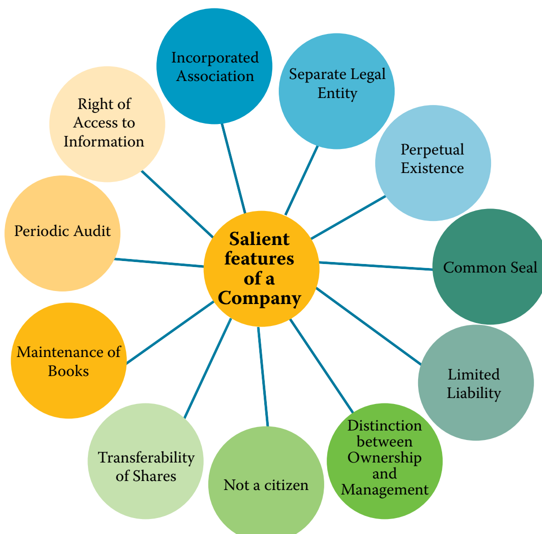
Meaning of a Company



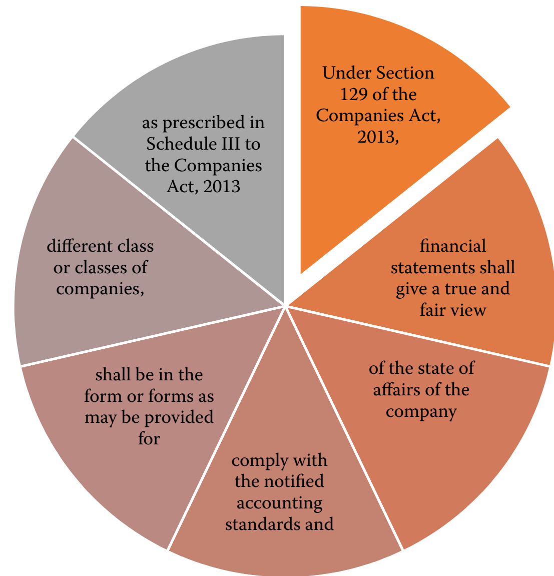
Types of Companies



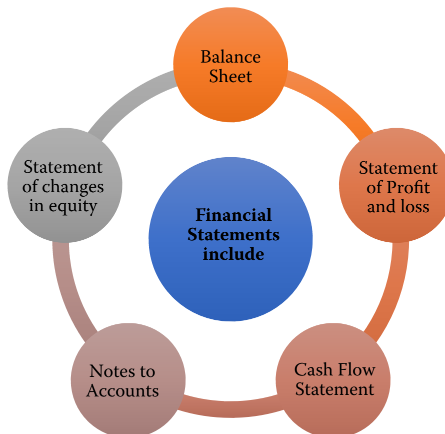
Salient Features of a company



Preparation of Financial Statements

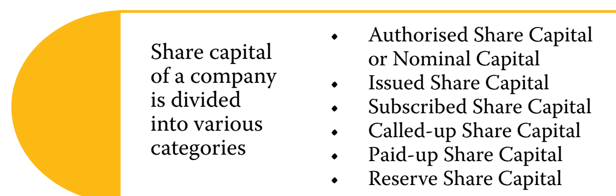


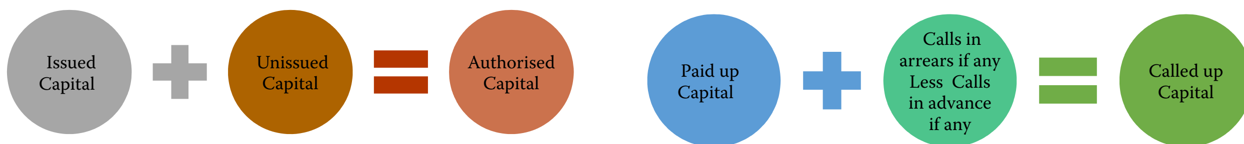
Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -



Share Capital

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

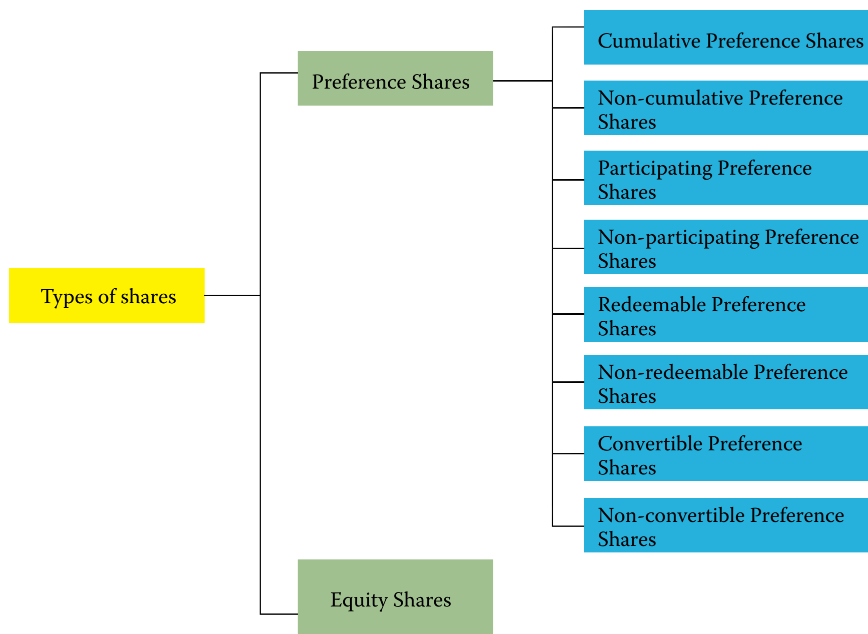




Subscribed Capital can be equal to or greater than or less than Issued Capital resulting in 3 situations respectively: Fully Subscribed; Over Subscribed and Under Subscribed.

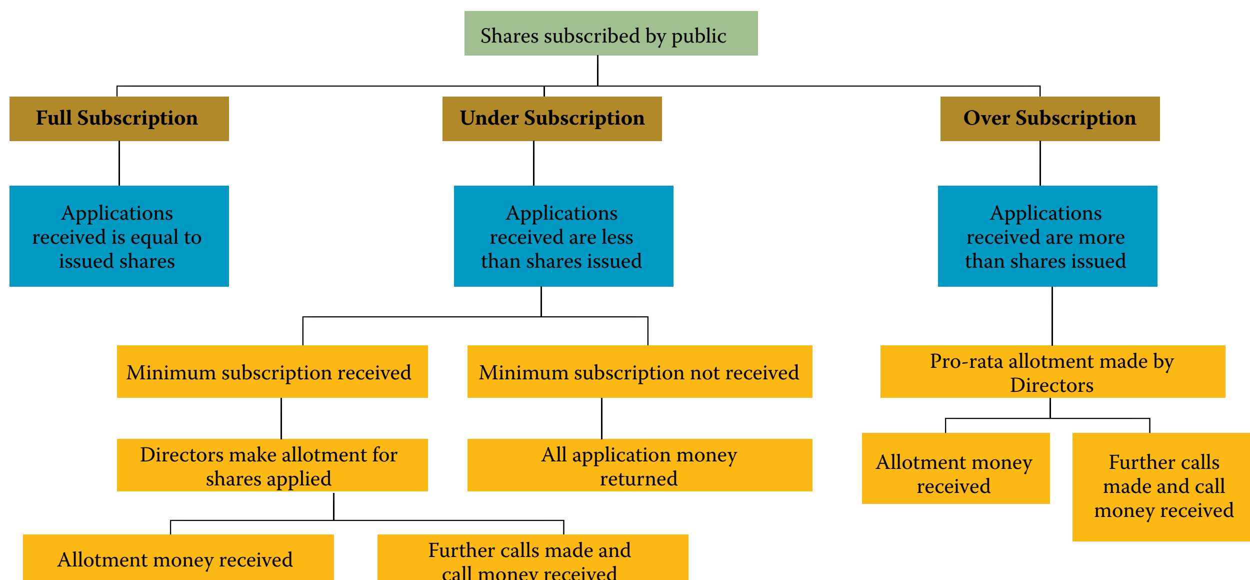
Types of Shares

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

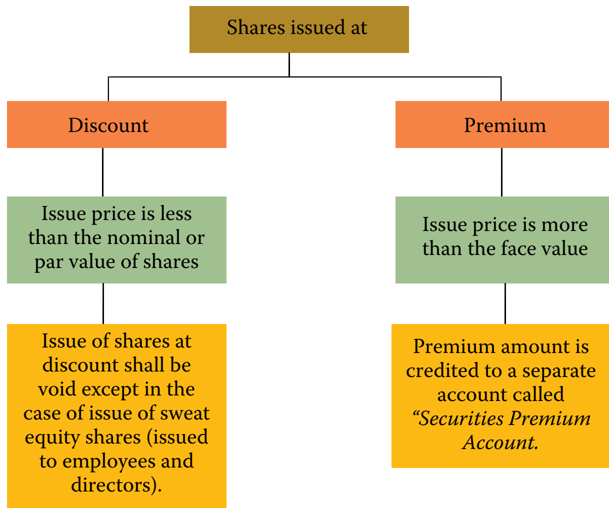


Subscription of Shares

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



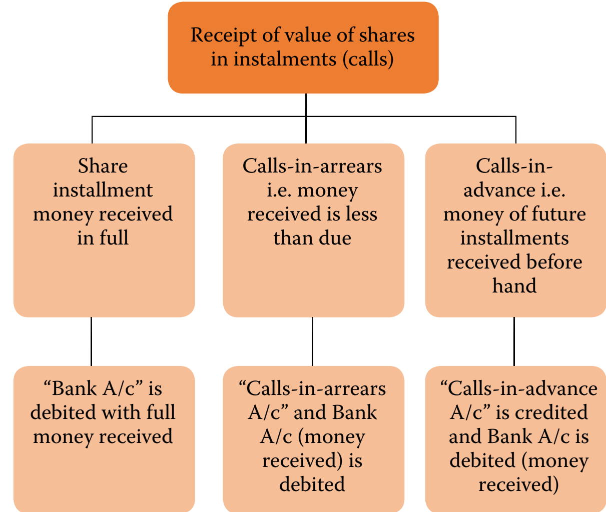
Accounting Treatment of Securities premium

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.

* *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



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.