



इरान्शे
Last Mile Referencer for

FOUNDATION

PAPER 1
ACCOUNTING

**The Institute of Chartered
Accountants of India**

(Set up by an Act of Parliament)

Board of Studies

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PREFACE

The Board of Studies (BoS) is dedicated to delivering outstanding services to its students, tirelessly striving for the highest standards of education and support. It imparts quality academic education through its value added study materials, that explain concepts clearly and in simple language. Illustrations and Test Your Knowledge Questions contained therein facilitate enhanced understanding and application of concepts learnt. Revision Test Papers provides Questions & Answers to help students to update themselves to revise the concepts by solving questions contained therein. Suggested Answers containing the ideal manner of answering questions set at examination which also helps students to revise for the forthcoming examination. Mock Test Papers empower students to gauge their readiness ahead of each examination, ensuring confidence and clarity. Additionally, BoS offers engaging live virtual classes led by distinguished faculty, reaching students far and wide across the nation.

To effectively engage with its students, the Board of Studies (BoS) has been publishing subject-specific capsules in its monthly Students' Journal, "The Chartered Accountant Student," since 2017. These capsules are aimed at facilitating efficient revision of concepts covered across various topics at the Foundation, Intermediate, and Final levels of the Chartered Accountancy Course. This initiative underscores the BoS's commitment to enhancing learning and comprehension among its students through accessible and attractive educational materials. Each issue of the journal includes a capsule relating to specific topic(s) in one subject at each of the three levels. In these capsules, the concepts and provisions are presented in attractive colours in the form of tables, diagrams and flow charts for facilitating easy retention and quick revision of topics.

The Board of Studies (BoS) is now introducing a comprehensive booklet titled 'Saransh - Last Mile Referencer for Foundation Paper 1 - Accounting'. This booklet aims to consolidate significant concepts across various topics in accounting, particularly those included in the syllabi at the Foundation level of CA Course. It features diagrams, flow charts, tables, and illustrated journal entries, providing a one-stop repository for key accounting topics.

However, the readers are advised to refer the study material for comprehensive study and revision. Under no circumstances, this booklet substitutes the detailed study of the material provided by the Board of Studies. Further, the readers are advised to enhance their ability to address the issues and solve the problems based on fundamentals of Accounting, illustrations and questions given in the study material, revision test papers and mock test papers.

By capturing essential points in a concise format, 'Saransh' will facilitate better understanding and retention of critical accounting principles, enhancing the learning experience for students preparing for their examinations and beyond. It will indeed serve as a valuable ready reckoner for readers, enabling them to grasp the essence of the subject comprehensively.

Happy Reading!

PRESIDENT'S MESSAGE



It is with immense pride that I introduce the Saransh booklets, a meticulously curated resource available across the Foundation, Intermediate, and Final levels of the Chartered Accountancy course. ICAI has always been dedicated to providing our students with the best possible resources to succeed in their studies and careers, and Saransh is a demonstration of this commitment.

The Saransh – Last Mile Referencers have been thoughtfully designed by the Board of Studies (BoS) to serve as an invaluable companion for your studies and exam preparation. Our aim is to simplify complex concepts and provisions, making them easier to understand, memorize, and revise. However, Saransh is not a substitute for the detailed BoS study material but a supplementary tool to complement your in-depth study.

The newly revamped Saransh booklets have been updated not only in content but also in their presentation. With a more logical and organized structure, enhanced visual appeal, and a user-friendly layout, these booklets are now more effective in aiding your studies.

We have extended the Saransh series to cover all core areas of the Chartered Accountancy course. Whether you are studying Direct Tax Laws and International Taxation, Indirect Tax Laws, Accounting Standards, Indian Accounting Standards, Auditing, Cost and Management Accounting, Strategic Cost Management and Performance Evaluation, Company Law, or Financial Management and Strategic Management, you will find a Saransh booklet for each subject.

Saransh is designed not only to help you grasp and recall essential concepts but also to guide you in approaching each subject strategically. The insights provided in these booklets will help you develop a structured approach to your studies, ensuring that you are well-prepared for your examinations.

I urge you to make the most of the Saransh booklets. While these booklets will support you, it is your dedication, perseverance, and hard work that will ultimately determine your success.

I wish each of you the very best in your studies and future careers.

Warm regards,

A handwritten signature in black ink, appearing to read 'Ranjeet Agarwal', written in a cursive style.

CA. Ranjeet Kumar Agarwal
President, ICAI

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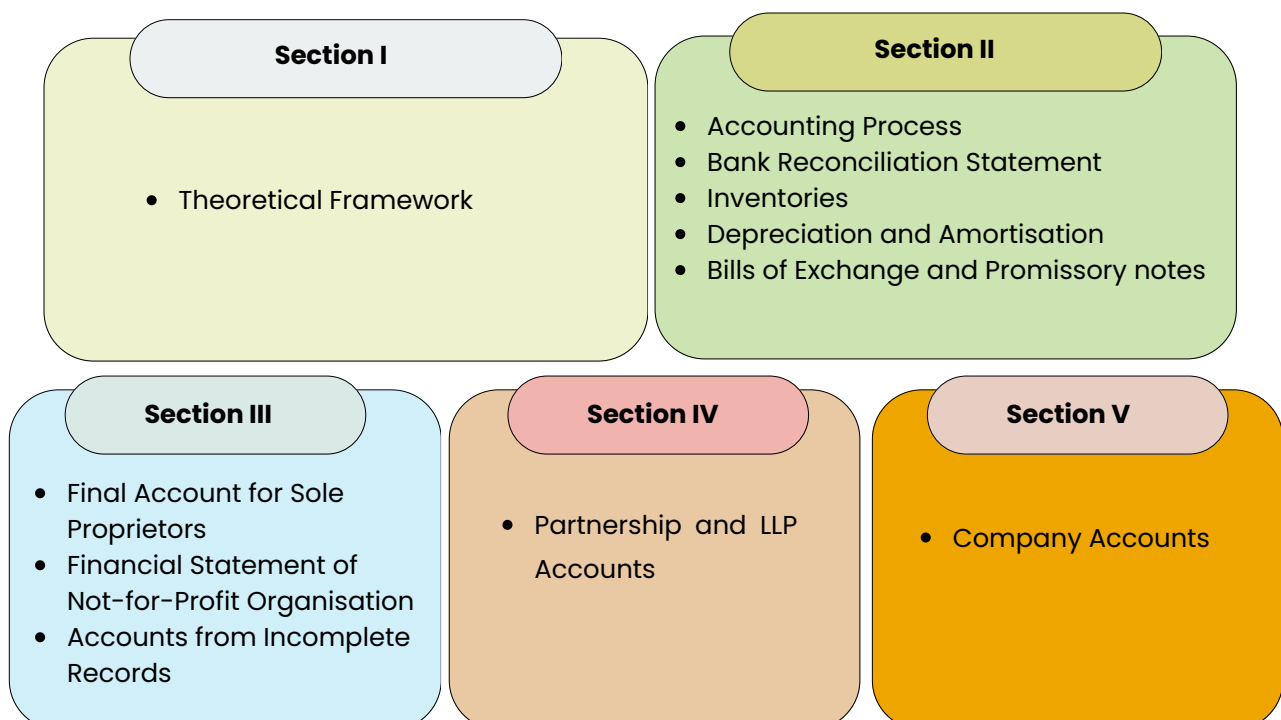
BEFORE WE BEGIN

Accounting is a vital area of core competence for Chartered Accountancy students. The significance of the subject can be judged from the fact that at every level of Chartered Accountant (CA) course we have a paper on Accounting and that too, the first paper at every level of CA Course. Accounting truly serves as the cornerstone of the Chartered Accountancy profession, providing a solid foundation for many other areas of expertise in the field.

The paper of Accounting at CA Foundation Course is designed to provide students with a strong conceptual understanding of essential accounting principles and practices and acquaint students with the basic concepts, theories and accounting techniques followed by different entities.

Know your Syllabus

The paper of Accounting at Foundation Level is divided into 11 chapters which are again divided into 5 sections. Each chapter is unique and important and should be understood thoroughly for grasping the entirety of a subject.



At the time of preparation, you should follow the sequence of chapters given in study material. The chapters of the accounting paper are structured in a logical sequence to facilitate the understanding of bookkeeping, preparation of accounts, and presentation of financial statements. This sequential arrangement helps to lay the groundwork to grasp fundamental accounting concepts appropriately. Chapter 1 and 2 serves as a foundation for later chapters or topics of accounting hence skipping or glossing over these chapters can lead to gaps in understanding and comprehending the subject. Understanding each chapter thoroughly ensures a strong foundation to build upon as you progress through your CA curriculum.

You should practice all the practical questions thoroughly before the examination. Practice is key to success in any examination, especially in subjects like accounting where application and problem-solving skills are essential. Thorough practice of practical questions not only helps in mastering the concepts but also improves speed and accuracy during exams. Regular practice builds confidence and enables you to perform your best when faced with challenging problems. It's essential to dedicate sufficient time to practice practical questions to excel in examinations.

How to write Answers during exams?

- While solving the paper in exam hall, you should first write the answer which you know the best. Starting with questions you are most comfortable with can boost your confidence and set a positive tone for the rest of the exam. Plus, it allows you to secure marks early on, giving you more time to tackle the more challenging questions later.
- It is advisable to attempt all the sub-parts of a question at one place. By answering all the sub-parts of a question together, can improve the overall presentation of your answers.
- The answers written on the answer sheet should be neat and working note should form part of your answers. Maintaining neatness and including working notes in your answers is crucial for effective communication of your understanding of concepts.
- Wherever necessary, suitable assumptions may be made and disclosed by way of a note.

How to manage time in examination?

The examination period of three hours is the most crucial time since it is the time when you apply the knowledge and skills you've acquired throughout your study period. How well you manage those three hours, how effectively you tackle the questions, and how accurately you present your answers all reflect your level of preparation.

You should follow the following tips:

Make optimum use of 15 minutes given for reading.

Go through all the questions quickly.

Select the questions that you would be attempting from all the questions.

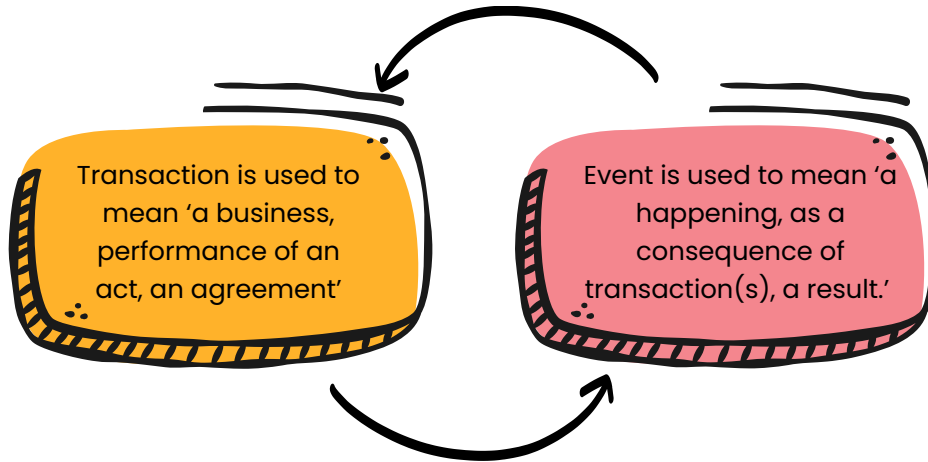
Mark the question which you will be attempting first.

Allocate an estimated time for each question based on their difficulty level and marks carried keeping aside 10-15 minutes for revisions. Adhere to time allocated.

Your commitment to quality effort and effective time management will enhance your understanding of the concepts and boost your performance in the CA examination. By thoroughly preparing each subject, you can optimize your time, deepen your grasp of accounting principles, and ultimately achieve success in your CA journey.

CHAPTER 1: THEORETICAL FRAMEWORK

Every individual performs some kind of economic activity. Such economic activities are performed through 'transactions and events'.



The Committee on terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

"Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."

In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

"The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions."

Thus, accounting may be defined as the process of recording, classifying, summarising, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

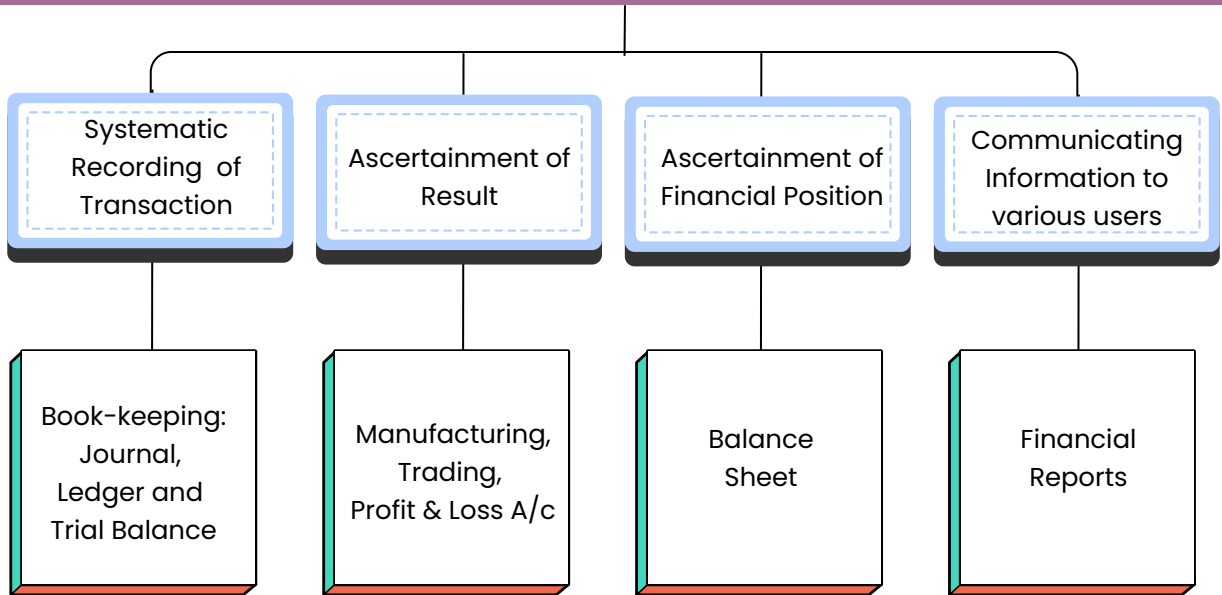
HISTORY & DEVELOPMENT OF ACCOUNTING

Luca Pacioli's, a Franciscan friar (merchant class), book Summa de Arithmetica, Geometria, Proportion at Proportionality (Review of Arithmetic and Geometric proportions) in Venice (1494) is considered as the first book on double entry bookkeeping.

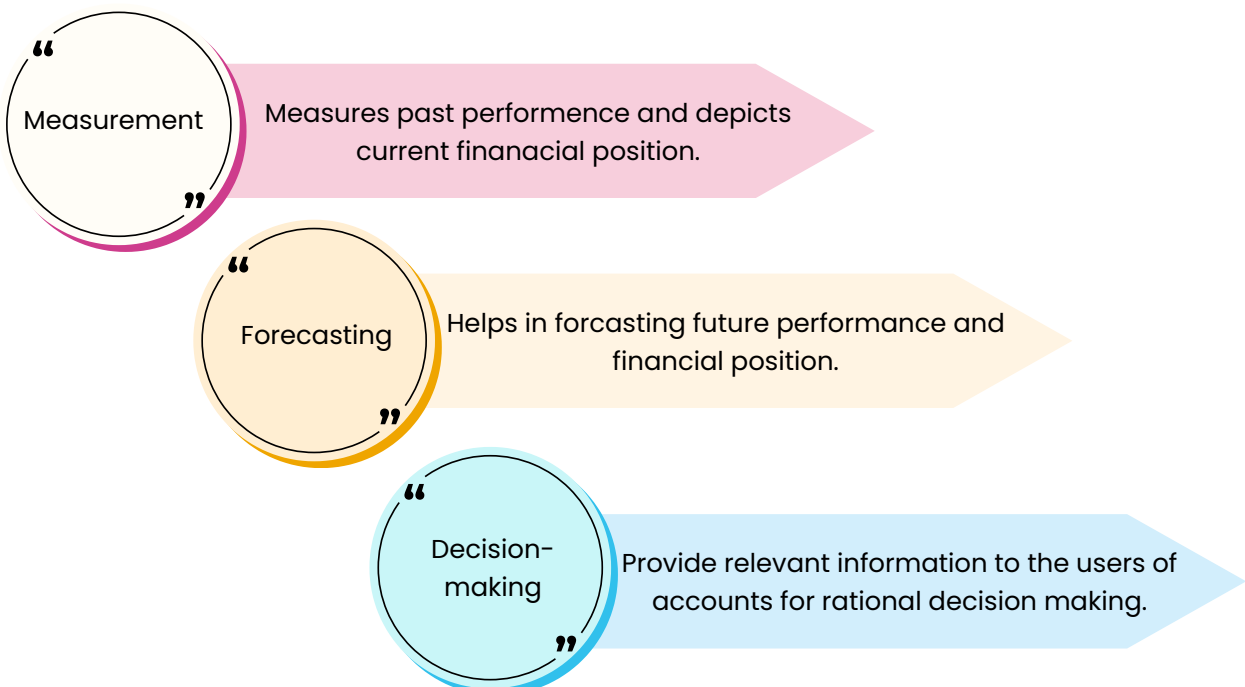
This book contains knowledge of business and book-keeping. He used the terms Debit (Dr.) and Credit (Cr.) in his books. These were the concepts used in latin terminology

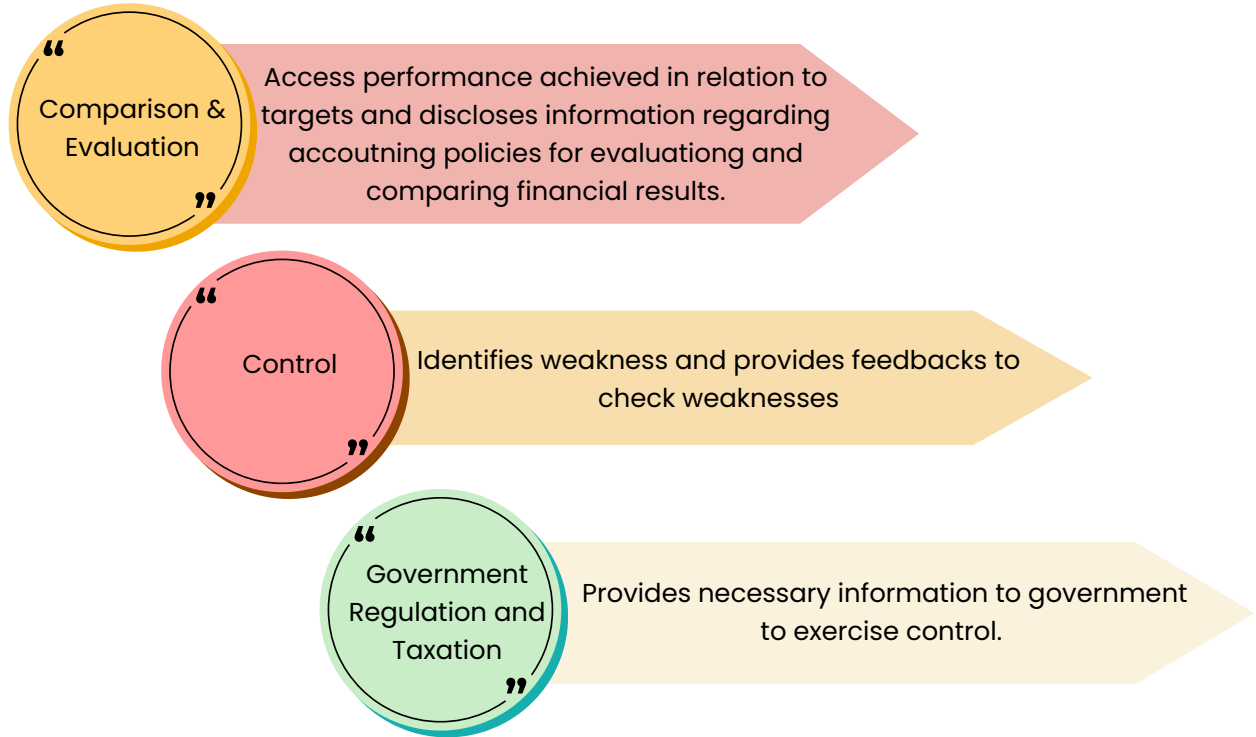
Debit comes from the Italian debito which comes from the Latin debita and debeo which means owed to the proprietor. Credit comes from the Italian credito which comes from the Latin 'credo' which means trust or belief (in the proprietor or owed by the proprietor).

OBJECTIVES OF ACCOUNTING



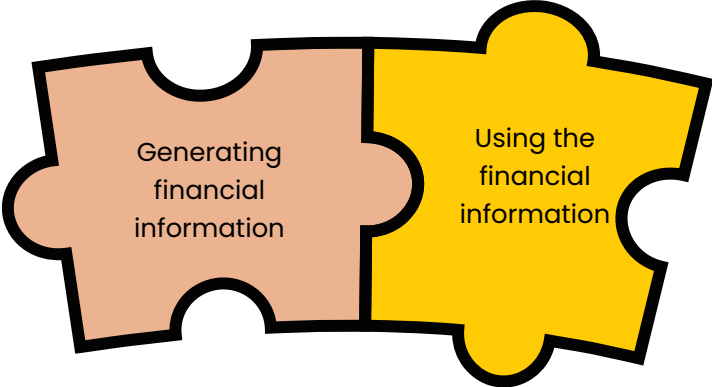
FUNCTIONS OF ACCOUNTING



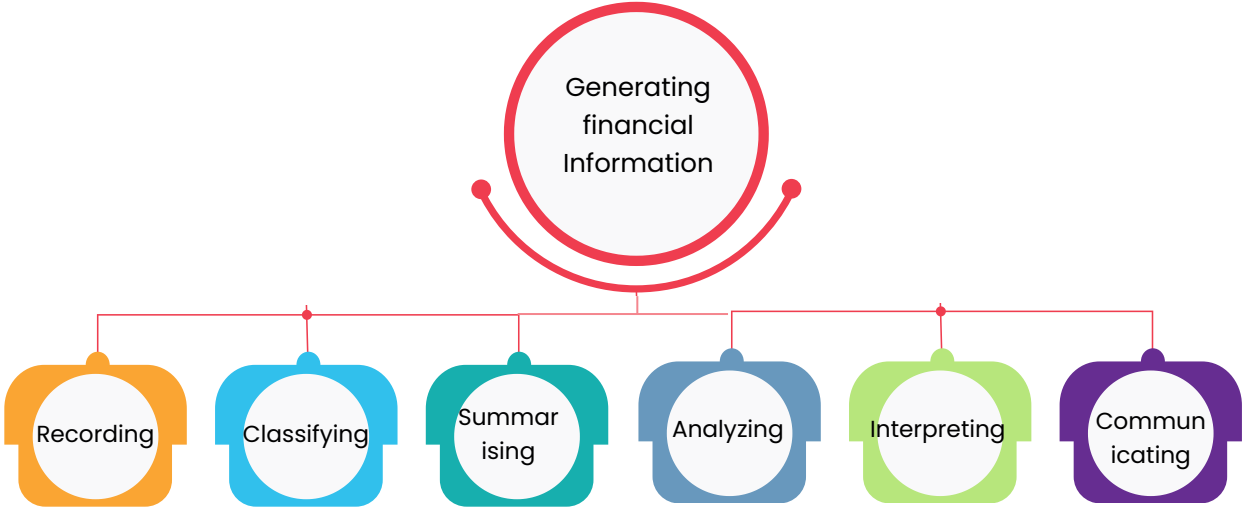


PROCEDURAL ASPECTS OF ACCOUNTING

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:



Generating Financial Information can be explained with the help of the following chart:



PROCEDURE OF ACCOUNTING

Recording

This is the basic function of accounting where recording is done in a book called "Journal."

It is further be divided into different types of subsidiary books as per the nature and size of the business.

Classifying

This step is a systematic classification of the recorded data and then the classified information is recorded into Ledgers.

it enables to find total expenditure incurred under each head.

Summarising

It is concerned with the preparation and presentation of the classified data useful to the internal as well as the external users of financial statements

This process leads to the preparation of financial statements i.e. Trial Balance, Profit and Loss Account, Balance Sheet, Cash-flow Statement.

Analysing

The term 'Analysis' means methodical classification of the data given in the financial statements.

The figures given in the financial statements will not help anyone unless they are in a simplified form.

Interpreting

The recorded financial data is analysed and interpreted in a manner that will enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations.

Communicating

It is concerned with the transmission of summarised, analysed & interpreted information to the end-users to enable them to make rational decisions.

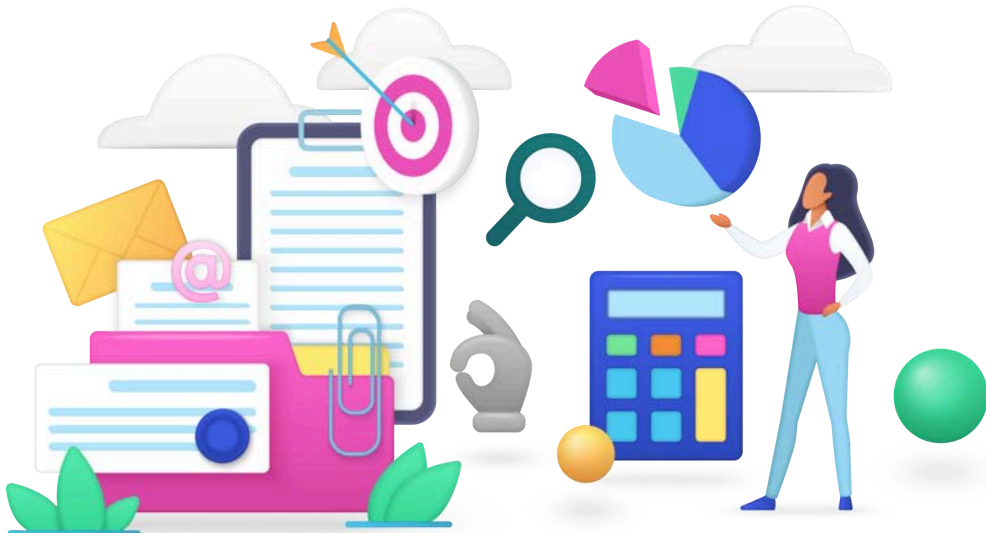
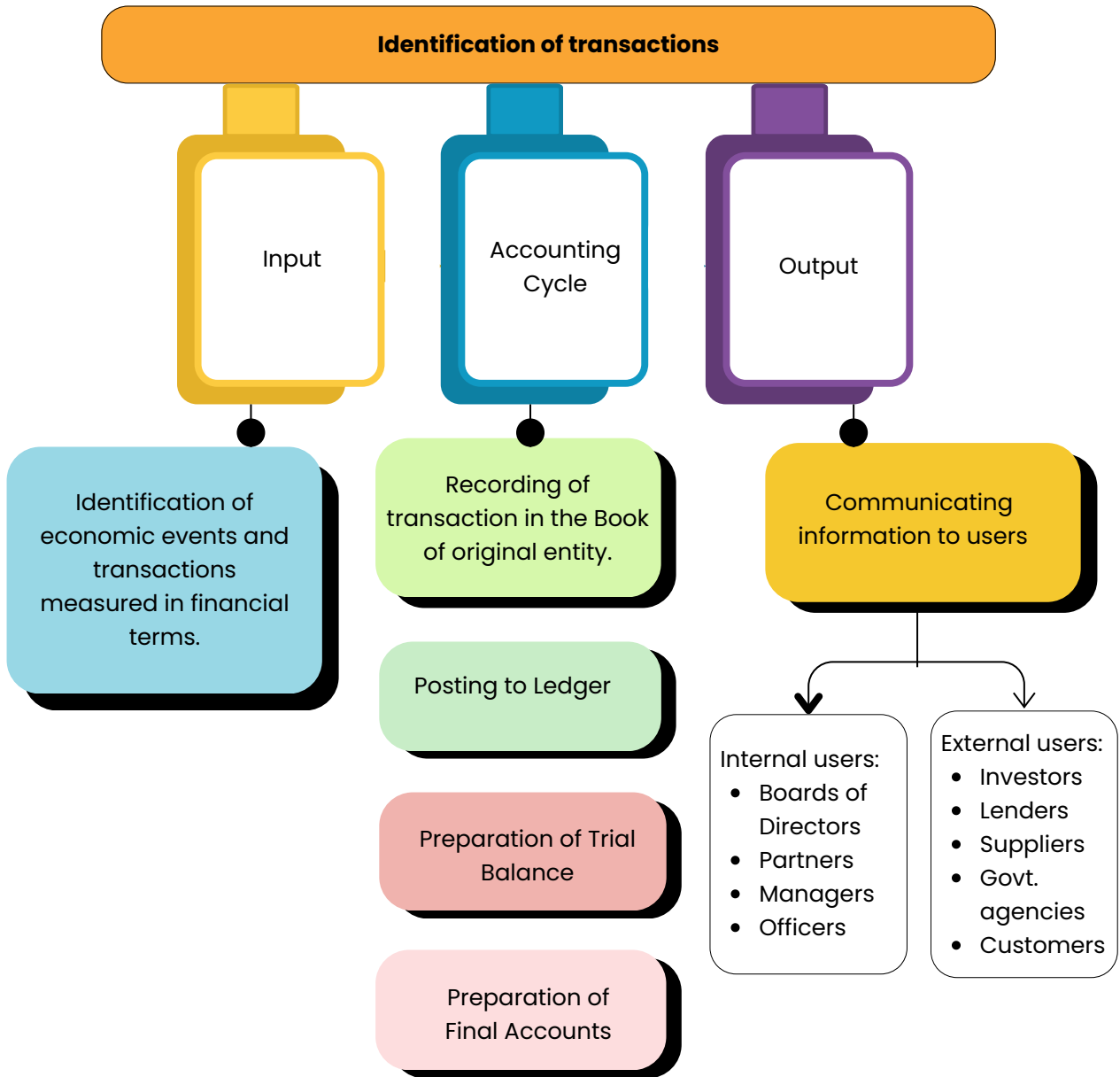
This is done through preparation and distribution of accounting reports.

USING THE FINANCIAL INFORMATION

There are certain users of accounts. Earlier it was viewed that accounting is meant for the proprietor or owner of the business, but changing social relationships diluted the earlier thinking. It is now believed that besides the owner or the management of the business enterprise, users of accounts include the investors, employees, lenders, suppliers, customers, government and other agencies and the public at large. For example, if an airlines company borrows money from a bank, buys oil from oil companies, sells tickets to the customers, has staff to be paid salaries to, all these group of people and entities are key stakeholders in that airlines business. They would like to know and understand whether the business of the company is going well or there are challenges for the company to run the business. Accounting provides the art of presenting information systematically to the users of accounts.



ACCOUNTING PROCESS



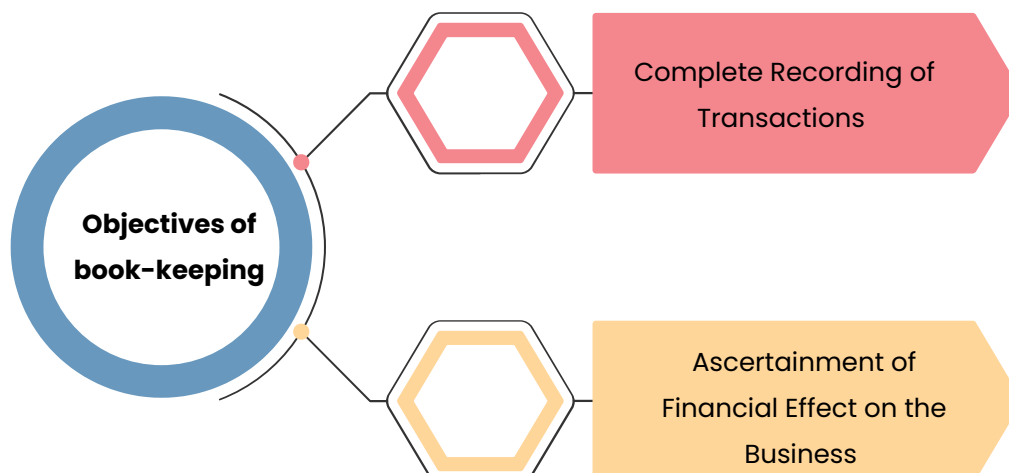
LIMITATIONS OF ACCOUNTING

- The Balance sheet cannot reflect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
- The Balance sheet cannot reflect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
- Accounting ignores changes in some money factors like inflation etc.
- There are occasions when accounting principles conflict with each other
- Certain accounting estimates depend on the sheer personal judgement of the accountant
- Financial statements consider those assets which can be expressed in monetary terms.
- Different accounting policies for the treatment of same item adds to the probability of manipulations.

In nutshell, it can be said that the language of accounting has certain practical limitations. Therefore, the financial statements should be interpreted carefully keeping in mind all various factors influencing the true picture.

BOOK KEEPING

Book-keeping refers to the recording of financial data relating to business operations in an and orderly manner.



DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Book-keeping	Accounting
Concerned with recording of transactions.	Concerned with summarising of the recorded transactions.
Base of accounting	Language of the business
Financial statements do not form part of this process.	Financial statements are prepared on the basis of book-keeping records.
Managerial decisions cannot be taken.	Management takes decisions on the basis of these records.
There is no sub-field of book-keeping	It has several sub-fields like financial accounting, management accounting etc.
Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

RELATIONSHIP OF ACCOUNTING AND BOOK-KEEPING CAN BE DEPICTED IN THE FOLLOWING CHART AS



SUBFIELDS OF ACCOUNTING

Financial Accounting

Covers the preparation and interpretation of financial statements and communication to the users of accounts

Management Accounting

Concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision-making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharge their functions are referred to as Management Accounting.

Cost Accounting

The process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.

Social Responsibility Accounting

Concerned with accounting for social costs incurred by the enterprise and social benefits created

Human Resource Accounting

An attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS



Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.



Accounting principles are a body of doctrines commonly associated with theory and procedures of accounting as a guide for selection of conventions or procedures where alternatives exist.



Accounting conventions emerge out of accounting practices, adopted by various organizations over a period of time.

ACCOUNTING CONCEPTS

Entity concept

Business enterprise is a separate identity apart from its owner. All the business transactions are recorded in the business books of accounts in keeping business affairs free from influence of personal affairs of owner.

Money measurement concept




Only those transactions, which can be measured in terms of money are recorded. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

Periodicity concept

This is also called the concept of definite accounting period. As per going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

According to this concept, accounts should be prepared after every period & not at the end of the life of the entity. Usually, this period is one year.

Hence, the periodicity concept facilitates in:

-  • Comparing of financial statements of different periods
-  • Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
-  • Matching periodic revenues with expenses for getting correct results of the business operations

Cost Concepts

The value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity.

Realisation concept

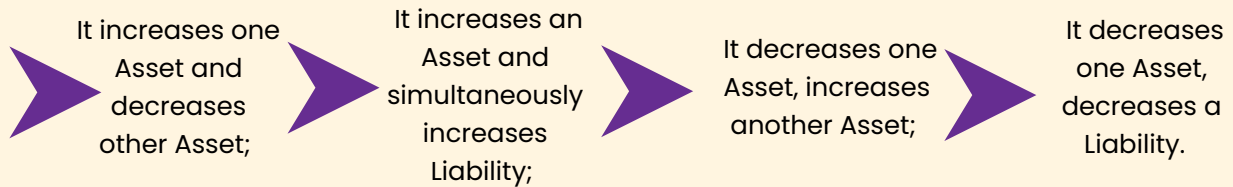
It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. If accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised.

Matching concept

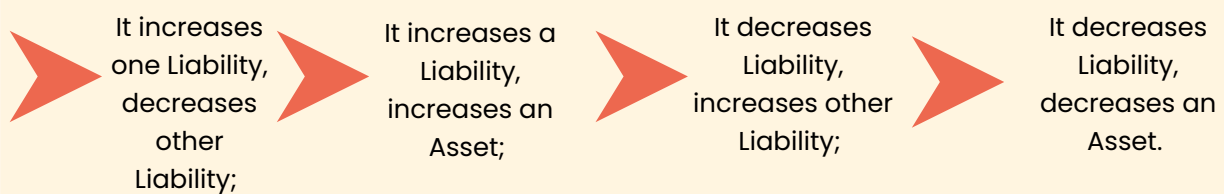
All expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized of the entity. This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash

Dual Aspect concept

This concept is the core of double entry book-keeping. Every transaction or event has two aspects:



Alternatively



Conservatism

Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. For this concept there should be at least three qualitative characteristics of financial statements, namely,

Faithful representation of alternative values.

Prudence, i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.

Neutrality, i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,

Materiality

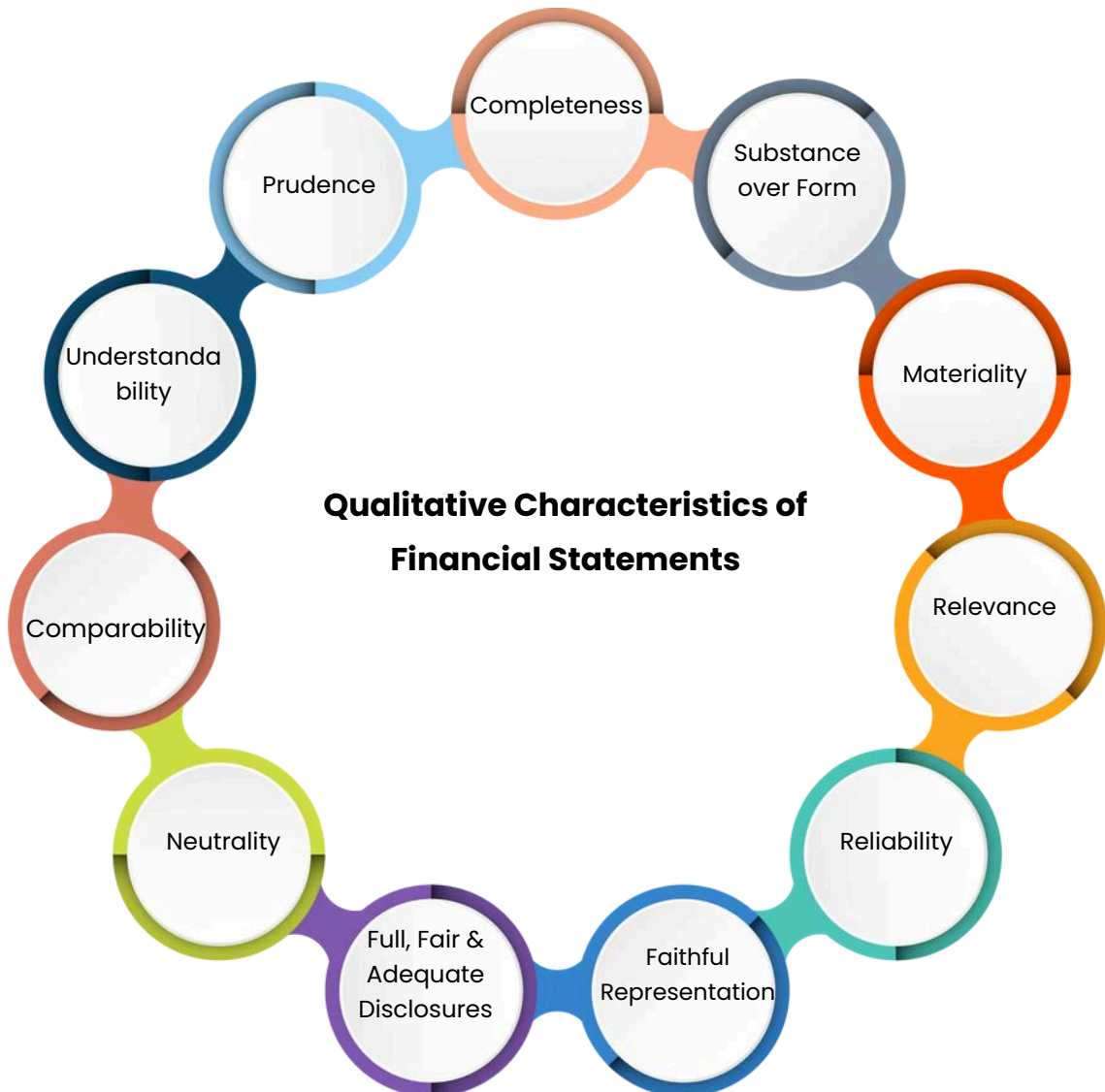
According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements.

Any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

<p style="text-align: center;">Going Concern</p> <p>The financial statements are prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.</p>	<p style="text-align: center;">Consistency</p> <p>Accounting policies are followed consistently from one period to another and change in an accounting policy is made only in certain exceptional circumstances.</p>	<p style="text-align: center;">Accrual</p> <p>The effects of transactions and other events are recognised on mercantile basis i.e. when they occur, they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.</p>
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QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS



CAPITAL AND REVENUE EXPENDITURE AND RECEIPTS

Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period.

Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period.

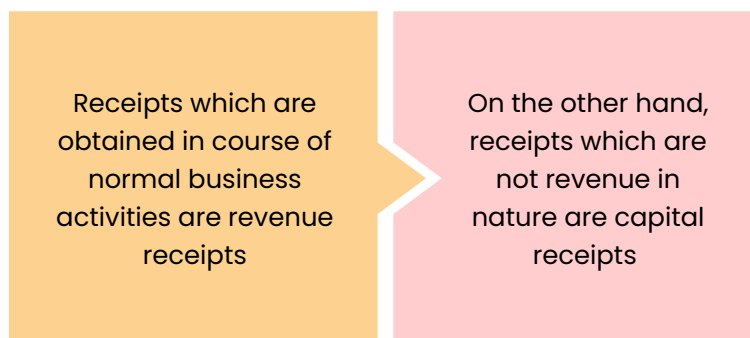
Considerations in determining capital and revenue expenditures

<p>Nature of business</p>	<ul style="list-style-type: none"> The nature of business is a very important criteria in separating an expenditure between capital and revenue. eg: For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset
<p>Recurring nature of expenditure</p>	<ul style="list-style-type: none"> If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year.
<p>Purpose of expenses</p>	<ul style="list-style-type: none"> Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.
<p>Effect on revenue generating capacity of business</p>	<ul style="list-style-type: none"> The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. If expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.
<p>Materiality of the amount involved</p>	<ul style="list-style-type: none"> Relative proportion of the amount involved is another important consideration in distinction between revenue and capital

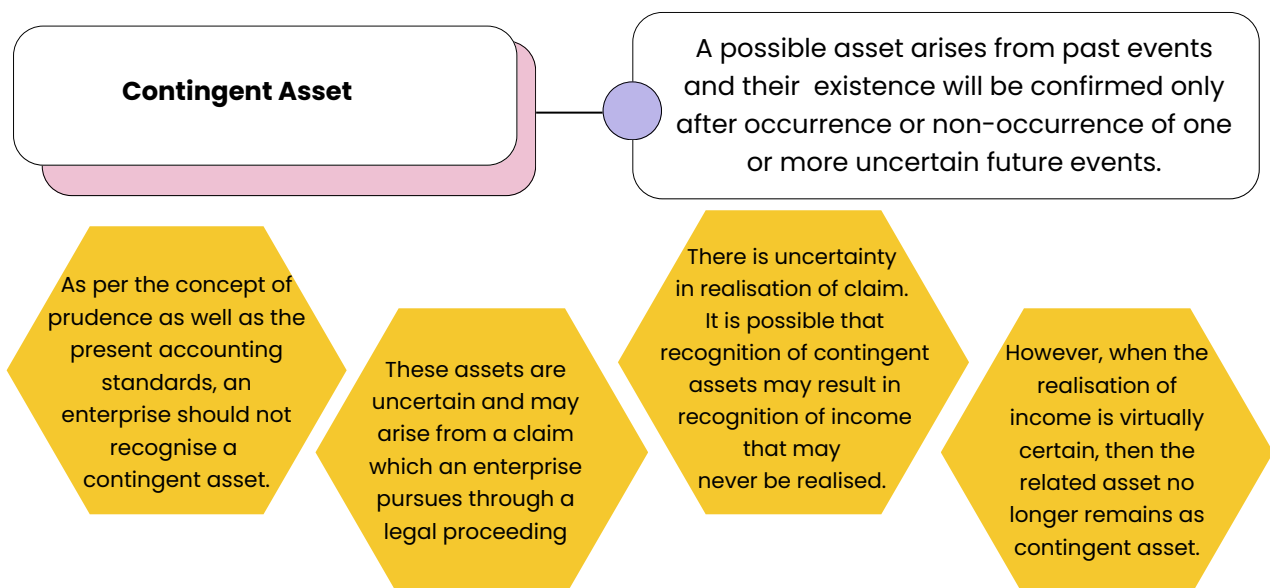
DIFFERENCES BETWEEN CAPITAL AND REVENUE EXPENDITURES

Key Differences	Capital Expenditure	Revenue Expenditure
Period of benefit	Any expenditure incurred to provide a benefit over a long-term period is capital expenditure.	Any expenditure incurred to provide a benefit during the current period is revenue expenditure.
Enhancement vs Maintenance	Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, it also includes an expenditure to reduce the costs of the business.	Revenue expenditure is incurred to maintain the earning capacity of the business.
Examples	Purchase of machine, car, furniture, etc.	Repairs and maintenance, salary of accounting staff, etc.

CAPITAL AND REVENUE RECEIPTS



CONTINGENT ASSETS AND CONTINGENT LIABILITIES



Contingent Liability

a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

a present obligation that arises from past events but is not recognised because:

- (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- (ii) a reliable estimate of the amount of the obligation cannot be made."

Example

Mr. X sells a machine to Mr. Y. Any damages incurred by Mr. Y while using the machine need to be compensated by Mr. X.

A few days later from the date of sale of machine, Mr. X received a notice from Mr. Y who is claiming damages of ₹20 lac. The notice mentioned that a worker met with an accident during the use of the machine and is required to be compensated.

Although, the receipt of the notice results into an event which requires recognition of a contingent liability since there is a possible obligation, and that can only be confirmed in future.

The receipt of this notice does not suggest that Mr. X is liable to pay the amount, although this needs to be investigated and confirmed, as whether the damage arose due to any defect in the machine or it is due to negligence while operating the machine.

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits.

On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

DISTINCTION BETWEEN PROVISIONS AND CONTINGENT LIABILITIES

	Provision	Contingent liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

ACCOUNTING POLICIES

ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.

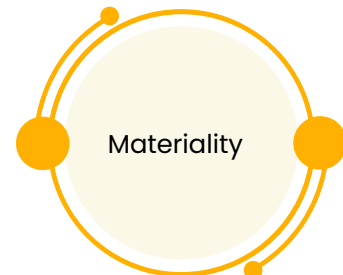
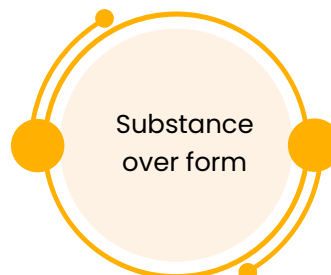
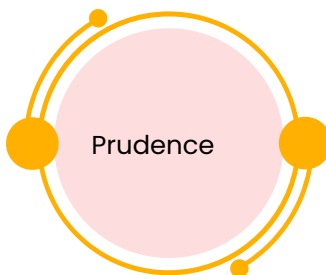
The areas wherein different accounting policies are frequently encountered can be given as follows:

- (1) Valuation of Inventories;
- (2) Valuation of Investments.

SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

Selection of Accounting Policies is based on



Examples wherein selection from a set of accounting policies is made

Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.

Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

It is required by some statute or for compliance with an Accounting Standard.

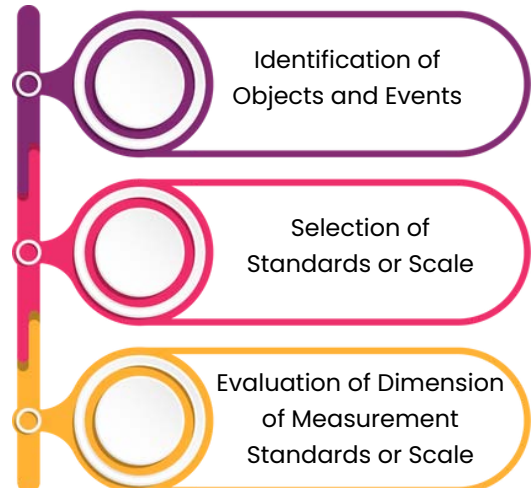
Change would result in more appropriate presentation of financial statement.

ACCOUNTING AS A MEASUREMENT DISCIPLINE – VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

Measurement

Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale.

Elements of Measurement



VALUATION PRINCIPLES

There are four generally accepted measurement bases or valuation principles. These are:

Historical Cost

It means acquisition price.

For example, the businessman paid ₹7,00,000 to purchase the machine and spend ₹1,00,000 on its installation, its acquisition price including installation charges is ₹8,00,000. The historical cost of machine would be ₹8,00,000.

Current Cost

Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realizable Value

As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Haphazard disposal may yield something less.

Present Value

As per present value, an asset is carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

ACCOUNTING ESTIMATES

There are certain items, which are not occurred therefore cannot be measured using valuation principles but still they are necessary to record in the books of account. For example, provision for doubtful debts.

In such a situation reasonable estimates based on the existing situation and past experiences are made.

As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated.

The process of estimation involves judgements based on the latest information available.

An estimate may require revision. Change in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated.

ACCOUNTING STANDARDS

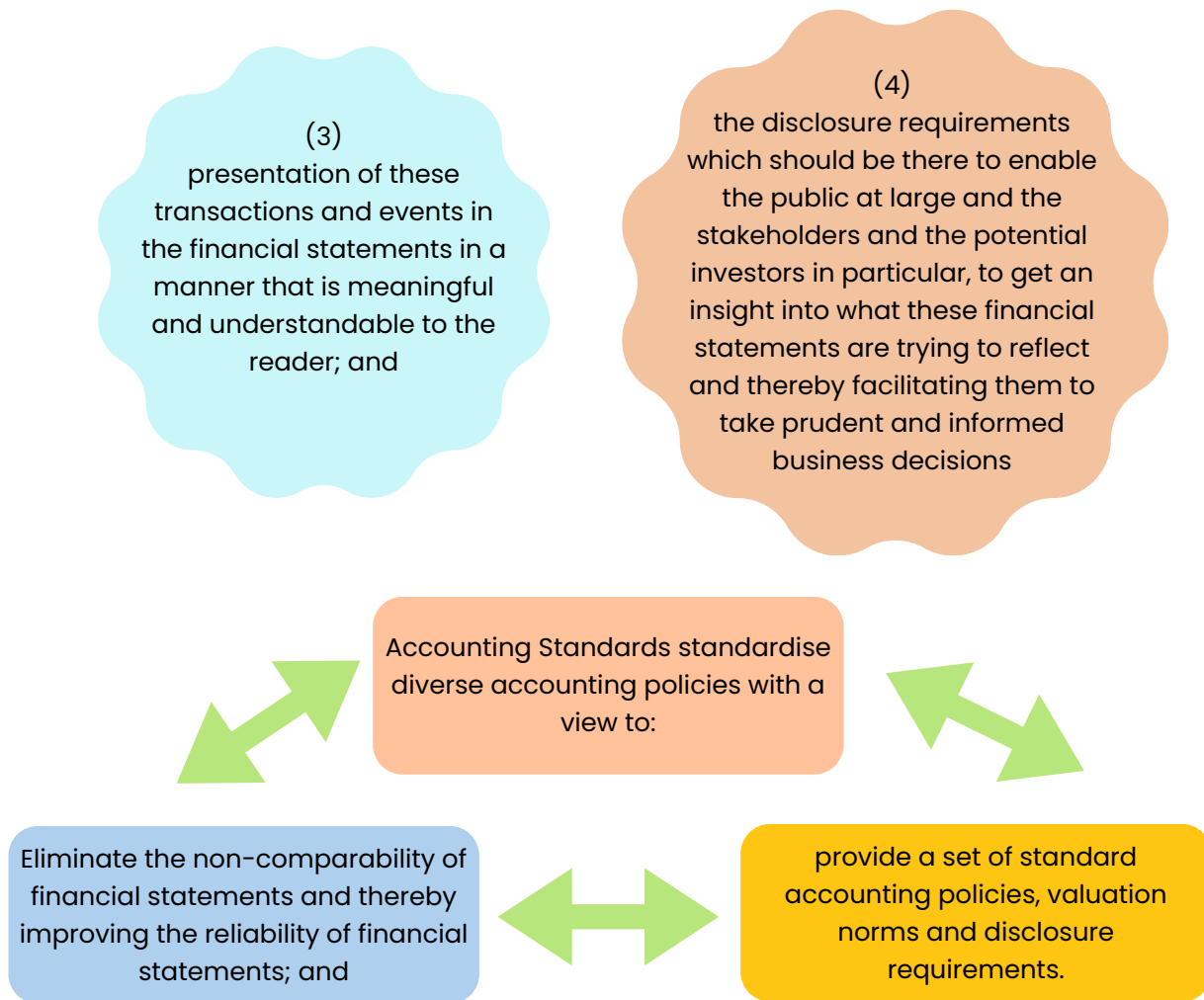
Accounting standards are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, treatment, measurement, presentation and disclosure of accounting transactions and events in the financial statements.

The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance.

The accounting standards deal with the issues of :

(1)
recognition of events and transactions in the financial statements;

(2)
measurement of these transactions and events;



BENEFITS OF ACCOUNTING STANDARDS

Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

LIMITATIONS OF ACCOUNTING STANDARDS

Difficulties in making choice between different treatments: Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

Restricted scope: Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

PROCESS OF FORMULATION OF ACCOUNTING STANDARDS (AS)

Identification of area for formulation of AS



Constitution of study group to prepare preliminary draft



Preparation of draft and its circulation to council members of ICAI and specified outside bodies



Ascertainment of views of different bodies on draft



Finalisation of exposure draft (E.D)



Comments received on exposure draft (E.D)



Modification of the draft



Issue of Accounting Standard (AS)

There are three sets of Accounting Standards to cater different categories of entities based on their nature, size, and legal framework under which they operate, ensuring that each entity follows appropriate accounting principles for financial reporting. These are:

- Indian Accounting Standards (Ind AS) are applicable to all listed companies and Non-Banking Financial Companies (NBFCs) and to unlisted companies and unlisted NBFCs with net worth of INR 250 crores or more.
- Accounting Standards (AS) notified under Companies (Accounting Standards) Rules, 2021, are applicable to the companies other than those following Ind AS, as given in point (i). These companies are required to apply Accounting Standards (AS) notified under the Companies Act as Companies (Accounting Standards) Rules, 2021.
- Accounting Standards (AS) prescribed by ICAI are applicable for entities other than companies.

LIST* OF ACCOUNTING STANDARDS IN INDIA

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
1.	AS 1	Disclosure of Accounting Policies
2.	AS 2 (Revised)	Valuation of Inventories
3.	AS 3 (Revised)	Cash Flow Statements
4.	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	AS 7 (Revised)	Accounting for Construction Contracts
7.	AS 9	Revenue Recognition
8.	AS 10	Property, Plant and Equipment
9.	AS 11 (Revised)	The Effects of Changes in Foreign Exchange Rates
10.	AS 12	Accounting for Government Grants
11.	AS 13	Accounting for Investments
12.	AS 14	Accounting for Amalgamations

Sl. No.	Number of the Accounting Standard (AS)	Title of the Accounting Standard
13.	AS 15 (Revised)	Employee Benefits
14.	AS 16	Borrowing Costs
15.	AS 17	Segment Reporting
16.	AS 18	Related Party Disclosures
17.	AS 19	Leases
18.	AS 20	Earnings Per Share
19.	AS 21	Consolidated Financial Statements
20.	AS 22	Accounting for Taxes on Income
21.	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
22.	AS 24	Discontinuing Operations
23.	AS 25	Interim Financial Reporting
24.	AS 26	Intangible Assets
25.	AS 27	Financial Reporting of Interests in Joint Ventures
26.	AS 28	Impairment of Assets
27.	AS 29	Provisions, Contingent Liabilities & Contingent Assets

*Note: The list of accounting standards given above does not form part of syllabus. It has been given here for the knowledge of students only.

** INDIAN ACCOUNTING STANDARDS (IND AS)



The Institute of Chartered Accountants of India (ICAI) being the accounting standards-setting body in India, way back in 2006, initiated the process of moving towards the International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) with a view to enhance acceptability and transparency of the financial information communicated by the Indian corporates through their financial statements. This move towards IFRS was subsequently accepted by the Government of India.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS- converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IFRS and departures have been made where considered absolutely essential. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

LIST OF IND AS ON 1ST AUGUST, 2024

Ind AS	Title of Ind AS
101	First -Time Adoption of Indian Accounting Standards
102	Share- Based Payment
103	Business Combinations
104	Insurance Contracts
105	Non-current Assets Held for Sale and Discontinued Operations
106	Exploration for and Evaluation of Mineral Resources
107	Financial Instruments: Disclosures
108	Operating Segments
109	Financial Instruments
110	Consolidated Financial Statements
111	Joint Arrangements
112	Disclosure of Interests in Other Entities
113	Fair Value Measurement
114	Regulatory Deferral Accounts
115	Revenue from Contracts with Customers

Ind AS	Title of Ind AS
116	Leases
1	Presentation of Financial Statements
2	Inventories
7	Statement of Cash Flows
8	Accounting Policies, Changes in Accounting Estimates and Errors
10	Events after the Reporting Period
12	Income Taxes
16	Property, Plant and Equipment
19	Employee Benefits
20	Accounting for Government Grants and Disclosure of Government Assistance
21	The Effects of Changes in Foreign Exchange Rates
23	Borrowing Costs
24	Related Party Disclosures
27	Separate Financial Statements
28	Investment in Associates and Joint Ventures
29	Financial Reporting in Hyperinflationary Economies
32	Financial Instruments: Presentation
33	Earnings per Share
34	Interim Financial Reporting
36	Impairment of Assets
37	Provisions, Contingent Liabilities and Contingent Assets
38	Intangible Assets
40	Investment Property
41	Agriculture

**** ACCOUNTING STANDARDS FOR LOCAL BODIES**

Accounting Standards for local bodies are Accounting Standards that are applicable to the local bodies whose primary objective is to deliver services to the public, rather than to make profits and generate a return on equity to investors. Consequently, the performance of such entities can be only partially evaluated by examination of financial position, financial performance and cash flows.

LIST OF ACCOUNTING STANDARDS FOR LOCAL BODIES (ASLB)

ASLB	Title of ASLB
1	Presentation of Financial Statements
2	Cash Flow Statements
3	Accounting Policies, changes in Accounting Estimates and Errors
4	The Effects of Changes in Foreign Exchange Rates
5	Borrowing Costs
9	Revenue from Exchange Transactions
11	Construction Contracts
12	Inventories
13	Leases
14	Events After the Reporting Date
16	Investment Property
17	Property, Plant and Equipment
18	Segment Reporting
19	Provision, Contingent Liabilities and Contingent Assets
20	Related Party Disclosures
21	Impairment of Non-Cash-Generating Assets
23	Revenue from Non-Exchange Transaction (Taxes and Transfers)
24	Presentation of Budget Information in Financial Statements
26	Impairment of Cash-Generating Assets

ASLB	Title of ASLB
31	Intangible Assets
32	'Service Concession Arrangements: Grantor
33	First-Time Adoption of Accrual Basis Accounting Standards for Local Bodies (ASLBs)
34	Separate Financial Statements
35	Consolidated Financial Statements
36	Investment in Associates and Joint Ventures
37	Joint Arrangements
38	Disclosure of Interests in Other Entities
39	Employee Benefits
40	Entity Combinations
42	Social Benefits
	Financial Reporting under Cash Basis of Accounting

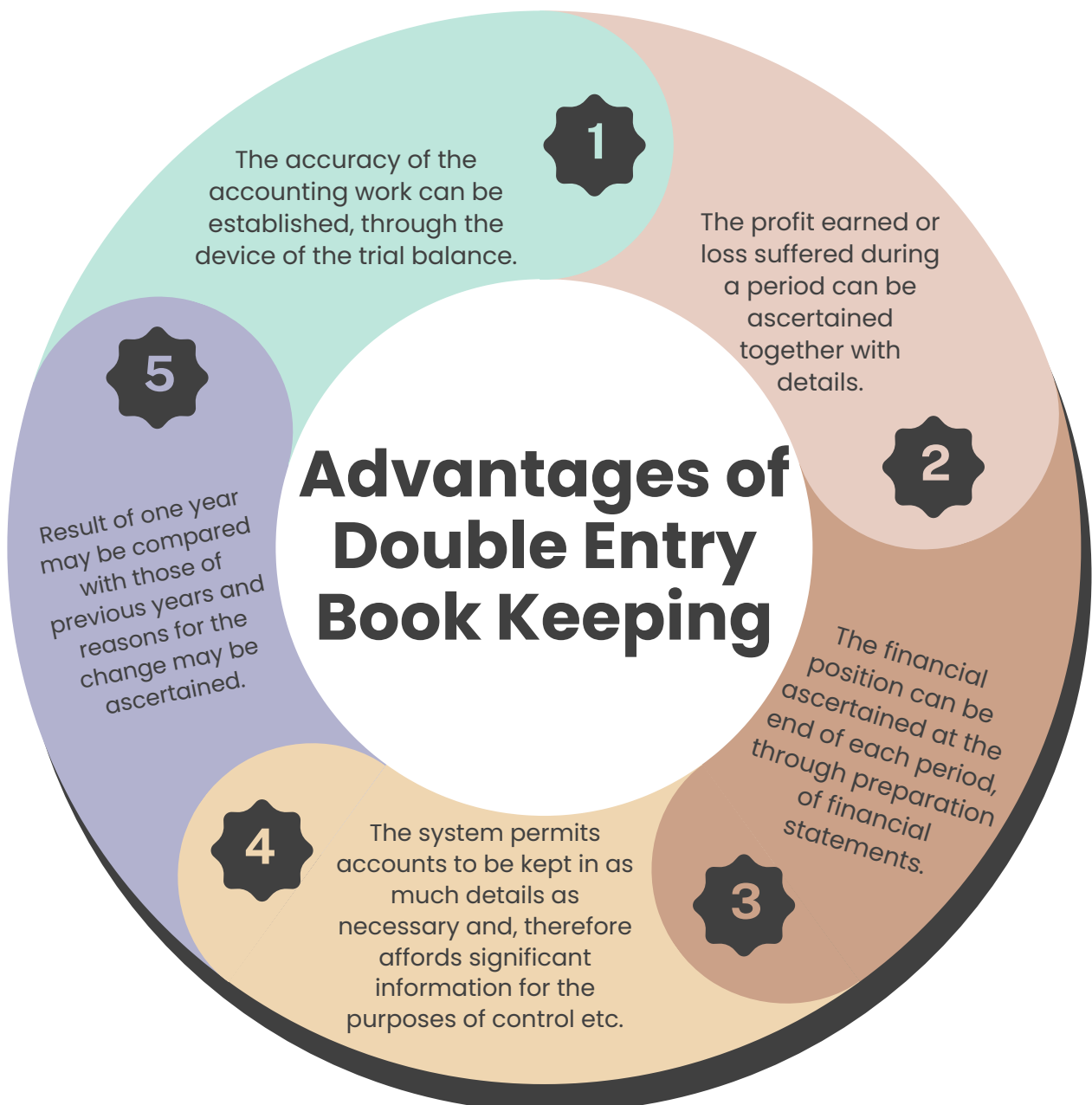
**Note: Ind AS and ASLB given above do not form part of the syllabus. They have been discussed here for the knowledge of students only

CHAPTER 2 : ACCOUNTING PROCESS

DOUBLE ENTRY BOOK KEEPING

Double entry system of book-keeping is a process of evolution of various accounting techniques and is the only scientific system of accounting. As per double entry system, every transaction has two-fold aspects—debit and credit and both the aspects are to be recorded in the books of accounts. Therefore, in every transaction at least two accounts are effected.

ADVANTAGES OF DOUBLE ENTRY BOOK KEEPING



ACCOUNT

In T-accounts, increase entries are made on the left side and decrease entries are made on the right side of the accounts for assets respectively and vice-versa for liabilities. These two columns are put usually in the form of an account, called the 'T' form.

FORMAT OF ACCOUNT

Date	Particulars	Ref.	Amount	Date	Particulars	Ref.	Amount

DEBIT AND CREDIT

Assets = Liabilities + Capital

or

Assets – Liabilities = Capital

To understand the equation better, let us expand it:-

Assets = Liabilities + Stockholders' Equity



Assets = Liabilities + (contributed capital + beginning retained earnings + revenue - expense - dividends)

Contributed capital	=	the original capital introduced by the owner.
Beginning Retained Earnings	=	previous earnings not distributed to the shareholders.
Revenue	=	generated from the ongoing activities of the business.
Expenses	=	cost incurred for the operations of the company.
Dividends	=	earnings distributed to the shareholders of the company.

RULES FOR DEBIT AND CREDIT

In T-accounts, increase entries are made on the left side and decrease entries are made on the right side of the accounts for assets respectively and vice-versa for liabilities. These two columns are put usually in the form of an account, called the 'T' form.

Sr. No.	Elements of Financial Statements	Effects
1]	Asset	
	Increases	Assets (Dr.)
	Decreases	Assets (Cr.)
2]	Liability	
	Increases	Liability (Cr.)
	Decreases	Liability (Dr.)
3]	Owner's Capital	
	Increases	Capital (Cr.)
	Decreases	Capital (Dr.)
4]	Expenses	
	Increases	Expenses (Dr.)
	Decreases	Expenses (Cr.)
5]	Revenue/Income	
	Increases	Income (Cr.)
	Decreases	Income (Dr.)
6]	Profit	Capital (Cr.)
7]	Loss	Capital (Dr.)

The terms debit and credit should not be taken to mean, respectively, favourable and unfavourable things. They merely describe the two sides of accounts.

A transaction is a type of event, which is generally external in nature. Transaction are analysed in terms of money and supported by proper documents are recorded in the books of accounts under double entry system. To analyse the dual aspect of each transaction, two approaches can be followed:

**Accounting
Equation
Approach**

**Traditional
Approach**

ACCOUNTING EQUATION APPROACH

The relationship of assets with that of liabilities and owners' equity in the equation form is known as 'Accounting Equation'. Basic accounting equation comes into picture when sum total of capital and liabilities equalises assets, where assets are what the business owns and capital and liabilities are what the business owes.

Under double entry system, every business transaction has two-fold effect on the business enterprise where each transaction affects changes in assets, liabilities or capital in such a way that an accounting equation is completed and equated

$$\text{Equity} + \text{Liabilities} = \text{Assets}$$

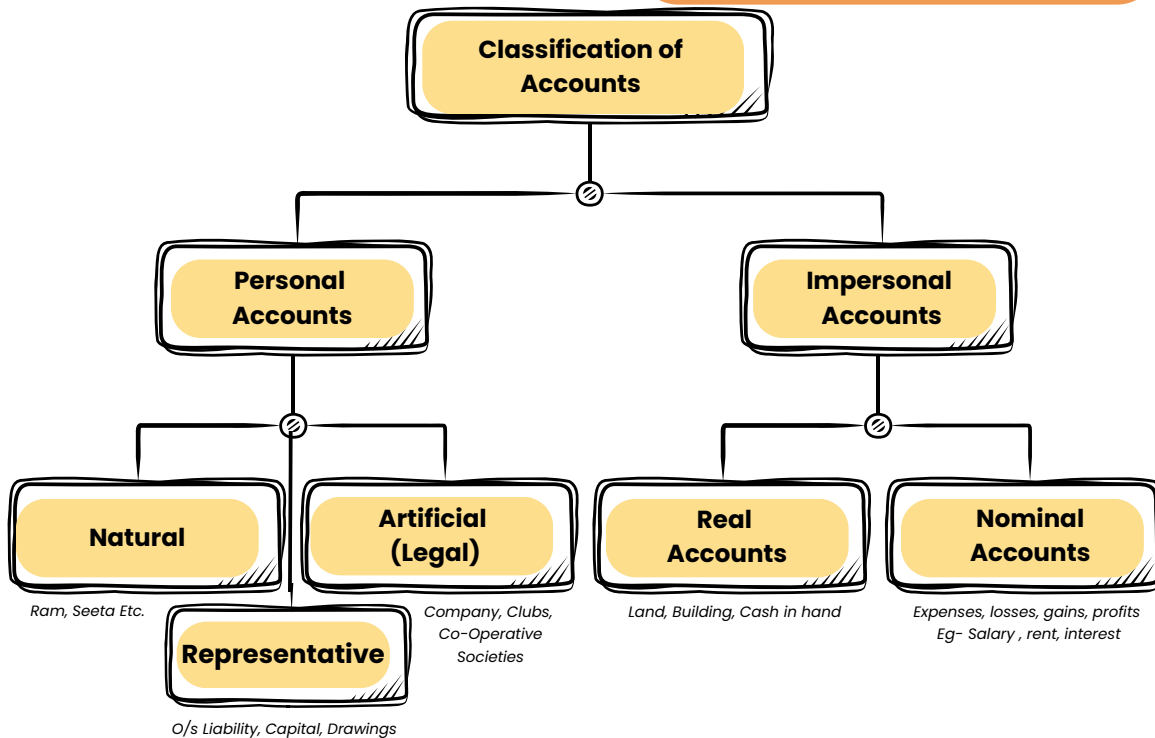
or, $\text{Equity} + \text{Long-Term Liabilities} = \text{Fixed Assets} + \text{Current Assets} - \text{Current Liabilities}$

TRADITIONAL APPROACH

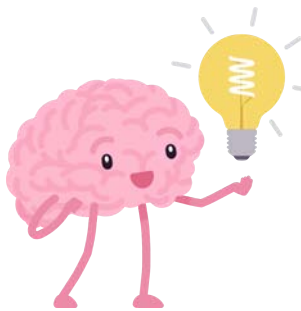
CLASSIFICATION OF ACCOUNTS

Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups

- 1 Personal transactions
- 2 Transactions related to assets and properties
- 3 Transactions related to expenses, losses, income and gains



GOLDEN RULES OF ACCOUNTING



Types of Account	Account to be Debited	Account to be Credited
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expense and losses	Income and gains

MODERN CLASSIFICATION OF ACCOUNTS

Real, nominal and personal accounts is the traditional classification of accounts. Now, let us see the modern and more acceptable classification of accounts:-

Types of account	Normal balance of account	Account to be debited when there is:	Account to be credited when there is:
Asset account	Debit	Increase	Decrease
Liabilities account	Credit	Decrease	Increase
Capital account	Credit	Decrease	Increase
Revenue account	Credit	Decrease	Increase
Expenditure account	Debit	Increase	Decrease
Withdraw account	Debit	Increase	Decrease

JOURNAL

Transactions are first entered in this book to show which accounts should be debited and which credited. Journal is also called subsidiary book. Recording of transactions in journal is termed as journalizing the entries. It is the book of original entry in which transactions are entered on a daily basis in a chronological order.

It would be difficult to maintain the records in an orderly manner. Debits and credits are listed along with the appropriate explanations. There are basically two types of journals :-

Types of Journals

1

General Journal

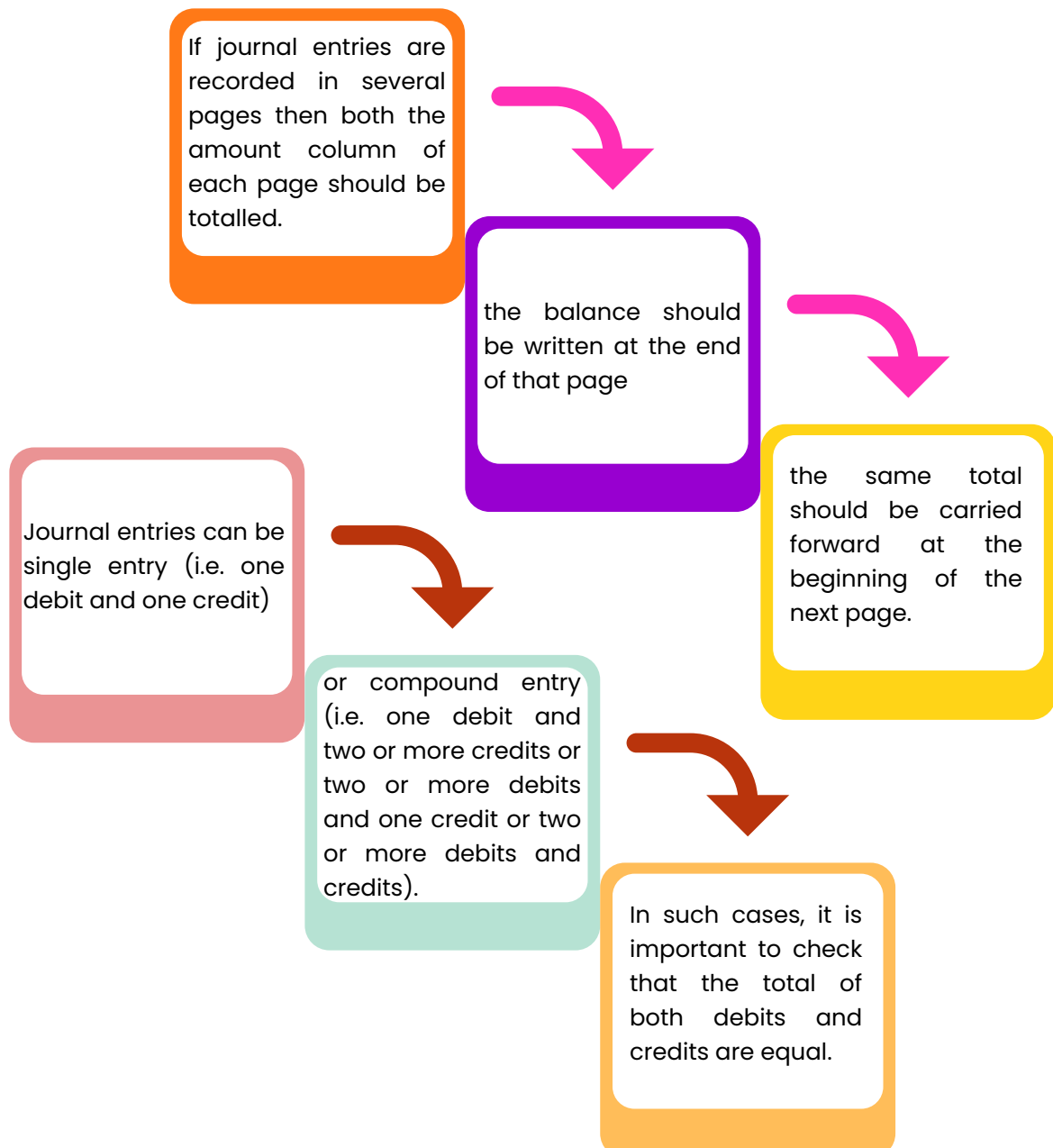
2

Specialized Journal

PERFORMA OF JOURNAL

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
(1)	(2)	(3)	(4)	(5)

POINTS TO BE TAKEN INTO CARE WHILE RECORDING A TRANSACTION IN THE JOURNAL



ADVANTAGES OF JOURNAL

ONE

As transactions are recorded on chronological order, one can get complete information about the business transactions on time basis.

TWO

Entries recorded in the journal are supported by a note termed as narration, which is a precise explanation of the transaction for the proper understanding of the entry. One can know the correctness of the entry through these narrations.

THREE

Journal forms the basis for posting the entries in the ledger. This eases the accountant in their work and reduces the chances of error.

ACCOUNTING FOR GST



INTRODUCTION TO GST

Goods and Services Tax (GST) is a comprehensive Indirect Tax which has subsumed multiple Indirect Taxes in India such as State Value added Tax (VAT) which was levied on sale of goods, Excise Duty, which was levied on manufacture or production of goods, Service Tax which was levied on provision of services etc. GST is a single tax on the supply of goods and services, right from the manufacturer to consumer.

SALIENT FEATURES OF GST

- GST is levied on supply i.e., manufacture or sale of goods and provision of services. In other words, supply is taxable event which on its occurrence creates or attracts the liability to pay tax.
- Under GST, tax is levied only on the value added at each stage of the supply chain.
- GST is a destination-based consumption tax, i.e. the tax is levied at the place where the goods or services are consumed, rather than the place where they are produced.
- There is **no tax on tax** or cascading of taxes under GST system.
- Under GST, there is a harmonization of laws, procedures and rates of tax across the country.

TYPES OF TAXES UNDER GST

GST has a dual aspect with the Centre and States simultaneously levying on a common tax base. There are three main components of GST which are:

1. **Central Goods and Service Tax (CGST)** is levied and collected by the Centre on the "Intra -State" supply of goods and services.
2. **State Goods and Services Tax (SGST)** is levied and collected by the State Governments (including Union Territories with legislature, for example Delhi, Pondicherry, Jammu and Kashmir) on "Intra state" supply of goods and services
3. **Union Territory Goods and Service Tax (UTGST)** is levied and collected by Union Territories without Legislatures [i.e. Andaman and Nicobar Islands, Lakshadweep, Ladakh, Dadra and Nagar Haveli & Daman and Diu and Chandigarh] on "intra-state" supply of goods and services.
4. **Integrated Goods and services tax (IGST):** It is the GST levied on the "inter state" supply of goods and services and is collected by the Centre. IGST is equivalent to the sum total of CGST and SGST.



GST is a "Consumption Based Tax" i.e. the tax is received by the State in which the goods or services are consumed and not by the state in which the goods and services are manufactured.



INPUT AND OUTPUT GST

“

Output tax means the GST charged on supply of goods or services made by a supplier.

”

“

Input tax means the credit of Input tax already paid.

”

UTILISATION OF INPUT TAX CREDIT UNDER GST

Tax credit of CGST, SGST and IGST can be utilized in the following manner:

- **Utilization of IGST Credit:** IGST credit has to be first utilized against IGST liability and if any balance is still available, the same can be utilized against CGST or/and SGST in any order and in any proportion.
- **Utilization of CGST Credit:** CGST credit has to be first utilized against CGST liability and if any balance is available, same can be utilized against IGST. However, CGST credit cannot be utilized against SGST.
- **Utilization of SGST Credit:** SGST credit has to be first utilized against SGST liability and if any balance is available, same can be utilized against IGST. However, SGST credit cannot be utilized against CGST.

DOUBLE ENTRY BOOK-KEEPING WITH GST

The Double entry book-keeping records need to show the GST values separately so that the purchases, expenses and sales are posted net i.e. without the addition of GST.

Journal entry in case of Sales of Goods or services

Account Receivable/Debtors A/c	Dr.	Gross Amount (including GST)
To Sales A/c		Net Amount (excluding GST)
To Output GST		Amount of GST

Journal entry in case of Purchase of Goods or services

Purchases A/c	Dr.	Net Amount (excluding GST)
Input GST A/c	Dr.	Amount of GST
To Account Payable/Creditors		Gross Amount (including GST)

Journal entry in case of Utilization of Input Tax Credit towards payment of Output Tax

Output CGST A/c	Dr.	Amount of GST liability
Output SGST A/c	Dr.	Amount of GST liability
Output IGST A/c	Dr.	Amount of GST liability
To Input CGST A/c		Amount of output GST liability paid utilizing Input CGST
To Input SGST A/c		Amount of output GST liability paid utilizing Input SGST
To Input IGST A/c		Amount of output GST liability paid utilizing Input IGST

LEDGERS

After recording the transactions in the journal, recorded entries are classified and grouped into by preparation of accounts. The book which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal books of account in which account-wise balance of each account is determined.

Specimen of Ledger Accounts

Dr.				Account				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)

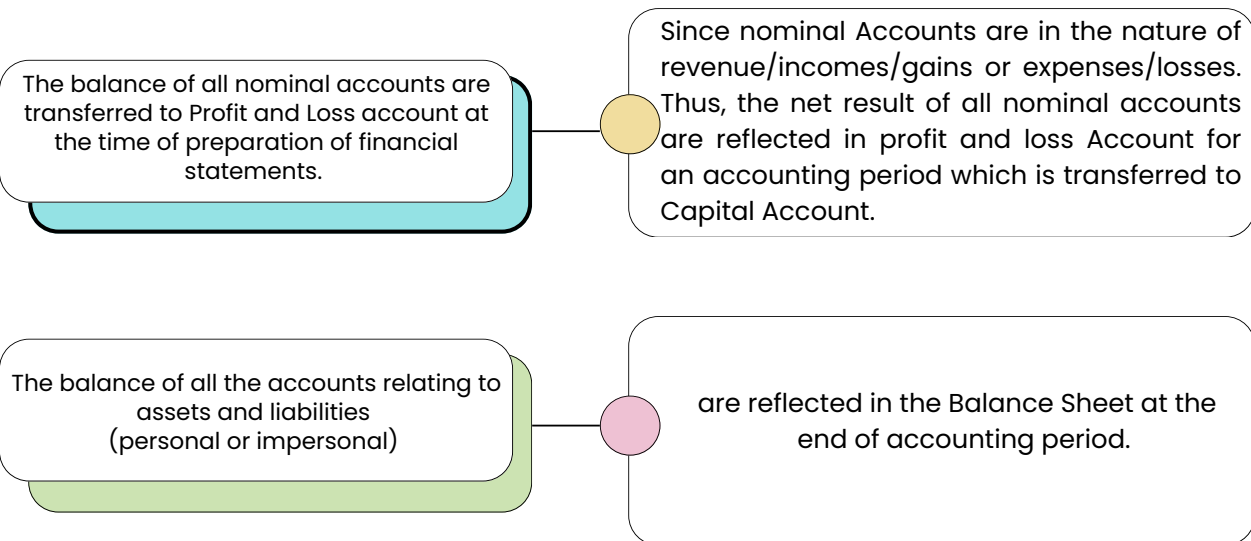
The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used with the accounts written on the debit side while 'By' is used with the accounts written on the credit side.

RULES REGARDING POSTING OF ENTRIES IN THE LEDGER

Separate account is opened in ledger book for each account and entries from ledger posted to respective account accordingly.

The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.



TRIAL BALANCE

Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance.

It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides where, the totals of the two columns should agree.



Also total of the debit balances will be equal to the total of the credit balances.



The process of Trial Balance follows Double Entry System where the amount written on the debit sides of various accounts is always equal to the amounts entered on the credit sides of other accounts and vice versa.



Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though it is not proof of cent per cent accuracy, because some errors of principle and compensating errors may still remain.

Because of Double entry system, trial balance can be prepared any time but it is preferable to prepare it at the end of the accounting year to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. It may be noted that trial balance is a statement and not an account. Trial Balance forms the basis for preparing final statement i.e. Profit and Loss Statement and Balance Sheet.

OBJECTIVES OF PREPARING A TRIAL BALANCE

Helps to establish arithmetical accuracy of the books.

The trial balance serves as a summary of what is contained in the ledger.

Financial statements are normally prepared on the basis of agreed trial balance

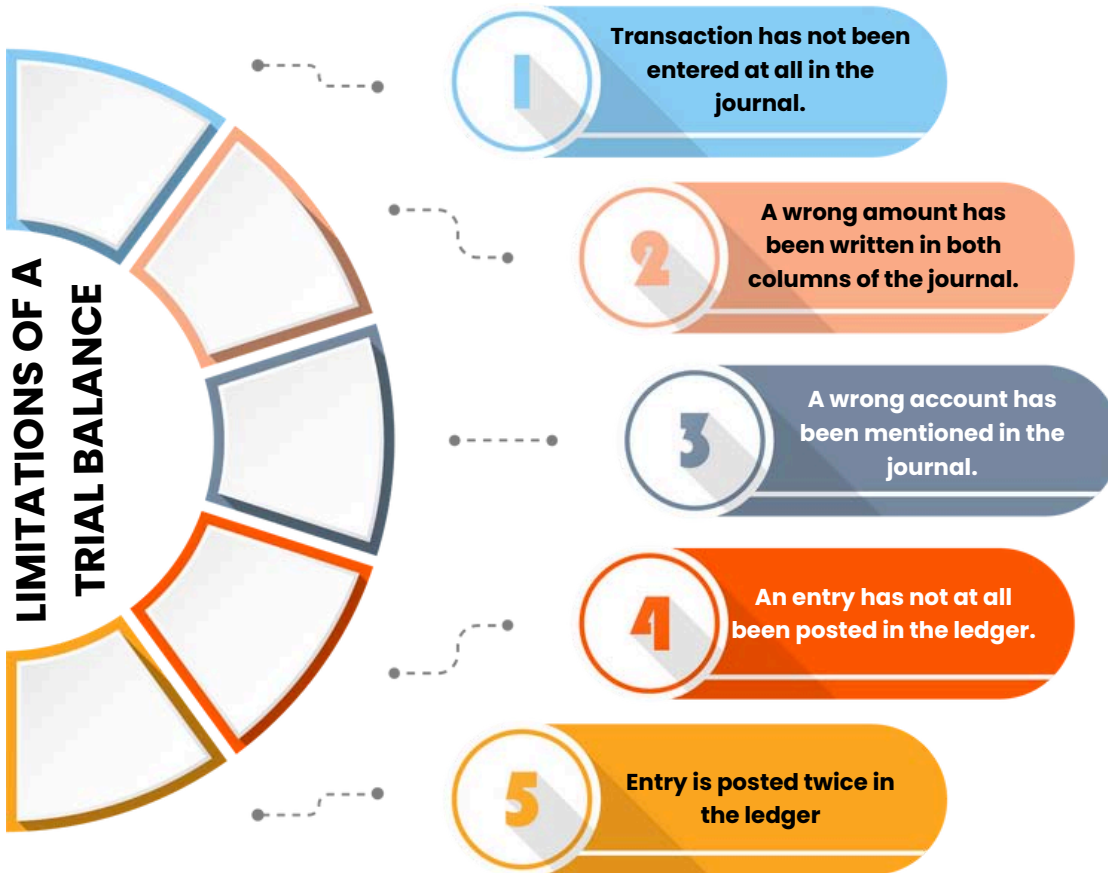
FORM OF A TRIAL BALANCE

Trial Balance
as at.....

S.No	Ledger Accounts	L.F.	Dr. Amount	Cr. Amount
			(Total or Balance) ₹	(Total or Balance) ₹

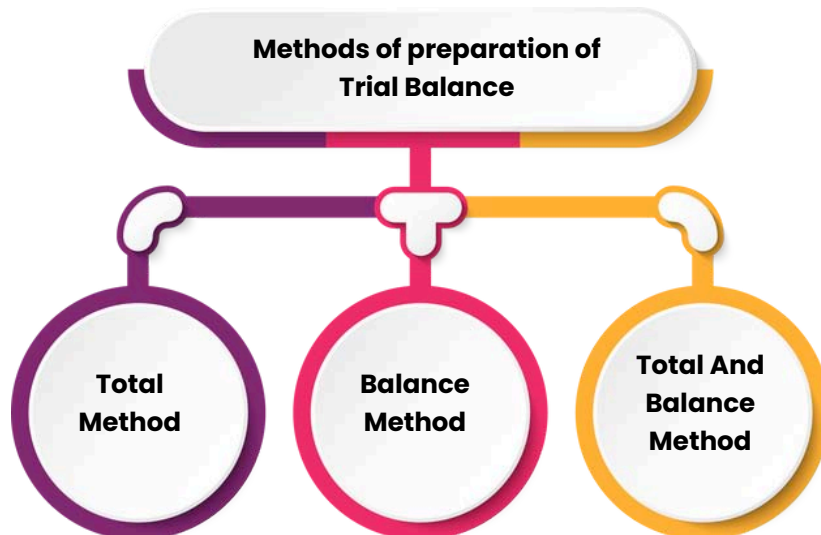
LIMITATIONS OF A TRIAL BALANCE

One should note that the agreement of Trial Balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

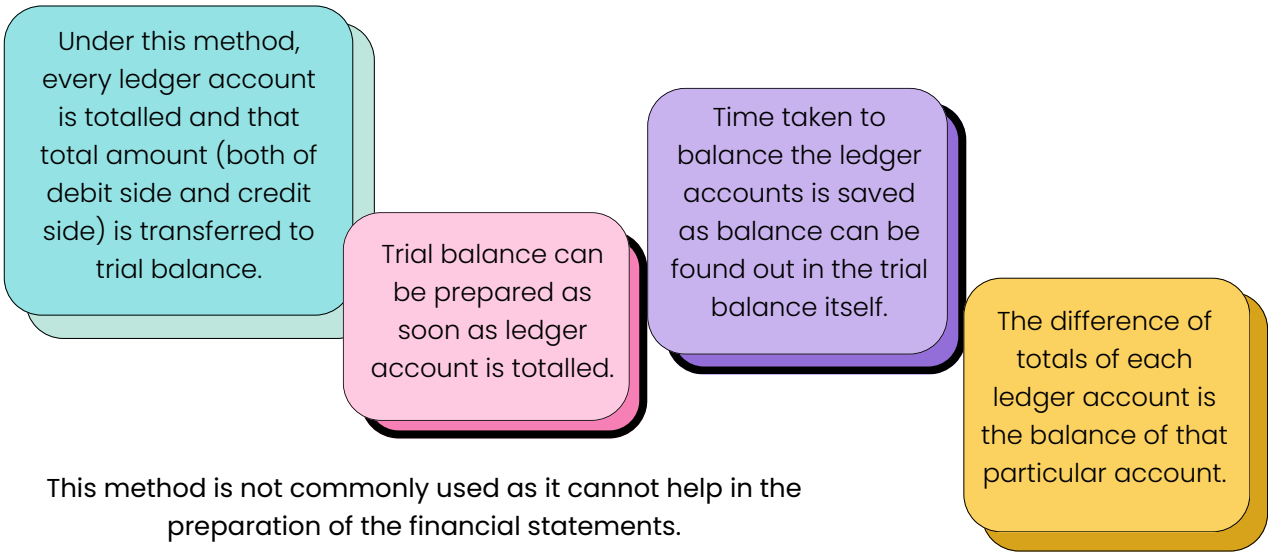


Still, the preparation of the trial balance is very useful; without it, the preparation of financial statement, the Profit and Loss Account and the Balance Sheet, would be difficult.

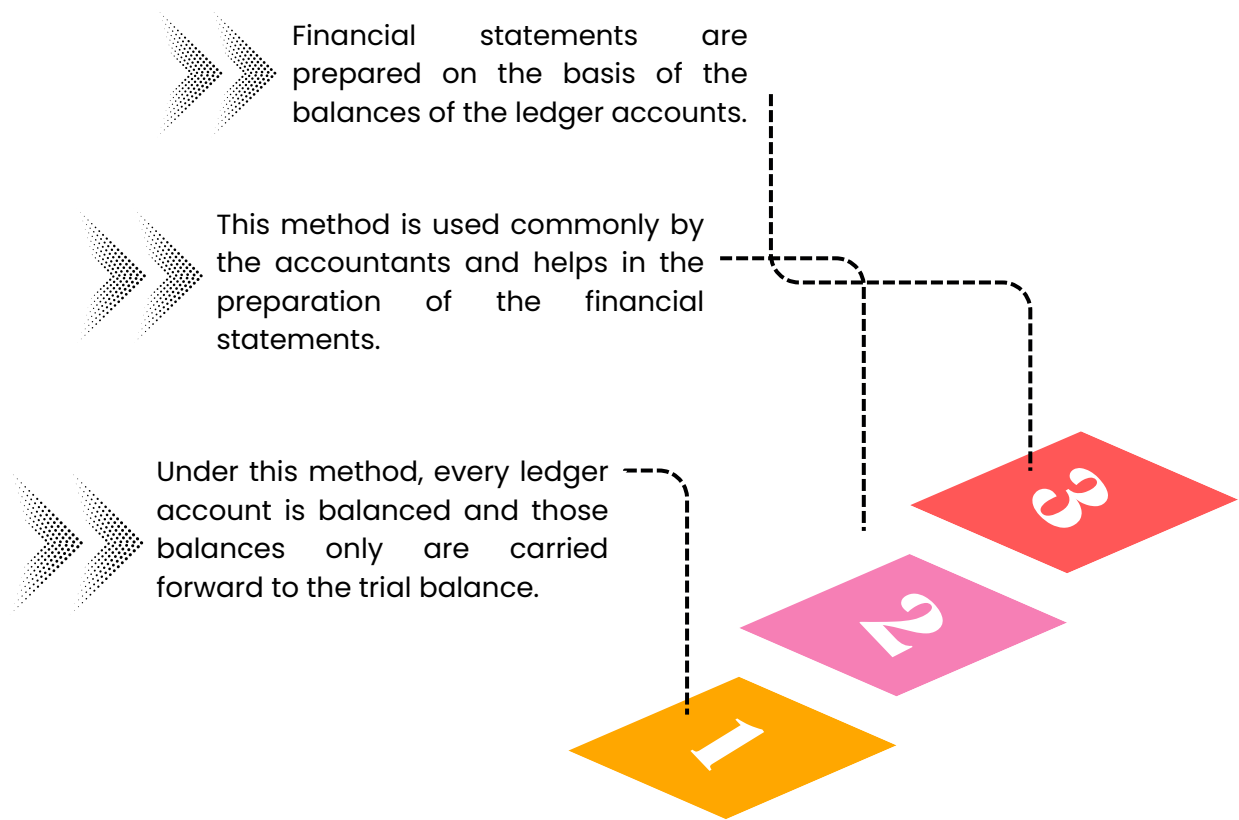
METHODS OF PREPARATION OF TRIAL BALANCE



TOTAL METHOD OF PREPARING A TRIAL BALANCE



BALANCE METHOD OF PREPARING A TRIAL BALANCE



TOTAL AND BALANCE METHOD OF PREPARING A TRIAL BALANCE

Under this method, the above two explained methods are combined. Under this method statement of trial balance contains seven columns instead of five columns.

PROFORMA OF TRIAL BALANCE UNDER THIS METHOD

Trial Balance of X as at 31.03.2024

Sl. No.	Heads of Account	L.F.	Debit Balance (₹)	Credit Balance (₹)	Debit Total (₹)	Credit Total (₹)
1.	Cash Account		7,500		35,500	28,000
2.	Furniture Account		3,000		3,000	
3.	Salaries Account		2,500		2,500	
4.	Shyam's Account			3,500	21,500	25,000
5.	Purchases Account		26,000		26,000	
6.	Purchase Returns Account			500		500
7.	Ram's Account		4,900		30,000	25,100
8.	Sales Account			30,500		30,500
9.	Sale Returns Account		100		100	
10.	Capital Account			9,500	500	10,000
	Total		44,000	44,000	1,19,100	1,19,100

ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

If the trial balance does not agree after transferring the balance of all ledger accounts including cash and bank balance and also errors are not located timely

then the trial balance is tallied by transferring the difference of debit and credit side to an account known as suspense account.

ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

This is a temporary account opened to proceed further and to prepare the financial statements timely.

RULES OF PREPARING THE TRIAL BALANCE

While preparing the trial balance from the given list of ledger balances, following rules should be taken into care:

The balances of the Accounts placed in the debit column of the trial balance

- Assets
- Expenses Accounts
- Losses
- Drawings
- Cash and Bank Balances

The balances of the Accounts placed in the credit column of the trial balance

- Liabilities
- Income Accounts
- Profits
- Capital

SUBSIDIARY BOOKS

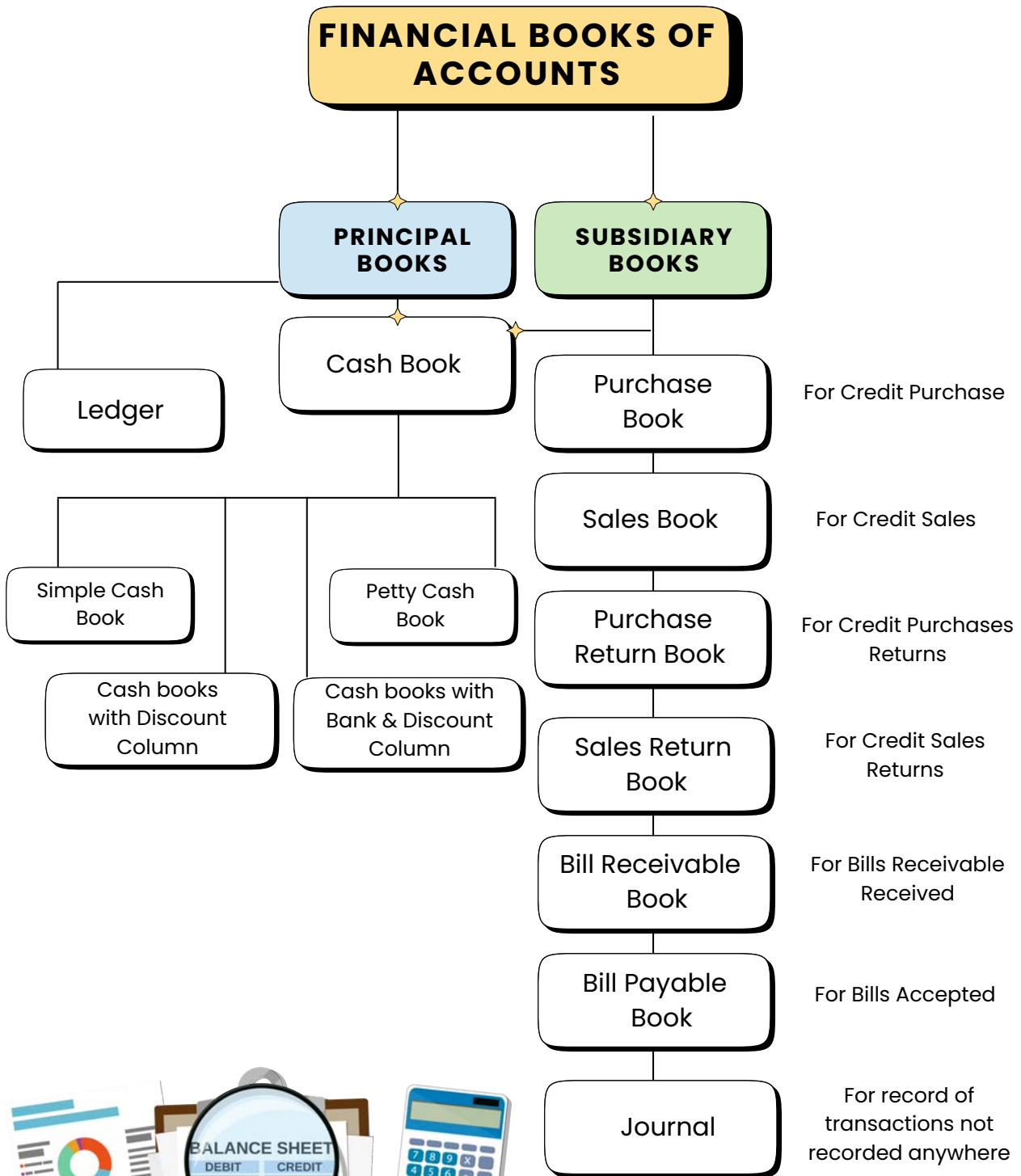
In a business, most of the transactions generally relate to receipts and payments of cash, purchases and sales of goods. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. Such register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



**BIFURCATION OF
SUBSIDIARY BOOKS AND PRINCIPAL BOOKS**



ADVANTAGES OF SUBSIDIARY BOOKS

Division of work

Since in the place of one journal there will be so many subsidiary books, the accounting work can be divided.

Specialisation and efficiency

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.

Saving of the time

Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to completing the work quickly.

Availability of information

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.

Facility in checking

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.

“

Cash purchases are not entered in this book since these will be entered in the cash book.

”

“

Credit purchases of things other than goods or materials, such as office furniture or typewriters are not entered in the Purchases Book.

”

POSTING THE PURCHASE BOOK

The Purchases Book shows the names of the parties from whom goods have been purchased on credit. These parties are now trade payables.

Their accounts have to be credited for the respective amounts shown in the purchase book.

The total of the amounts column shows the credit purchases made in a period.

The amount is debited to the Purchase Account to indicate receipt of goods.

SALES BOOK

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

“ Cash sales are not entered in this book since these will be entered in the cash book. ”

“ Credit sales of things other than goods dealt in by the firm are not entered in the Sales Book. ”

POSTING THE SALES BOOK

The names appearing in the Sales Book are of those parties which have received the goods.

The accounts of the parties have to be debited with the respective amounts.

The total of the Sales Book shows the credit sales made during the period concerned; the amount is credited to the Sales Account.

Sales Return or Return Inward 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.
- This Book is similar to the Sales Book and entries are also made in the same manner.

Purchase Return or Return Outward 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.
- This Book is similar to the Purchases Book and entries are also made in the same manner.

Bills Receivable and Bills Payable Book

- 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.

SINCE WE KNOW

Bill transactions are entered in the Bills Receivable Books or the Bills Payable books, if these are maintained.

Cash transactions are recorded in the Cash Book

Credit purchases of goods are recorded in the Purchases Book.

Returns to suppliers are entered in the Purchase Returns Book.

Returns from customers are recorded in the Sale Returns Book

Credit sales of goods are recorded in the Sales Book.

ROLE OF THE JOURNAL

Except the transactions discussed previously, there are some other 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.

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.

Rectification entries

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

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

Credit purchase other than goods or materials required for production of goods.

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.

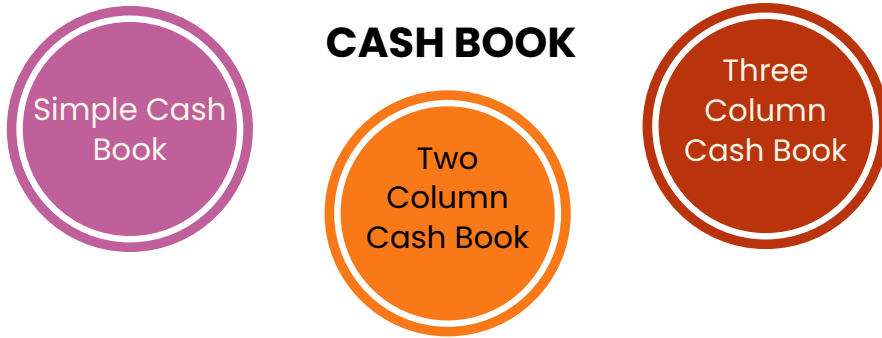
An amount becoming irrecoverable, say, because, customer becoming insolvent.

Effects of accidents such as loss of property by fire.
Transfer of net profit to capital account.

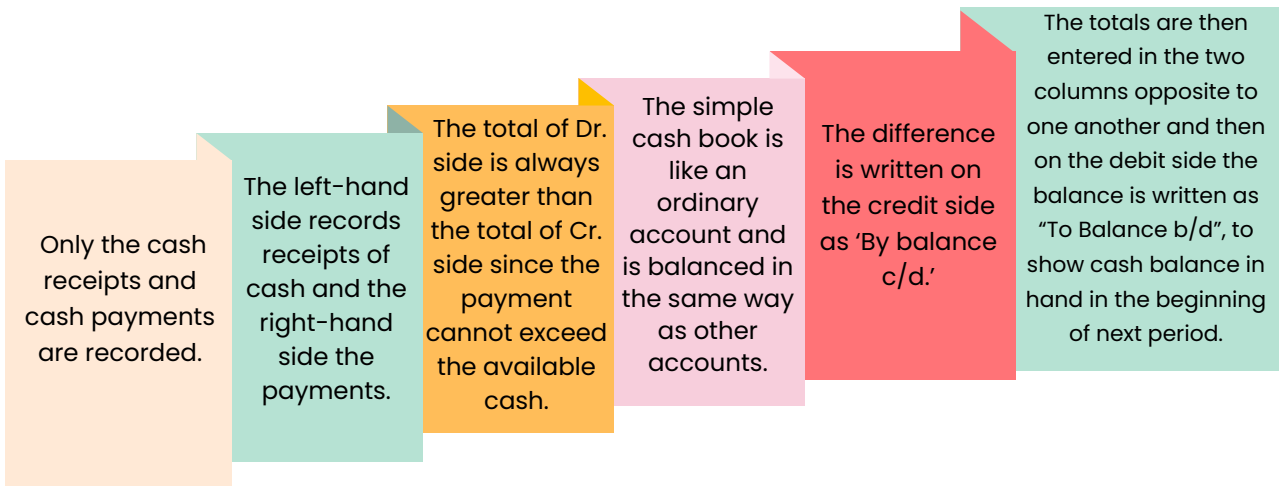
CASH BOOK

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 and 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.

KINDS OF CASH BOOK

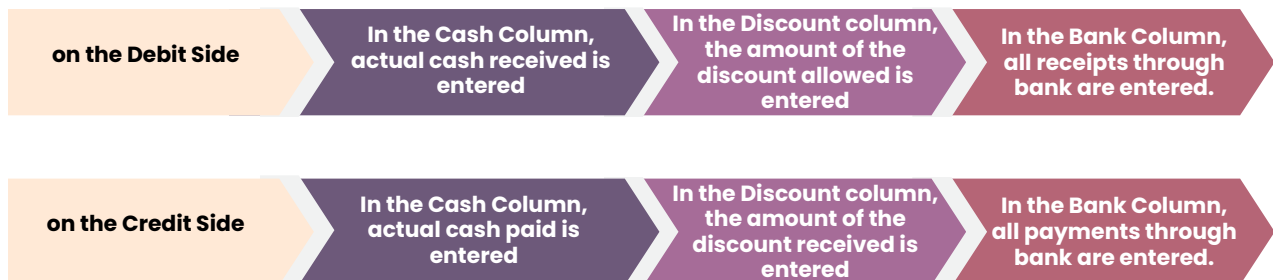


SIMPLE CASH BOOK



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.



BALANCING

Discount columns are not balanced, they are merely totalled. The total of the receipts shows total discount allowed to customers and is debited to the Discount Account. The total of payments shows total discount received and is credited to the Discount Account.

The bank columns are also balanced and the balancing figure is called bank balance.

The Cash columns are balanced.

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 is entered in the discount column.

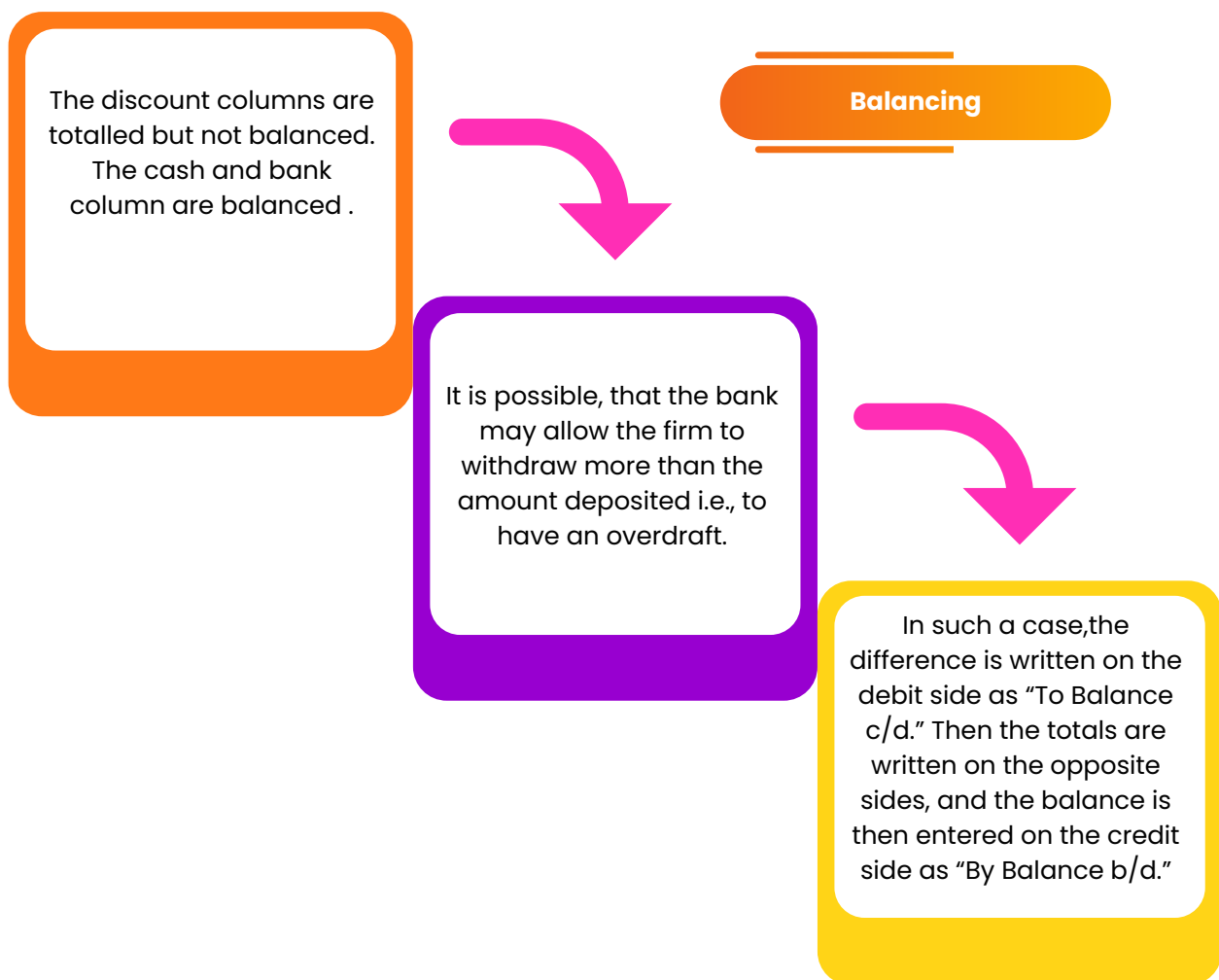
All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. Discount received is entered in the discount column.

Often cash is withdrawn from bank for use in the office or cash is sent to the bank. In such 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.

If cheque issued by the firm is not paid on presentation, it is entered in the Bank column on the debit side with the name of the party to whom the cheque was given.

Incase, a cheque received may be given to some other party, i.e., endorsed. On receipt, it must have been entered in the bank column on the debit side; on endorsement the amount will be written in the bank column on the credit side.



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.

IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period

Such a system is known as the Imprest System of Petty Cash.

Thus, he will again have the fixed amount in the beginning of the new period.

ADVANTAGES OF PETTY CASH BOOK

Saving of time of the chief cashier

Saving in labour in writing up the cash book and posting into the ledger

Control over small payments

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

WRONG ENTRY	Wrong entry of the value of transactions and events in the subsidiary books, Journal Proper and Cash Book may occur. Example: Credit purchases ₹17,270 are entered in the Purchases Day Book as ₹17,720. Credit sales of ₹15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at ₹15,000.
WRONG CASTING OF SUBSIDIARY BOOKS	Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may arise totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors. Example: For the month of January, 2024 total of credit sales are ₹1,75,700, this is wrongly totalled as ₹1,76,700 and posted to sales account as ₹1,76,700.
WRONG CASTING IN CASH BOOK	Wrong casting in cash book
WRONG POSTING FROM SUBSIDIARY BOOKS	Wrong amount may be posted to the ledger account or the amount may be posted to the wrong side or to the wrong account. Example : Purchases from A may be posted to B's account
WRONG CASTING OF LEDGER BALANCES	Any ledger account balance may cast wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances. Whenever there arises independent casting error that is called wrong casting of ledger balances.

STAGES OF ERRORS

At the stage of recording the transaction in Journal

At the stage of posting the entries in Ledger

At the stage of balancing the Ledger Account

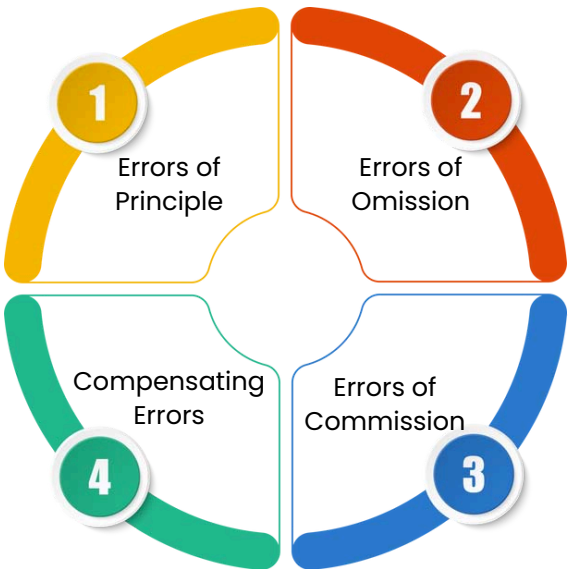
At the stage of preparing trail balance

- Errors of principle
- Errors of omission
- Errors of commission

- Wrong Totalling of a/cs
- Wrong Balancing of a/cs

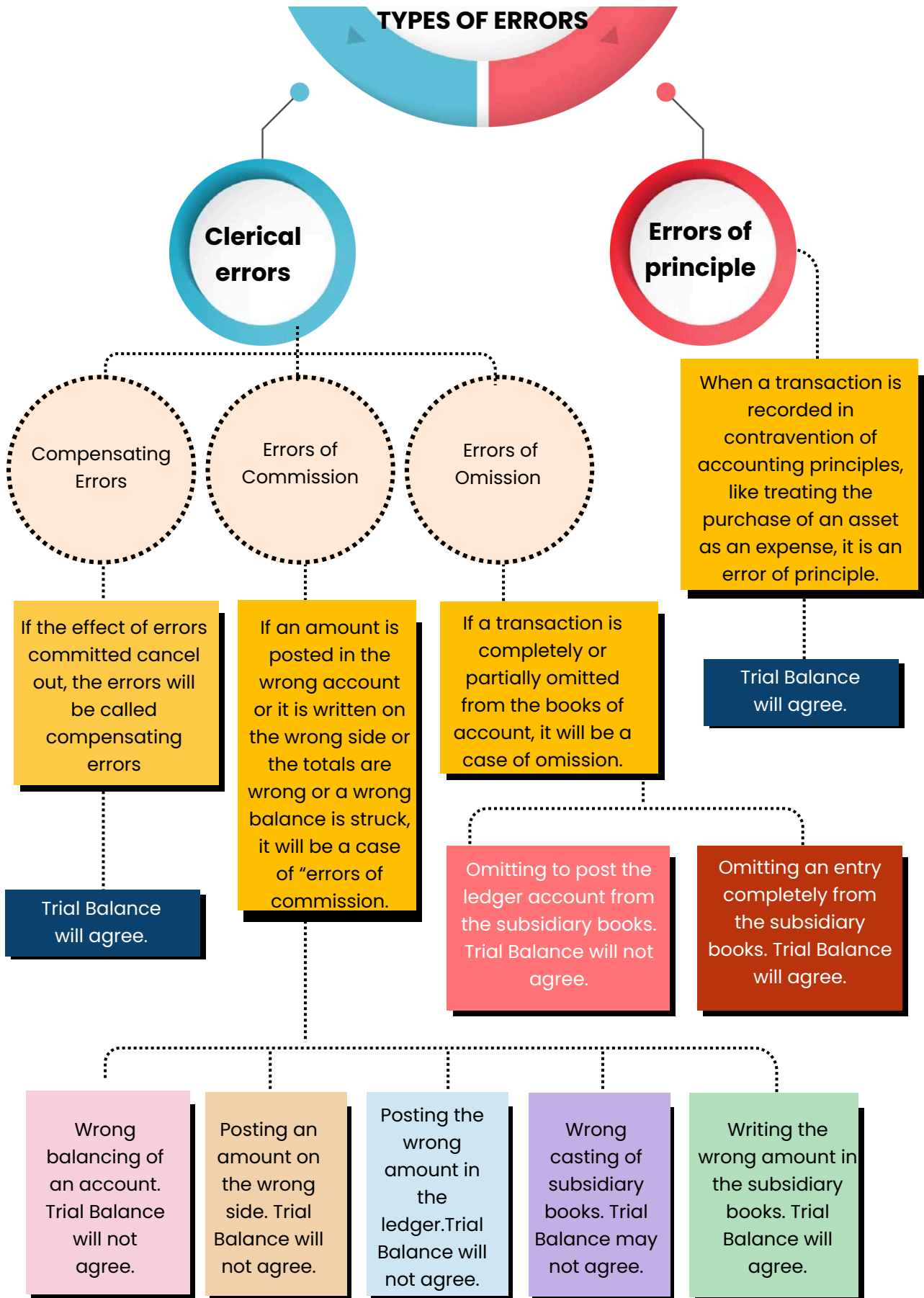
- Errors of omission
 - Partial omission
 - Complete omission
- Errors of commission
 - Posting to wrong account
 - Posting of wrong amount
 - Posting on the wrong side

- Errors of commission
 - 1 Taking wrong account
 - 2 Taking wrong amount
 - 3 Taking to the wrong side
- Errors of omission



We can classify the errors in four broad categories

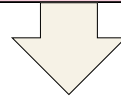
TYPES OF ERRORS



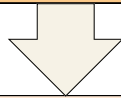
STEPS TO LOCATE ERRORS

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 :

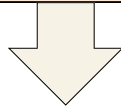
The two columns of the Trial Balance should be totalled again. If in place of a number of accounts, only one amount has been written in the Trial Balance, the list of such accounts should be checked and totalled again.



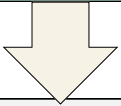
It should be seen that the cash and bank balances have been written in the trial balance.



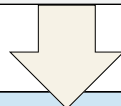
The exact difference in the trial balance should be established. The ledger should be gone through; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written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



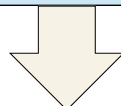
The ledger accounts should be balanced again.



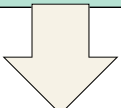
The casting of subsidiary books should be checked again, especially if the difference is ₹100, ₹1,000 etc.



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 those cases should be seen; it is possible that an error has been committed.

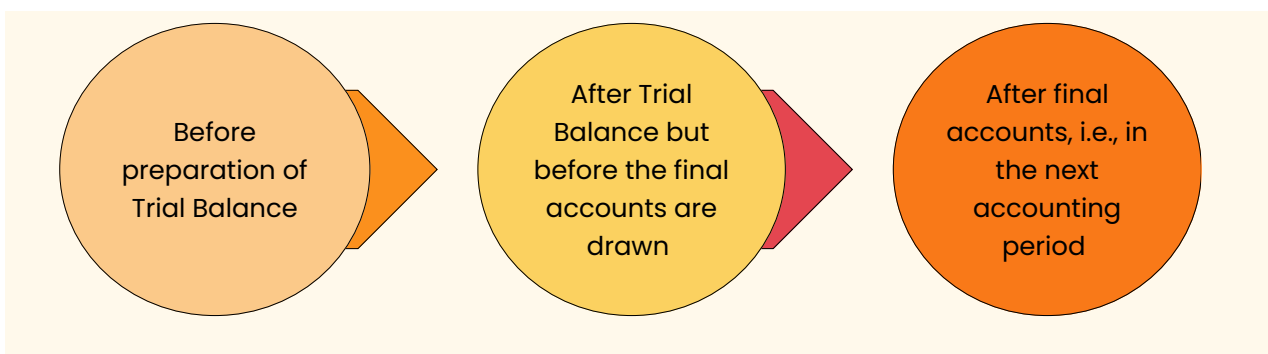


Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.



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

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

₹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 ₹50,000. The rectification will be by the entry. "By Omission of posting ₹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, 2024 is cast ₹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.	₹15,000	
To Sales Account		₹15,000

(Correction of error of undercasting the sales book for Nov. 2024)

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 ₹1,000 in December, 2023 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.	₹1,000	
To Suspense Account			₹1,000

It will mean that the Purchases Account for year 2024 will be ₹1,000 more than the actual amount relating to year 2024 and thus the profit that year 2024 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.

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.

Banks are essential institutions in a modern society. Now-a-days, most of the transactions of the business are done through bank whether it is a receipt or a payment.

A Bank accepts deposits from people, in various forms, and lends funds to those who need; it also invests some funds in profitable investments.

Thus, money which would have been otherwise idle is put to use and is made available to those who need it.

BANK PASSBOOK

Bank passbook is a copy of the customer's account in the book of a bank where all deposits and withdrawals made by the customer during the particular period is recorded.

The bank balance shown in the passbook is known as pass book balance for reconciliation purpose. The credit balance as per passbook is the deposit made by the customer while debit balance is the overdraft balance for the customer

BANK RECONCILIATION STATEMENT

BRS

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:-

1

Bank column of the
Cash Book
(in customer books);

2

Bank statement
Pass Book
(i.e. in the banks books)

The cash book is maintained by the person having the bank account whereas the bank statement is prepared by the bank. Therefore, the balance in both should be equal and opposite in nature.

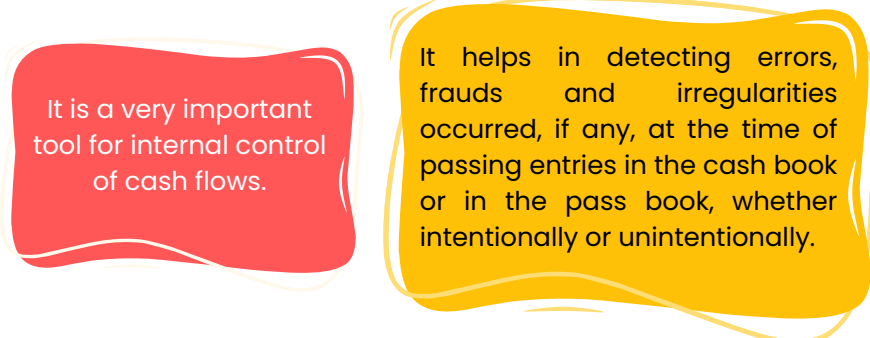
But most of the times these two balances do not match. The process of eliminating this difference and bringing the two statements in line with each other is known as "Reconciliation"

The statement which reconciles the bank balance as per cash book with the balance as per the pass book by showing all the causes of difference is known as "**BANK RECONCILIATION STATEMENT**".

SALIENT FEATURES OF BANK RECONCILIATION STATEMENT



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:-

1

TIMING

Sometimes a transaction is recorded at two different times in cash book and the passbook.

2

TRANSACTIONS

There are various transactions which the bank carries out by itself without intimating the customer.

3

ERRORS

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:

i) Cheques issued but not presented for payment

The entry in the cash book is made immediately on issue of cheque but entry will be made by the bank only when the cheque is presented for payment. There will thus be a gap of some days between the entry in the cash book and in the pass book.

ii) Cheques paid into the bank but not cleared

As soon as cheques are sent to the bank, entries are made on the debit side of the bank column of the cash book. But usually banks credit the customer's account only when they have received the payment from the bank concerned due to which there will be gap between the entry in both books.

iii) 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.

iv) 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.

v) 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.

vi) 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.

vii) 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.

viii) 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.

ix) 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.

x) 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.

TABLE SUMMARISING IN BRIEF THE TIMINGS OF DIFFERENT TRANSACTIONS

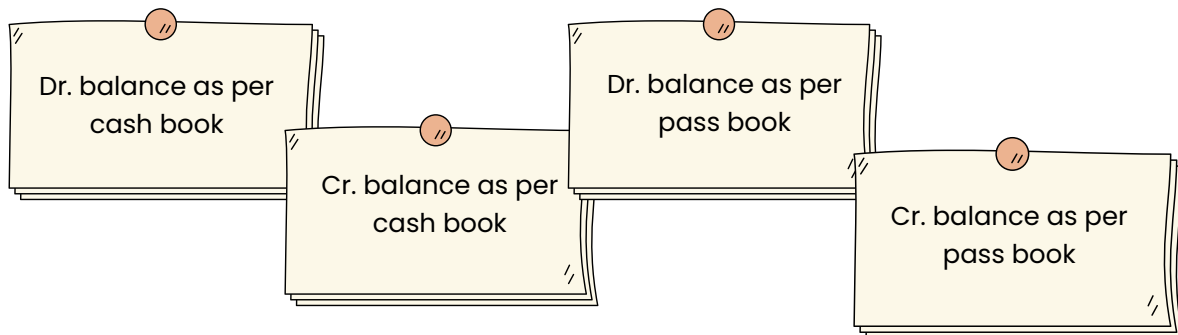
Sl. No.	Transaction	Time of recording in cash book	Time of recording in pass book
1.	Payment done by the account holder through issuing a cheque.	At the time of issuing the cheque.	At the time of presenting the cheque to the bank for payment.
2.	Receipt by the account holder through a cheque.	At the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

● When causes of difference are not given

When causes of difference 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

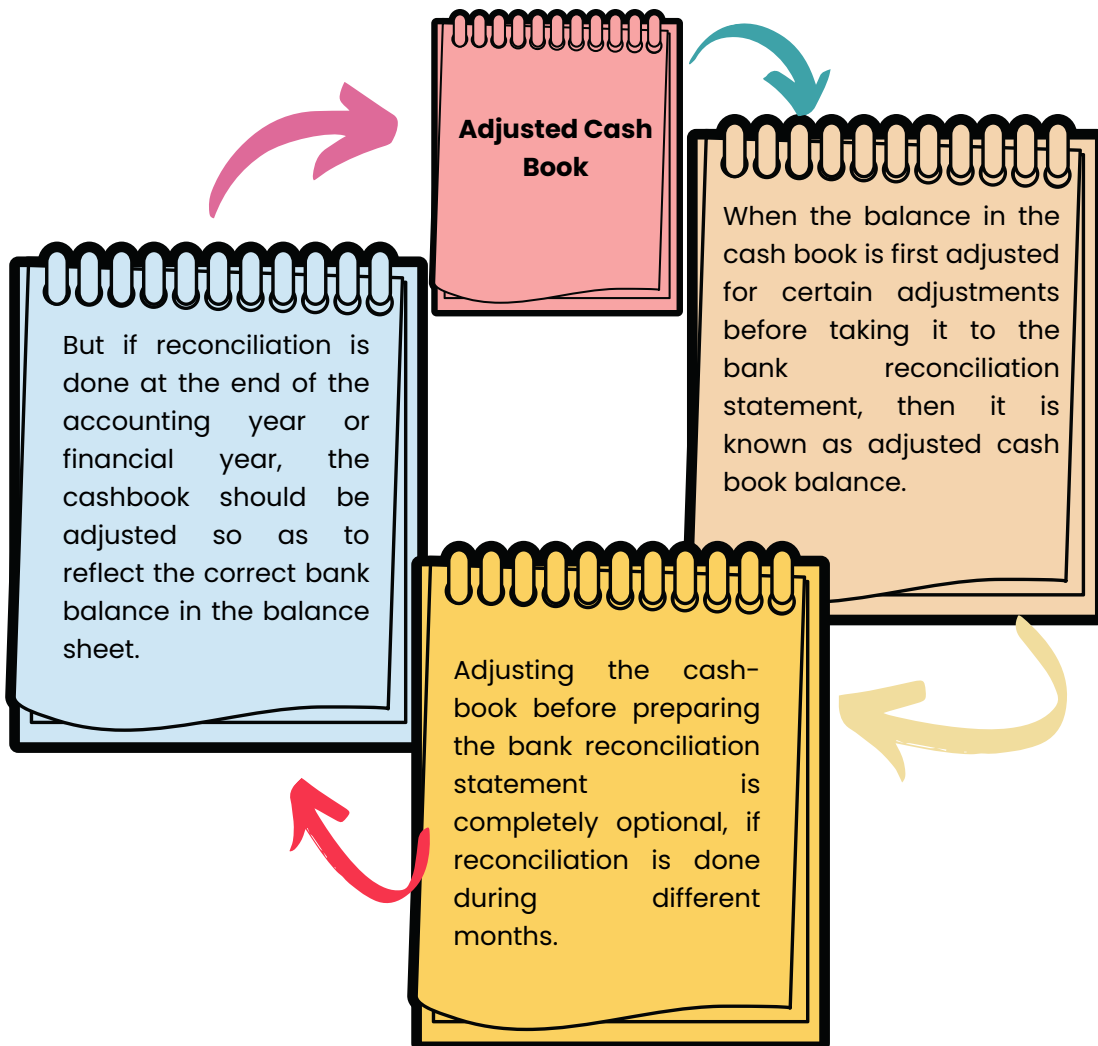
Compare the debit entries of cash book with the credit entries of the pass-book and vice-versa. The entries, which do not tally, are the causes of difference in the balances of both the books. Once the causes are located, their effects on both the books are analysed and then reconciliation statement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

TABLE SUMMARISING IN BRIEF THE TIMINGS OF DIFFERENT TRANSACTIONS

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
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:-

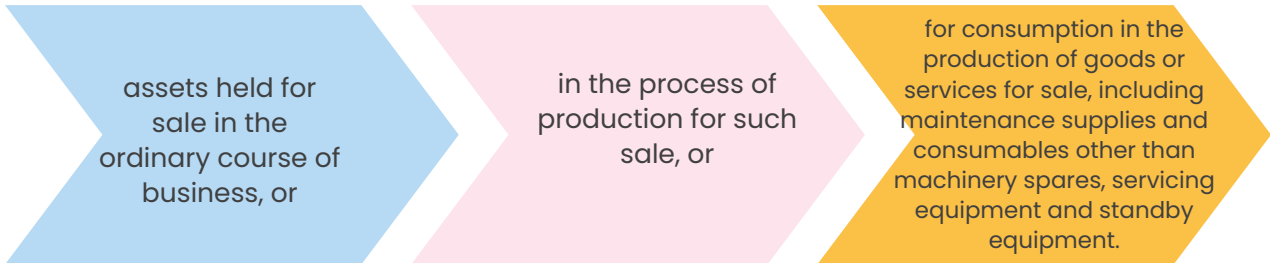
All the errors (like wrong amount recorded in the cash-book, entry posted twice in the cash-book, over/ undercasting of the balance etc.) and

Omissions (like bank charges recorded in the pass-book only, interest debited by the bank, direct receiptor payment by the bank, dishonour of cheques/bills etc.) by the cash-book are taken into care

CHAPTER 4: INVENTORIES

INTRODUCTION

Inventory can be defined as



TYPES OF INVENTORY



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:

When closing inventory is overstated, net income for the accounting period will be overstated.	When opening inventory is overstated, net income for the accounting period will be understated.	When closing inventory is understated, net income for the accounting period will be understated.	When opening inventory is understated, net income for the accounting period will be overstated.
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(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.

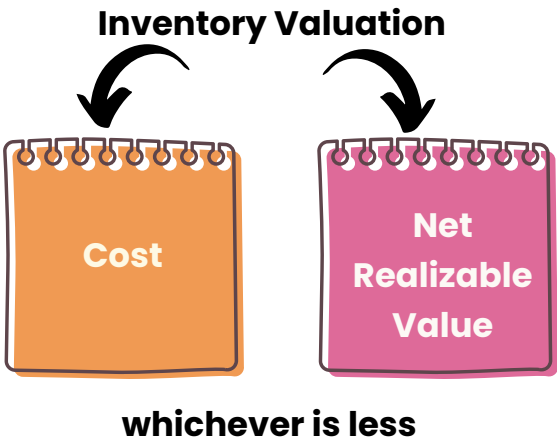
(iv) Statutory Compliance: Schedule III to the Companies Act, 2013 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements.

As per the requirements of the Accounting Standards, the financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used, and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

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.

COST 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.

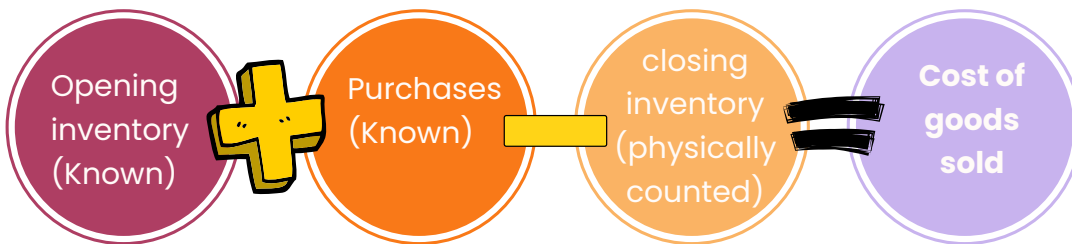
In case of raw materials	replacement cost is generally considered as net realisable value.
In case of work in progress	Net realisable value mean expenses and overheads required to be incurred to convert work in progress into finished goods and making it ready for sale as reduced from selling price.
In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



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.

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.

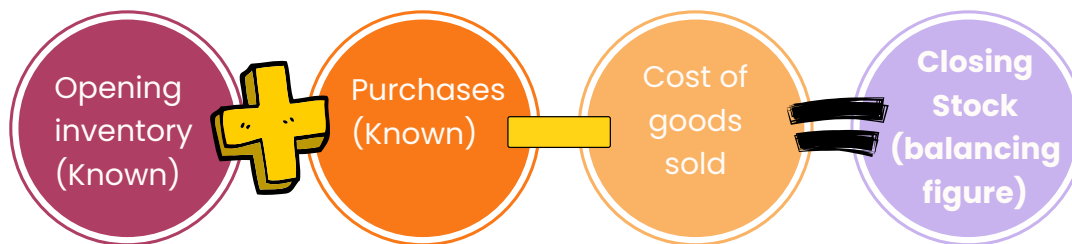
Inventory control is not possible under this system.

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

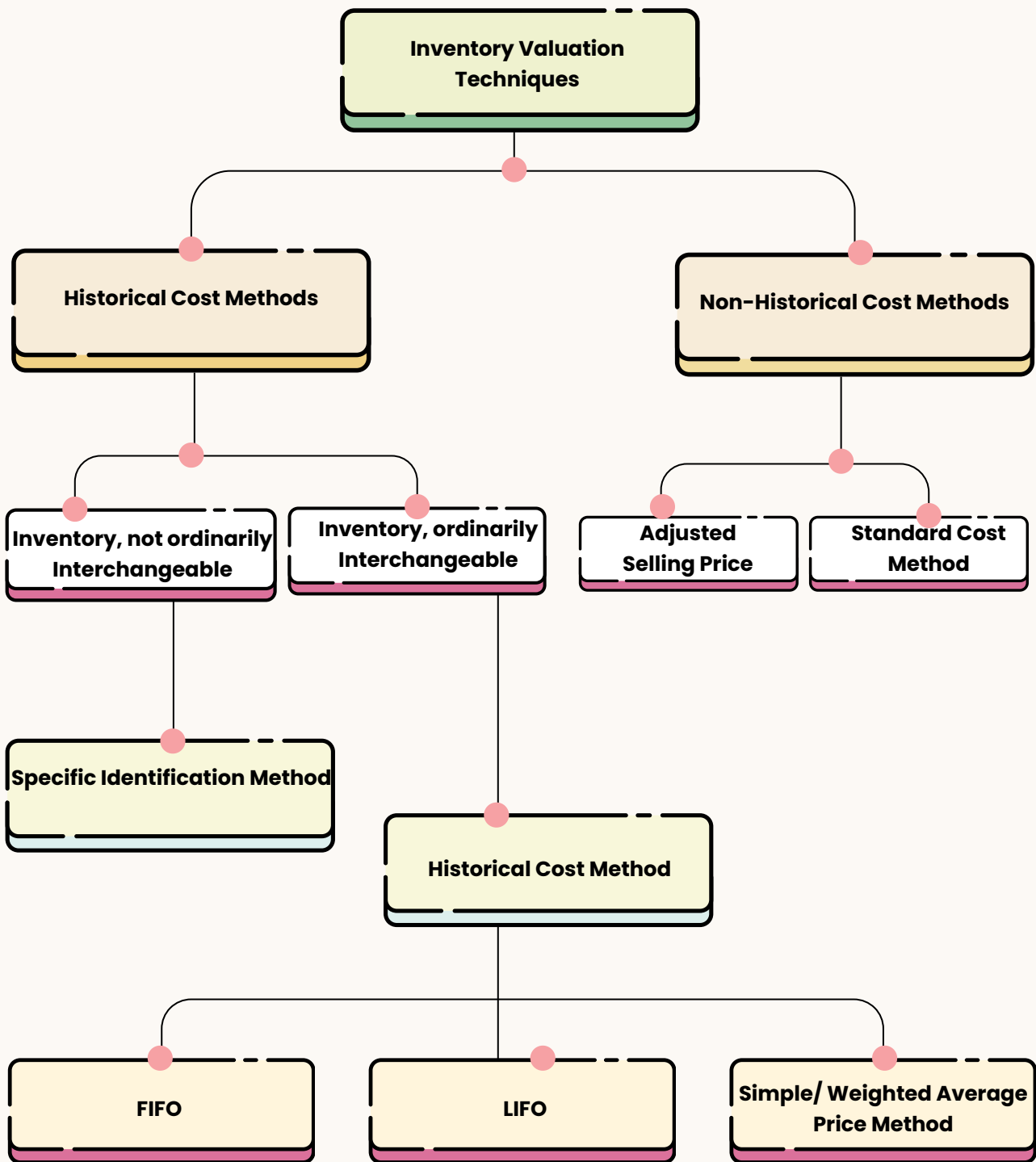
Perpetual inventory system is a system of **recording inventory balances after each receipt and issue**. In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined 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 inhand 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 =

$$\frac{\text{Total cost of goods available for sale during that period}}{\text{Total number of units available for sale during that period}}$$

- 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.

CHAPTER 5: DEPRECIATION AND AMORTISATION

MEANING OF DEPRECIATION

As per Schedule II
under the
Companies Act, 2013,

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

CONCEPT OF PPE

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

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

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

OBJECTIVES OF PROVIDING DEPRECIATION

Correct income
measurement

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

True position
statement

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

Funds for replacement

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

Ascertainment of true cost of production

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

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

REASONS FOR DECREASE 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

1

Estimated life of asset

2

Cost of the asset

3

Residual value of the asset at the end of the of its estimated useful life

DEPRECIATION ON COMPONENTS OF AN ASSET

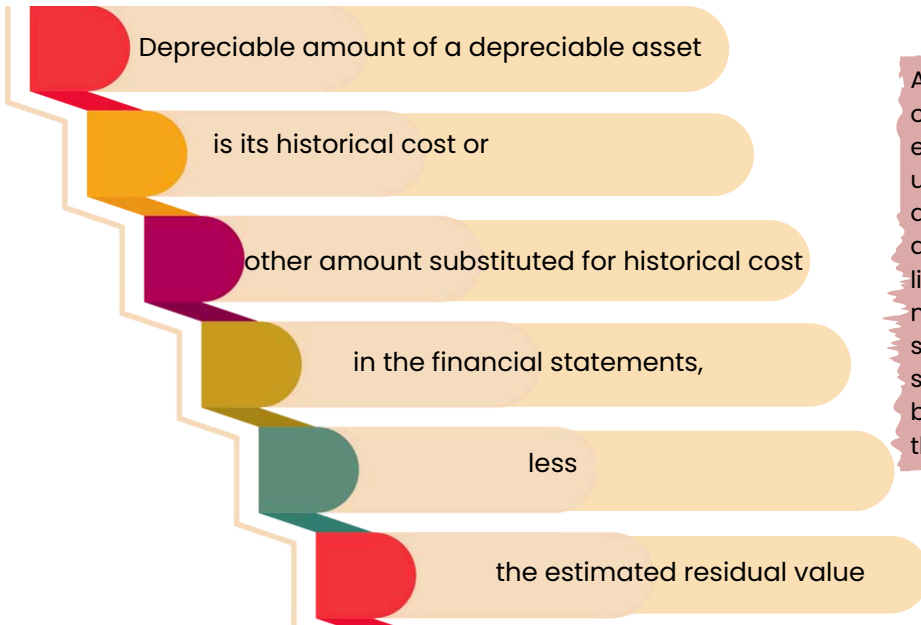
- It may be noted that Accounting Standards as well as the Companies Act, 2013 requires
- depreciation to be charged
- on a component basis.**
- Each part of an item of Property, Plant and Equipment
- with a cost that is significant in relation to the total cost of the item
- should be depreciated separately.**
- An enterprise should allocate
- the amount initially recognised in respect of an item of property, plant and equipment**
- to its significant parts/components and**
- should depreciate each such part separately
- based on the useful life and residual value of each particular component.**

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

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

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

DEPRECIABLE AMOUNT



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.

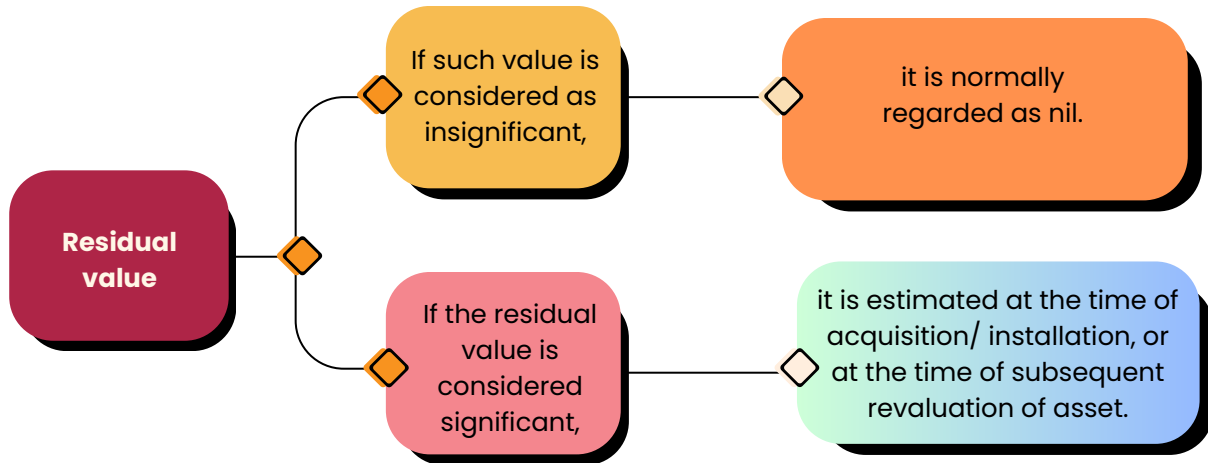
1
 Determination of the useful life

2
 is a matter of estimation and

3
 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.

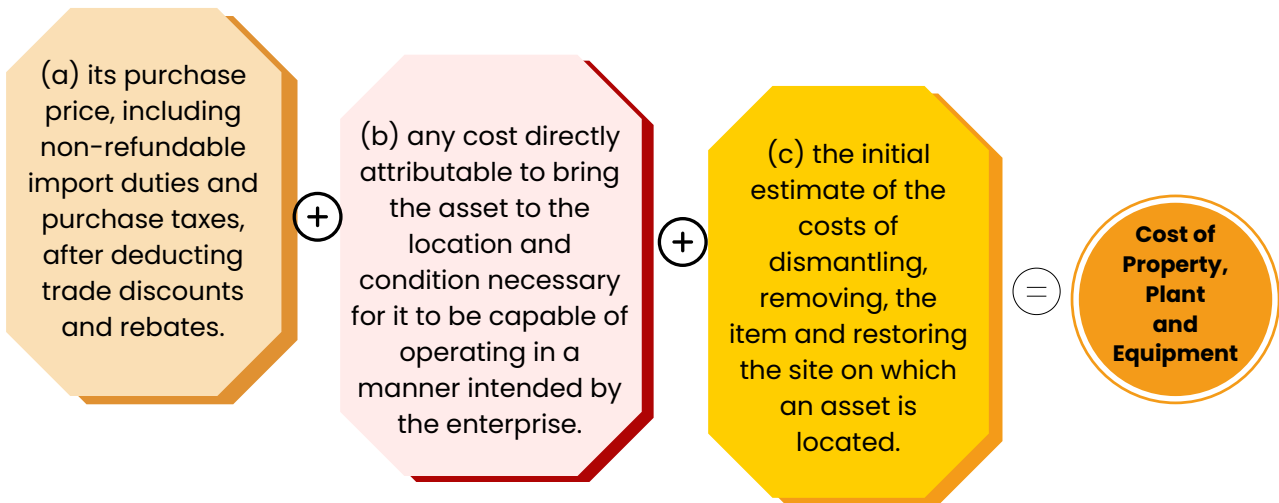
DETERMINATION OF THE RESIDUAL VALUE



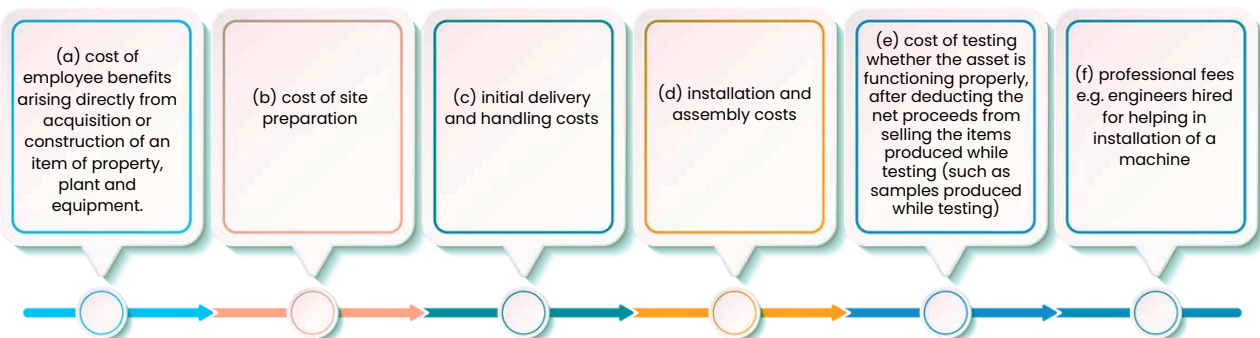
A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.



COST OF PROPERTY, PLANT AND EQUIPMENT

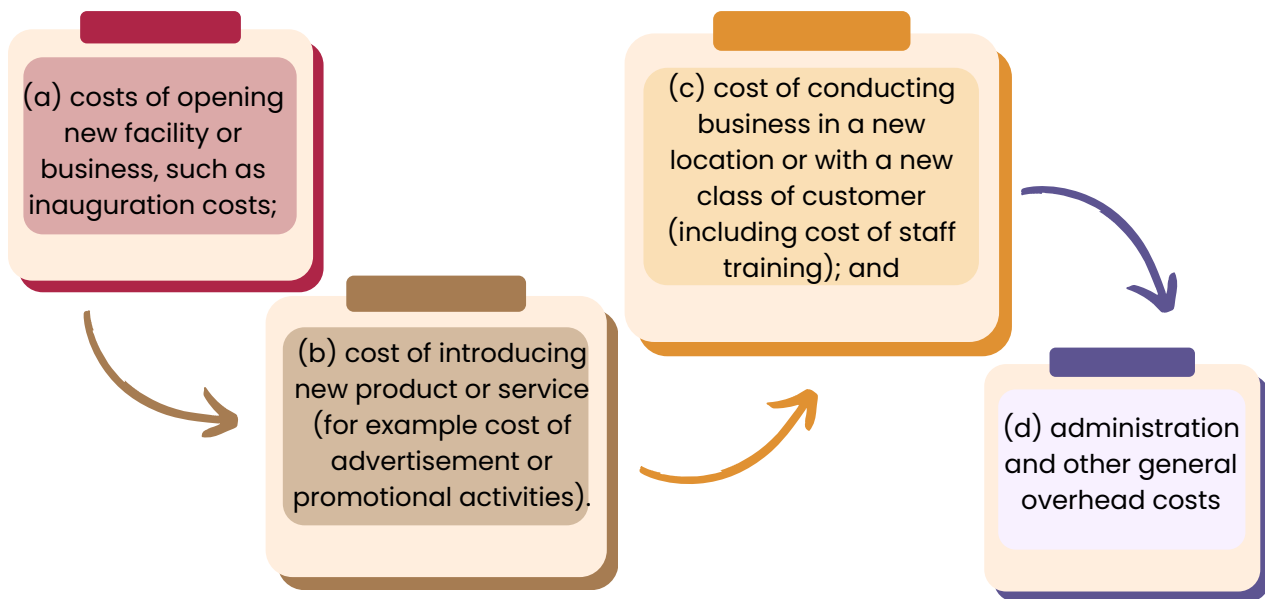


EXAMPLES OF DIRECTLY ATTRIBUTABLE COSTS ARE



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 THAT DOES NOT BECOME PART OF COST OF ASSET

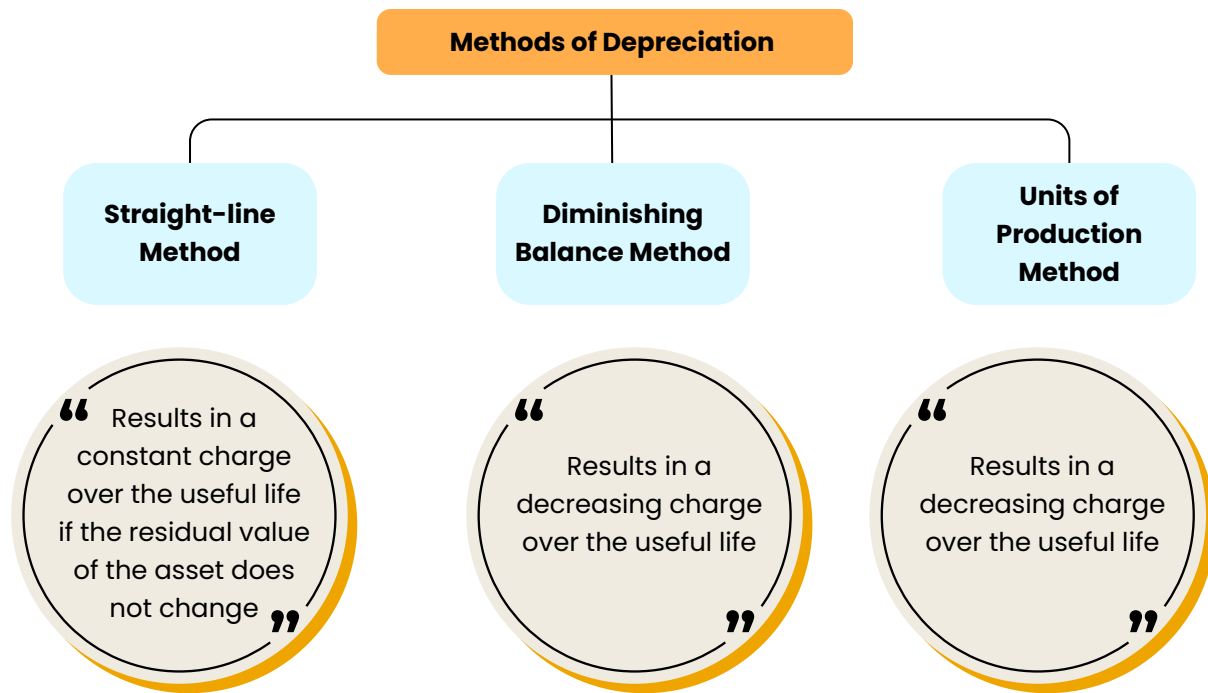


Once an asset has been brought to its intended condition and location of use, no cost should be recognized as part of cost of the asset unless there is major repair or addition which increases the useful life of the asset or improves the production capacity of the asset. Accordingly, cost incurred while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

Limitation of Reducing or Diminishing Balance Method

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.

MACHINE HOUR METHOD

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.

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:

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

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:

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.

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

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)

PRODUCTION UNITS METHOD

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

Depreciation for the period

Depreciable Amount

×

$\frac{\text{Production during the period}}{\text{Estimated total production}}$

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

DEPLETION METHOD



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



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



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

PROFIT OR LOSS ON THE SALE / DISPOSAL OF PROPERTY, PLANT AND EQUIPMENT

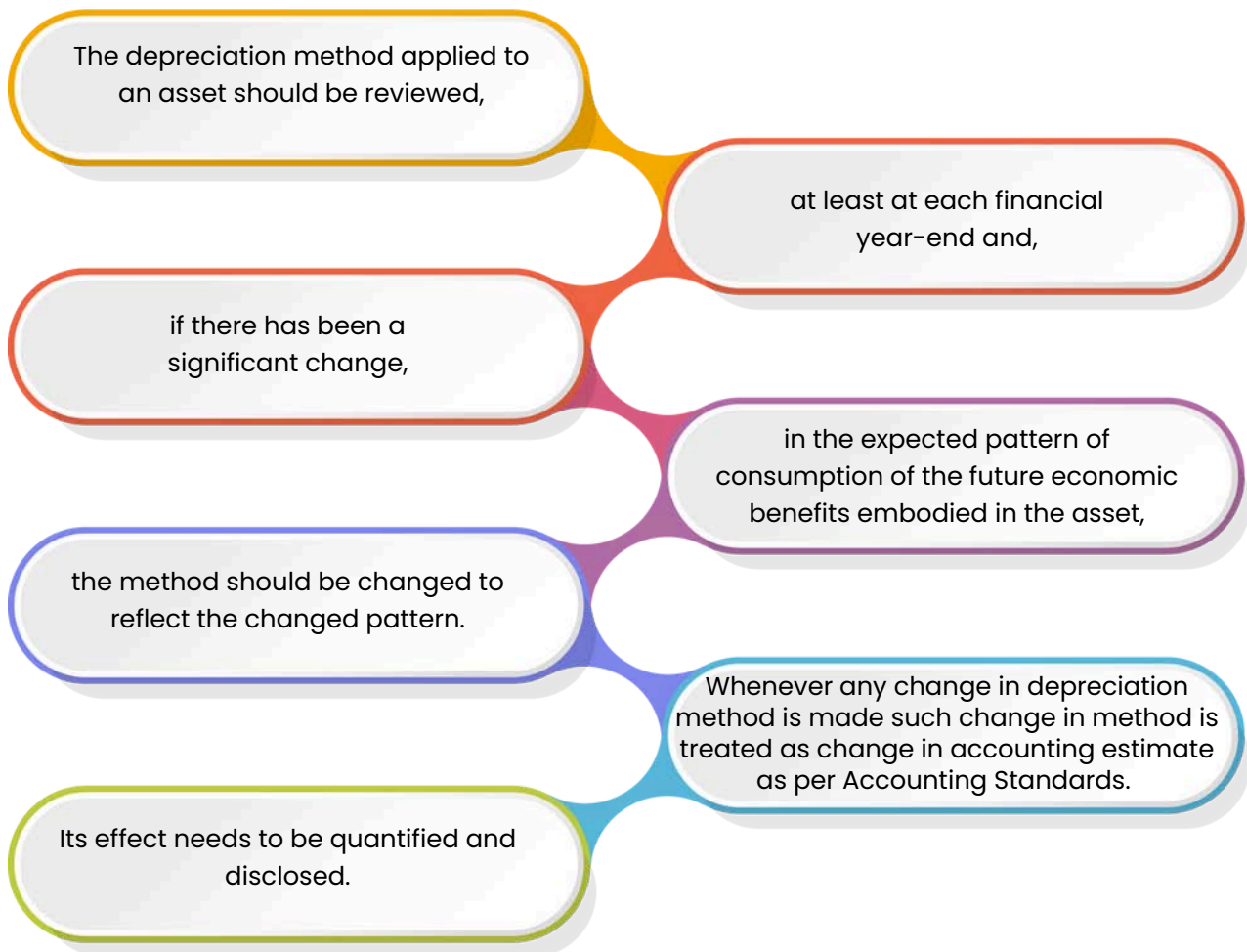
Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has

been used in the sale year.

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

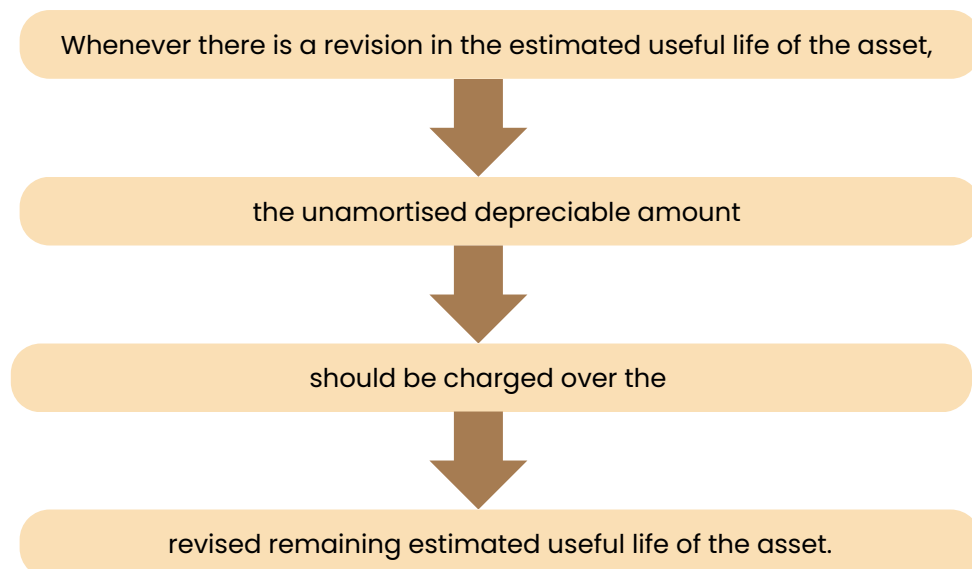
The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account.

CHANGE IN THE METHOD OF DEPRECIATION



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

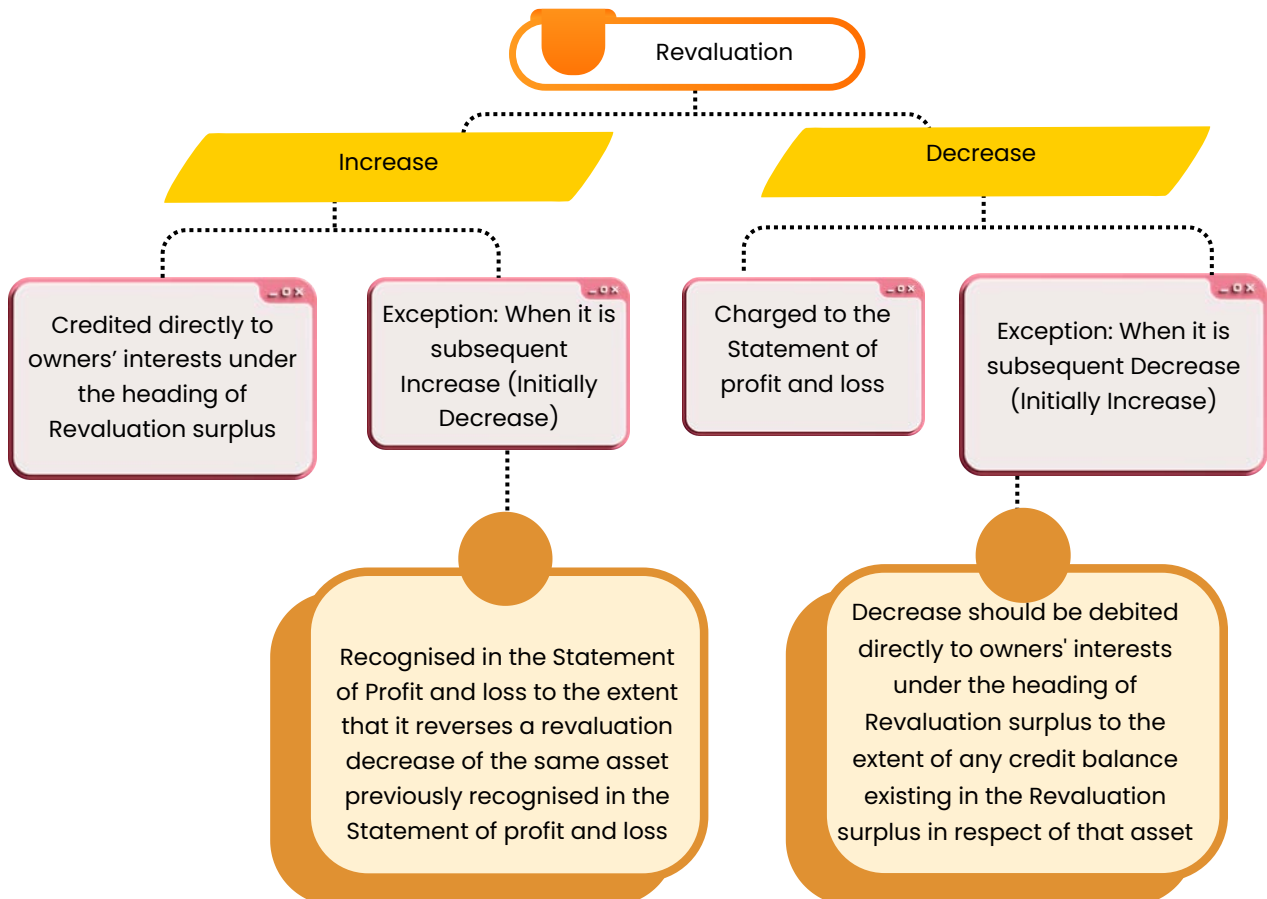
Remaining useful life as per revised estimate = 5 years

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

REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

After recognizing an asset initially, the asset whose fair value could be reliably measured could be carried at the revalued amount, being the fair value at revaluation date and reduced by successively accumulated depreciation and successive accumulated impairment losses (permanent decline in value) (if any).

It may be pertinent to note that revaluation of Property, Plant and Equipment is an accounting policy choice, and not mandatory under the accounting standards or the Companies Act, 2013.



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.

INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Examples of intangible assets include:

Broadcasting rights of events such as the Cricket World Cup, the Indian Premier League, the Pro Kabaddi League etc.

Broadcasting rights of events such as the Cricket World Cup, the Indian Premier League, the Pro Kabaddi League etc.

Landing rights / time slots at airports which permit aircrafts to land or take-off during a particular time frame.

Goodwill (purchased)

Streaming rights of movies / TV shows / web series on platforms like Netflix, Disney Hot Star, Amazon Prime / Sony LIV etc.

Computer Software.

Customer data collected by the entities such as customer contact numbers / email IDs and spending data at stores like Pantaloons, Westside etc. could be a major intangible asset for these entities.

Patents, Trademarks, Copyrights and Long-term customer contracts.

Intangible assets can be recognized in the financial statements provided they meet the following conditions:

The intangible asset is identifiable. Being identifiable means the entity could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

The enterprise can exercise control over such intangible asset. Control means the power available with the enterprise to obtain economic benefits from the asset and at the same time, can restrict access of others to those benefits.

It is probable that the future economic benefits attributable to the asset will flow to the enterprise; and

The cost of the intangible asset can be measured reliably.

An intangible asset acquired separately usually measured at cost, as cost can be measured reliably in such cases. The cost of the intangible asset would comprise of:

Purchase price

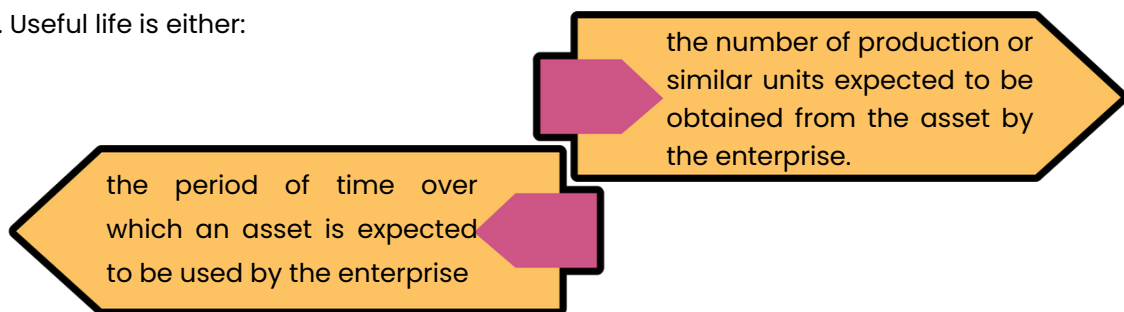
Any import duties and taxes (other than those subsequently recoverable by the enterprise from the tax authorities)

Any directly attributable expenditure on making the asset ready for its intended use e.g., professional fees towards legal services. Any trade discounts and rebates are deducted in arriving at the cost.

Tangible Assets	Intangible Assets
These are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.	These are identifiable assets that do NOT have a physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
Tangible Assets have a finite life based on expected usage.	Intangible Assets have a finite life based on contractual terms. In some cases, intangible assets could also have an indefinite life e.g. purchased goodwill.
Useful life is based on expected usage, with no presumption laid down for the same.	Useful life of Intangible Assets is presumed not to exceed 10 years unless evidence exists to the contrary.
Tangible Assets are depreciated over the useful life. In other words, writing off the value of tangible assets on an annual basis is known as depreciation.	Intangible Assets are amortised over the useful life. In other words, writing off the value of intangible assets on an annual basis is known as amortisation.
Examples include Property, Machinery, Vehicles etc.	Examples include software, streaming rights, landing rights, trademarks, patents etc.

AMORTISATION

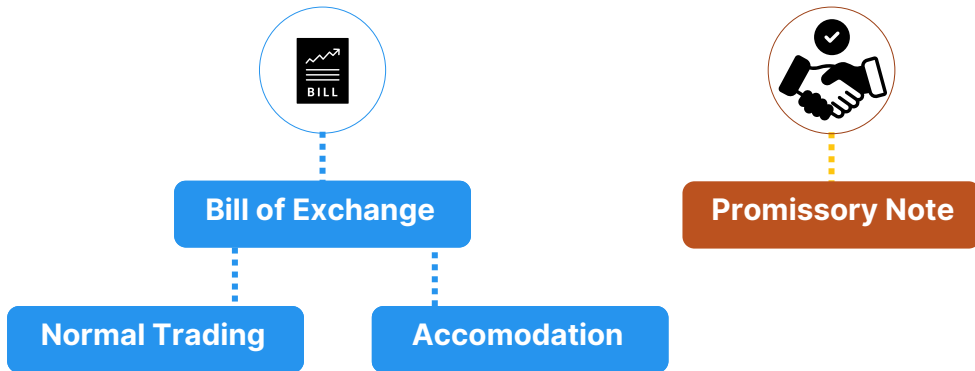
Amortisation can be defined as ‘the systematic allocation of the depreciable amount of an intangible asset over its useful life’. Depreciable amount is the cost of an asset less its residual value. Useful life is either:



- Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.
- The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use.

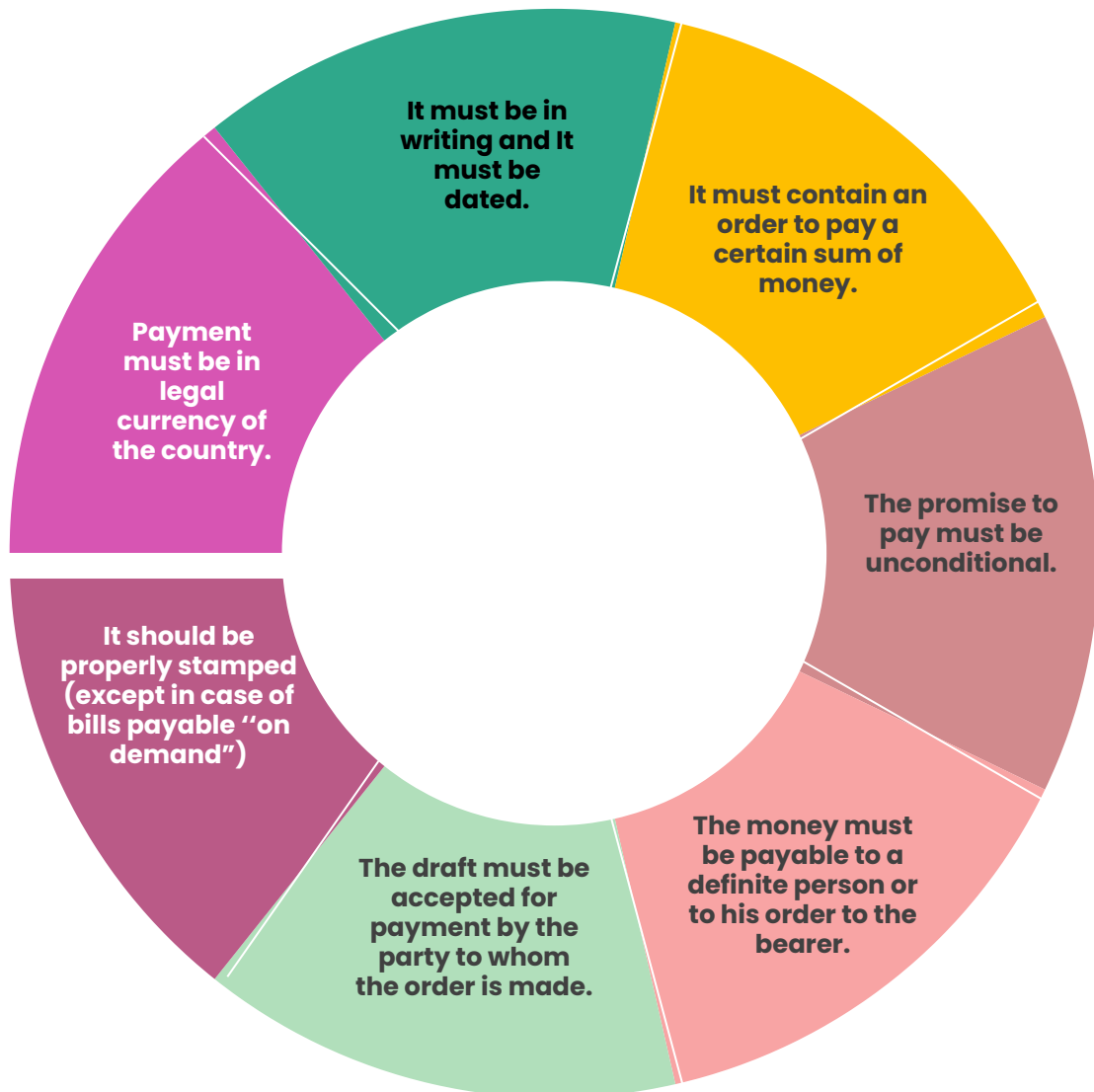
CHAPTER 6: BILLS OF EXCHANGE AND PROMISSORY NOTES

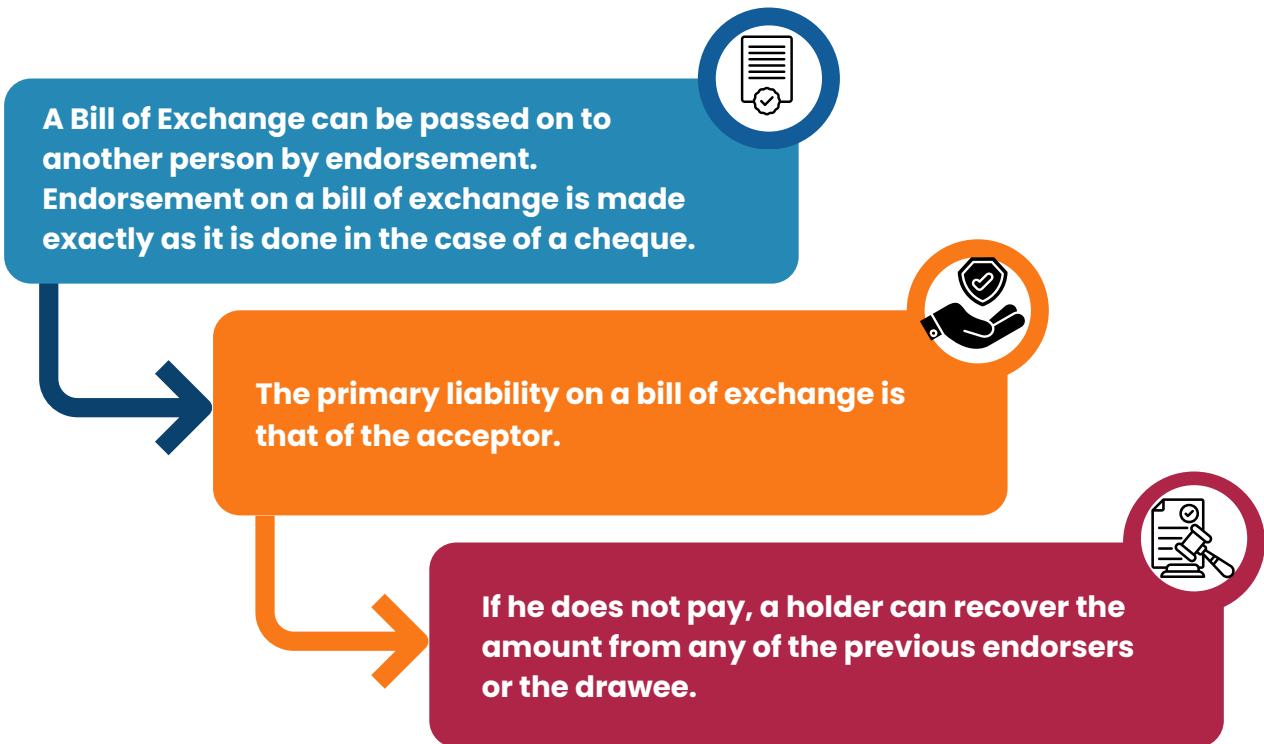
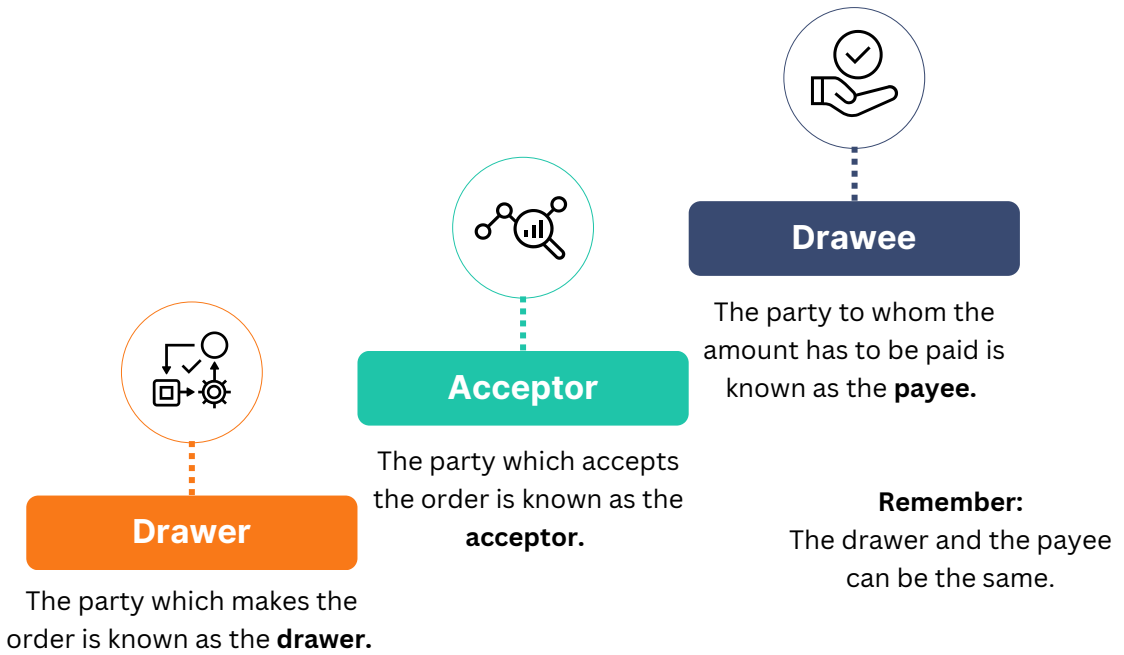
BILL OF EXCHANGE



A Bill of Exchange has been defined as an “instrument in writing containing an unconditional order signed by the maker directing certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument”. When such an order is accepted in writing on the face of the order itself, it becomes a valid bill of exchange.

A Bill of Exchange has the following characteristics:

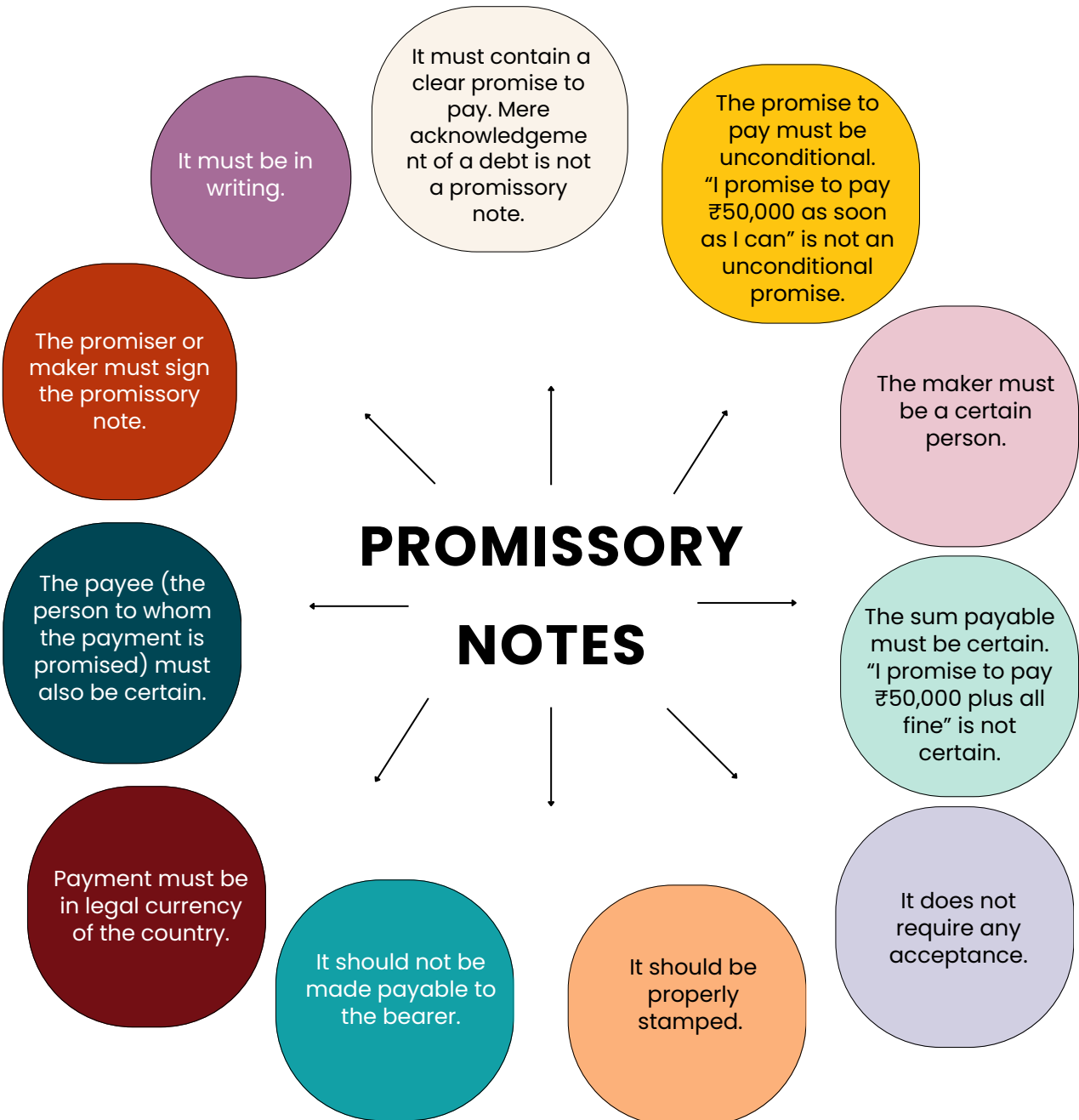




PROMISSORY NOTES

A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person. Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.

A Promissory Note has the following characteristics:



DIFFERENCES BETWEEN BILL OF EXCHANGE AND PROMISSORY NOTE

Bill of Exchange	Promissory Note
A bill contains an order to pay	A promissory note contains only a promise to pay certain sum of money.
There are generally 3 parties (Drawer, Drawee and Payee) in bill of exchange.	There are 2 parties (Maker and Payee) in promissory note.
A bill is paid by acceptor	A promissory note is paid by maker.
A bill is drawn by creditor	A promissory note is made by debtor
The drawer and payee may be same person in case of bill of exchange	In promissory note maker and payee cannot be same person
In a bill of exchange the liability of drawer is secondary and conditional. He will be liable only in case the acceptor does not honour the bill.	In a promissory note the liability of a maker is primary and absolute.
A bill of exchange can be accepted conditionally.	A promissory note cannot be made conditionally.
In a bill of exchange, notice of dishonour must be given.	Notice of dishonour is not required in case of promissory note.
In case of dishonour, a bill of exchange must be noted and protested.	Noting and protest is not required in case of dishonour of a promissory note.

RECORD OF BILLS OF EXCHANGE AND PROMISSORY NOTES

Particulars	Books of Drawer	Drawee
A transaction is executed	Debtors/Drawee A/c --- Dr. To Sales	Purchases A/c --- Dr. To Cred. /drawer
Bills drawn	Bills receivable A/c --- Dr. To Debtors /drawee A/c	Drawer a/c --- Dr. To Bills Payable A/c
Options after bills drawn	Retained :- No entry	
	Discounted:- Bank/Cash A/c --- Dr. Discount A/c --- Dr. To Bills Receivable A/c	
	Endorsed :- Creditors/Endorsee A/c --Dr. To Bills Receivable A/c	
	Sent for collection :- Bill sent for collection Dr. To Bills Receivable A/c	
On due date – Bill Honored	Retained :- Bank A/c ----- Dr. To Bills Receivable A/c	Bills Payable A/c Dr. To Bank A/c
	Endorsed :- No entry	
	Sent for collection:- Bank A/c --- Dr. To Bill sent for coll. A/c	
On due – Bill dishonoured	Retained :- Drawee A/c --- Dr. To Bills Receivable A/c	Bills Payable A/c Dr. To Drawer A/c
	Discounted :- Drawee A/c --- Dr. To Bank A/c	
	Endorsed :- Drawee A/c ----- Dr. To Creditor A/c	
	Bills sent for collection :- Drawee A/c --- Dr. To Bill sent for coll. A/c	

TERM OF A BILL

The term of bill of exchange may be of any duration. Usually the term does **not exceed 90 days from the date of the bill.**

When a bill is drawn after sight, the term of the **bill begins to run from the date of 'sighting'**, i.e., when the bill is **accepted.**

When a bill is drawn after date, the term of the **bill begins to run from the date of drawing the bill.**

EXPIRY / DUE DATE OF A BILL & DAYS OF GRACE

The date on which the term of the **bill terminates** is called as 'Expiry/Due Date of the bill'.

Every instrument payable otherwise than on demand is entitled to **three days** of grace.

DATE OF MATURITY OF BILL

The date which comes after adding three days of grace to the expiry/due date of a bill, is called the date of maturity.

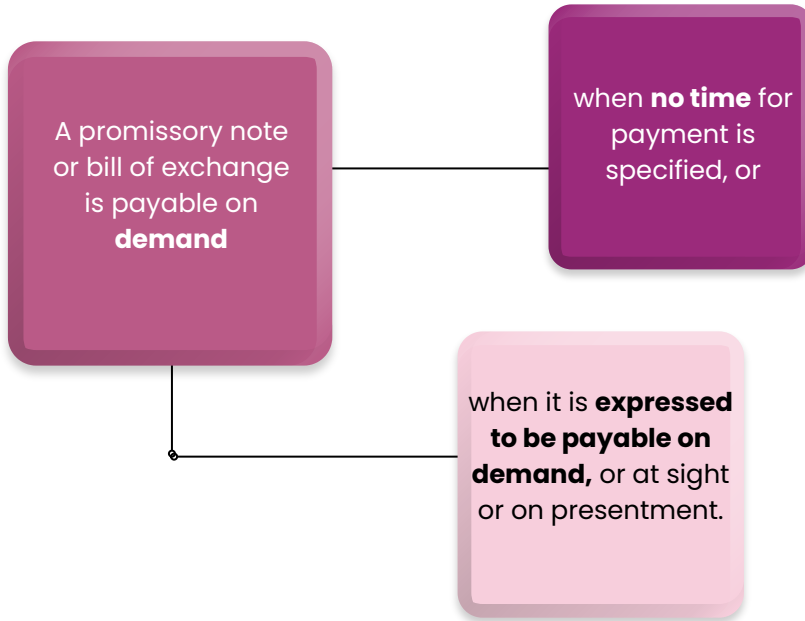
The maturity of a promissory note or bill of exchange is the date at which it falls due.

Every promissory note or bill of exchange gets matured on the third day after the day on which it is expressed to be payable, except when it is expressed to be payable:

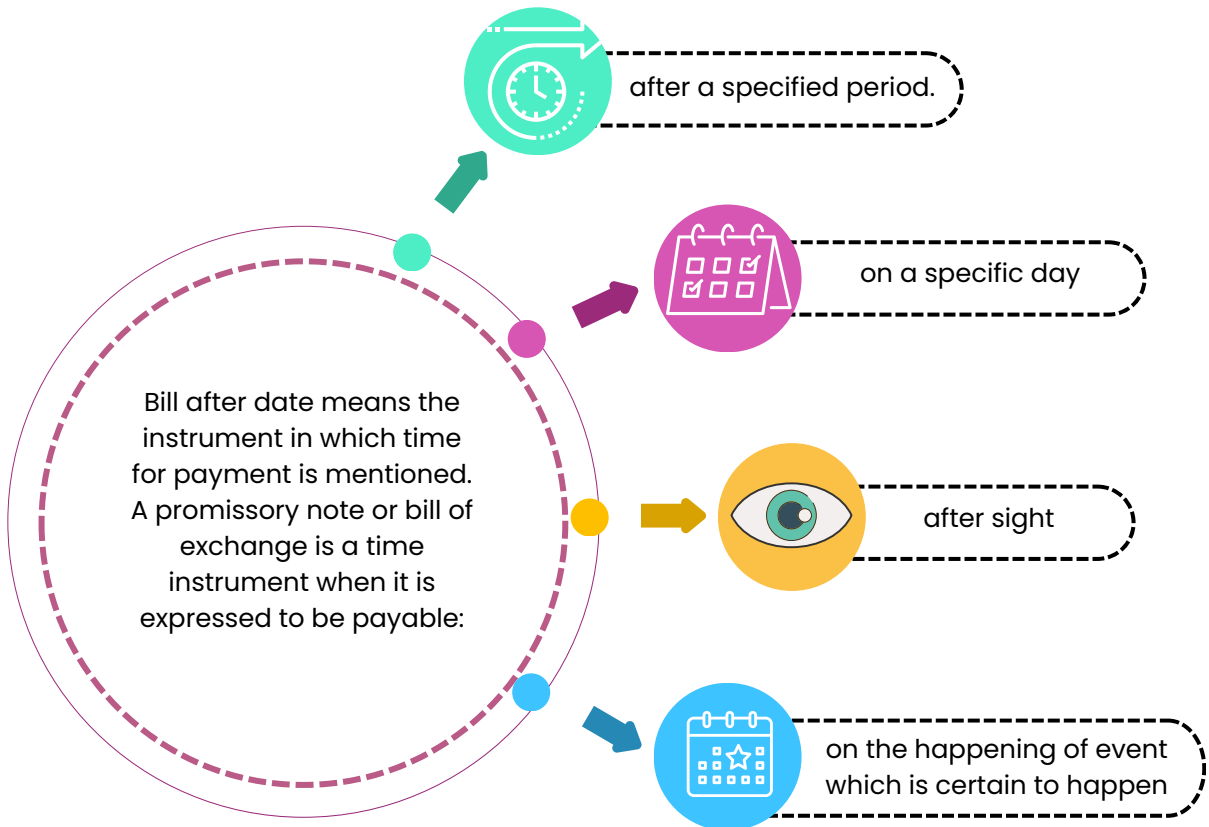
- (i) on demand,
- (ii) at sight, or
- (iii) on presentment

BILL AT SIGHT

Bill at Sight means the instruments in which no time for payment is mentioned. A cheque is always payable on demand



BILL AFTER DATE



HOW TO CALCULATE DUE DATE OF A BILL

The due date of each bill is calculated as follows:

Case	Due Date
(a) When the bill is made payable on a specific date.	(a) That specific date will be the due date.
(b) When the bill is made payable at a stated number of months(s) after date.	(b) That date on which the term of the bill shall expire will be the due date.
(c) When the bill is made payable at a stated number of days after date.	(c) That date which comes after adding stated number of days to the date of bill, shall be the due date.
(d) When the due date is a public holiday.	(d) The preceding business day will be the due date.
(e) When the due date is an emergency/ unforeseen holiday.	(e) The next following day will be the date.

Note: The term of a Bill after sight commences from the date of acceptance of the bill whereas the term of a Bill after date commences from the date of drawing of bill.

NOTING CHARGES

When bill is dishonored, bill is to be presented to notary public (govt. appointed authority)

1

Notary public will note the fact of dishonor, so it becomes evidence for court cases.

2

Charges of notary public are known as noting charges.

3

Noting charges are paid by holder & recovered from drawee.

4

RENEWAL OF BILL

Renewal means giving further time for making payment.

If acceptor is **unable** to pay amt. of bill on maturity date.

Drawer charges interest on delayed period.

RETIREMENT OF BILLS OF EXCHANGE & REBATE

Renewal of bill is made when a person doesn't have sufficient fund to pay. Drawee is required to pay interest on delayed payment.

Whereas, Retirement of bill is when acceptor has funds before maturity of due date. In such cases, the acceptor gets certain rebate or interest for pre-mature payment.

INSOLVENCY

Insolvency of a person means that he is unable to pay his liabilities. This means that bills accepted by him will be dishonored.



When it is known that a person has become insolvent, entry for dishonor of his acceptance must be passed. Later on, something may be received from his estate.



When and if an amount is received, the journal entry will be:

Cash A/c	Dr (Amt recoverd)
Bad Debts A/c	Dr (Bal Fig)
To Debtors A/c	(Amt receivable)



In the books of drawee of the bill, the amount not ultimately paid by him due to insolvency, should be credited to Deficiency Account.

ACCOMMODATION BILLS



Accomodation Bills

1

When 2 parties are in need of funds.

2

One party draws a bill and second party accepts the bill.

3

There is no purchase & sell between 2 parties.

4

It is not a trade bill.

5

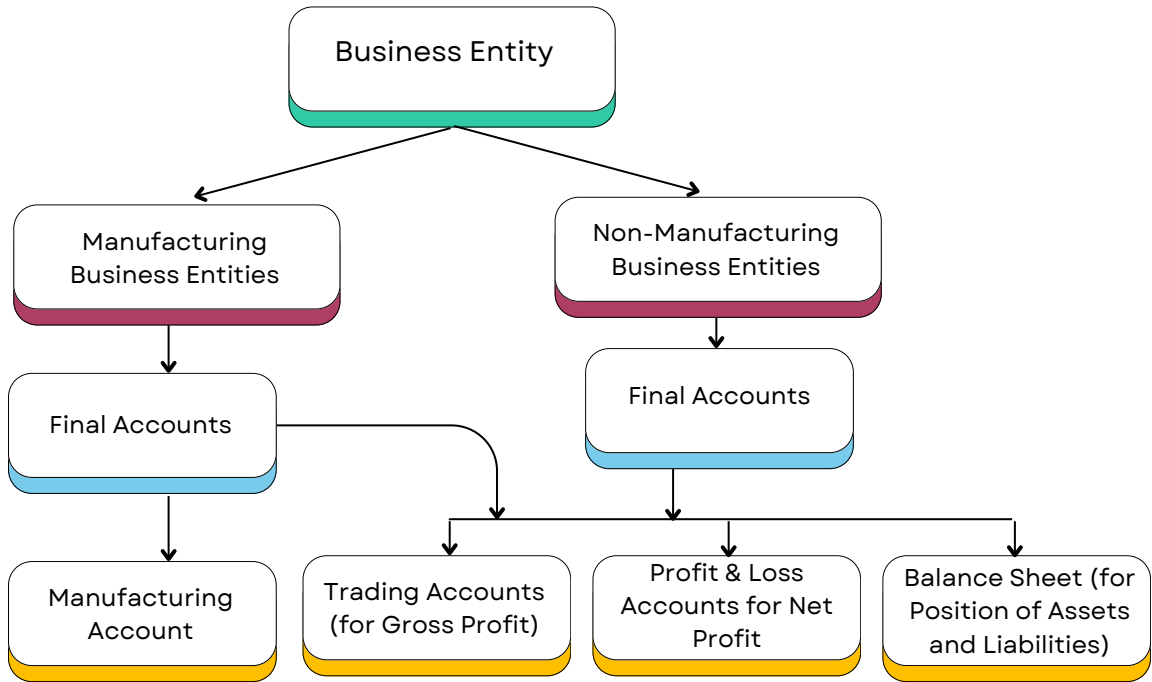
This mechanism is utilized to raise finance.

6

At the end, drawer sends certain amount to drawee for settlement of the bill.

PREPARATION OF 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.

Trading account shows Gross Profit while Manufacturing Account shows cost of goods sold which includes direct expenses.

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:

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.

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.

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	xxx
+Direct Manufacturing Wages	xxx
+Direct Manufacturing Expenses	xxx
Direct Manufacturing Cost	xxx
+Indirect Manufacturing expenses or Manufacturing Overhead	xxx
Total Manufacturing Cost	xxx

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 positions 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) 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.

(c) 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.



(d) 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.

(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.

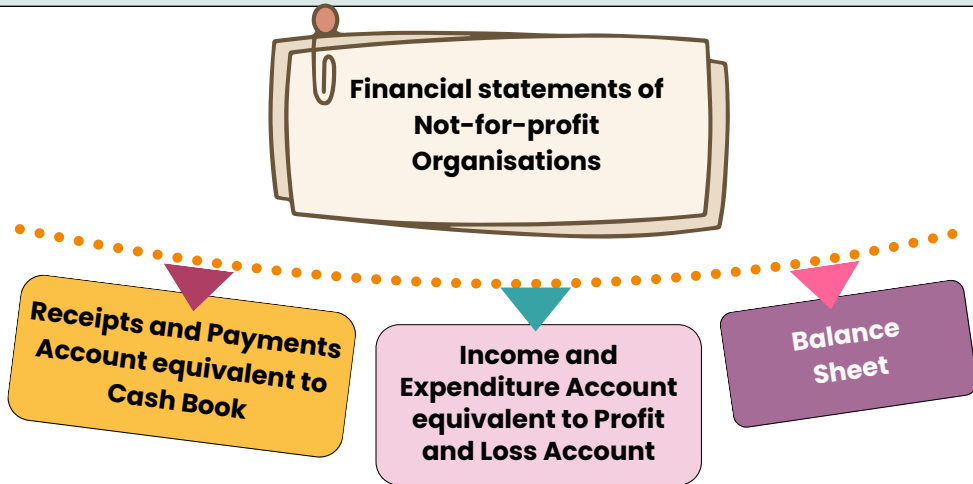


	Adjustment	Adjustment Entry	Treatment in Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
1	Closing Stock	Closing Stock A/c Dr. To Trading A/c	Shown on credit side		Shown on the assets side
2	Goods sold but omitted to be recorded	Debtors A/c Dr. To Sales A/c	Added to sales on the credit side		Added to Debtors on the assets side
3	Goods purchased but omitted to be recorded	Purchases A/c Dr. To Creditors A/c	Added to purchases on the debt side		
4	Sale of goods on approval basis	(i) Sales A/c Dr. To Debtors A/c (ii) Closing Stock A/c Dr. To Trading A/c	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 sample A/c Dr. To Purchase A/c	Deducted from purchases on the debt side	Shown on the debt side	
6	Drawings in goods	Drawing A/c Dr. To Purchase A/c	Deducted from purchases on the debt side		Deducted from capital on the liabilities side
7	Depreciation	Depreciation A/c Dr. To Asset A/c		Shown on the debt side	Deducted from the concerned asset on the assets side
8	Provision Doubtful debts	Profit & Los A/c Dr. To Prov. for Doubtful Debts A/c		Added to Bad-debts on the debit side	Deducted from debtors on the assets side
9	Provision for discount on debtors	Profit & Los A/c Dr. To Prov. for Disc. on Debtors A/c		Shown on the debit side as a separate item	Deducted from debtors on the assets side
10	Further Bad-debts	Bad-debts A/c Dr. To Sundry Debtors A/c		Added to Bad-debts (given in Trial Balance) on the debit side	Deducted from debtors on the assets side

	Adjustment	Adjustment Entry	Treatment in Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
11	Outstanding Expenses	Expenses A/c Dr. To O/s Expenses A/c	Added to the respective expense on the debt side	Added to the respective expense of the debit side	Shown on the liabilities side
12	Prepaid or unexpired expenses	Prepaid Expenses A/c Dr. To Expenses A/c	Deducted from the respective expense on the debt 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 Dr. To Income A/c		Added to the respective income on the credit side	Shown on the assets side
14	Unearned Income (Income received in advance)	Income A/c Dr. To Unearned Income A/c		Deducted from the respective income on the credit side	Shown on the liabilities side
15	Interest on capital	Interest on capital A/c Dr. To Capital A/c		Shown on the debit side	Added to the capital on the liabilities side
16	Interest on Drawings	Interest on Drawings A/c Dr. To Interest on Drawings A/c		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 Dr. To Loan A/c		Shown on the debit side	Added to the loan on the liabilities side
18	Abnormal loss of stock	Insurance Company A/c Dr. Profit & Loss A/c Dr. To Purchases A/c	Total amount of loss is deducted from purchases on the debt 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 Dr. To Purchase A/c	Deducted from purchases on the debit side	Shown on the debit side	
20	Manager's Commission	Manager's Comm. A/c Dr. To O/s Commission A/c		Shown on the debit side	Shown on the liabilities side

CHAPTER 8: 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 nonprofit organizations. These items have separate treatment, some being capitalized while others are treated on accrual basis.

RECEIPTS AND PAYMENTS ACCOUNT

A Receipts and Payments Account is a summary of the cash book without date column. It is commonly adopted by not for profit making concerns such as hospitals, clubs, societies, Temples, churches etc., for presenting the result of their working periodically.

It consists of a classified summary of cash/bank receipts and payments over a certain period together with the cash balances at the beginning and close of the period.

The receipts are entered on the left hand side, and payments on the right hand side i.e., same way as they appear in Cash Book.

FEATURES OF RECEIPT AND PAYMENT ACCOUNT

It is the summary of the cash and bank transactions like cash book, all the receipts (capital or revenue) are debited, similarly, all the expenditures (capital or revenue) are credited.

It starts with opening cash and bank balances and also ends with their closing balances.

This account is usually not a part of the double entry system as it includes all cash and bank receipts and payments, whether they are related to current, past or future periods

Surplus or deficit for an accounting period cannot be ascertained from this account, since, it shows only the Cash/Bank position and excludes all non cash items.

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 subscription 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 favored 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 taken 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 byelaws 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.

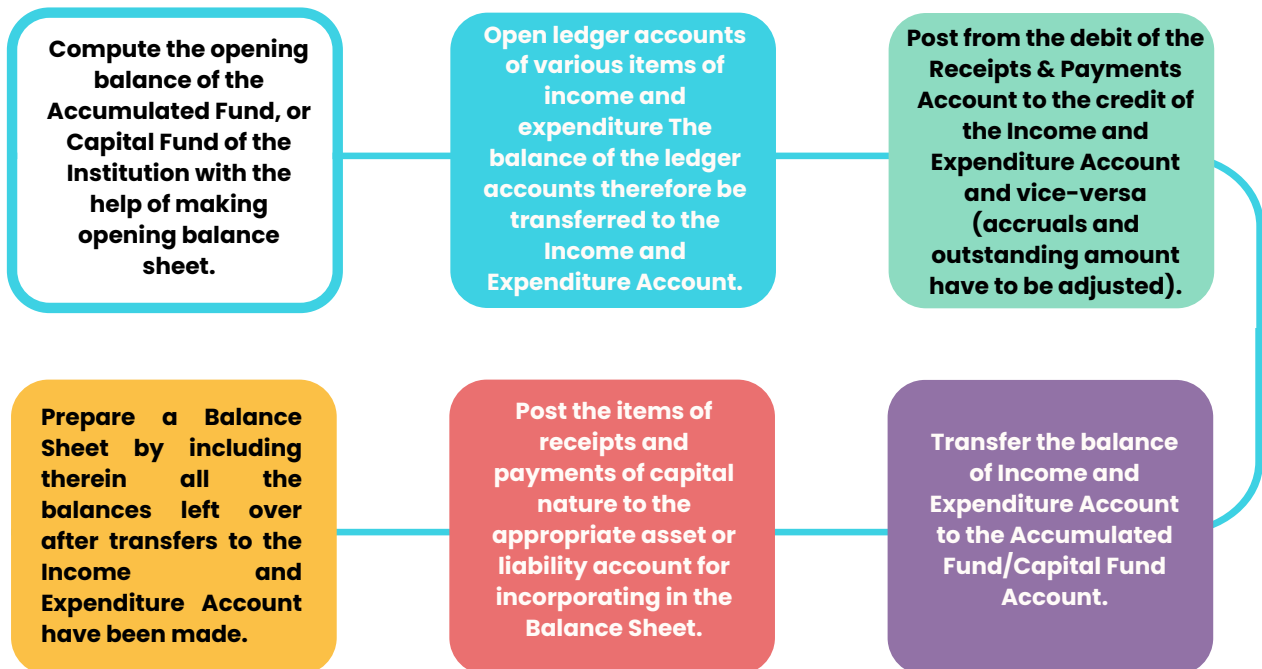
It may be noted that after various accounts have been adjusted and all the revenue accounts have been closed off by transfer to the Income and Expenditure Account, there will still be a number of balances left over. These are included in the Balance Sheet.

DISTINCTION BETWEEN RECEIPTS AND PAYMENTS ACCOUNT AND INCOME AND EXPENDITURE ACCOUNT

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.

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

1

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.

2

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.

3

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.

4

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 & 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.

CHAPTER 9: ACCOUNTS FROM INCOMPLETE RECORDS

OVERVIEW

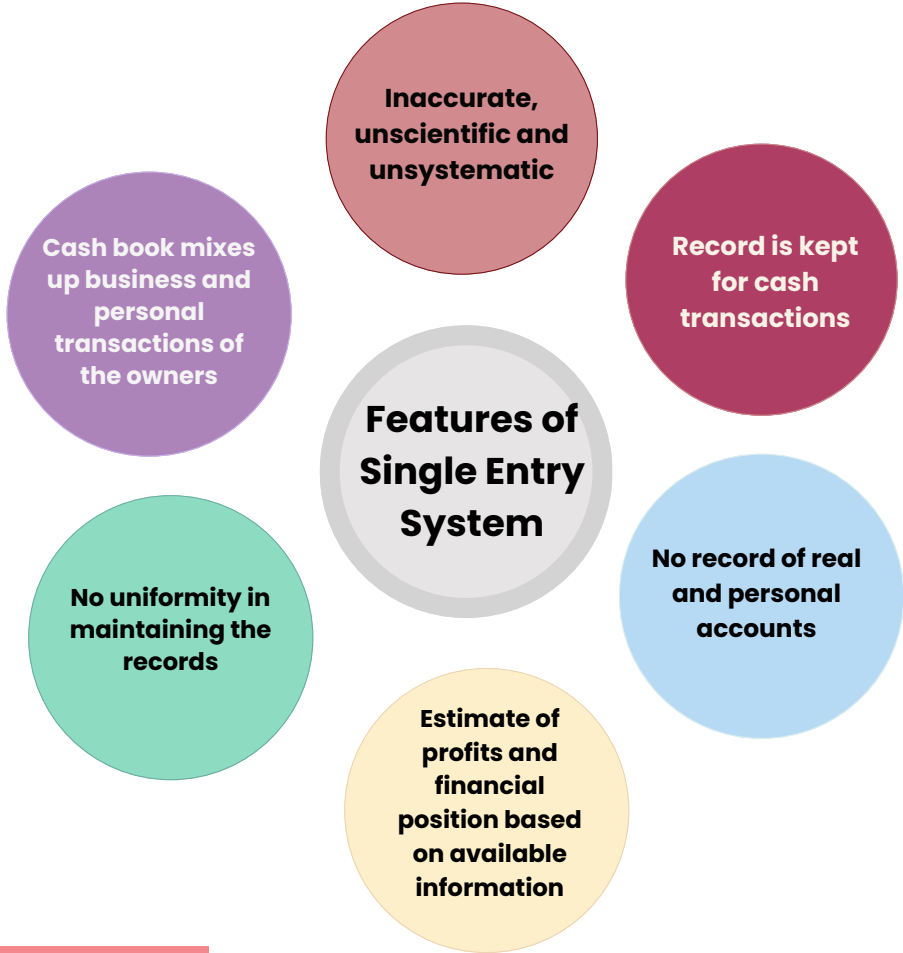


DEFINITION OF SINGLE ENTRY SYSTEM

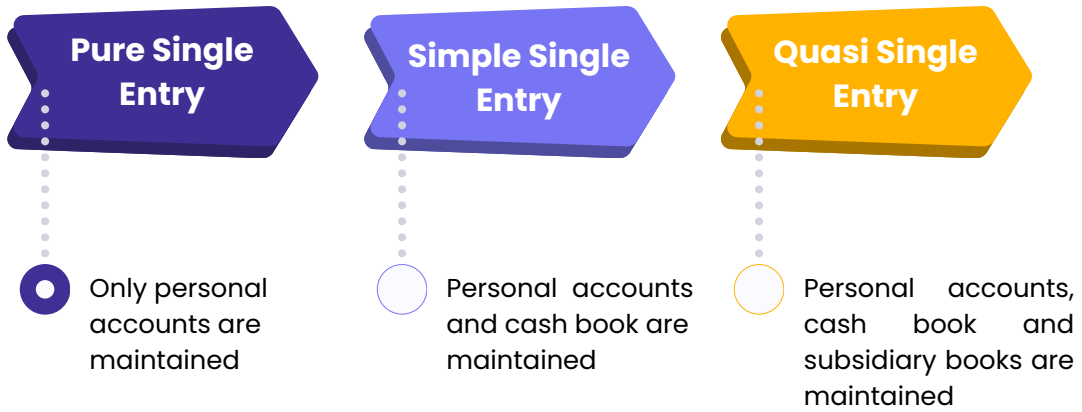
The term "Single Entry System" is popularly used to describe the problems of accounts from incomplete records.



FEATURES OF SINGLE ENTRY SYSTEM



TYPES OF SINGLE ENTRY SYSTEM



ASCERTAINMENT OF PROFIT BY CAPITAL COMPARISON AT DIFFERENT POINTS OF TIME

Net Worth method or Statement of Affairs Method.



Particulars	₹
Capital at the end (a)	xxx
Add: Drawings	xxx
Less: Fresh capital introduced	xxx
Capital at the beginning (b)	xxx
Profit/Loss (a-b)	xxx

PREPARATION OF STATEMENT OF AFFAIRS

Sources utilized by accountant



- Sources utilized by accountant- Collection of necessary information about assets and liabilities
- Derivation of opening and closing capitals - Statement of Affairs at different points of time

DESIGN OF STATEMENT OF AFFAIRS

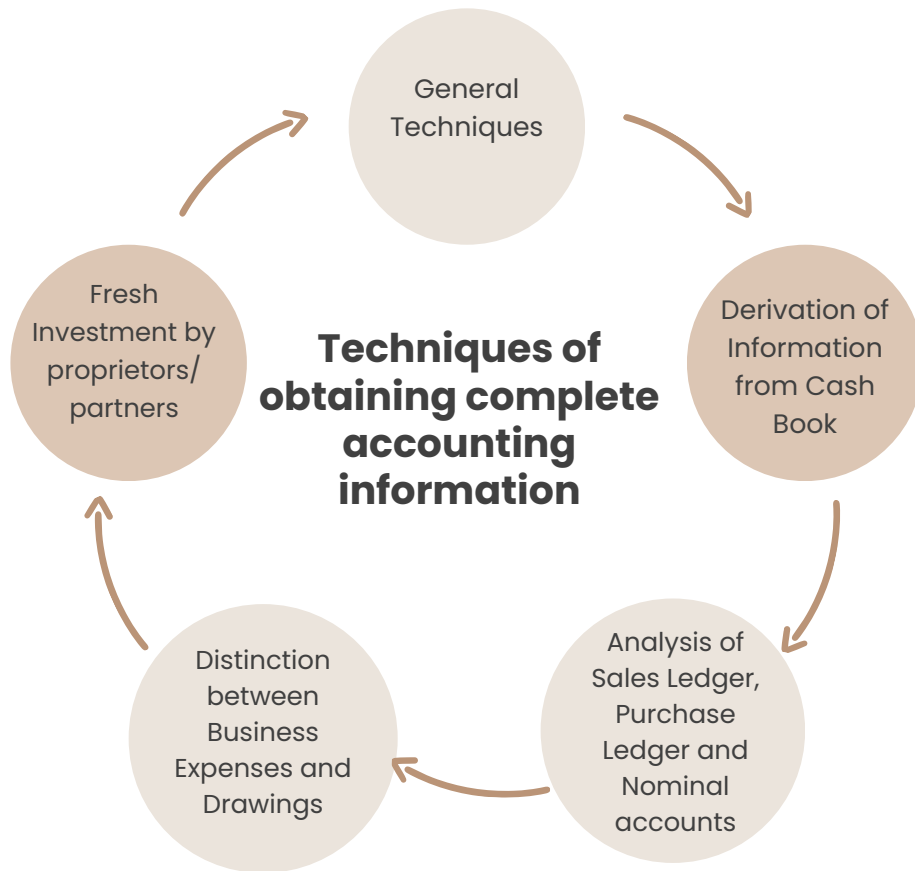
Statement of Affairs as at.....

Liabilities	Amount	Assets	Amount
Capital (Bal. Fig.)	xxx	Building	xxx
Loans, Bank overdraft	xxx	Machinery	xxx
Sundry creditors	xxx	Furniture	xxx
Bills payable	xxx	Inventory	xxx
Outstanding expenses	xxx	Sundry Debtors	xxx
		Bills receivable	xxx
		Loans and advances	xxx
		Cash and bank	xxx
		Prepaid expenses	xxx
TOTAL	xxx	TOTAL	xxx

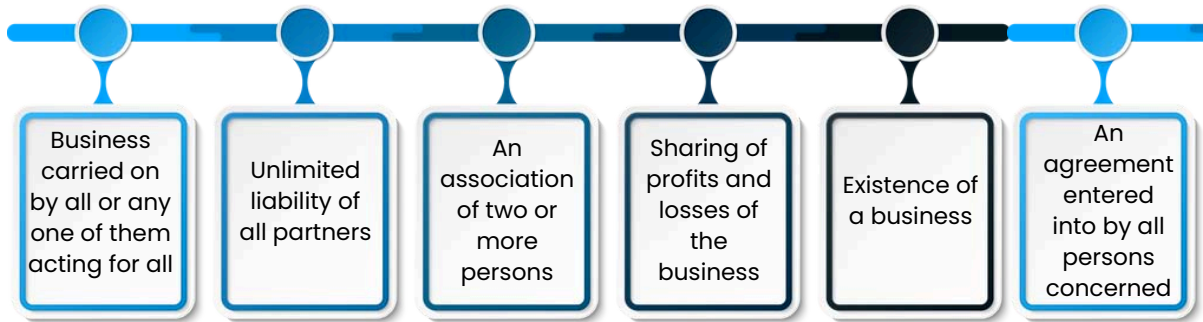
PREPARATION OF STATEMENT OF AFFAIRS

Basis	Statement of affairs	Balance sheet
Reliability	It is prepared on the basis of transactions partly recorded on the basis of double entry book keeping and partly on the basis of single entry.	It is based on transactions recorded strictly on the basis of double entry book keeping.
Capital	In this statement, capital is merely a balancing figure being excess of assets over capital. Hence assets need not be equal to liabilities.	Capital is derived from the capital account in the ledger and total of assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared on basis of incomplete records, it is difficult to locate assets and liabilities, if they are omitted from the books.	All items are properly recorded. It is easy to locate missing items since the balance sheet will not agree.
Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; no method of valuation is disclosed.	The valuation of assets is done on scientific basis. Method of valuation is disclosed.
Objective	The object of preparing this statement in the calculation of capital figures in beginning and at end of accounting period respectively.	The object of preparing the balance sheet is to ascertain the financial position on a date.

TECHNIQUES OF OBTAINING COMPLETE ACCOUNTING INFORMATION



CHAPTER 10: PARTNERSHIP AND LLP 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



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

**Minimum Partners:
Two (2)**

**Maximum Partners:
Fifty (50)***

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

LIMITED LIABILITY PARTNERSHIP

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

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

No partner would be liable on account of the independent or unauthorized 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 (LLP's) 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.
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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.

NATURE OF LIMITED LIABILITY PARTNERSHIP

A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

A limited liability partnership should have perpetual succession.

Non-applicability of the Indian Partnership Act, 1932

Provisions of the Indian Partnership Act, 1932 should not apply to a limited liability partnership.

Any change in the partners of a limited liability partnership should not affect the existence, rights or liabilities of the limited liability partnership.

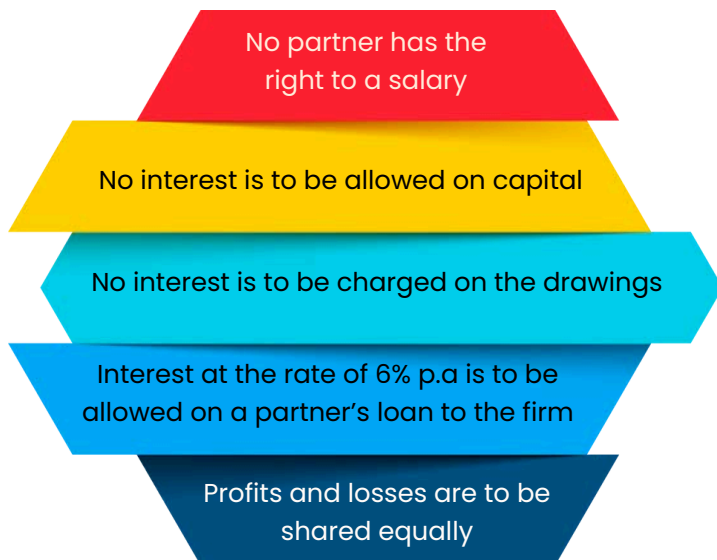
DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

S.No.	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



RULES IN THE ABSENCE OF PARTNERSHIP DEED



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

POWERS OF PARTNERS

01

Buying and selling of goods

02

Receiving payments on behalf of the firm and giving valid receipt

03

Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm

04

Borrowing money on behalf of the firm with or without pledging the inventories-in-trade

05

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:

Submitting a dispute relating to the firm arbitration

Opening a bank account on behalf of the firm in the name of a partner

Compromise or relinquishment of any claim or portion of claim by the firm

Withdrawal of a suit or proceeding filed on behalf of the firm

Admission of any liability in a suit or proceedings against the firm

Acquisition of immovable property belonging to the firm

Entering into partnership on behalf of the firm

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

ACCOUNTS

- ◆ Partnership Act doesn't specify 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 Profit and Loss Account will show the profit earned by the firm or loss suffered by it.

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

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).

METHODS OF ACCOUNTING

Two Methods of Accounting:

1. Fluctuating capital method
2. Fixed capital method

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

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.

Net loss and Interest on Capital

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 AccountDr.
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.

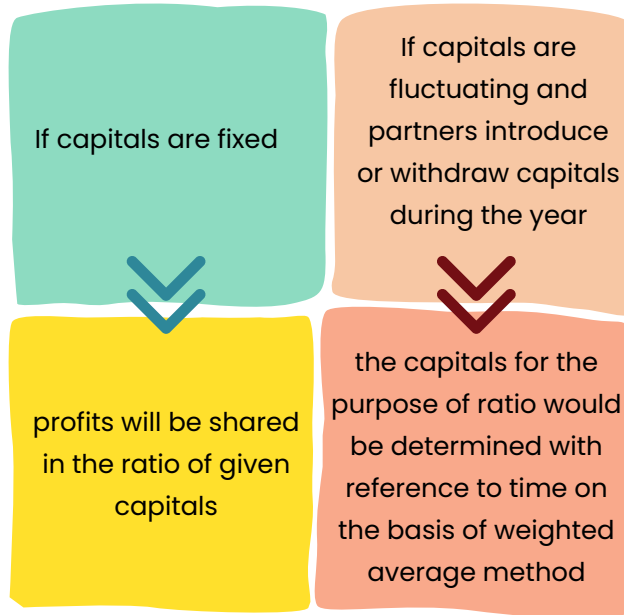
There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- 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

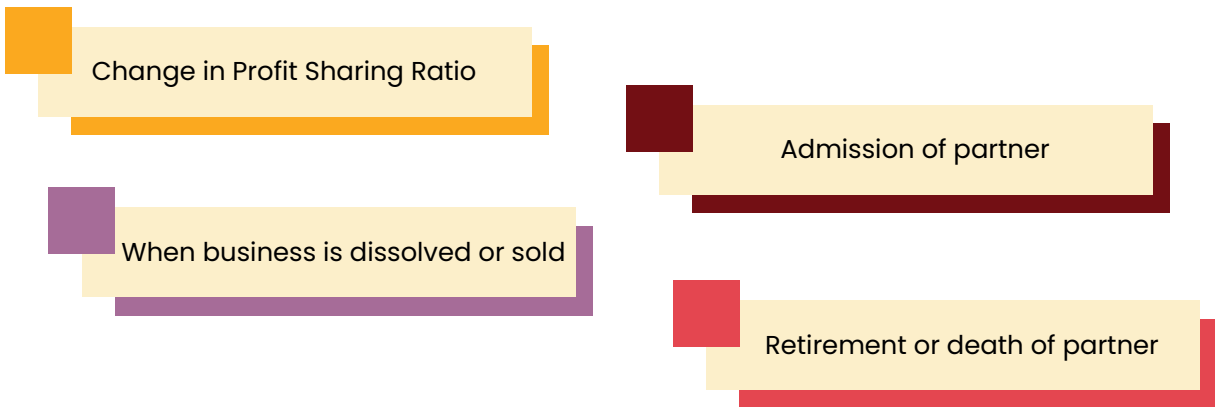
Partners may agree to share profits and losses in the capital ratio.



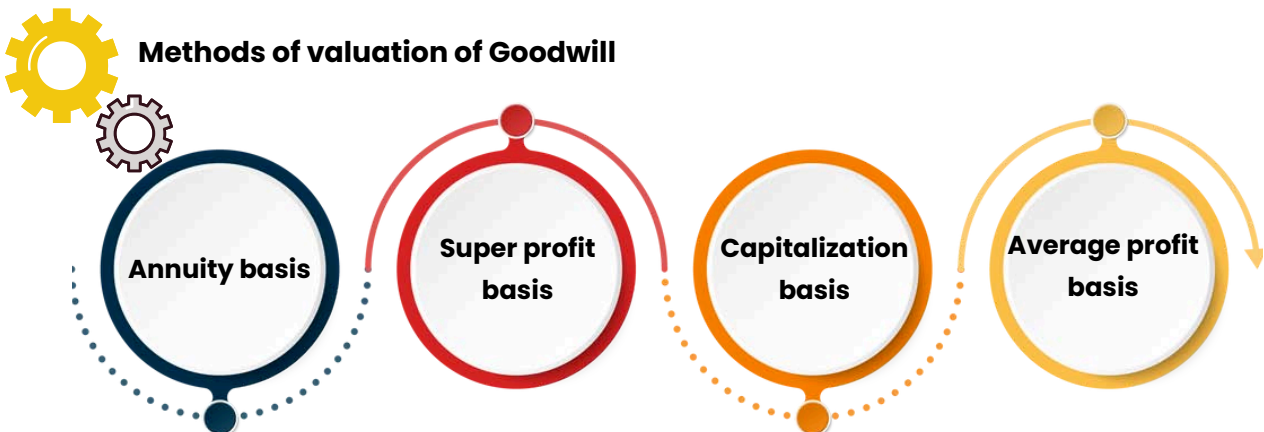
VALUATION OF GOODWILL

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



Methods of valuation of Goodwill



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

Annuity basis

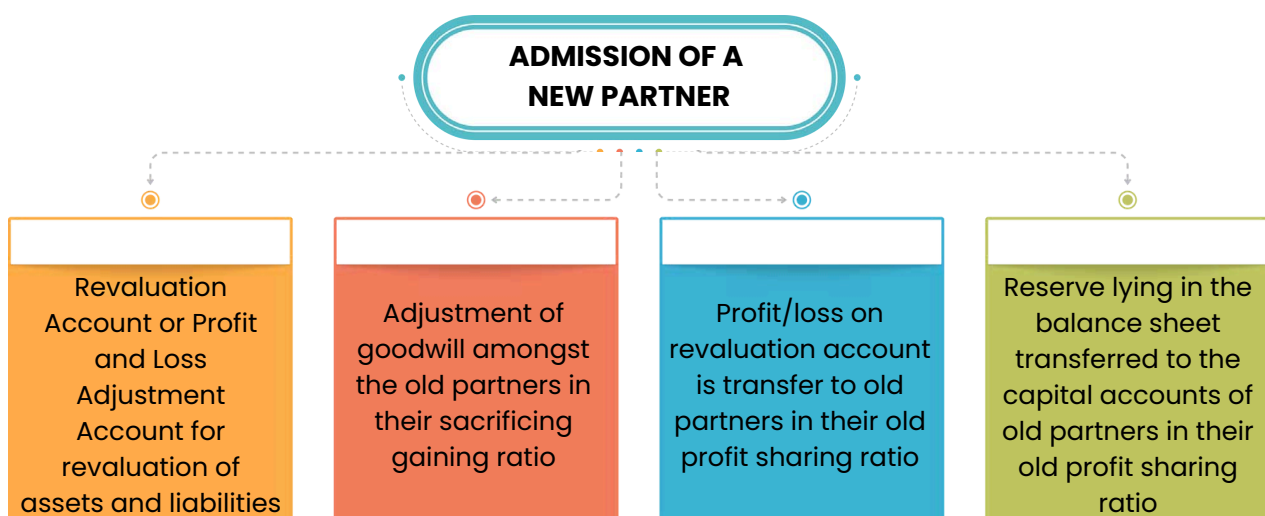
- Goodwill = Super Profit x Annuity Number

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.



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.

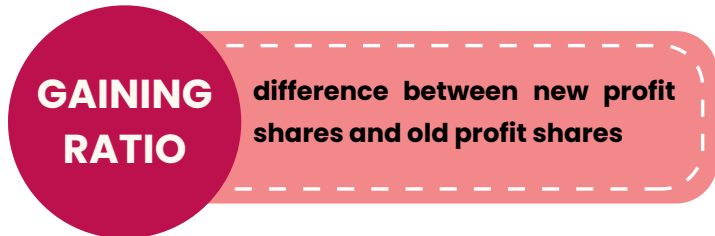
ACCOUNTING ENTRIES

1.	Revaluation Account	Dr.	
	To Assets Account		with the reduction in the value of the assets
	<i>(Individually which show a decrease)</i>		
	To the Liabilities Accounts		with the increase in the liabilities.
	<i>(Individually which have to be Increased)</i>		
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

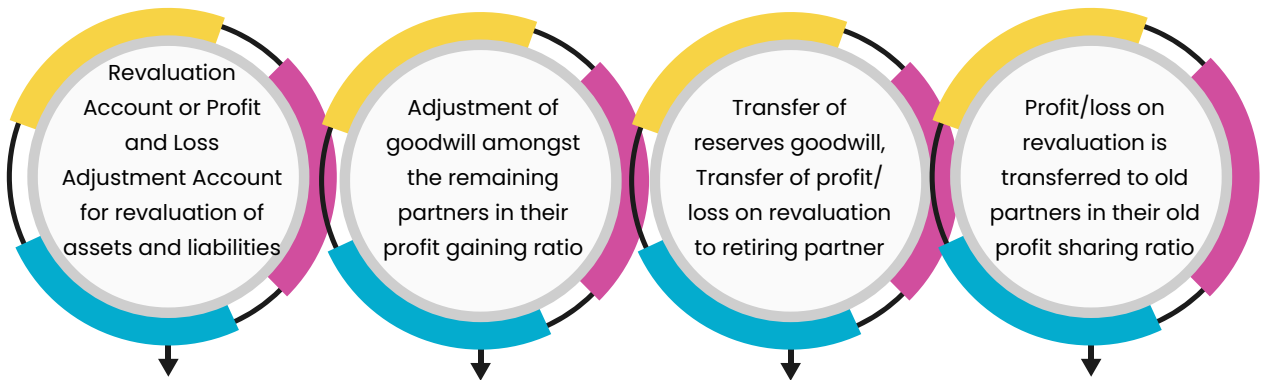


HIDDEN GOODWILL

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



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/cDr.
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/cDr.
 To Retiring Partner's Loan A/c
 To Bank A/c

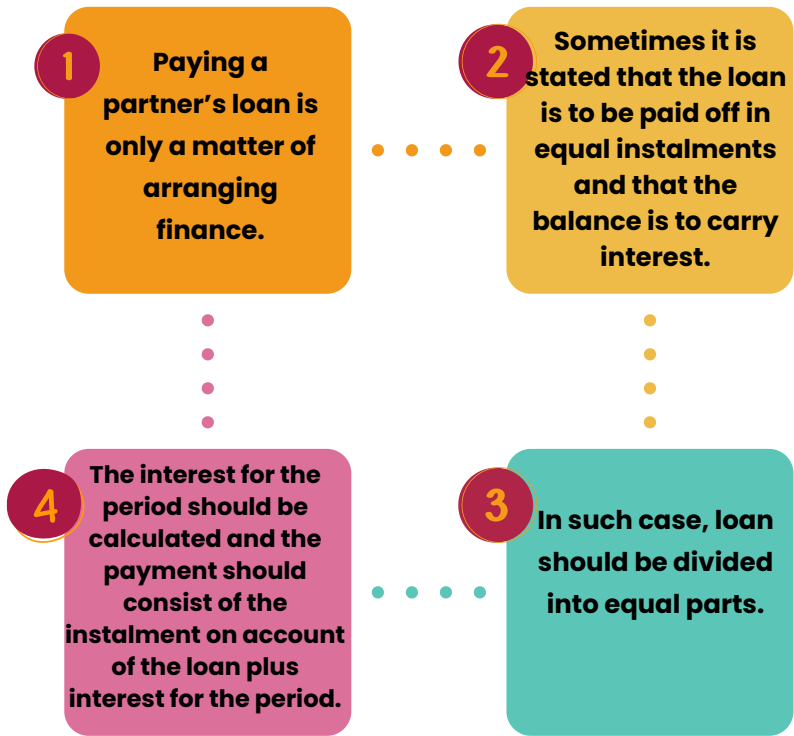
As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

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

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

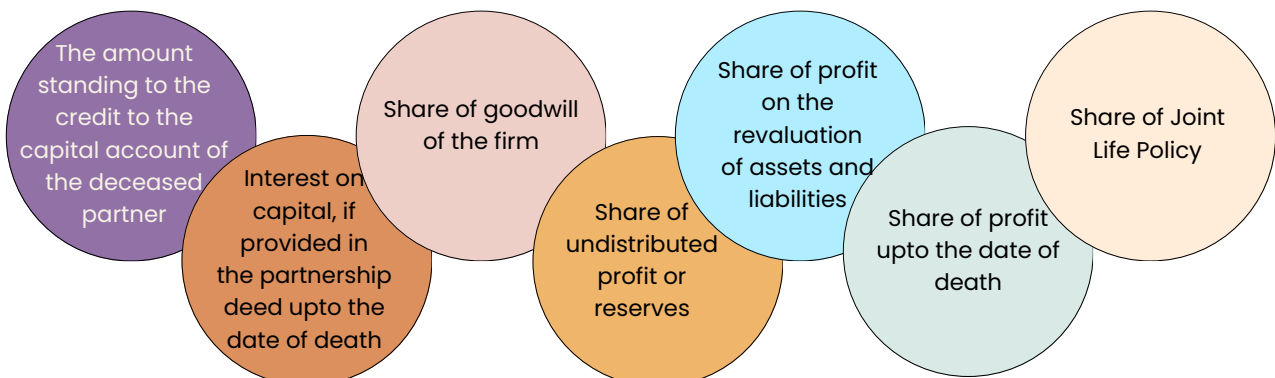
- Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is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



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

AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

The representatives of dead partners are entitled to



CALCULATION OF PROFIT UP TO THE DATE OF DEATH OF A PARTNER

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

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

*Such profit is ascertained by either of the following methods

Time Basis

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

Turnover or Sales Basis

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

DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

First of all, it is required to comprehend the circumstances leading to the dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also, the special adjustments relating to the insolvency of partners and the settlement of the partnership's liabilities must be thoroughly understood.

Let us understand the difference between Dissolution of Partnership and Dissolution of Partnership Firm.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between the partners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/ death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, the business ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.
Economic relationships among partners may remain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued.	Assets are realized and liabilities are paid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

Circumstances Leading to Dissolution of Partnership

A partnership dissolves or comes to an end on:

The expiry of the term for which it was formed

Death of a partner

Completion of the venture for which it was entered into

Insolvency of a partner

The partners or remaining partners (in case of death or insolvency of a partner) may continue to do the business. In such a case there will be a new partnership, but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:

The partners agree that the firm should be dissolved

The business becomes illegal

In case of partnership at will, a partner gives notice of dissolution

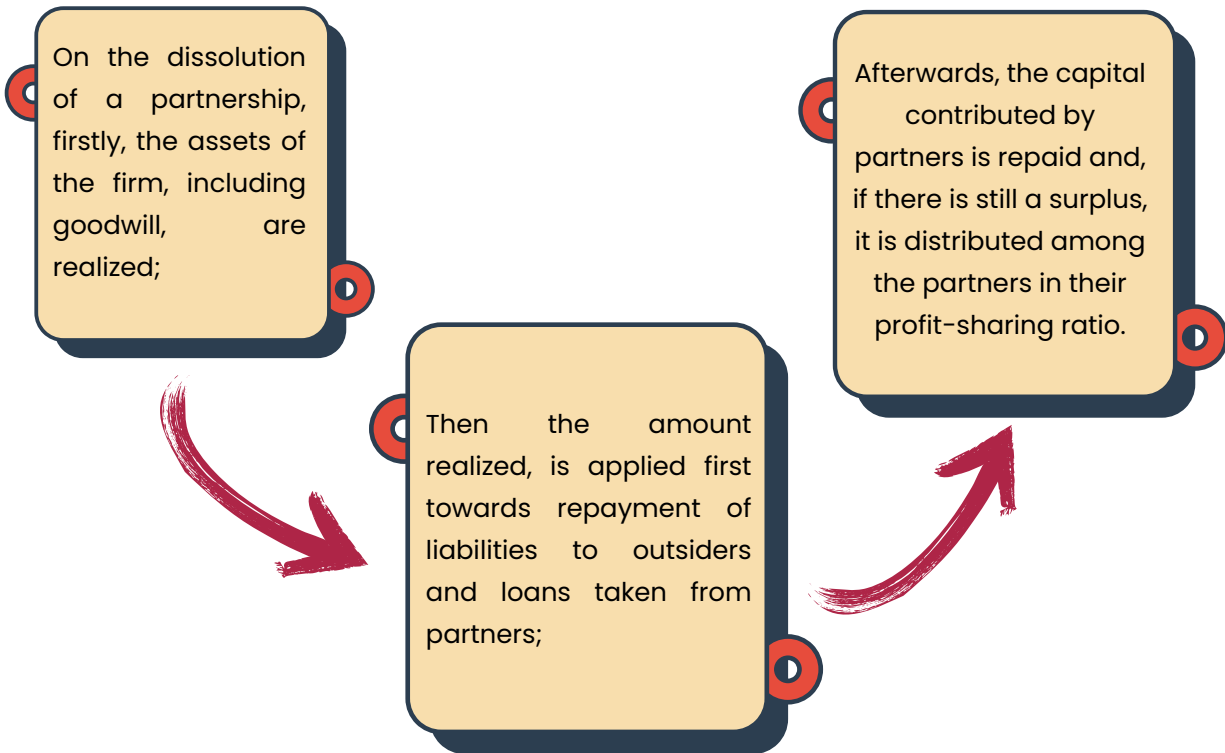
All partners except one become insolvent

The court orders dissolution

The court has the option to order dissolution of a firm if

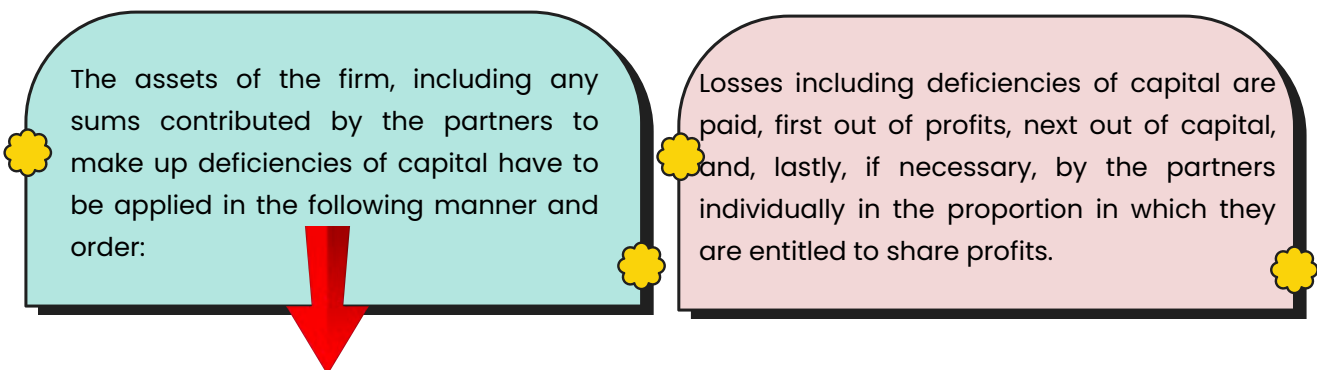
- A partner has become of unsound mind;
- A partner suffers from permanent incapacity;
- A partner is guilty of misconduct of the business;
- A partner persistently disregards the partnership agreement;
- A partner transfers his interest or share to a third party;
- The business cannot be carried on except at a loss; and
- It appears to be just and equitable.

CONSEQUENCES OF DISSOLUTION



Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:



in paying the debts of the firm to third parties	in paying the debts in paying to each partner what is due to him on account of capital.	in paying the debts in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital of the firm to third parties	the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits
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DISSOLUTION BEFORE THE EXPIRY OF A FIXED TERM

- A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

No claim in this respect will arise if

Firm is dissolved due to the death of a partner;

Dissolution is mainly due to the partner's (claiming refund) own misconduct;

Dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit-sharing ratio.

CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

To close books of accounts of Partnership Firm, we need to transfer all the assets and liabilities to Realization Account.

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

KEY POINTS

If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of asset taken over.

Pay off the liabilities (if not transferred to Realization A/c) crediting cash, and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realization Account.

Liabilities to outsiders may also be transferred to the Realization Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realization Account, Cash Account being credited. If liability is taken over by a partner, Realization Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.

Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.

The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various Partners' Capital Accounts; follow the opposite course in the case of a profit.

The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.

CONSEQUENCES OF INSOLVENCY OF A PARTNER

If a partner goes insolvent, the following are the consequences:

The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.

The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.

The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication.

The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of Garner vs. Murray.

As per the above decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

DETERMINATION OF CAPITAL RATIO ON INSOLVENCY

The partners are free to have either fixed or fluctuating capitals in the firm.

If the partners are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.

If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.

If capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization.

INSOLVENCY OF ALL PARTNERS

When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account.

The balance of the creditors accounts is transferred to Deficiency Account. Creditors may be paid the amount available including the amount contributed by the partners.

The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed.

PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time.

In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted.

In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order of payments.

Maximum Loss Method

Each installment realised is considered to be the final payment i.e., outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either Garner vs. Murray Rule or the profit-sharing ratio.

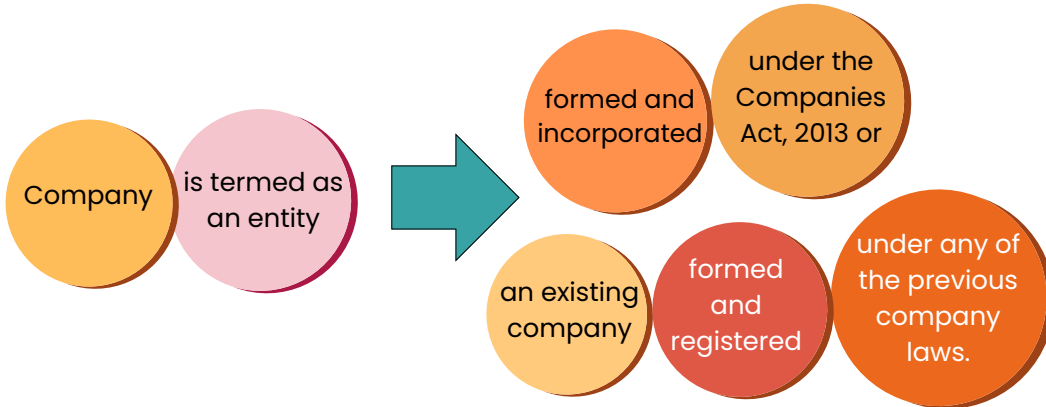
Highest Relative Capital Method

- The partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off.
- For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated.

The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

CHAPTER 11: COMPANY ACCOUNTS

MEANING OF A COMPANY



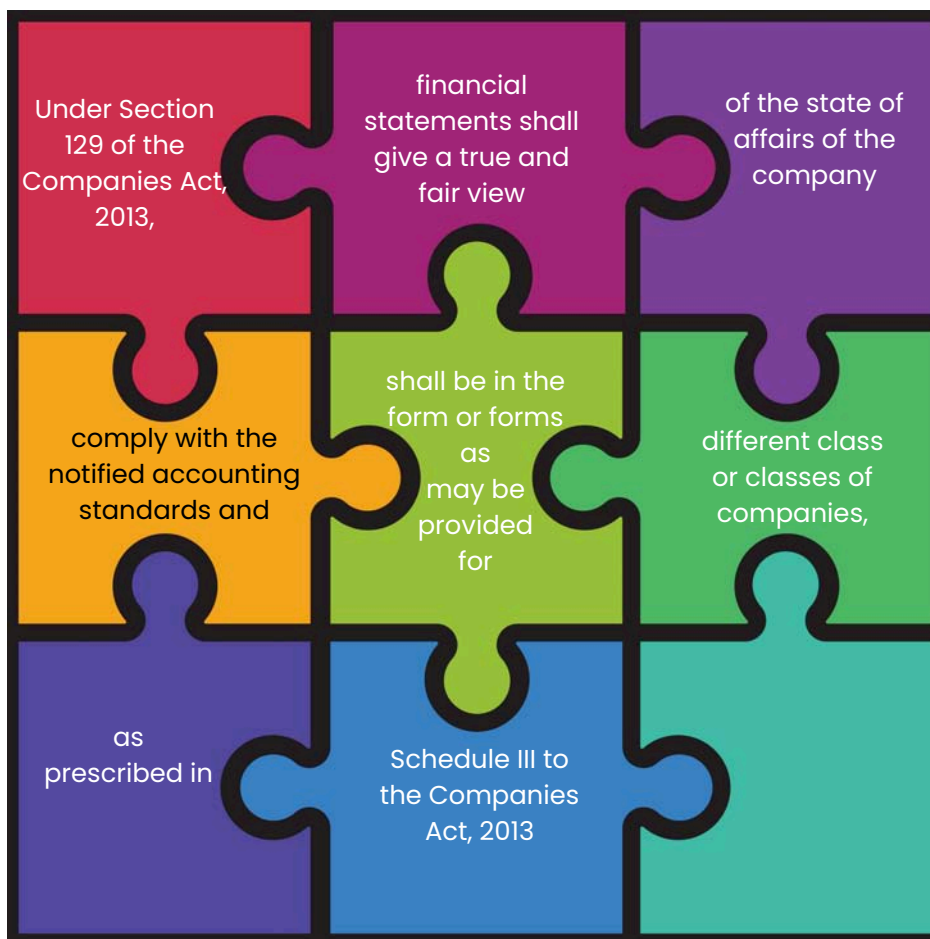
TYPES OF COMPANIES

- | | |
|---|---|
| <ul style="list-style-type: none"> • Government Company • Foreign Company • Private Company • Public Company • One Person Company • Small Company | <ul style="list-style-type: none"> • Listed Company • Unlimited Company • Company limited by Shares • Company limited by Guarantee • Holding Company • Subsidiary Company |
|---|---|

SALIENT FEATURES OF A COMPANY



PREPARATION OF FINANCIAL STATEMENTS



REQUISITES OF FINANCIAL STATEMENTS

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

PROVISIONS APPLICABLE

1

Specific Act is Applicable

For instance, any

- (a) Insurance company
- (b) Banking company or
- (c) Any company engaged in generation or supply of electricity or
- (d) Any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company.

2

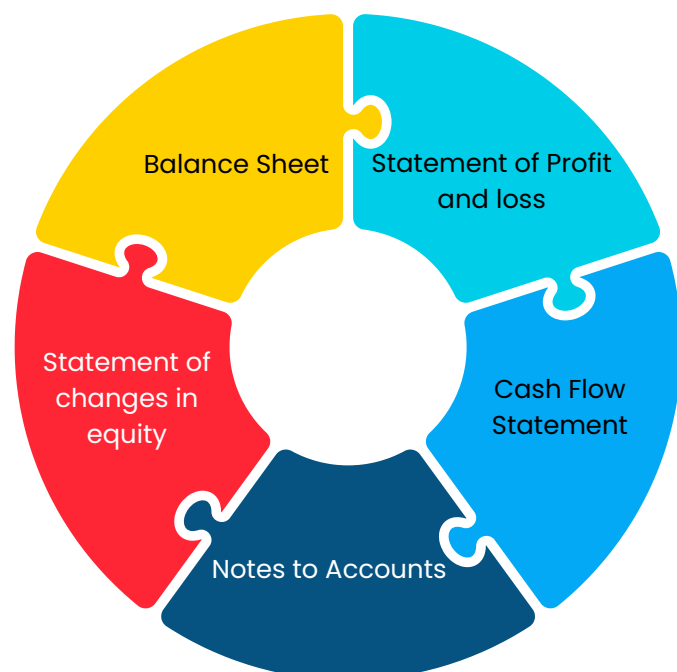
In case of all corporate entities:
Schedule III to the Companies Act, 2013 deals with the format of the financial statements. However, Schedule III contains three divisions either based on the applicability of the standards or on the nature of the entity. Each division of Schedule III contains parts dealing with formats of financial statements. Part I prescribes the format of Balance Sheet while Part II prescribes the format of Statement of Profit and Loss.

Applicability of Divisions as given under Schedule III has been explained below:

Division	Applicable to:
Division I	Companies that are required to apply Accounting Standards notified under the Companies Act, 2013.
Division II	Companies that are required to apply Indian Accounting Standards notified under the Companies Act, 2013.
Division III	Non-Banking Finance Companies (NBFCs) that are required to apply Indian Accounting Standards notified under the Companies Act, 2013.

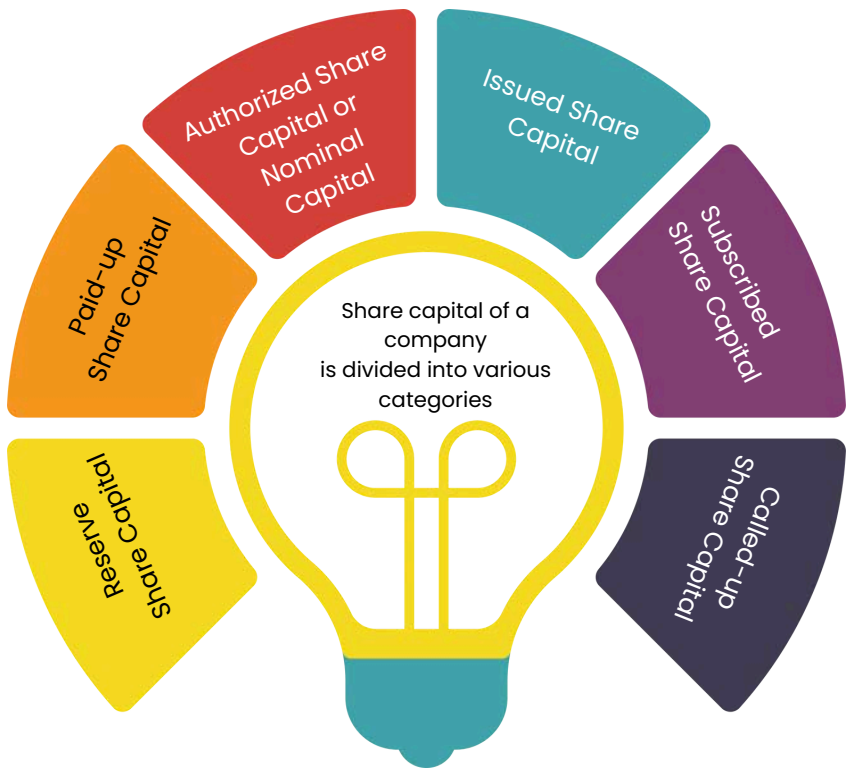
FINANCIAL STATEMENTS

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'.



Issued Capital	+	Unissued Capital	=	Authorised Capital
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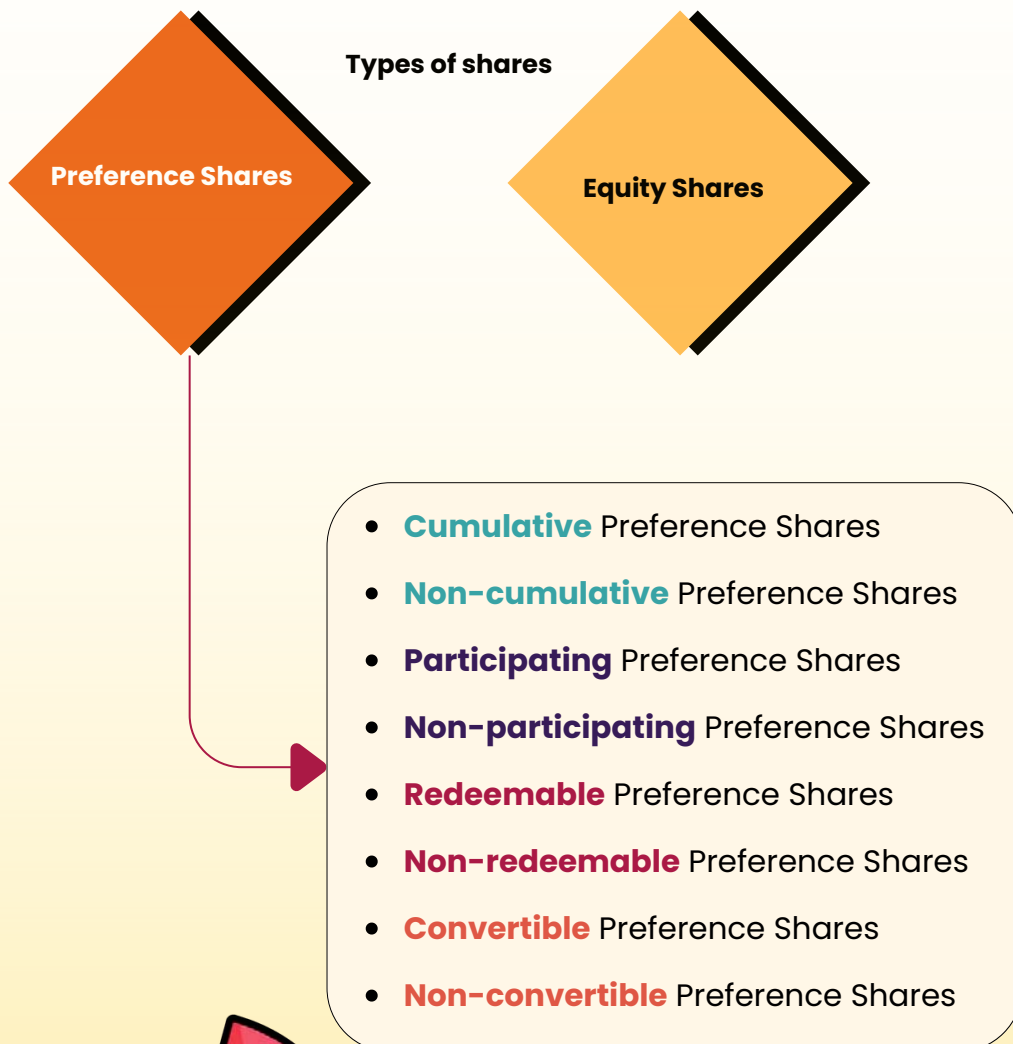
Paid up Capital	+	Calls in arrears if any Less Calls in advance if any	=	Called up Capital
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Subscribed Capital can be equal to or greater than or less than Issued Capital resulting in 3 situations respectively:

- Fully Subscribed;
- Over Subscribed and
- Under Subscribed.

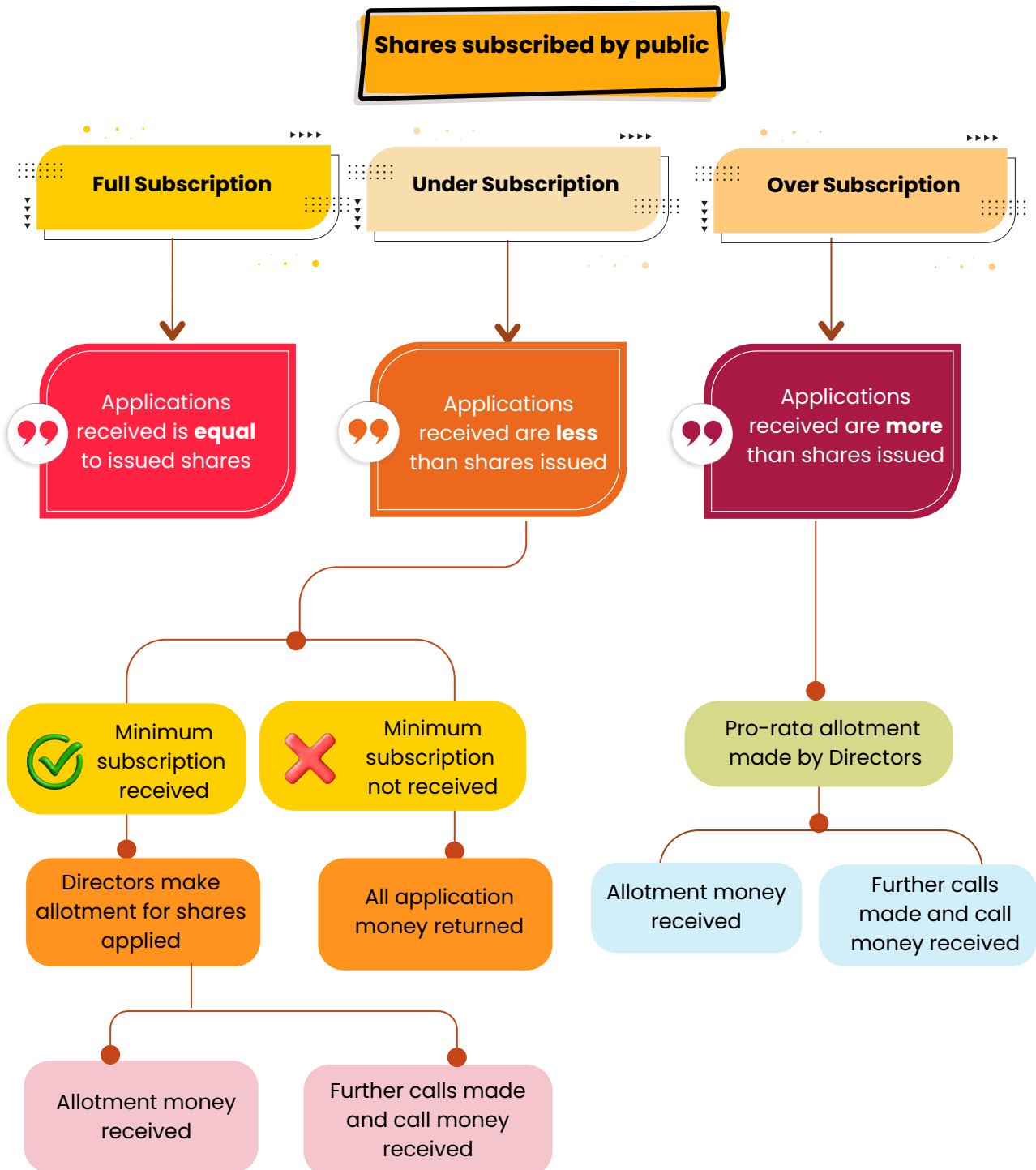
TYPES OF SHARES

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



SUBSCRIPTION OF SHARES

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



ISSUE OF SHARES

Shares issued at

Discount

Issue price is less than the nominal or par value of shares

Issue of shares at discount shall be void except in the case of issue of sweat equity shares (issued to employees and directors).

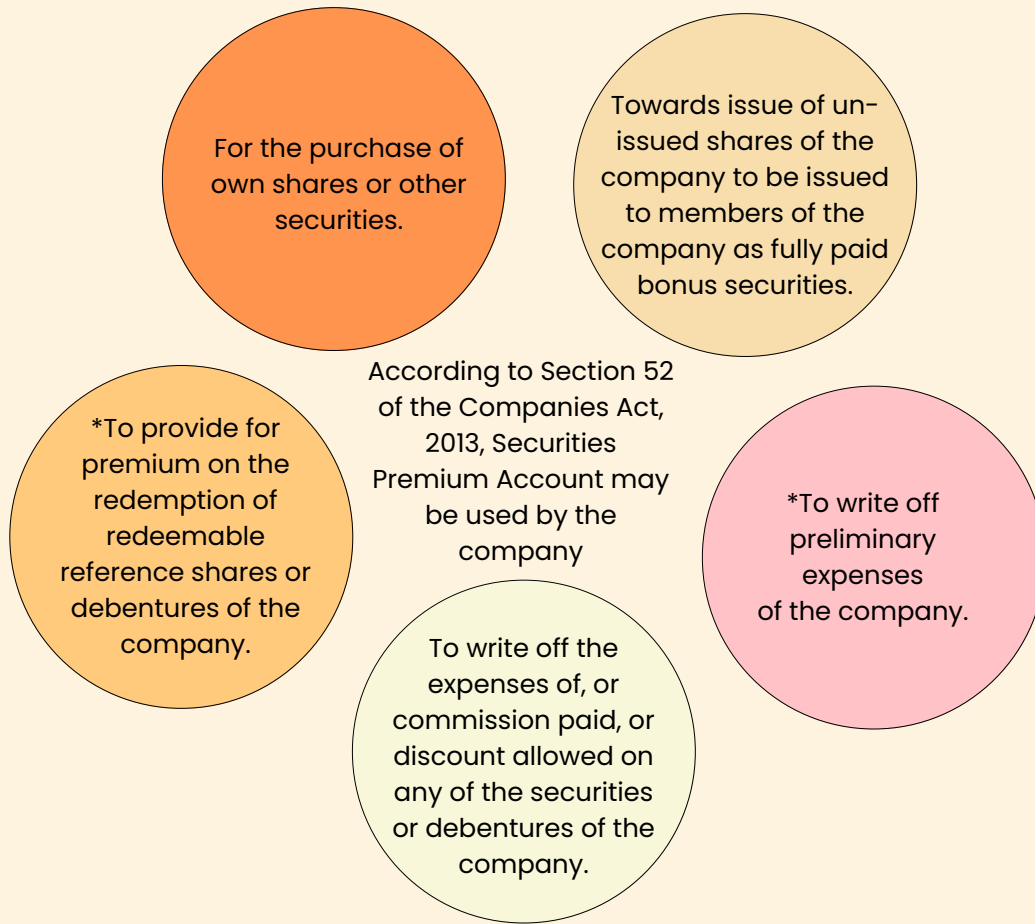
Premium

Issue price is more than the face value

Premium amount is credited to a separate account called "Securities Premium Account."

ACCOUNTING TREATMENT OF SECURITIES PREMIUM

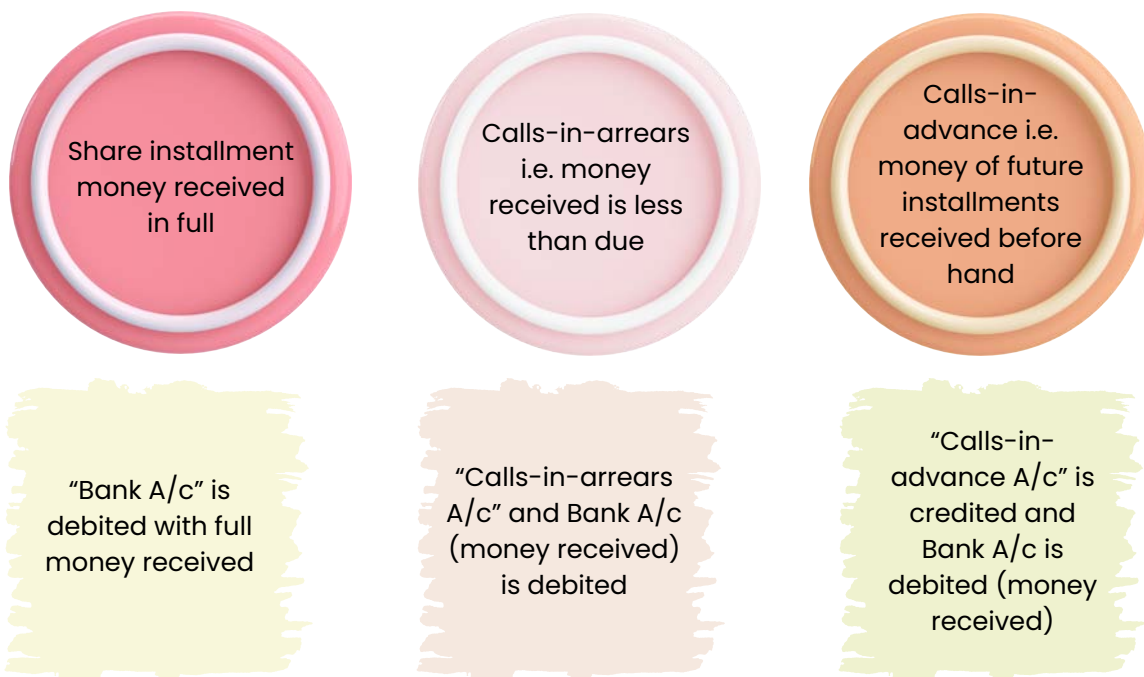
- Securities Premium is not a part of share capital. It represents a gain of capital nature to the company.
- Being a credit balance, Securities premium Account is shown under the heading, "Reserves and Surplus". However, 'Reserves and Surplus' is shown as 'shareholders funds' in the Balance Sheet as per Schedule III.



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

CALLS-IN-ARREARS AND CALLS-IN-ADVANCE

Receipt of value of shares in instalments (calls)



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

Where the amounts due on allotment, first call and final call is not received, the entry will be:

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 the premium is already received by the company, it cannot be cancelled even if the shares are forfeited in the future

If premium not received, the entry will be:

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, the entry will be:

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.


ISSUE OF DEBENTURES

Meaning


A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Section 2 (30) of the Companies Act, 2013 defines debentures as "Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.


FEATURES OF DEBENTURES




1. It is a document which evidences a loan made to a company.




2. It is a fixed interest-bearing security where interest falls due on specific dates.




3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.



4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.



5. It may or may not create a charge on the assets of a company as security.

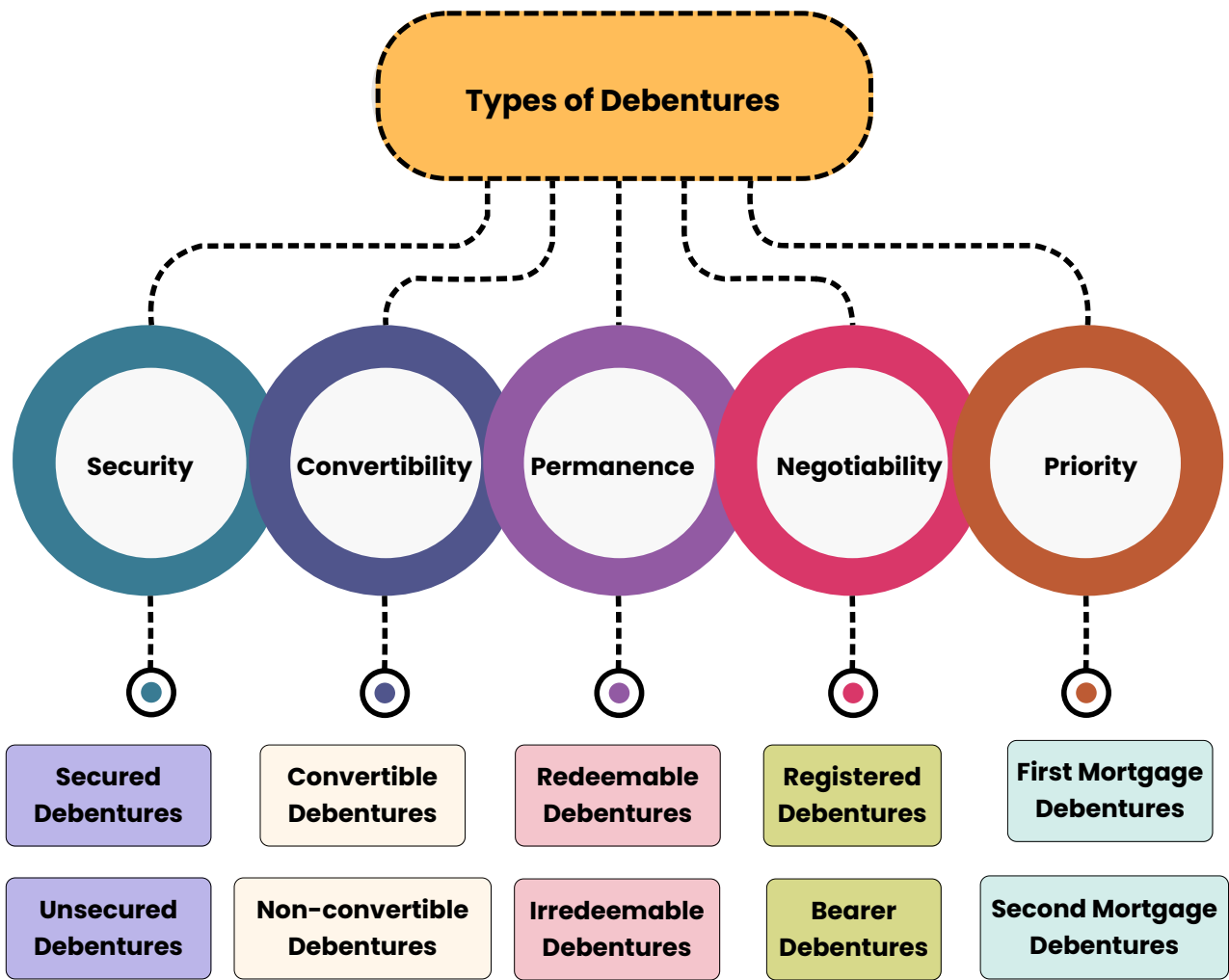


6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company.	2. Shareholders have voting rights and consequently control the total affairs of the company.
3. Debenture interest is generally paid at a pre-determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profit and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured/ Unsecured; Redeemable/ Irredeemable; Registered / Bearer; Convertible/ Non-convertible, etc.	5. There are only two kinds of shares—Equity Shares and Preference Shares.
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	7. Shares cannot be converted into other shares in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders.	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

TYPES OF DEBENTURES



1. SECURITY

(a) Secured Debentures:

These debentures are secured by a charge upon some or all assets of the company. There are two types of charges:
 (i) Fixed charge; and
 (ii) Floating charge.

Lightbulb: A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders.

Lightbulb: A floating charge generally covers all the assets of the company including future one.

(b) Unsecured or "Naked" Debentures:

These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

2. CONVERTIBILITY

-
- **(a) Convertible Debentures:**
- These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.

-
-
- **(b) Non-Convertible Debentures:**
- These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.
-

3. PERMANENCE

(a) Redeemable Debentures:

These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

(b) Irredeemable Debentures:

These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. NEGOTIABILITY

(a) Registered Debentures: These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

(a) Bearer Debentures: These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. PRIORITY

(a) First Mortgage Debentures:

These debentures are payable first out of the property charged.

(b) Second Mortgage Debentures:

These debentures are payable after satisfying the first mortgage debentures.

ACCOUNTING ENTRIES FOR ISSUE OF REDEEMABLE DEBENTURES

Journal entries in each of the above cases are discussed below:

1. Debentures issued at par redeemable at par:

When debenture are issued at par, the issue price is equal to par value, in this regard the following entries are recorded:

(a) For receipt of application money :

Bank A/c	Dr.
To Debenture Application A/c	

(b) For transfer of application money to debentures account :

Debenture Application A/c	Dr.
To ...% Debenture A/c	

2. Debentures issued at Discount and Redeemable at par or at discount :

When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures.

The entries with regards to issue are given below :

(a) For receipt of application money

Bank A/c	Dr.
	To Debenture Application A/c

(b) At the time of making allotment

(i) Debenture Application A/c	Dr.
Discount on issue of deb. A/c	Dr.
	To ...% Debentures A/c

3. Debentures Issued at Premium and Redeemable at par or at discount

When debenture are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regard, the following journal entries are recorded:

When premium amount is received at the time of application;**(a) For receipt of application money**

Bank A/c	Dr.
	To Debenture Application A/c

(b) For transfer of application of money at the time of allotment

Debenture application A/c	Dr.
	To ...% Debentures A/c
	To Securities Premium A/c



When debentures are issued at par or premium value but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books at the time of issue of debentures as per the conservatism concept. The utilisation of premium on debentures shall be based on the provisions of Section 52 of Companies Act, 2013.

4. Debentures issued at par and redeemable at a premium**(a) For receipt of application money**

Bank A/c	Dr.
To Debenture application A/c	

(b) At the time of making allotment**(i) Transfer of application money to debenture account**

Debenture Application A/c	Dr.
To ...% Debenture A/c	

(ii) Call made consequent upon allotment

Debenture Allotment A/c	Dr.	
Loss on issue of deb. A/c	Dr.	[Equal to Debenture Redemption Premium]
To ...% Debenture A/c		
To Debenture redemption premium A/c		

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Loss on issue of debenture A/c	Dr.
To ...% Debenture A/c	
To Debenture redemption premium A/c	

5. Debentures Issued at discount and redeemable at premium**(a) For the receipt of application money**

Bank A/c	Dr.
To Debenture Application A/c	

(b) At the time of making allotment**(i) Transfer of application money to debenture account**

Debenture Application A/c	Dr.
To % Debentures A/c	

(ii) Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture Allotment A/c	Dr.	
Discount on issue of debenture A/c	Dr.	[Amount equal to the discount on issue of debenture]
Loss on issue of Debentures A/c	Dr.	[Amount equal to premium on redemption of debenture]
To ...% Debenture A/c		
To Debentures Redemption Premium A/c		

Alternatively, the Discount on issue of debentures and Loss on Issue of Debentures may be combined and debited to Loss on issue of debentures A/c. In that case, the journal entry will be

Debenture Allotment A/c	Dr.
Discount/Loss on issue of debenture A/c	Dr. [Amount equal to the discount on issue of debenture plus premium on redemption of debenture]
To ...% Debenture A/c	
To Debentures Redemption Premium A/c	

(c) For receipt of call made on allotment

Bank A/c	Dr.
To Debenture Allotment A/c	

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Discount/Loss on issue of debentures A/c	Dr.
To ...% Debentures A/c	
To Debenture redemption premium A/c	

6. Debentures Issued at premium and redeemable at premium

(a) For the receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c	Dr.
To % Debentures A/c	

(ii) Call made consequent upon allotment of debenture at premium and Redeemable at premium

Debenture Allotment A/c	Dr.
Loss on issue of debenture A/c	Dr. [Amount equal to the premium on redemption]
To ...% Debenture A/c	
To Securities Premium A/c	[Amount equal to premium on issue]
To Premium on Redemption of Debentures A/c	[Amount equal to Debentures premium on redemption]


Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c Dr.
 Loss on issue of Debentures A/c Dr.
 To ...% Debentures A/c
 To Securities Premium A/c
 To Premium on redemption of debentures A/c

The Debenture Application A/c and Debenture allotment A/c are closed after the allotment of debentures.

The net effect of the above 6 situations can be summarised as given below:

Condition under which debentures are issued	Debenture issued at par or discount or premium	Debenture redemption at premium
Debentures issued at par	Bank A/c Dr. To Debentures A/c (Face value)	Bank A/c Dr. Loss on issue of Debentures A/c Dr. To Debentures A/c (Face value) To Premium on Redemption of Deb. A/c
Debentures issued at premium	Bank A/c Dr. To Debentures A/c (Face value) To Securities premium (premium)	Bank A/c Dr. Loss on issue of Debentures A/c Dr. To Debentures A/c (Face value) To Securities premium (premium) To Premium on Redemption of Deb. A/c
Debentures issued at Discount	Bank A/c Dr. Discount on issue of deb. A/c Dr. To Debentures A/c (Face value)	Bank A/c Dr. Discount on issue of Deb. A/c Dr. Loss on issue of Debentures A/c Dr. To Debentures A/c (Face value) To Premium on Redemption of Deb. A/c OR Bank A/c Dr. Loss on issue of Deb. A/c Dr. To Debentures A/c (Face value) To Premium on Redemption of Deb. A/c



When the debentures are redeemed at a premium (as per terms and conditions of issue), the premium payable on redemption should be recognised at the time of issue of debenture itself considering the principle of conservatism or prudence.

This recognition involves loss on issue of debentures A/c (i.e. discount on issue of debentures) and Premium on redemption A/c.

*Alternatively, the discount on issue of debentures, can be combined with loss on issue of debentures A/c as both discount and redemption premium represent loss to the company.

Accounting for issue of debentures payable in installments

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

Debentures Issued at Par

The debentures which are issued at par are issued at the same price as their nominal value; that is, if a debenture with a nominal value of ₹100 is issued at par, the company receives ₹100.

Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account. Debentures may be issued at par, at a premium, or at a discount.

Debentures Issued at Par:

The accounting entries would be as follows:

(a) When cash is received

Bank A/c Dr.
 To Debentures Application A/c
 (Being money received on.... debentures @ ₹each)

(b) When excess money is refunded or adjusted for future calls

Debentures Application A/c Dr.
 To Bank A/c (Amount refunded)
 To Debenture Allotment A/c (Amount adjusted for allotment)
 (Being excess money...debentures adjusted as per Board's Resolution No....dated....)

(c) When the debentures are allotted

Debentures Application A/c Dr.
 To % Debentures A/c
 (Being the allotment of...debentures of ₹each as per Board's Resolution No....dated....)

(d) On Allotment money being called

Debenture Allotment A/c Dr.
 To % Debentures A/c
 (Being Allotment Money Called)

(e) On Allotment money being received

Bank A/c Dr.
 To Debenture Allotment A/c
 (Being Allotment money received)

(f) On Debenture Call money being called

Debenture Calls A/c Dr.
 To % Debentures A/c
 (Being Call money made due)

(g) On Debenture Call money being called

Bank A/c Dr.
 To Debenture Calls A/c
 (Being Call money received)

Debentures Issued at a Premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value. If a debenture with a nominal value of ₹100 is issued at 10% premium, the company receives at ₹110 where the investor gets slightly less interest than stated in the debenture.



The premium on debentures is credited to 'Securities Premium Account' as 'Debentures' are covered in the definition of 'securities' specified in the clause (h) of section 2 of the Securities Contracts (Regulation) Act. Therefore, restriction of utilization of debentures (securities) premium will also be governed by Section 52 of the Companies Act, 2013.



The accounting entries would be as follows:

(a) When cash is received

Bank A/c Dr. [Nominal value plus premium]

To Debentures Application A/c

(Being money received on....debentures @ ₹..... each including premium of ₹

(b) When excess money is refunded

Debentures Application A/c Dr.

To Bank A/c

(Being refund of money on....debentures @ ₹ each, as per Board's Resolution No....dated....)

(c) When the debentures are allotted

Debentures Application A/c Dr.

To % Debentures A/c

To Securities Premium A/c

(Being the allotment of....debentures, premium transferred to Securities Premium A/c, as per Board's Resolution No....dated....)

4. Debentures Issued at a Discount

The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no limit for discount on issue of debentures. This is why it is very common for debentures to be issued at a discount. The debentures which are issued at a discount are issued at a lower price than nominal value, that is, if a debenture with a nominal value of ₹100 is issued at 10% discount, the company receives ₹90 only. The issue of debentures at a discount slightly increases the true rate of interest payable.

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account. In the subsequent years, Discount on Issue of Debentures is written-off proportionately by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years. However, this cannot go beyond tenure of debentures.

The accounting entries would be as follows :

(a) When Cash is received

Bank A/c Dr. [Actual cash received]
 To Debentures Application A/c
 (Being money received on...debentures @ ₹each)

(b) When excess money is refunded

Debentures Application A/c Dr.
 To Bank A/c
 (Being excess money on...debentures refunded as per Board's Resolution No.....dated...)

(c) When the debentures are allotted

Debentures Application A/c Dr. [Actual cash received]
 Discount on Issue of Debentures A/c Dr. [Discount on debentures]
 To % Debentures A/c [Nominal value of debentures]
 (Being the allotment of...debentures of ₹.....each @ ₹each as per Board's Resolution No.....dated...)

In fact, the discount on issue of debentures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount amortised.

Issue of debentures as collateral security

Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

In such cases, the holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Issue of Debentures in Consideration other than for Cash

Just like shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc. In this case, the following entries are passed:

(a) Sundry Assets Account Dr. [Assets taken over]
 To Sundry Liabilities Account [Liabilities assumed]
 To Vendors Account [Purchase consideration]
 (Being the assets and liabilities taken over)

(b) Vendors Account Dr.
 To Debentures Account
 (Being the issue of....debentures to satisfy purchase consideration)

Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly. Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par

$$\text{No. of Debentures} = \frac{\text{Purchase consideration}}{\text{Per Value}}$$

2. When debentures are issued at premium

$$\text{No. of Debentures} = \frac{\text{Purchase consideration}}{\text{Per Value} + \text{Premium}}$$

3. When debentures are issued at discount

$$\text{No. of Debentures} = \frac{\text{Purchase consideration}}{\text{Per Value} - \text{Discount}}$$

Treatment of Discount/Loss on Issue of Debentures

The discount on issue of debentures is amortised* over a period between the issuance date and redemption date. It should be written-off in the following manner depending upon the terms of redemption:

(a) If the debentures are redeemable after a certain period of time, say at the end of 5 years, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight line method). The main advantage of this method is that it spreads the burden of discount equally over the years.

(b) If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of debenture amount outstanding in each year. This method is suitable when debentures are redeemed by unequal instalments.

The accounting entries would be as follows :

Profit and Loss Account Dr.

 To Discount on Issue of Debentures Account

(Being the amount of discount on issue of debentures written-off)

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.



* Accounting Standard 16 Borrowing Costs states that ancillary borrowing costs and discounts or premiums related to borrowings can be amortized over the loan period. It also states that share issue expenses, discount on shares, and ancillary costs—such as discount premiums on borrowing—are excluded from the scope of Accounting Standard 26 Intangible Assets.

Keeping this in view, Guidance Note clarified that following the generally accepted accounting principle to amortize these expenses over the period of benefit, typically 3 to 5 years is acceptable.

Interest on Debentures

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable as per the provisions of the Income tax act 1961. The companies will deposit the tax so deducted with income tax authorities.

Following accounting entries are to be recorded in this regard:

1. For making interest due

Interest A/c Dr.
 To Debenture holders' A/c

2. For making payment of interest and deduction of tax at source (TDS)

Debenture holders A/c Dr.
 To TDS Payable A/c
 To Bank A/c

3. For making payment of tax deducted at source

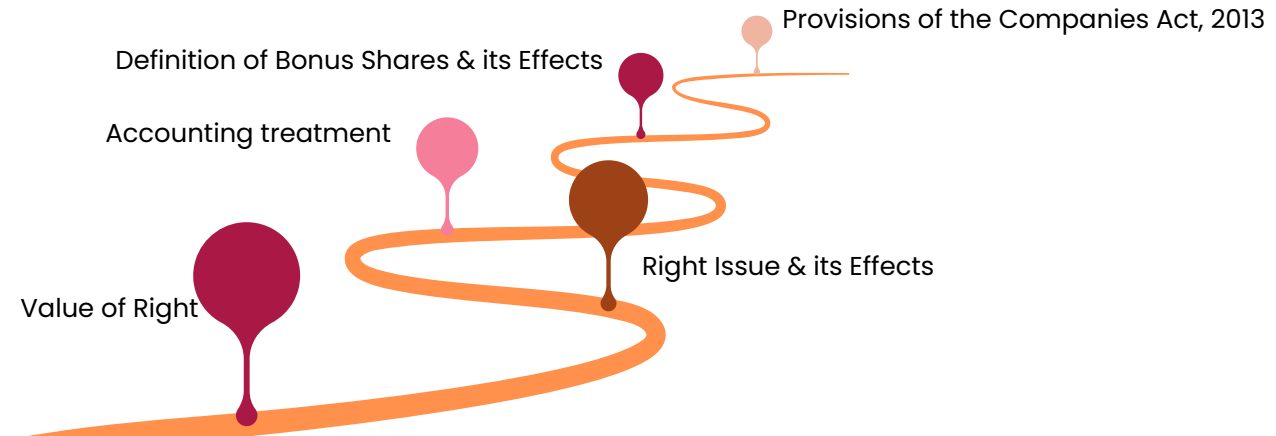
TDS payable A/c Dr.
 To Bank A/c

4. For transferring interest to profit and loss account

Profit and Loss A/c Dr.
 To Interest A/c

ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

OVERVIEW



DEFINITION OF BONUS ISSUE

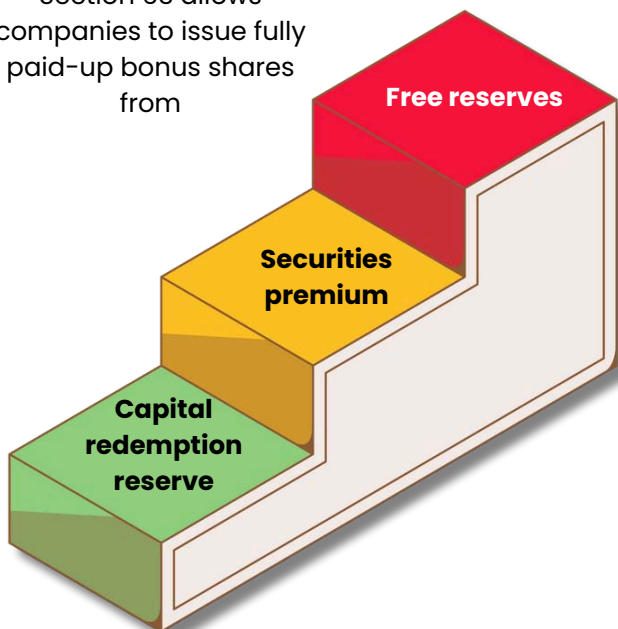
Issue of shares at no cost to current shareholders in a company

Based upon the number of shares

That the shareholder already owns

PROVISIONS OF THE COMPANIES ACT

Section 63 allows companies to issue fully paid-up bonus shares from



Bonus shares

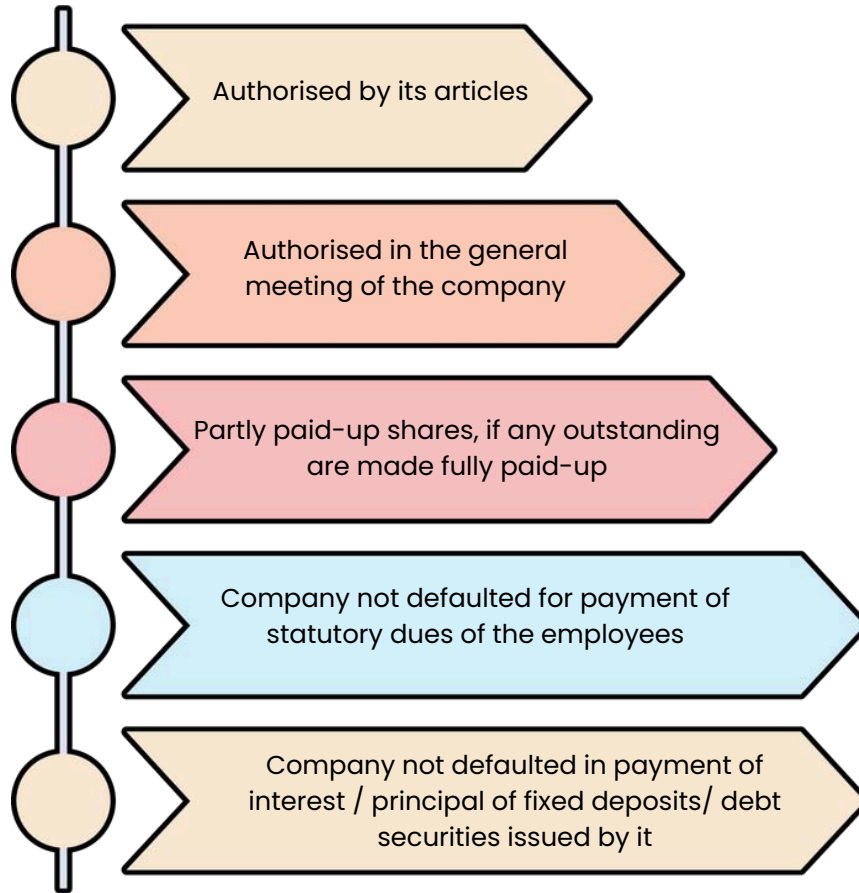
Can't be issued

Out of reserves created by revaluation of assets

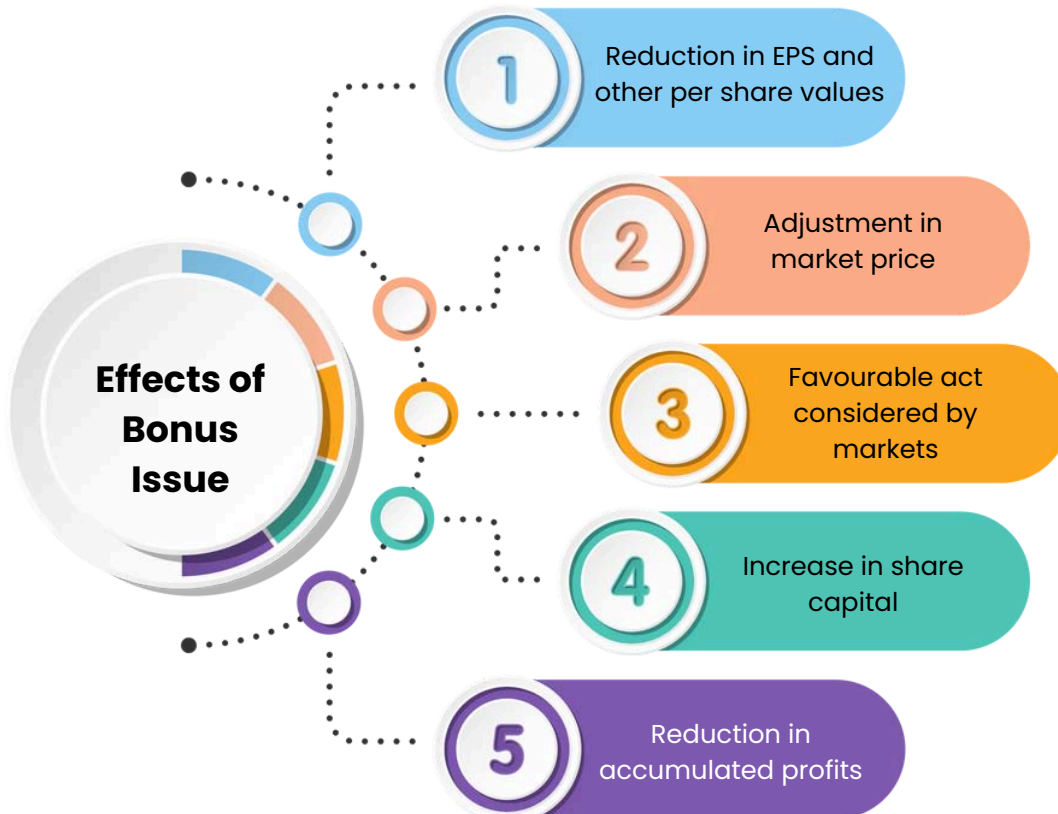
in lieu of dividend

As per Section 63(2) of The Companies Act, 2013, Bonus shares cannot be issued unless partly paid up shares are made fully paid up.

CONDITIONS FOR ISSUE OF BONUS SHARES



EFFECTS OF BONUS ISSUE



ACCOUNTING ENTRIES

Upon the sanction of an issue of bonus shares

Capital Redemption Reserve A/c Dr.
 Securities Premium A/c Dr.
 General Reserve A/c Dr.
 Profit & Loss A/c Dr.
 To Bonus to Shareholders A/c

Upon issue of bonus shares

Bonus to Shareholders A/c Dr.
 To Share Capital A/c

Upon the sanction of bonus by converting partly paid shares into fully paid shares

General Reserve A/c Dr.
 Profit & Loss A/c Dr.
 To Bonus to Shareholders A/c

On making the final call due

Share Final Call A/c Dr.
 To Share Capital A/c

On adjustment of final call

Bonus to Shareholders A/c Dr.
 To Share Final Call A/c

RIGHT ISSUE; VALUE OF RIGHT AND RIGHT OF RENUNCIATION

The existing shareholders have a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares.

$$\begin{array}{l}
 \text{Value of right} = \text{Cum-right value of share} \text{ Less } \text{Ex-right value of share} \\
 \text{Ex-right value of the shares} = \frac{[\text{Cum-right value of the existing shares} + (\text{Rights shares} \times \text{Issue Price})]}{\text{Divided by } (\text{Existing Number of shares} + \text{No. of right shares})}
 \end{array}$$

Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person.

EFFECTS OF RIGHT ISSUE

Maintenance of existing shareholders' proportional holding in company and retain their financial and governance rights

Convenience in handling issue

Dilution in the value of share.

Image enhancement

CONDITIONS FOR RIGHT ISSUE AS PER THE COMPANIES ACT

Notice specifying the number of shares offered and limiting a time not being < 15 days and not > 30 days from the date of the offer

Offer to include a right exercisable by the person concerned to renounce the shares offered to him unless articles provide otherwise

After the expiry of the time specified in notice or on receipt of earlier intimation from person that he declines to accept the shares offered, BoD may dispose of them in a manner which is not disadvantageous to shareholders and company

EXCEPTION TO THE RIGHTS OF EXISTING EQUITY SHAREHOLDERS

Situations when shares can be offered, without being offered to the existing shareholders, provided the company has passed a special resolution and shares are offered to

Employees under a scheme of ESOP

Any persons, either for cash or for a consideration other than cash, if the price of such shares is determined by registered valuer

When companies borrow money through debentures / loans and give their creditor an option to buy equity shares of a company.

When loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

ACCOUNTING TREATMENT

Same as ordinary share

Bank A/c debited

Equity share capital A/c credited

REDEMPTION OF PREFERENCE SHARES

INTRODUCTION

Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price. The redeemable shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (along with frequent payment of a specified amount as return on investment during the tenure of the preference shares).

PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company may issue redeemable preference shares because of the following:

- It is a proper way of raising Finance in dull market.
- A company may face difficulty in raising share capital, if its shares are not traded on the stock exchange.
- The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use.
- No dividend is required to be paid, if there is a loss of no profit.

PROVISIONS OF THE COMPANIES ACT

A company limited by shares, if so authorised by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. It should be noted that:

- no shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

- no such shares can be redeemed unless they are fully paid;

- (i) in case of prescribed companies whose financial statements comply with the accounting standards prescribed for such class of companies under Section 133 of the Companies Act, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed;

in case of other companies (not falling under (i) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

- where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the Companies Act, apply as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company.

- The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

On the redemption of redeemable preference shares out of accumulated profits it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of capital made for the purpose of redemption.

Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

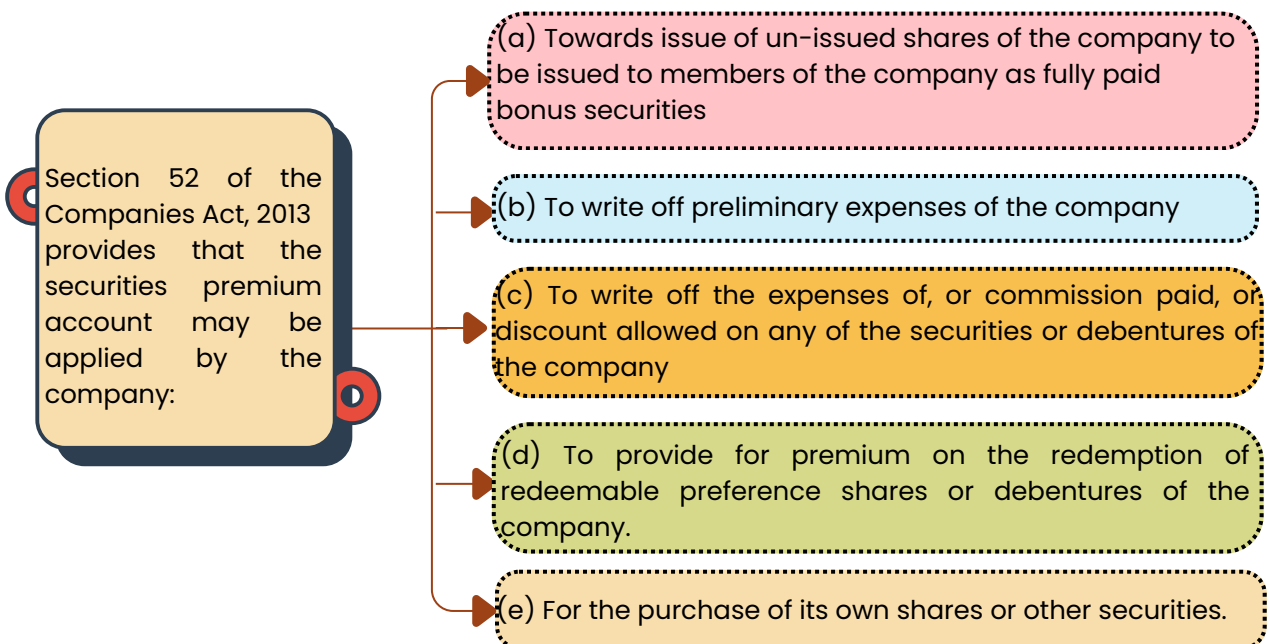
Methods of redemption of redeemable preference shares



REDEMPTION OF PREFERENCE SHARES BY FRESH ISSUE OF SHARES

A company can issue new shares (equity share or preference share) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilised for the purpose.



Note: It may be noted that certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d).

Any other way, except the above prescribed ways, in which securities premium account is utilized will be in contravention of law.

The proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

REASONS FOR ISSUE OF NEW EQUITY SHARES

A company may prefer issue of new equity shares for the following reasons:

When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares which carry a fixed rate of dividend.

When the balance of profit, which would otherwise be available for dividend, is insufficient.

When the liquidity position of the company is not good enough.

ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY ISSUE OF FRESH EQUITY SHARES

Advantages

- No cash outflow of money – now or later.
- New equity shares may be issued at a premium.
- Shareholders retain their equity interest.

Disadvantages

- There will be dilution of future earnings.
- Share-holding pattern in the company is changed.

CALCULATION OF MINIMUM FRESH ISSUE OF SHARES TO PROVIDE FUNDS FOR REDEMPTION

1

Maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before redemption and the additional information provided in the problem.

2

Make adjustment for premium payable on redemption out of profits and then compute

Minimum Proceeds of Fresh Issue of shares :

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

3

After computation of minimum proceeds, calculate

Minimum Number of Shares

Minimum proceeds divided by face value of one share

4

Thus to calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated.

- if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 are not violated.

REDEMPTION OF PREFERENCE SHARES BY CAPITALIZATION OF UNDISTRIBUTED PROFITS

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares.

When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit.

ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

Advantages

- No change in the percentage of equity share-holding of the company;
- Surplus funds can be used.

Disadvantage

- There may be a reduction in liquidity.

REDEMPTION OF PREFERENCE SHARES BY COMBINATION OF FRESH ISSUE AND CAPITALISATION OF UNDISTRIBUTED PROFITS

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits.

• Amount to be Transferred to Capital Redemption Reserve

Face value of shares redeemed	xxx
Less: Proceeds from new issue	xxx

• Proceeds to be collected from New Issue

Face value of shares redeemed	xxx
Less: Profits available for distribution as dividend	xxx

Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.

REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The problem of unpaid calls on fully called up shares may be studied under following categories:

When Calls-In-Arrears is received by the Company

If the amount of unpaid calls is received by the Company before redemption, the entry passed is as under:

Bank A/c	Dr.
To Calls-in-Arrears A/c	

After receipt of calls in arrears, the shares become fully paid up and, then, company can proceed with redemption in the normal course.

In Case of Forfeited Shares

If, on getting a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, entry for forfeiture is passed as usual.

ACCOUNTING ENTRIES FOR REDEMPTION OF PREFERENCE SHARES

When preference shares are redeemed at par

Redeemable Preference Share Capital Account	Dr.
To Preference Shareholders Account	

When preference shares are redeemed at a premium

Redeemable Preference Share Capital Account	Dr.
Premium on Redemption of Preference Shares Account	Dr.
To Preference Shareholders Account	

When payment is made to preference shareholders

Preference Shareholders Account	Dr.
To Bank Account	

For adjustment of premium on redemption

Profit and Loss Account	Dr.
To Premium on Redemption of Preference Shares Account	

For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account

General Reserve Account	Dr.
Profit and Loss Account	Dr.
To Capital Redemption Reserve Account	

REDEMPTION OF DEBENTURES

A debenture is an instrument issued by a company under its seal, acknowledging a debt and contains provisions as regards repayment of the principal and interest. Under Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.

Types of Debentures	Security	<ul style="list-style-type: none"> Secured Debentures Unsecured Debentures
	Convertibility	<ul style="list-style-type: none"> Convertible Debentures Non-Convertible Debentures
	Permanence	<ul style="list-style-type: none"> Redeemable Debentures Irredeemable Debentures
	Negotiability	<ul style="list-style-type: none"> Registered Debentures Bearer Debentures
	Priority	<ul style="list-style-type: none"> First Mortgage Debentures Second Mortgage Debentures

METHODS OF REDEMPTION OF DEBENTURES

Redemption by paying off the debt on account of debentures issued can be done by one of these methods:

By payment in lumpsum

At maturity or at the expiry of a specified period of debenture, the payment of entire debentures is made in one lot.

By payment in Instalments

The payment of specified portion of debenture is made in instalments at specified intervals.

Purchase of Debentures in Open Market

Debentures sometimes are purchased in open market, by debiting own debentures account.

Provisions under the Companies Act, 2013 for issue of debentures

A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.

No company can issue any debentures which carry any voting rights.

Where debentures are issued by a company, the specified companies need to create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilized by the company for any purpose other than the redemption of debentures.

Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting.

Debentures are usually redeemable i.e. either redeemed in cash or convertible after a specified time period.

Redeemable debentures may be redeemed:

- after a fixed number of years; or
- any time after a certain number of years has elapsed since their issue; or
- on giving a specified notice; or
- by annual drawing.

A company may also purchase its debentures, as and when convenient, in the open market and when debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them. As per Rule 18 (1) of the Companies (Share Capital and Debentures) Rules, 2014, a company shall not issue secured debentures, unless it complies with the following conditions, namely:



An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue:

Provided that the following classes of companies may issue secured debentures for a period exceeding ten years but not exceeding thirty years,

- Companies engaged in setting up of infrastructure projects;
- Infrastructure Finance Companies' as defined in clause (viia) of sub-direction (1) of direction 2 of Non-Banking Financial (Non-deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
- Infrastructure Debt Fund Non-Banking Financial Companies' as defined in clause (b) of direction 3 of Infrastructure Debt Fund Non-Banking Financial Companies (Reserve Bank) Directions, 2011;
- Companies permitted by a Ministry or Department of the Central Government or by Reserve Bank of India or by the National Housing Bank or by any other statutory authority to issue debentures for a period exceeding ten years.



Such an issue of debentures shall be secured by the creation of a charge on the properties or assets of the company or its subsidiaries or its holding company or its associates companies, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon.



The company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders; and



The security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on-

- any specific movable property of the company or its holding company or subsidiaries or associate companies or otherwise.
- any specific immovable property wherever situate, or any interest therein:

Provided that in case of a non-banking financial company, the charge or mortgage under sub-clause (i) may be created on any movable property.

Note: Provided further that in case of any issue of debentures by a Government company which is fully secured by the guarantee given by the Central Government or one or more State Government or by both, the requirement for creation of charge under this sub-rule shall not apply.

Provided also that in case of any loan taken by a subsidiary company from any bank or financial institution the charge or mortgage under this sub-rule may also be created on the properties or assets of the holding company.

DEBENTURE REDEMPTION RESERVE

A company issuing debentures may be required to create a debenture redemption reserve account (DRR) out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment.

An appropriate amount is transferred from profits every year to Debenture Redemption Reserve and its investment is termed as Debenture Redemption Reserve Investment (or Debenture Redemption Fund). In the last year or at the time of redemption of debentures, Debenture Redemption Reserve Investments are encashed and the amount so obtained is used for the redemption of debentures.

REQUIREMENT TO CREATE DEBENTURE REDEMPTION RESERVE

Section 71 of the Companies Act 2013 covers the requirement of creating a debenture redemption reserve account. This states as follows:



(1) Where a company issues debentures under this section, it should create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.



(2) The amounts credited to the debenture redemption reserve should not be utilised by the company for any purpose except for the purpose aforesaid.



(3) The company should pay interest and redeem the debentures in accordance with the terms and conditions of their issue.



(4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

BALANCE IN DEBENTURE REDEMPTION RESERVE

When the company is required to create DRR, the amount prescribed, is credited to the Debenture Redemption Reserve account and debited to profit and loss account. That shows the intention of the company to set aside sum of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit Debenture Redemption Reserve Investments and credit Bank.

ADEQUACY OF DEBENTURE REDEMPTION RESERVE

As per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year in accordance with the conditions.

- Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;
- the limits with respect to adequacy of DRR and investment or deposits, as the case may be, shall be as per the table given on the next page.

S. NO	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
1.	All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures	No DRR is required
2.	Other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013	DRR will be as applicable to NBFCs registered with RBI (as per (3) below)
3.	For listed companies (other than AIFIs and Banking Companies as specified in Sr. No. 1 above):	
a.	All listed NBFCs (registered with RBI under section 45-IA of the RBI Act,) and listed HFCs (Housing Finance Companies registered with National Housing Bank) for both public as well as privately placed debentures	No DRR is required
b.	Other listed companies for both public as well as privately placed debentures	No DRR is required
4.	For unlisted companies (other than AIFIs and Banking Companies as specified in Sr. No. 1 above)	
a.	All unlisted NBFCs (registered with RBI under section 45-IA of the RBI (Amendment) Act, 1997) and unlisted HFCs (Housing Finance Companies registered with National Housing Bank) for privately placed debentures	No DRR is required
b.	Other unlisted companies	DRR shall be 10% of the value of the outstanding debentures issued

INVESTMENT OF DEBENTURE REDEMPTION RESERVE (DRR) AMOUNT

As per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, all listed NBFCs; all listed HFCs; all other listed companies (other than AIFs, Banking Companies and Other FIs); and all unlisted companies which are not NBFCs and HFCs shall on or before the 30th day of April in each year, in respect of debentures issued, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of next year, in any one or more of the following methods, namely:

- a) in deposits with any scheduled bank, free from charge or lien;
- b) in unencumbered securities of the Central Government or of any State Government;
- c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
- d) in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

- ▶ The amount deposited or invested, as the case may be, above should not be utilised for any purpose other than for the redemption of debentures maturing during the year referred to above.
- ▶ Provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.
- ▶ In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debentures issued.
- ▶ The amount credited to DRR shall not be utilised by the company except for the purpose of redemption of debentures.

JOURNAL ENTRIES

The necessary journal entries passed in the books of a company are given below:

1. After allotment of debentures

a. For setting aside the fixed amount of profit for redemption	
Profit and Loss A/c	Dr.
To Debenture Redemption Reserve A/c	
b. For investing the amount set aside for redemption	
Debenture Redemption Reserve Investment A/c	Dr.
To Bank A/c	

c. For receipt of interest on Debenture Redemption Reserve Investments (DRRI)	
Bank A/c	Dr.
To Interest on Debenture Redemption Reserve Investment A/c	
d. For transfer of interest on Debenture Redemption Reserve Investments (DRRI)	
Interest on Debenture Redemption Reserve Investment A/c	Dr.
To Profit and loss A/c*	

* Considering the fact that interest is received each year through cash/ bank account.

2. At the time of redemption of debentures

a. For encashment of Debenture Redemption Reserve Investments	
Bank A/c	Dr.
To Debenture Redemption Reserve Investment A/c	
b. For amount due to debenture holders on redemption	
Debentures A/c	Dr.
To Debenture holders A/c	
c. For payment to debenture holders	
Debenture holders A/c	Dr.
To Bank A/c	
d. After redemption of debentures, Debenture Redemption Reserve A/c should be transferred to general reserve	
Debenture Redemption Reserve A/c	Dr.
To General Reserve	