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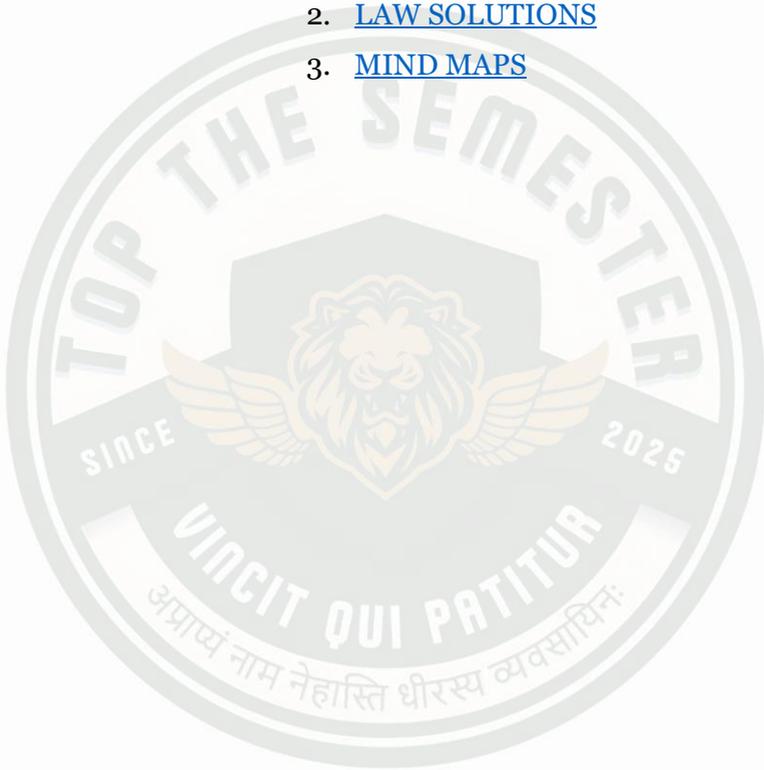
ADV. MOHIT TANWR

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STATUE STATION

**DELVE INTO THE INTRICACIES OF LAW
WITH OUR METICULOUSLY CURATED
STUDY MATERIAL. THIS MODULE
OFFERS A SEAMLESS LEARNING
EXPERIENCE, ALLOWING YOU TO
GRASP COMPLEX SUBJECTS
EFFORTLESSLY.**

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FINANCIAL ACCOUNTING

UNIT-I: INTRODUCTION TO FINANCIAL ACCOUNTING

- a. Definition, Meaning, Nature and Scope of Accounting;
- b. Functions, Objectives and Significance of Financial Accounting;
- c. Accounting Concepts; Books of Accounting and Book Keeping;
- d. Interrelationship of Accounting with other disciplines;
- e. Branches of Accounting; Limitations of Accounting;
- f. Financial Accounting Principles and Standards: Accounting Principles and Conventions,
- g. Meaning and relevance of GAAP,
- h. Introduction to Accounting Standards laid down by ICAI.

UNIT-II: JOURNALIZING TRANSACTIONS

- a. Journal Entries,
- b. Compound Journal Entries,
- c. Opening Entry, Preparation of Ledger and Ledger Posting,
- d. Cash Book Entries, Sales and Purchase Book Entries;
- e. Preparation of Trial Balance;
- f. Company Final Accounts: Preparation of Final Accounts with Adjustments, Trading Accounts,
- g. Profit and Loss account, Balance Sheet as per Schedule-III of the New Companies Act 2013.

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- a. Concept of Deprecation,
- b. Causes of Depreciation, Basic Features of Depreciation,
- c. Meaning of Depreciation Accounting,
- d. Objectives of Providing Depreciation,
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- f. Forfeiture of Shares, Surrender of Shares, and Right Shares.
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- i. Methods of Redemption, Redemption of Debentures

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UNIT 1

INTRODUCTION TO LAW

1.1 DEFINITION, MEANING, NATURE, AND SCOPE OF ACCOUNTING

Financial accounting is a branch of accounting that involves the collection, recording, summarization, and presentation of a company's financial transactions in the form of financial statements. These statements are used by various stakeholders, such as investors, creditors, and regulators, to evaluate the financial health of a company and make informed decisions. This comprehensive overview of financial accounting will cover its definition, meaning, nature, and scope.

Definition: Accounting is the process of systematically recording, summarizing, analyzing, and reporting financial transactions and events to provide relevant, timely, and accurate information to various stakeholders. This information is essential for decision-making, planning, and controlling activities, as well as assessing the overall financial performance and position of an organization.

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Meaning: Accounting is often referred to as the "language of business," as it communicates the financial health and performance of a company to stakeholders. The primary objective of accounting is to provide a clear and accurate picture of an organization's financial activities. This includes recording and classifying transactions, generating financial statements, and analyzing financial information to make informed decisions.

Nature of Accounting: Accounting can be classified into various categories based on its nature and purpose, such as financial accounting, management accounting, cost accounting, and tax accounting. The following are some key characteristics of the nature of accounting:

1. **Identifying:** Accounting identifies economic events and transactions that affect the financial position of an organization.
2. **Measuring:** It assigns monetary values to financial transactions and events.
3. **Recording:** Accounting involves the systematic and chronological recording of financial transactions in books of accounts.
4. **Classifying:** Transactions are classified into different categories, such as assets, liabilities, equity, revenue, and expenses, to facilitate analysis and reporting.
5. **Summarizing:** Accounting summarizes financial data in the form of financial statements, which include the

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balance sheet, income statement, and cash flow statement.

6. **Analyzing:** Accounting involves the examination and interpretation of financial statements to evaluate a company's financial health and performance.
7. **Communicating:** Accounting communicates financial information to various stakeholders, such as management, investors, creditors, and regulators, for decision-making purposes.

Scope of Accounting: The scope of accounting is broad and encompasses various functions and activities, which are essential for the effective management and control of an organization's financial resources. Some of the key areas within the scope of accounting include:

Financial Accounting: This involves the preparation of financial statements that provide a summary of an organization's financial transactions over a specific period. Financial accounting follows Generally Accepted Accounting Principles (GAAP) and is primarily intended for external stakeholders.

Management Accounting: This focuses on providing financial information to internal users, such as managers and executives, for decision-making, planning, and performance evaluation. Management accounting includes activities such as budgeting, variance analysis, and cost-volume-profit analysis.

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Cost Accounting: This branch of accounting deals with the collection, analysis, and allocation of costs associated with the production of goods and services. Cost accounting helps organizations to determine the cost of products, optimize resource utilization, and control costs.

Tax Accounting: Tax accounting involves the preparation of tax returns and the management of tax liabilities. It ensures that organizations comply with tax laws and regulations, and helps them minimize their tax burden through tax planning strategies.

Auditing: Auditing is the process of examining and verifying an organization's financial records and statements to ensure their accuracy, completeness, and compliance with accounting standards and regulations. Auditing can be internal (conducted by the organization itself) or external (conducted by an independent auditor).

Non-profit Accounting: This area of accounting focuses on the financial management of non-profit organizations, such as charities, educational institutions, and government agencies. Non-profit accounting involves the tracking and reporting of revenues, expenses, and fund balances to ensure that resources are used effectively and in accordance with the organization's mission.

International Accounting: International accounting deals with the accounting issues and practices of multinational corporations and organizations operating in different countries. This includes areas such as foreign

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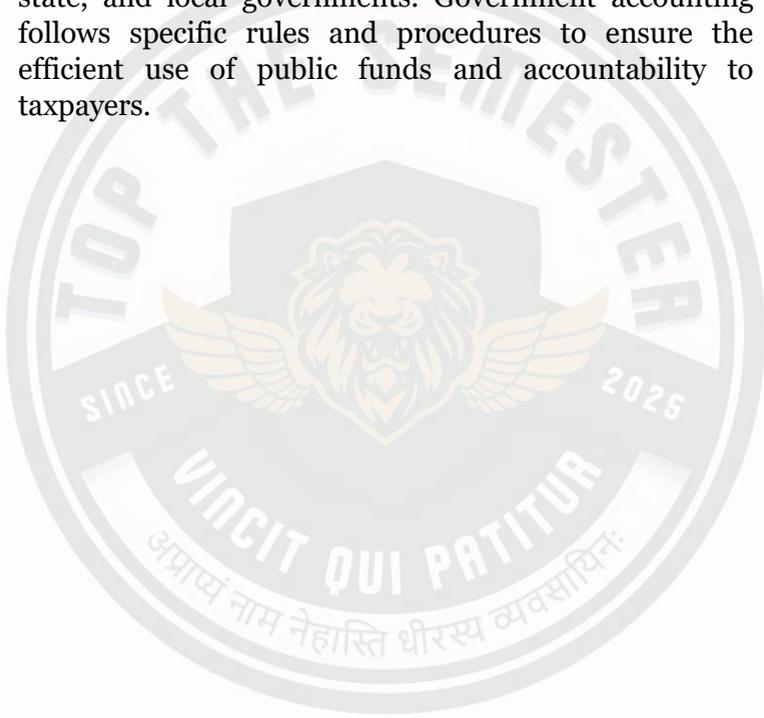
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currency translation, international taxation, and accounting for cross-border transactions.

Government Accounting: This area of accounting focuses on the financial management and reporting of government entities at various levels, including federal, state, and local governments. Government accounting follows specific rules and procedures to ensure the efficient use of public funds and accountability to taxpayers.



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1.2 FUNCTIONS, OBJECTIVES, AND SIGNIFICANCE OF FINANCIAL ACCOUNTING:

Functions of Financial Accounting:

Recording Financial Transactions: The primary function of financial accounting is to record all financial transactions in a systematic and chronological manner. This includes sales, purchases, expenses, and other financial activities. These transactions are recorded in books of accounts, such as the general ledger and subsidiary ledgers.

Classifying Financial Transactions: Financial accounting involves organizing transactions into different categories, such as assets, liabilities, equity, revenue, and expenses. This classification facilitates the analysis and interpretation of financial data, making it easier for stakeholders to understand the company's financial activities.

Summarizing Financial Data: Financial accounting summarizes financial data in the form of financial statements, which provide a snapshot of the company's financial position and performance. These statements include the balance sheet, income statement, and cash flow statement. They are prepared at the end of an accounting period, usually on a quarterly or annual basis.

Communicating Financial Information: Financial accounting communicates financial information to

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various stakeholders, such as investors, creditors, regulators, and management. These stakeholders use this information to make informed decisions, evaluate the company's financial health, and assess its performance against industry benchmarks.

Objectives of Financial Accounting:

Provide Accurate and Reliable Financial Information: The main objective of financial accounting is to provide accurate and reliable financial information that reflects the true financial position and performance of a company.

Facilitate Decision-Making: Financial accounting helps stakeholders make informed decisions by providing them with relevant financial data. This information is crucial for tasks such as investment decisions, credit evaluation, and regulatory compliance.

Evaluate Financial Performance: Financial accounting enables stakeholders to assess a company's financial performance over time, as well as compare it with competitors and industry benchmarks. This evaluation helps identify areas of strength and weakness, leading to more effective decision-making and planning.

Ensure Accountability and Transparency: Financial accounting promotes accountability and transparency by

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providing stakeholders with a clear and accurate picture of the company's financial activities. This helps build trust and confidence in the company's management and financial reporting.

Significance of Financial Accounting:

Stakeholder Communication: Financial accounting plays a vital role in communicating a company's financial health and performance to various stakeholders. This information is essential for investors, creditors, and regulators to make informed decisions and assess the company's financial standing.

Compliance with Legal and Regulatory Requirements: Financial accounting ensures that companies comply with legal and regulatory requirements, such as the preparation and submission of financial statements and tax returns. Compliance is crucial for avoiding penalties, maintaining a company's reputation, and ensuring its long-term viability.

Effective Financial Management: Financial accounting provides the necessary information for effective financial management, enabling companies to make informed decisions about resource allocation, cost control, and investment opportunities.

Performance Evaluation and Benchmarking: Financial accounting enables companies to evaluate their performance against industry benchmarks and identify areas for improvement. This helps drive continuous

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improvement and enhances the overall efficiency and effectiveness of the organization.



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1.3 ACCOUNTING CONCEPTS, BOOKS OF ACCOUNTING, AND BOOKKEEPING

Accounting concepts are the fundamental principles and assumptions that underpin the preparation and presentation of financial statements. These concepts are generally accepted and followed by accounting professionals worldwide. Some of the key accounting concepts include:

Business Entity Concept: This concept assumes that a business is a separate legal entity from its owners. As a result, the financial activities of the business are recorded and reported separately from the personal financial activities of its owners.

Going Concern Concept: This concept assumes that a business will continue to operate indefinitely, or at least for the foreseeable future. Consequently, financial statements are prepared on the assumption that the company will continue its operations and meet its financial obligations.

Money Measurement Concept: This concept states that only those transactions and events that can be measured in monetary terms are recorded in the books of accounts. It implies that financial accounting does not account for non-monetary events, such as employee satisfaction or brand reputation, which may also impact a company's performance.

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Accrual Concept: The accrual concept requires that revenues and expenses be recognized in the accounting period in which they are earned or incurred, regardless of when cash is received or paid. This approach provides a more accurate representation of a company's financial performance and position.

Consistency Concept: According to this concept, accounting methods and practices should remain consistent from one accounting period to another. This enables stakeholders to make meaningful comparisons of financial statements over time.

Conservatism Concept: This concept advises that a conservative approach should be taken when making estimates or judgments in the preparation of financial statements. This means that potential losses should be recognized as soon as they become apparent, while potential gains should only be recognized when they are realized.

Materiality Concept: The materiality concept states that financial statements should only include information that is material or significant enough to influence the decisions of stakeholders. Insignificant or immaterial information can be excluded, as it does not have a meaningful impact on the overall financial picture.

Books of Accounting:

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Books of accounting are the records in which a company's financial transactions and events are systematically recorded. These books form the basis for the preparation of financial statements. Some of the primary books of accounting include:

General Journal: The general journal is a chronological record of all financial transactions, including sales, purchases, expenses, and other financial activities. Each transaction is recorded as a journal entry, which includes the date, accounts affected, and the corresponding debit and credit amounts.

General Ledger: The general ledger is a summary of all accounts used by a company, including assets, liabilities, equity, revenues, and expenses. It contains a separate account for each financial transaction and is used to prepare financial statements.

Subsidiary Ledgers: Subsidiary ledgers are supplementary records that provide detailed information about specific accounts, such as accounts receivable, accounts payable, or inventory. These ledgers help maintain the accuracy and completeness of the general ledger.

Trial Balance: The trial balance is a report that lists all accounts and their balances at the end of an accounting period. It is used to ensure that the total debits equal the total credits, indicating that the books of accounts are in balance.

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Bookkeeping:

Bookkeeping is the process of recording, classifying, and maintaining financial transactions in the books of accounting. It forms the foundation of the accounting process and provides the necessary data for preparing financial statements and analyzing a company's financial performance. Bookkeeping involves the following activities:

Recording Financial Transactions: Bookkeeping involves the systematic and chronological recording of all financial transactions, including sales, purchases, expenses, and other financial activities. These transactions are recorded as journal entries in the general journal.

Posting to Ledger Accounts: After recording transactions in the general journal, the next step in bookkeeping is to post these transactions to the appropriate ledger accounts. This involves transferring the debit and credit amounts from the journal entries to the corresponding accounts in the general ledger.

Balancing Ledger Accounts: At the end of an accounting period, ledger accounts are balanced by comparing the total debits and credits. This ensures that the books of accounts are in balance and helps identify any errors or discrepancies in the recording process.

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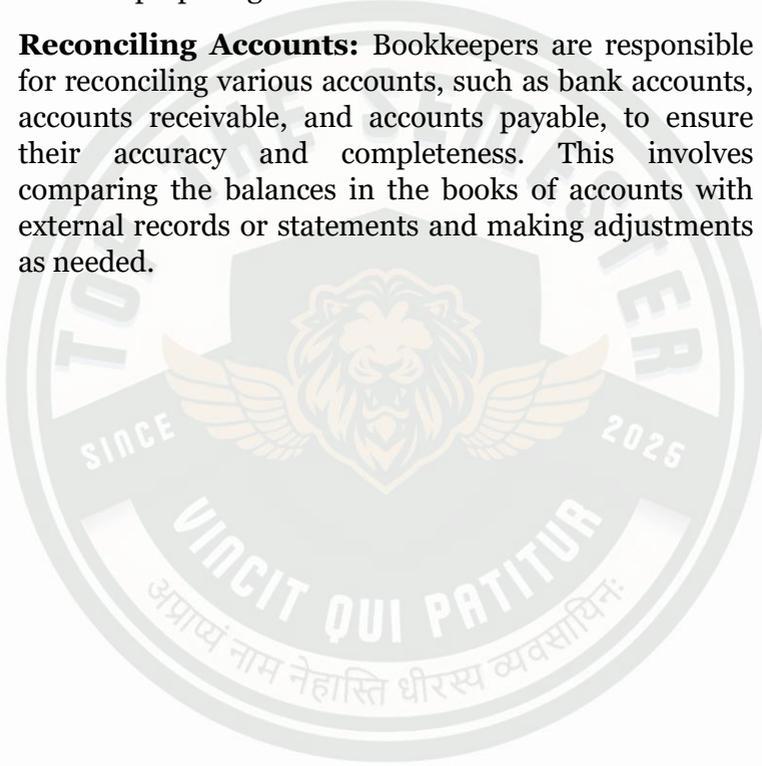
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Preparing Trial Balance: Bookkeepers prepare a trial balance, which lists all accounts and their balances at the end of an accounting period. This report is used to verify the accuracy of the books of accounts and serves as the basis for preparing financial statements.

Reconciling Accounts: Bookkeepers are responsible for reconciling various accounts, such as bank accounts, accounts receivable, and accounts payable, to ensure their accuracy and completeness. This involves comparing the balances in the books of accounts with external records or statements and making adjustments as needed.



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1.5 INTERRELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Finance: Finance and financial accounting are closely related, as they both deal with the management of a company's financial resources. Financial accounting provides the data and information required for financial decision-making, such as investment analysis, capital budgeting, and working capital management. In turn, finance professionals rely on accurate financial accounting information to make informed decisions and ensure the efficient allocation of resources.

Economics: Economics is the study of how individuals, businesses, and societies allocate scarce resources to satisfy their needs and wants. Financial accounting plays a critical role in the functioning of the economy by providing transparent and reliable financial information to various stakeholders. This information helps investors, creditors, and policymakers make informed decisions, allocate resources, and assess the overall health of the economy.

Management: Financial accounting is essential for effective management, as it provides managers with the necessary information to make informed decisions, plan, and control operations. Managers rely on financial statements and accounting data to assess the company's performance, identify areas for improvement, and develop strategies to achieve organizational goals.

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Statistics: Statistics is the science of collecting, analyzing, and interpreting numerical data. Financial accounting relies on statistical techniques to analyze financial data, identify trends, and make predictions about future performance. For example, statistical methods such as regression analysis, time series analysis, and forecasting can be used to analyze sales data, predict future revenues, and estimate the impact of various factors on financial performance.

Information Technology (IT): IT plays a crucial role in the modern accounting process, as most financial transactions and records are maintained electronically. Accounting software, enterprise resource planning (ERP) systems, and other IT tools have significantly improved the efficiency, accuracy, and security of financial accounting. In turn, financial accounting professionals must have a solid understanding of IT systems and tools to effectively manage financial data and generate accurate reports.

Law: Financial accounting is subject to various legal and regulatory requirements, such as the preparation and submission of financial statements, tax returns, and compliance with accounting standards. A strong understanding of laws and regulations is essential for financial accounting professionals to ensure that the company meets its legal obligations and avoids potential penalties and reputational damage.

Auditing: Auditing is the process of examining and verifying a company's financial records and statements to

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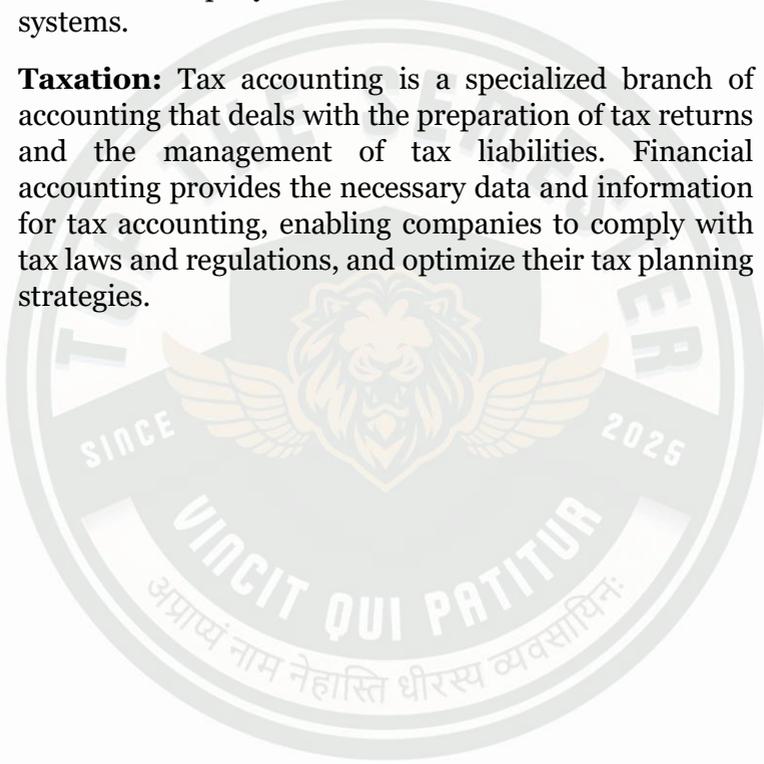
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ensure their accuracy, completeness, and compliance with accounting standards and regulations. Financial accounting provides the basis for auditing, as auditors rely on financial statements and accounting records to assess the company's financial health and internal control systems.

Taxation: Tax accounting is a specialized branch of accounting that deals with the preparation of tax returns and the management of tax liabilities. Financial accounting provides the necessary data and information for tax accounting, enabling companies to comply with tax laws and regulations, and optimize their tax planning strategies.



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1.6 BRANCHES AND LIMITATIONS OF ACCOUNTING

Branches of Accounting

Accounting is a multifaceted discipline comprising various specialized branches, each tailored to meet the distinct needs of different stakeholders and organizational functions. The primary branches of accounting are outlined as follows:

1. Financial Accounting

Financial accounting is the foundational branch of the discipline, concerned with the systematic recording, classification, and reporting of financial transactions. Its principal objective is to produce accurate and reliable financial statements that present the financial position and performance of an entity to external stakeholders, including investors, creditors, regulatory authorities, and the general public. These statements are typically prepared in accordance with established accounting standards and frameworks, such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP).

2. Management Accounting

Management accounting serves the internal informational needs of an organization's management. It encompasses the provision of financial and non-financial

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data to aid in strategic planning, operational control, performance evaluation, and decision-making processes. Key components of management accounting include budgeting, cost analysis, variance analysis, and cost-volume-profit analysis. Unlike financial accounting, management accounting is not governed by statutory standards and may be tailored to suit internal decision-making requirements.

3. Cost Accounting

Cost accounting focuses specifically on the identification, measurement, analysis, and control of costs associated with the production and delivery of goods and services. By analyzing cost behavior and allocating costs accurately, this branch facilitates cost control, pricing decisions, and operational efficiency. It plays a critical role in optimizing resource utilization and enhancing overall profitability.

4. Tax Accounting

Tax accounting pertains to the application of tax laws and regulations in the preparation of tax returns and the management of tax liabilities. It ensures compliance with statutory tax obligations and supports organizations in implementing lawful tax planning strategies to minimize tax burdens. Given the jurisdictional specificity of tax laws, this branch often varies considerably across different countries and legal systems.

5. Auditing

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Auditing involves the independent examination and verification of an organization's financial records and statements to assess their accuracy, completeness, and conformity with applicable accounting standards. Audits may be internal—conducted by personnel within the organization—or external—undertaken by independent, qualified auditors. The overarching aim of auditing is to provide assurance to stakeholders regarding the integrity and reliability of financial disclosures.

6. Non-Profit Accounting

Non-profit accounting addresses the unique financial management requirements of entities that operate without the primary objective of profit generation, such as charities, educational institutions, and governmental organizations. This branch emphasizes accountability, stewardship of resources, and compliance with donor and regulatory expectations. It involves tracking revenues, expenditures, and fund balances in a manner that reflects adherence to the entity's stated mission.

7. International Accounting

International accounting deals with the accounting challenges faced by multinational corporations and organizations engaged in cross-border activities. It includes areas such as foreign currency translation, international taxation, transfer pricing, and adherence to global accounting standards. This branch is increasingly

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relevant in an era of globalization, where financial comparability and transparency across jurisdictions are essential.

8. Government Accounting

Government accounting is concerned with the recording and reporting of financial transactions by public sector entities, including federal, state, and local governments. It adheres to specialized accounting frameworks designed to ensure fiscal accountability, transparency, and the efficient utilization of public resources. This branch is vital for public policy formulation and the maintenance of public trust in government institutions.

Limitations of Accounting

While accounting serves as a critical tool in financial decision-making and regulatory compliance, it is not without its limitations. Users of accounting information must be cognizant of the inherent constraints that may affect the accuracy, relevance, and completeness of financial data. The principal limitations are as follows:

1. Historical Orientation

Accounting records are inherently retrospective, capturing and reporting past financial transactions and events. Although historical data provide valuable insights into an entity's performance over time, they may not

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adequately inform future-oriented decision-making or reflect current economic realities.

2. Exclusivity to Monetary Transactions

The accounting framework is grounded in the money measurement concept, whereby only transactions and events measurable in monetary terms are recorded. Consequently, significant qualitative factors—such as employee morale, brand equity, customer loyalty, and corporate reputation—are excluded, despite their substantial influence on organizational success.

3. Use of Estimates and Subjective Judgments

Accounting often relies on estimates and managerial judgment in areas such as asset depreciation, bad debt provisioning, and the valuation of intangible assets. This reliance introduces subjectivity, which may lead to variability and bias in financial reporting, potentially undermining comparability and reliability.

4. Inadequacy During Inflationary Periods

Financial statements are commonly prepared on a historical cost basis, without adjustments for inflation. In periods of significant inflation, this approach can distort the real value of assets and liabilities, leading to financial statements that fail to reflect true economic conditions.

5. Variability in Accounting Policies

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The existence of multiple accounting standards and permissible policy choices (e.g., differing inventory valuation or depreciation methods) can result in inconsistencies across financial statements. This lack of uniformity hinders direct comparability between entities, even within the same industry.

6. Limitations of Financial Ratios

While financial ratios derived from accounting data are widely used to assess performance, liquidity, and solvency, they are constrained by the limitations of the underlying data. Being backward-looking and quantitative in nature, these ratios may not capture emerging risks or forward-looking indicators of financial health.

7. Exclusion of Non-Quantifiable Elements

Accounting prioritizes quantifiable and financial elements, such as revenue, expenses, and capital. However, many strategic factors—such as competitive positioning, innovation capacity, or regulatory changes—cannot be easily quantified and are consequently omitted, despite their relevance to comprehensive financial analysis.

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1.7 FINANCIAL ACCOUNTING PRINCIPLES AND STANDARDS: ACCOUNTING PRINCIPLES AND CONVENTIONS

Accounting Principles:

Accounting principles are the fundamental concepts and rules that govern the preparation of financial statements. These principles ensure that financial information is presented in a consistent and accurate manner, enabling stakeholders to make informed decisions. Some of the key accounting principles include:

Business Entity Principle: This principle assumes that a business is a separate legal entity from its owners. As a result, the financial activities of the business are recorded and reported separately from the personal financial activities of its owners.

Going Concern Principle: This principle assumes that a business will continue to operate indefinitely, or at least for the foreseeable future. Consequently, financial statements are prepared on the assumption that the company will continue its operations and meet its financial obligations.

Money Measurement Principle: This principle states that only those transactions and events that can be measured in monetary terms are recorded in the books of accounts. It implies that financial accounting does not account for non-monetary events, such as employee

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satisfaction or brand reputation, which may also impact a company's performance.

Accrual Principle: The accrual principle requires that revenues and expenses be recognized in the accounting period in which they are earned or incurred, regardless of when cash is received or paid. This approach provides a more accurate representation of a company's financial performance and position.

Consistency Principle: According to this principle, accounting methods and practices should remain consistent from one accounting period to another. This enables stakeholders to make meaningful comparisons of financial statements over time.

Conservatism Principle: This principle advises that a conservative approach should be taken when making estimates or judgments in the preparation of financial statements. This means that potential losses should be recognized as soon as they become apparent, while potential gains should only be recognized when they are realized.

Materiality Principle: The materiality principle states that financial statements should only include information that is material or significant enough to influence the decisions of stakeholders. Insignificant or immaterial information can be excluded, as it does not have a meaningful impact on the overall financial picture.

Accounting Conventions:

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Accounting conventions are the customary practices and guidelines that have evolved over time and are generally accepted by the accounting profession. Some of the common accounting conventions include:

1. **Conservatism:** As mentioned earlier, conservatism is the practice of recognizing potential losses as soon as they become apparent, while deferring the recognition of potential gains until they are realized. This convention helps ensure that financial statements do not overstate a company's financial position or performance.
2. **Consistency:** Consistency refers to the practice of using the same accounting methods and practices from one accounting period to another, enabling meaningful comparisons of financial statements over time.
3. **Full Disclosure:** The full disclosure convention requires that all material and relevant information be disclosed in the financial statements, notes, or supplementary schedules. This ensures that stakeholders have access to all the information necessary to make informed decisions.
4. **Materiality:** As discussed earlier, the materiality convention states that financial statements should only include information that is material or significant enough to influence the decisions of stakeholders.

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Accounting Standards:

Accounting standards are a set of rules and guidelines that prescribe the methods and practices to be followed in the preparation and presentation of financial statements. These standards ensure that financial information is consistent, comparable, and reliable across different organizations and industries. Accounting standards are developed and issued by various regulatory bodies and standard-setting organizations, such as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the United States.

Some of the widely followed accounting standards include:

1. **International Financial Reporting Standards (IFRS):** IFRS is a set of accounting standards developed by the IASB and is followed by companies in over 140 countries. The goal of IFRS is to establish a single set of high-quality, globally accepted accounting standards that enhance the comparability and transparency of financial information.
2. **Generally Accepted Accounting Principles (GAAP):** GAAP is a set of accounting principles, standards, and conventions that are followed by companies in the United States. GAAP is developed and maintained by the FASB and aims to ensure that financial information is presented consistently and accurately.

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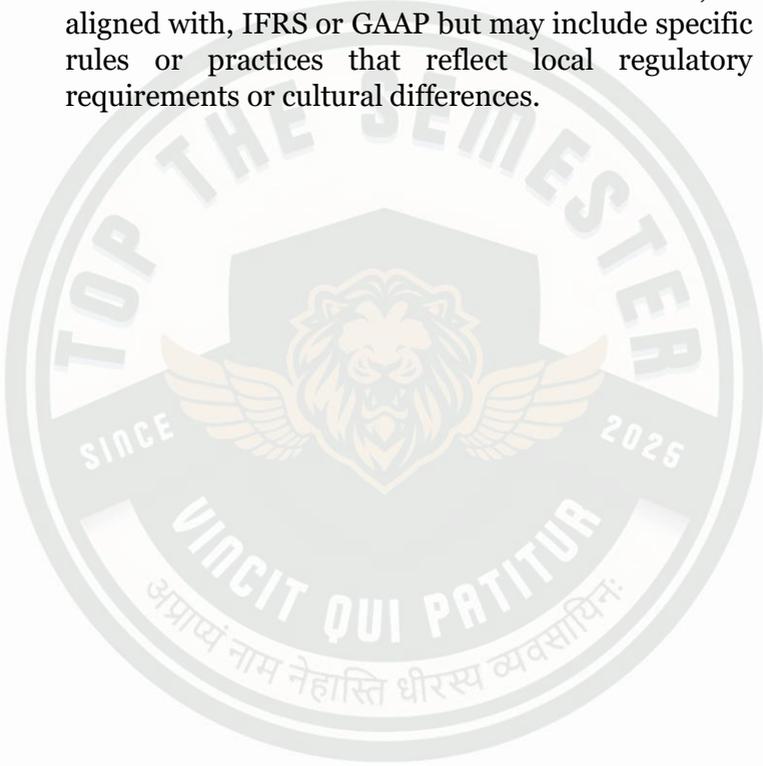
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3. Other National Accounting Standards: In addition to IFRS and GAAP, various countries have their own national accounting standards that may be followed by companies operating within their jurisdiction. These national standards are often based on, or aligned with, IFRS or GAAP but may include specific rules or practices that reflect local regulatory requirements or cultural differences.



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1.8 MEANING AND RELEVANCE OF GAAP

Generally Accepted Accounting Principles (GAAP) refer to a comprehensive set of rules, standards, and conventions that govern the field of financial accounting and reporting in the United States. These principles ensure that financial statements are prepared in a consistent, transparent, and reliable manner.

GAAP is developed and maintained by the **Financial Accounting Standards Board (FASB)**—an independent, non-profit organization tasked with establishing and updating financial accounting standards in the U.S. Additional guidance comes from other authoritative sources such as the **American Institute of Certified Public Accountants (AICPA)** and the **Securities and Exchange Commission (SEC)**.

Core Purpose of GAAP

The primary objective of GAAP is to enhance the **quality, comparability, and integrity** of financial statements. By adhering to GAAP, companies ensure that their financial reports fairly represent their economic activities, facilitating informed decision-making by stakeholders.

Key Components of GAAP

GAAP encompasses a wide array of accounting standards and principles, including but not limited to:

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- **Principle of Regularity** – adherence to enforced rules and laws
- **Principle of Consistency** – consistent standards are applied throughout the reporting process
- **Principle of Sincerity** – accountants provide an accurate and impartial depiction of a company's financial situation
- **Principle of Permanence of Methods** – consistent procedures are used to allow comparability
- **Principle of Non-Compensation** – full details of financial information are presented without expectations of offsetting debt
- **Principle of Prudence** – financial data is presented cautiously and without speculation

Relevance and Importance of GAAP

Consistency

GAAP ensures uniformity in financial reporting across companies and industries. This consistency allows stakeholders such as **investors**, **creditors**, and **regulators** to compare financial statements meaningfully and assess a company's performance over time or against competitors.

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Reliability

GAAP establishes a structured framework for preparing financial reports, which increases the **accuracy** and **credibility** of financial information. Reliable data is essential for stakeholders making high-stakes financial decisions.

Transparency

One of the fundamental goals of GAAP is to promote **transparency** in financial reporting. Companies are required to disclose all material and relevant information in their financial statements, including footnotes and supplementary schedules. This transparency enables stakeholders to form a complete understanding of the company's financial health.

Regulatory Compliance

Public companies in the U.S. are legally required to follow GAAP under the regulations set forth by the **Securities and Exchange Commission (SEC)**. Compliance with GAAP helps companies avoid legal penalties and maintain a strong reputation in the financial markets.

Investor Confidence

By adhering to GAAP, companies enhance **investor trust**. Investors are more inclined to invest in firms that follow standardized, rigorous accounting practices, as it ensures the financial data they rely on is both accurate and comparable.

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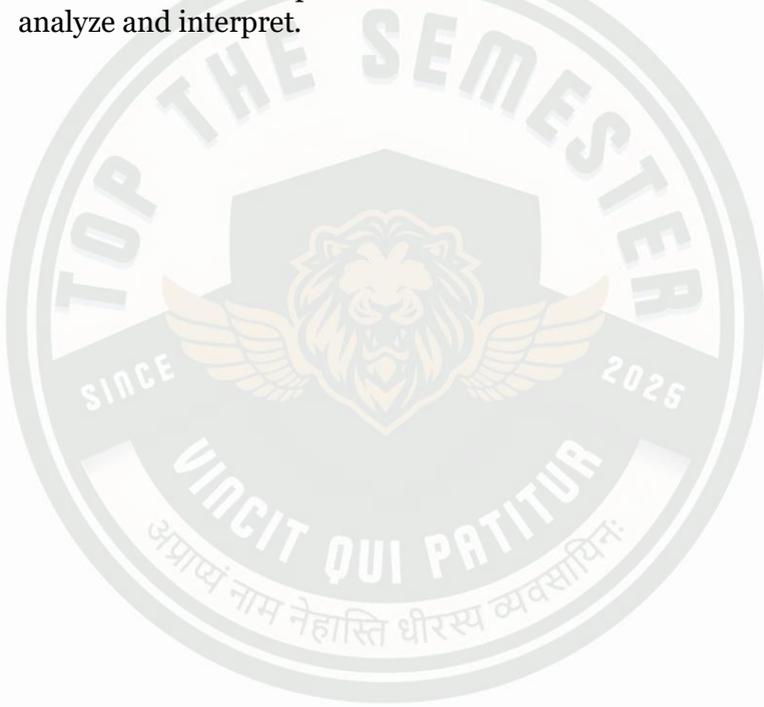
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Facilitation of Cross-Border Investment

Although GAAP is specific to the United States, its standards are internationally recognized and respected. Adherence to GAAP can simplify cross-border investment and financing decisions, as foreign investors often find GAAP-compliant financial statements easier to analyze and interpret.



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1.9 INTRODUCTION TO ACCOUNTING STANDARDS ISSUED BY ICAI

Significance of Accounting Standards

Accounting standards constitute the foundational framework governing the recognition, measurement, presentation, and disclosure of financial transactions and events in financial statements. These standards ensure uniformity, comparability, and transparency in the financial reporting process. Within the Indian context, the authoritative body responsible for the formulation and issuance of accounting standards is the **Institute of Chartered Accountants of India (ICAI)**, a statutory body established under the **Chartered Accountants Act, 1949**.

Accounting standards serve multiple critical purposes in both microeconomic and managerial decision-making contexts:

- **They reduce asymmetries of information** between managers and stakeholders.
- They form the **legal and normative basis** for financial audits, taxation, mergers, and investment decisions.
- They enhance **credibility in capital markets**, ensuring that investor confidence is not undermined by opaque or inconsistent financial reporting practices.

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ICAI's accounting standards are not merely procedural instruments; they also embed within them the logic of economic rationality, legal enforceability, and international harmonization.

ICAI and the Evolution of Accounting Standards in India

A. Statutory Basis and Constitutional Role of ICAI

The ICAI is recognized as the apex accounting regulator in India. Established under an Act of Parliament, it functions under the administrative control of the **Ministry of Corporate Affairs (MCA)**. Through its **Accounting Standards Board (ASB)**, ICAI develops Accounting Standards (AS) after due consultation with various stakeholders, including government representatives, industry experts, and legal professionals.

ICAI plays a dual role:

1. **Regulatory Function** – Prescribing mandatory standards for entities.
2. **Advisory Function** – Issuing guidance notes, interpretations, and clarifications that supplement the standards.

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B. Phases in the Development of Indian Accounting Standards

The evolution of accounting standards in India can be broadly classified into three phases:

1. Pre-2000 Phase: Emergence of Indigenous Standards

- Initial standards were heavily influenced by British accounting traditions.
- The ASB began issuing standards from **1977** onward, with AS-1 (Disclosure of Accounting Policies) as the foundational standard.

2. 2000–2015: Towards Convergence

- Increasing integration with global capital markets prompted alignment with **International Financial Reporting Standards (IFRS)**, developed by the **International Accounting Standards Board (IASB)**.
- The Ministry of Corporate Affairs endorsed the roadmap for convergence, resulting in the formulation of **Indian Accounting Standards (Ind AS)**.

3. Post-2016: Implementation of Ind AS

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- Ind AS became mandatory for listed and large unlisted companies in a phased manner.
- These standards reflect a high degree of **IFRS convergence**, with necessary carve-outs to address Indian legal, economic, and regulatory specificities.

Structure and Classification of ICAI-Issued Standards

ICAI accounting standards can be broadly classified into two primary categories:

A. Accounting Standards (AS) – Pre-Ind AS Regime

These apply primarily to **non-corporate entities**, and to certain corporates not covered under the Ind AS framework. There are **29 standards**, though not all are currently mandatory.

Examples include:

- **AS 1: Disclosure of Accounting Policies**
- **AS 2: Valuation of Inventories**
- **AS 10: Accounting for Fixed Assets**
- **AS 18: Related Party Disclosures**

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B. Indian Accounting Standards (Ind AS) – IFRS Converged

These apply to **corporate entities** as defined under the Companies Act, 2013, based on prescribed net worth and listing criteria.

Key Ind AS include:

- **Ind AS 1: Presentation of Financial Statements**
- **Ind AS 109: Financial Instruments**
- **Ind AS 115: Revenue from Contracts with Customers**
- **Ind AS 116: Leases**

The **Ind AS framework is principles-based**, as opposed to the more rule-based structure of traditional AS. This allows greater flexibility but necessitates higher levels of professional judgment.

Legal Recognition and Enforceability of Accounting Standards

A. Integration with the Companies Act, 2013

Section 133 of the **Companies Act, 2013** provides the legal mandate for the **National Financial Reporting Authority (NFRA)** and the **Ministry of Corporate Affairs** to prescribe accounting standards in

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consultation with ICAI. Thus, standards issued by ICAI have the **force of law** when notified by the MCA.

Furthermore, non-compliance with accounting standards can attract penal consequences under:

- **Section 129:** Financial statements must give a true and fair view.
- **Section 447:** Fraudulent statements can lead to criminal prosecution.
- **SEBI (LODR) Regulations:** For listed entities, adherence to accounting standards is monitored by the Securities and Exchange Board of India.

B. Role in Taxation, Contract Law, and Corporate Governance

Accounting standards have pervasive influence across multiple legal domains:

- **Direct Taxation:** Several judicial precedents have emphasized that accounting standards form the basis of *book profits* under **Section 115JB** of the Income Tax Act.
- **Contractual Obligations:** In legal disputes involving contracts, especially in M&A, accounting standards often define the benchmark for assessing *fair value* and *earnings before interest, tax, depreciation, and amortization (EBITDA)*.

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- **Corporate Governance:** The standards support the mandate of the **Audit Committee** under **Clause 49** of the SEBI listing agreement, enhancing board-level financial oversight.

Objectives of Accounting Standards: Managerial and Economic Relevance

From a **managerial economics perspective**, accounting standards serve the following essential functions:

A. Decision-Relevant Information for Managers

Managers rely on standardized financial data to undertake:

- **Cost-volume-profit analysis**
- **Capital budgeting**
- **Performance benchmarking**
- **Risk management and hedging decisions** (especially under Ind AS 109)

By ensuring consistency in accounting treatment, these standards facilitate the use of econometric models and managerial control systems.

B. Reduction of Transaction Costs and Information Asymmetry

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As per **George Akerlof's "Market for Lemons"** framework, markets characterized by informational asymmetries tend to suffer from adverse selection. Accounting standards mitigate such asymmetries by mandating disclosure norms, segmental reporting, and fair valuation principles.

C. Harmonization and Global Competitiveness

In the age of globalized finance, adherence to Ind AS enhances a firm's access to:

- **Global capital markets**
- **Cross-border mergers and acquisitions**
- **Foreign institutional investments**

The **OECD Principles of Corporate Governance (2015)** explicitly underscore the role of high-quality accounting standards in fostering financial market integrity and economic efficiency.

Comparative Perspective: Indian Standards vs. International Frameworks

A. Ind AS vs. IFRS: A Convergence with Carve-Outs

While Ind AS standards are largely **converged** with IFRS, certain **carve-outs and carve-ins** have been instituted to reflect domestic conditions.

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Key Divergences:

- **Treatment of Investment Property:** Ind AS mandates cost model; IFRS permits fair value model.
- **Foreign Currency Convertible Bonds:** Differing treatment of conversion option valuation.
- **Dividend Recognition:** Timing of recognition varies under Ind AS and IFRS.

These divergences ensure **regulatory sovereignty** while striving for **global comparability**.

B. Ind AS vs. US GAAP

The **United States Generally Accepted Accounting Principles (US GAAP)** differ significantly from Ind AS in conceptual basis:

- US GAAP is **rules-based**, while Ind AS is **principles-based**.
- US GAAP allows **Last-In-First-Out (LIFO)** inventory valuation; prohibited under Ind AS.
- Impairment testing and lease accounting differ materially.

Despite differences, many **Indian multinational subsidiaries** maintain dual reporting structures to meet

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both **domestic and international compliance** mandates.



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UNIT 2

JOURNALIZING TRANSACTIONS

2.1 JOURNAL ENTRIES,

Journal entries serve as the cornerstone of the double-entry accounting system, providing a methodical way to record the financial effects of transactions. Each journal entry captures the dual impact of business activities on the accounting equation, ensuring that the basic accounting principle of balance (Assets = Liabilities + Equity) is maintained. The importance of journal entries lies in their role in ensuring the accuracy, completeness, and transparency of financial reporting.

The process of recording journal entries is a vital component of the accounting cycle, which begins with transaction identification and continues through to the preparation of the financial statements. In this context, journal entries not only facilitate the initial recording of business events but also serve as a record that will support financial reporting, tax compliance, and auditing processes.

Definition and Characteristics

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A journal entry is defined as the first step in the accounting cycle, in which a transaction or event is recorded in a journal. It consists of the following components:

- **Date of the Transaction:** Specifies when the transaction occurred.
- **Accounts Involved:** Every journal entry involves at least two accounts: one that is debited and another that is credited.
- **Debit and Credit Amounts:** Each account involved in the transaction is either debited or credited. The total debits must always equal total credits, ensuring the balance of the accounting equation.
- **Description:** A brief explanation of the transaction is often provided to facilitate understanding.

The basic principle governing journal entries is that every transaction affects at least two accounts, with one being debited and the other being credited. This principle is the basis of double-entry bookkeeping and ensures that the accounting equation remains in balance.

For example, when a company purchases inventory for cash, it will debit the inventory account (increasing assets) and credit the cash account (decreasing assets).

Accounting Equation and Double-Entry System

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The double-entry system, as outlined by Luca Pacioli in the 15th century, is the foundation of modern accounting. According to this system, each transaction affects at least two accounts in such a way that the accounting equation (Assets = Liabilities + Owner's Equity) remains in balance.

In this framework:

- A **debit** is an entry on the left-hand side of the ledger that typically represents an increase in assets or a decrease in liabilities or equity.
- A **credit** is an entry on the right-hand side of the ledger, typically representing an increase in liabilities or equity or a decrease in assets.

Journal entries systematically capture these debits and credits to ensure that the accounting equation remains in equilibrium. For example, a company borrowing money would debit cash (an asset) and credit a loan payable account (a liability).

Principles Governing Journal Entries

Several principles govern the structure and formation of journal entries. These principles are aligned with widely accepted accounting standards such as the Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), and the Indian Accounting Standards (Ind AS).

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1. **Accrual Basis of Accounting:** According to the accrual basis, transactions are recorded when they occur, not when cash changes hands. This principle is embodied in standards such as AS 9 (Revenue Recognition), which governs how revenue should be recognized in financial statements. Journal entries based on accrual accounting ensure that income and expenses are recorded in the period they relate to, not when cash is received or paid.
2. **Consistency Principle:** Journal entries should be recorded consistently across periods, meaning that once a method for recording a specific type of transaction is established, it should be consistently applied in subsequent periods. This principle enhances comparability and transparency in financial reporting.
3. **Materiality Principle:** Journal entries should accurately reflect the substance of transactions. However, minor errors or omissions may not have a significant impact on the financial statements if they are immaterial, following the materiality principle as outlined in AS 5 (Net Profit or Loss for the Period, Prior Period Items, and Changes in Accounting Policies).
4. **Matching Principle:** Expenses should be matched with the revenues they help generate. This principle ensures that journal entries properly reflect the costs incurred in producing revenues during the same accounting period. For example, when a company

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sells a product, the cost of goods sold (COGS) is recorded as an expense to match the revenue from the sale.

5. **Going Concern Concept:** Journal entries should be based on the assumption that the business will continue operating indefinitely, unless there is evidence to suggest otherwise. This concept influences the classification and recognition of assets and liabilities in financial statements.

Types of Journal Entries

Journal entries can be categorized into various types based on the nature of the transaction. Some of the most common types are:

1. **Simple Journal Entries:** These involve only two accounts – one debited and the other credited. For example, when a company receives cash for services rendered, the journal entry would debit the cash account and credit the service revenue account.
2. **Compound Journal Entries:** These involve more than two accounts. For example, when a company borrows money and incurs interest, the journal entry may involve debiting both the cash account and the interest expense account while crediting the loan payable account.
3. **Adjusting Journal Entries (AJEs):** These entries are made at the end of an accounting period to update the balances of certain accounts in line with accrual

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accounting principles. For example, accrued expenses such as wages or utilities may require an adjusting entry to record the expense in the appropriate period.

4. **Closing Journal Entries:** These are made at the end of the accounting period to close temporary accounts, such as revenues and expenses, and transfer the net income or loss to the owner's equity account. This process is necessary to prepare the accounts for the next accounting period.
5. **Recurring Journal Entries:** These are entries made periodically for transactions that occur regularly, such as rent payments or monthly payroll. These entries often have the same amount and accounts involved, making them easy to automate.
6. **Correcting Journal Entries:** These entries are used to correct errors made in previous journal entries. For example, if a transaction was recorded with the wrong amount or in the wrong account, a correcting entry would be made to rectify the error.

Recording and Posting Journal Entries

Once journal entries are created, they must be posted to the appropriate ledger accounts. The general ledger contains a separate account for each type of asset, liability, equity, revenue, and expense, and serves as the repository for all journal entries.

The process of posting journal entries involves transferring the debit and credit amounts from the

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journal to the appropriate ledger accounts. Each entry is posted by first identifying the affected accounts and then recording the debits and credits in the corresponding ledger.

This process ensures that the financial statements are an accurate reflection of the transactions that have taken place during the period.

Regulatory Framework and Accounting Standards

The formulation and maintenance of accounting standards play a critical role in ensuring that journal entries are recorded in a manner that is consistent, reliable, and transparent. In the Indian context, the **Institute of Chartered Accountants of India (ICAI)** is responsible for issuing **Accounting Standards (AS)**, while **Ind AS** (Indian Accounting Standards) is aligned with **IFRS** (International Financial Reporting Standards), and both frameworks require proper accounting entries to be recorded as per specific guidelines.

For example, **Ind AS 1 (Presentation of Financial Statements)** and **Ind AS 10 (Events After the Reporting Period)** provide guidance on the recognition and measurement of transactions in the financial statements and, by extension, on the journal entries that should be made in respect of these transactions.

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In the context of legal provisions, the **Companies Act, 2013** mandates certain types of financial disclosures, and **Income Tax Act, 1961** outlines specific guidelines for tax accounting. These legal frameworks affect how journal entries must be recorded to ensure compliance with statutory requirements.

Illustration of Journal Entries

To further clarify the process of recording journal entries, consider the following illustration:

- A company purchases equipment for ₹100,000 in cash.

The journal entry would be:

- **Date:** 01/09/2025
- **Debit:** Equipment ₹100,000
- **Credit:** Cash ₹100,000

This journal entry reflects an increase in assets (equipment) and a decrease in assets (cash).

The Importance of Journal Entries in the Accounting Cycle

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Journal entries are integral to the entire accounting cycle, a systematic process that ensures the financial information is recorded, processed, and presented in the form of financial statements. The accounting cycle involves several stages, each dependent on accurate journal entries:

1. **Transaction Identification:** Journal entries begin with the identification of financial transactions, which are then analyzed to determine the accounts affected and the amounts of debits and credits.
2. **Journalizing:** After the transaction is identified, the journal entry is made in the general journal or subsidiary book. This includes determining the correct accounts to debit and credit and ensuring that the entry adheres to accounting principles.
3. **Posting to the Ledger:** Once journal entries are made, they are posted to the general ledger, which accumulates all transactions for each account.
4. **Trial Balance:** The balances from the ledger accounts are transferred to the trial balance, where the total debits and credits are compared. A trial balance ensures that the accounting equation is in balance.
5. **Financial Statements Preparation:** Based on the balances in the trial balance, the company prepares its financial statements, including the balance sheet, income statement, and cash flow statement.

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6. **Closing Entries:** At the end of the accounting period, closing journal entries are made to reset temporary accounts (revenues, expenses) to zero, transferring their balances to permanent accounts (retained earnings or



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2.2 COMPOUND JOURNAL ENTRIES

A compound journal entry is a specific type of journal entry that involves more than two accounts. This contrasts with simple journal entries, where only two accounts are involved—one debit and one credit. A compound journal entry typically includes multiple debits and/or credits and is used when a single transaction affects more than two accounts.

The utility of compound journal entries lies in their efficiency and the ability to accurately reflect complex transactions within the accounting records. Compound entries help maintain the integrity of the accounting system by ensuring that each transaction is fully recorded in accordance with the double-entry accounting principle. This principle asserts that every debit entry must have a corresponding credit entry, ensuring that the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Equity}$) remains balanced.

Key Features of Compound Journal Entries

1. **Multiple Accounts:** The most distinguishing feature of a compound journal entry is the involvement of more than two accounts. This is often necessary when a transaction involves multiple facets, such as an asset acquisition funded by both cash and credit or adjustments to various accounts during the period-end closing.

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- 2. Balance:** As with traditional journal entries, compound entries must adhere to the accounting equation. The total debits must always equal the total credits, ensuring that the books remain balanced.
- 3. Simplification of Record-Keeping:** Rather than creating separate journal entries for each aspect of a complex transaction, a compound journal entry consolidates all components, providing a cleaner and more efficient record. This is particularly valuable in businesses that process large volumes of transactions.
- 4. Transparency and Clarity:** While compound journal entries can seem more complex than simple journal entries, they provide a clear and comprehensive view of the complete financial effect of a single transaction. This transparency is essential for preparing accurate financial statements and audits.
- 5. Compliance with Accounting Standards:** Compound journal entries are prepared in accordance with accounting standards such as GAAP, IFRS, and Ind AS. For instance, IFRS (International Financial Reporting Standards) and Ind AS require compound journal entries in cases involving simultaneous recognition of multiple elements like revenue, liabilities, and expenses in the same transaction.

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Why Are Compound Journal Entries Used?

1. **Efficiency in Recording Transactions:** For transactions that involve multiple accounts, compound journal entries reduce the need for creating numerous separate journal entries. This streamlines the accounting process and reduces administrative burdens.
2. **Complex Transactions:** Compound journal entries are essential in situations where a single transaction affects several accounts. Examples include a combination of cash payments, asset acquisitions, and liabilities incurred, all of which must be accurately represented in the financial statements.
3. **Compliance and Accuracy:** From a compliance perspective, compound journal entries ensure that financial transactions are recorded in line with accounting principles such as the matching principle and the accrual basis of accounting. This is critical for maintaining accurate financial reporting and ensuring the integrity of financial statements.

Structure of a Compound Journal Entry

A compound journal entry includes the following components:

- **Date of Transaction:** The date on which the transaction occurred.

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- **Accounts Involved:** A listing of all accounts impacted by the transaction (e.g., Cash, Accounts Receivable, Accounts Payable).
- **Debit Amounts:** The amounts to be debited, placed in the left column of the journal entry.
- **Credit Amounts:** The amounts to be credited, placed in the right column.
- **Explanation:** A brief description of the nature of the transaction.

A typical compound journal entry may look as follows:

Date	Account	Debit (\$)	Credit (\$)
Jan 15, 2025	Cash	10,000	
	Accounts Payable		6,000
	Equipment (Purchased equipment on credit)	4,000	

In this example, the company has purchased equipment worth \$10,000, with \$6,000 to be paid on credit and \$4,000 paid in cash. The compound journal entry reflects the debit to the cash account and the equipment account, as well as the credit to accounts payable.

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Examples of Compound Journal Entries

1. Purchase of Equipment on Credit and Cash

A company buys equipment for \$20,000, paying \$5,000 in cash and the remaining \$15,000 on credit. The compound journal entry for this transaction would be:

Date	Account	Debit (\$)	Credit (\$)
Mar 10, 2025	Equipment	20,000	
	Cash		5,000
	Accounts Payable		15,000
	(Purchase of equipment)		

This entry reflects the increase in assets (Equipment) and the decrease in cash, along with the increase in liabilities (Accounts Payable).

2. Payment of Wages with Deductions

In another scenario, a company may pay wages of \$10,000, with various deductions such as taxes, insurance, and pension contributions. The compound journal entry would involve multiple credits for each deduction:

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Date	Account	Debit (\$)	Credit (\$)
Apr 30, 2025	Wages Expense	10,000	
	Cash		7,500
	Income Tax Payable		1,000
	Pension Fund Payable		500
	Insurance Payable		1,000
	(Payment of wages with deductions)		

In this case, the company debits the full wages expense, then credits the cash account for the net amount paid to employees, and credits the appropriate liability accounts for the tax, pension, and insurance deductions.

Importance of Compound Journal Entries in Financial Reporting

Compound journal entries are crucial for ensuring that complex transactions are accurately reflected in the accounting records. Without them, companies would have to record multiple simple journal entries for each aspect of a transaction, leading to inefficiency, increased risk of errors, and potential gaps in financial reporting.

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Moreover, compound journal entries are integral to ensuring that the **Trial Balance** remains balanced. This balance is necessary for the preparation of **Financial Statements** (Balance Sheet, Income Statement, Cash Flow Statement), which are the primary tools used by management, investors, and regulatory authorities to assess a company's financial performance.

Compound journal entries serve several purposes:

1. **Streamline Recording:** Compound journal entries allow for the efficient recording of complex financial transactions that involve multiple accounts, reducing the need for multiple simple journal entries.
2. **Enhance Clarity:** By providing a comprehensive record of a complex transaction in a single entry, compound journal entries offer greater clarity and understanding of the transaction's impact on the company's financial position.
3. **Maintain Double-Entry Bookkeeping:** Like simple journal entries, compound journal entries adhere to the double-entry bookkeeping system, ensuring that the accounting equation remains in balance and enhancing the reliability of financial information.
4. **Facilitate Error Detection:** The process of recording compound journal entries can help identify errors and inconsistencies in the accounting records, allowing for timely correction and accurate financial reporting.

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Challenges and Best Practices in Compound Journal Entries

While compound journal entries are efficient and necessary, they also pose challenges for accountants:

- **Complexity:** The more accounts involved in the entry, the more complex it becomes to track and verify each debit and credit.
- **Error-prone:** With multiple accounts in play, the likelihood of making an error increases. A small mistake in any debit or credit entry can cause the entire accounting system to become unbalanced.
- **Reconciliation:** The need for accurate reconciliation of accounts becomes more pronounced. Without proper documentation and review, mistakes in compound journal entries may remain undetected.

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2.3 OPENING ENTRY, PREPARATION OF LEDGER AND LEDGER POSTING

It represents the initial record in a set of books, typically used to reflect the financial position of an entity at the commencement of an accounting period. Opening entries are an integral part of the double-entry system of accounting, ensuring that the balances carried forward from the previous period are accurately reflected in the current period's books of accounts.

The preparation and recording of the opening entry is a crucial step in the process of accounting, serving as the starting point for all subsequent financial transactions and their related entries. Properly documenting this entry ensures that the financial statements are based on correct historical information, maintaining consistency and accuracy in the presentation of an entity's financial health.

The Role and Purpose of Opening Entries

Opening entries serve to initialize the general ledger for a new accounting period, reflecting the balances carried forward from the previous period. These entries act as the bridge between the closing balances of the prior period and the opening balances of the new period. Their accurate recording is essential for the consistency of financial reports, as any error in the opening entry could lead to distorted financial outcomes throughout the accounting period.

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The main objectives of the opening entry can be summarized as follows:

1. **Establishing Financial Continuity:** Opening entries ensure that all the balances (assets, liabilities, equity) from the previous accounting period are transferred to the new period's records, establishing continuity between periods.
2. **Foundation for Further Transactions:** By setting the starting point for the financial year, the opening entry forms the base upon which all future accounting entries, adjustments, and transactions are built.
3. **Reflecting Accurate Financial Position:** It serves as a formal reflection of the financial status of the entity at the beginning of the period, including the status of assets, liabilities, and equity.
4. **Legal and Compliance Requirements:** Accurate opening entries are necessary to comply with accounting standards and regulations. Misstatements or omissions in opening entries could lead to non-compliance with frameworks such as IFRS, Ind AS, or local GAAP, depending on the regulatory environment.

Components of an Opening Entry

An opening entry generally consists of the following components:

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1. **Assets:** All assets (current and non-current) of the entity are recorded in the opening entry at their respective balances, carried over from the previous accounting period.
2. **Liabilities:** The balances of liabilities, both short-term and long-term, are also brought forward, ensuring that any obligations or debts from the previous period are accurately reflected.
3. **Equity:** The owner's equity, which includes capital, reserves, and retained earnings, is recorded in the opening entry, representing the claim of the owners on the business at the start of the new accounting period.

In essence, the opening entry is a formal snapshot of the financial position of the company as of the first day of the new accounting period.

Accounting Treatment of Opening Entries

Opening entries are treated differently from other transactions in the accounting cycle because they are the first entries recorded in a new period and essentially "set the stage" for the entire accounting cycle. The specific steps involved in making an opening entry can be outlined as follows:

1. **Identification of Carrying Balances:** At the end of the previous accounting period, the balances of assets, liabilities, and equity accounts are

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determined. These balances are then carried forward to the new period as the opening balances.

- 2. Creation of the Opening Entry:** The opening entry is created by transferring the closing balances from the previous period. This involves debiting and crediting the respective accounts to reflect their proper opening balances. For example, if an asset such as cash had a balance of \$10,000 at the close of the last period, the opening entry for cash in the new period would be a debit of \$10,000.
- 3. Double-Entry Principle:** According to the double-entry system, each opening balance must be matched with a corresponding credit or debit. For example, if the business's liabilities include a \$5,000 loan, the opening entry would involve debiting the appropriate liability account and crediting the equity or retained earnings account to reflect this balance.
- 4. Capital Accounts and Retained Earnings:** If the business is a corporation, the capital accounts (share capital) or retained earnings will reflect the closing balances of the previous period. The opening entry in this case would establish the capital structure for the new period, ensuring that all investor claims (equity) are properly carried forward.

Example of an Opening Entry

Consider the following scenario where the balances for the previous period are as follows:

- **Cash:** ₹50,000

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- **Accounts Receivable:** ₹30,000
- **Accounts Payable:** ₹20,000
- **Owner's Equity (Capital):** ₹60,000

The opening entry would be recorded as:

Account Title	Debit (₹)	Credit (₹)
Cash	50,000	
Accounts Receivable	30,000	
Accounts Payable		20,000
Owner's Equity (Capital)		60,000

This entry ensures that the balances from the previous period are properly brought forward into the new accounting period.

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Impact of Opening Entries on Financial Statements

The opening entries play a critical role in the preparation of financial statements. Since these entries are directly related to the starting balances of all accounts, their accuracy ensures that subsequent transactions are accurately recorded and reflected in the financial statements of the company. The key impact areas of opening entries on financial statements include:

1. Balance Sheet:

The opening entry directly affects the balance sheet by reflecting the assets, liabilities, and equity of the business at the start of the accounting period. This provides a clear snapshot of the financial position of the entity, which is then used for comparison with subsequent periods.

2. Income Statement:

While opening entries do not directly affect the income statement, the accurate recording of assets and liabilities ensures that income and expenses related to those accounts are recognized correctly. For example, any accrued revenue or expense from the previous period, if not accounted for in the opening entry, could distort the income statement for the current period.

3. Cash Flow Statement:

Opening entries may also indirectly influence the cash flow statement, especially if there are adjustments to cash

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or bank balances carried forward from the previous period. These balances, reflected in the opening entry, affect the classification of cash inflows and outflows in the new period.

Illustration

Consider the case of Tata Motors' acquisition of Jaguar Land Rover (JLR) in 2008. Upon acquisition, Tata Motors had to adjust the opening entries to reflect the fair value of JLR's assets and liabilities. This included the recognition of intangible assets such as brand value, along with tangible assets like inventory and property. The treatment of opening entries in this case was critical for the consolidation process and for the accurate representation of Tata Motors' financial position after the acquisition.

Preparation of Ledger

A ledger is a book or database that records all of a company's transactions, organized by accounts. Unlike the journal, which records transactions in chronological order, the ledger organizes transactions by individual accounts. Each account is used to track the balance of a specific category, such as cash, accounts payable, or revenue.

The ledger serves as the central repository for all financial transactions of an entity, classified according to their respective accounts. The process of **preparing the**

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ledger involves setting up individual accounts for each type of asset, liability, income, expense, and equity. The ledger is integral to the double-entry system, where every transaction is recorded in at least two accounts: one as a debit and the other as a credit.

Structure of the Ledger

Each ledger account typically consists of the following components:

1. **Account Name:** The title or name of the account, such as Cash, Accounts Payable, or Sales Revenue.
2. **Debit Side:** The left side of the account, where increases in assets or expenses and decreases in liabilities or equity are recorded.
3. **Credit Side:** The right side of the account, where increases in liabilities or equity and decreases in assets or expenses are recorded.
4. **Balance Column:** The column used to indicate the balance of the account after each transaction is posted.
5. **Date and Description:** Each entry in the ledger should be accompanied by the date of the transaction and a brief description.

Example of a Ledger Account

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Let us consider a **Cash** account in the ledger, with an opening balance of ₹50,000 and subsequent transactions during the period.

Date	Description	Debit (₹)	Credit (₹)	Balance (₹)
01/04/2025	Opening Balance	50,000		50,000
05/04/2025	Cash Sales	10,000		60,000
10/04/2025	Payment to Vendor		5,000	55,000
15/04/2025	Cash Receipt	15,000		70,000

In this example, the Cash account reflects all transactions involving cash during the accounting period, allowing for a clear and comprehensive record of changes in cash balances.

Ledger Posting

Ledger posting refers to the process of transferring journal entries into the appropriate ledger accounts. After transactions are recorded in the journal (or book of original entry), they are posted to the corresponding ledger accounts. This process is essential for the classification and summarization of transactions,

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enabling the preparation of trial balances and financial statements.

Process of Ledger Posting

The ledger posting process involves several key steps:

1. **Identify the Journal Entry:** Determine which accounts are affected by the transaction and whether they should be debited or credited.
2. **Transfer the Amounts:** For each affected account, transfer the amount from the journal entry to the appropriate ledger account. The debit amounts go to the left side of the ledger, and the credit amounts go to the right side.
3. **Balance the Accounts:** After posting all transactions for the period, calculate the balance of each account by summing the debits and credits. The balance is carried forward to the next period.
4. **Cross-Reference Journal and Ledger:** Ensure that each entry in the ledger is cross-referenced with the corresponding journal entry, typically by including the journal page number and date.

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Example of Ledger Posting

Consider the following journal entries for a company during a period:

Date	Account Title	Debit (₹)	Credit (₹)
01/04/2025	Cash	50,000	
01/04/2025	Capital		50,000
05/04/2025	Cash	10,000	
05/04/2025	Sales Revenue		10,000
10/04/2025	Accounts Payable	5,000	
10/04/2025	Cash		5,000

The posting of these journal entries would involve transferring the amounts into the respective ledger accounts:

1. **Cash:** Debit ₹50,000 from the opening entry, Debit ₹10,000 from cash sales, Credit ₹5,000 for payment to the vendor.
2. **Capital:** Credit ₹50,000 as the owner's equity.
3. **Sales Revenue:** Credit ₹10,000 for sales revenue.
4. **Accounts Payable:** Debit ₹5,000 for payments made to creditors.

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This detailed posting process allows for the accurate tracking and classification of financial information, enabling the creation of trial balances and ultimately the preparation of financial statements.

Significance of Ledger Posting

Ledger posting serves several critical purposes in the accounting process:

1. **Accuracy in Financial Reporting:** Posting ensures that all financial data is organized in the appropriate accounts, enabling the preparation of accurate financial statements such as the balance sheet and income statement.
2. **Segregation of Accounts:** The ledger enables the classification of transactions into separate accounts, allowing for easier tracking and analysis of business activities.
3. **Audit Trail:** Proper ledger posting creates a clear audit trail that links journal entries to individual accounts, ensuring transparency and accountability in financial reporting.
4. **Facilitating Reconciliation:** Ledger balances are used to reconcile with external records, such as bank statements or supplier accounts, helping to identify discrepancies and prevent fraud.

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2.4 CASH BOOK ENTRIES

component of the Constitution, as it deals with the protection of fundamental rights and the judicial review of laws that infringe upon these rights.

The Cash Book, a fundamental element of financial accounting, is an integral part of maintaining accurate and detailed records of a company's cash transactions. It serves as both a journal and a ledger, recording cash inflows and outflows, and subsequently helps in tracking cash balances over time. Unlike other journals, the Cash Book is a specialized book used exclusively for cash transactions, and its entries are critical for ensuring the proper reflection of a company's liquidity. The management of cash is central to the financial stability of a business, and thus, cash book entries require utmost accuracy and attention.

Cash Book entries provide a dual function: they record daily cash transactions and help maintain a running balance of the available cash. This is pivotal in managing day-to-day business operations. Cash transactions, being relatively straightforward, must be recorded under clearly defined accounting principles, which are provided by standards such as the Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), and Indian Accounting Standards (Ind AS).

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The Structure of a Cash Book

A typical cash book comprises the following essential components:

1. **Date:** This records the date on which the transaction occurred.
2. **Particulars (Details):** This section provides a brief description of the transaction, such as the name of the payer or payee and the nature of the transaction.
3. **Voucher No.:** The reference number for the supporting documentation, typically a receipt or payment voucher.
4. **Debit Side (Receipts):** This column records all incoming cash or bank transactions.
5. **Credit Side (Payments):** This section records all outgoing cash or bank transactions.
6. **Balance:** A running balance is maintained in the cash book to reflect the cumulative cash or bank position after each transaction.

Types of Cash Books

There are several types of Cash Books used depending on the complexity of a business's transactions. The most common types are:

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Simple Cash Book: This is the most basic form of the Cash Book, used by businesses with limited cash transactions. It records only the cash receipts and payments, divided into two sides:

- **Receipts** on the debit side.
- **Payments** on the credit side.

Double Column Cash Book: This version of the Cash Book includes two columns on both the debit and credit sides:

- One column records cash transactions.
- The other records bank transactions.

This format is helpful for businesses that deal with both cash and bank transactions on a regular basis.

Triple Column Cash Book: In this more complex form of the Cash Book, there are three columns:

- Cash column.
- Bank column.
- Discount column.

The addition of the discount column enables the recording of discounts allowed and received, which is crucial for accurate financial reporting.

Petty Cash Book: Used for recording small, day-to-day expenses, this type of cash book is separate from the main

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cash book. It is typically handled by a petty cashier, who maintains records of minor payments like postage, stationary, or minor repairs.

Cash Book Entry Mechanisms

A Cash Book functions both as a journal and a ledger, and this dual role is critical to the process of financial recording. To comprehend the intricacies of Cash Book entries, it is necessary to understand how they are created and maintained:

Debit Side Entries (Cash Inflows):

- **Cash Receipts:** These represent any inflows of cash to the business, whether from sales, loans, or other financial sources. Cash receipts are recorded on the debit side of the Cash Book.
- **Bank Deposits:** When cash is deposited into the business's bank account, this transaction is also recorded on the debit side under the bank column (in the case of a double-column or triple-column Cash Book).
- **Cash Sales:** These are sales where payment is made in cash, and the transaction increases the cash balance of the business. This is recorded as a debit to the Cash Book.

Example:

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If a business sells goods worth ₹20,000 for cash, the entry would be:

Debit Cash A/c ₹20,000

Credit Sales A/c ₹20,000

Credit Side Entries (Cash Outflows):

- **Cash Payments:** Cash paid out of the business, including payments for purchases, expenses, or salaries, is recorded on the credit side of the Cash Book.
- **Bank Withdrawals:** Similar to cash payments, any withdrawal from the bank, for instance, for paying creditors, is also recorded on the credit side under the bank column in the double-column or triple-column Cash Book.
- **Cash Purchases:** When the business purchases goods or services with cash, the cash balance is reduced, and the transaction is recorded on the credit side.

Example:

If a business pays ₹5,000 for office supplies, the entry would be:

Debit Office Supplies A/c ₹5,000

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Credit Cash A/c ₹5,000

Accounting Treatment of Cash Book Entries

The Cash Book entries are governed by the principles of double-entry bookkeeping, which requires that every debit entry must have a corresponding credit entry. This ensures that the accounting equation, Assets = Liabilities + Equity, remains balanced.

- **Receipts:** When cash is received, it is debited to the Cash Book (or Bank if the transaction involves a deposit into the bank). The corresponding credit will typically be to a relevant revenue or liability account such as Sales Revenue, Loan Payable, or Receivables.
- **Payments:** When cash is paid out, it is credited to the Cash Book (or Bank for bank withdrawals). The corresponding debit will be to an expense account or a liability account like Purchases, Salaries, or Accounts Payable.

It is essential to note that the Cash Book, being a journal of cash transactions, ensures that all such transactions are captured in a systematic manner, and the cash balance is updated immediately after each entry. This immediate update is crucial for businesses to avoid liquidity issues and manage daily operations effectively.

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Cash Book and its Role in the Financial Statements

The Cash Book plays an essential role in the preparation of the financial statements, particularly the **Cash Flow Statement**. The **Cash Flow Statement** is a crucial financial document that provides insights into the inflow and outflow of cash within a business. It helps external stakeholders assess the financial health and liquidity of an organization. The data recorded in the Cash Book directly influences the Cash Flow Statement, which is divided into three sections:

- **Operating Activities:** The Cash Book entries related to receipts from customers and payments to suppliers will appear in this section.
- **Investing Activities:** This includes cash flows related to the purchase or sale of long-term assets, such as property, plant, and equipment.
- **Financing Activities:** Cash inflows and outflows related to raising capital, repaying debt, or issuing dividends will be reflected here.

Moreover, the **Balance Sheet** also reflects cash and bank balances derived from the Cash Book. A detailed reconciliation of these balances ensures the accuracy of the reported financial position of the business.

Role of Cash Book Entries in Internal Control Systems

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The Cash Book is not only a tool for recording transactions but also plays a critical role in the internal control systems of a business. Effective internal controls are necessary to safeguard the cash and ensure that the business operates efficiently and within legal frameworks. The maintenance of the Cash Book is pivotal for the following reasons:

1. **Prevention of Fraud and Mismanagement:** A well-maintained Cash Book serves as a deterrent to fraudulent activities. Since cash transactions are highly susceptible to mismanagement or theft, the accuracy and regular reconciliation of the Cash Book ensure that any discrepancies can be quickly identified. Frequent reconciliations also allow for the detection of errors or potential fraud early, allowing corrective action to be taken.
2. **Auditing:** Auditors rely heavily on the Cash Book when reviewing a company's financial statements. Since cash is one of the most liquid assets, its accurate documentation is crucial in the audit process. The Cash Book provides a transparent and verifiable record of all cash transactions, simplifying the audit process and supporting the credibility of the financial statements.
3. **Ensuring Compliance:** Many legal and regulatory frameworks require businesses to maintain accurate records of cash transactions. For example, the **Companies Act, 2013** in India mandates that businesses maintain proper books of accounts,

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including the Cash Book. By adhering to these requirements, businesses can ensure compliance with laws and avoid penalties.

- 4. Effective Cash Management:** The Cash Book helps management monitor cash flow, track expenses, and project future cash requirements. Through this continuous monitoring, the business can ensure that there are no liquidity issues, which is essential for operational efficiency. Cash management practices, when coupled with accurate Cash Book entries, help in maintaining optimal cash levels, ensuring there are enough funds for day-to-day operations without the risk of running into a cash shortfall.

SALES BOOK ENTRIES

The **Sales Book** is a special journal used for recording all credit sales made by a business. It is a subsidiary book that helps in tracking sales transactions without cluttering the general journal. The Sales Book plays an important role in the overall recording of transactions, especially in businesses that deal heavily in credit sales.

Structure and Purpose

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The primary purpose of the Sales Book is to record only those sales that are made on credit (i.e., sales for which payment has not yet been received). Cash sales are not recorded in the Sales Book; instead, they are entered directly into the Cash Book.

The Sales Book typically includes the following columns:

- **Date:** The date of the transaction.
- **Invoice Number:** A unique reference number for the sale.
- **Particulars:** A description of the transaction.
- **Ledger Account:** The account to which the sale is related.
- **Amount:** The total value of the sale.

Entries in the Sales Book

In the Sales Book, each credit sale transaction is recorded by noting the relevant details of the transaction. The entries made in the Sales Book are then posted to the **Accounts Receivable** (or **Debtors**) ledger and the **Sales** ledger.

Entry for Credit Sale: When a business makes a credit sale, the entry in the Sales Book is recorded as:

- Date | Particulars | Invoice Number | Amount

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- 01/01/2025 | Sale to XYZ Ltd. | INV-001 | 5000

The corresponding entry in the **general ledger** would be:

Accounts Receivable (XYZ Ltd.) Dr. 5000 To Sales Account 5000

PURCHASE BOOK ENTRIES

The **Purchase Book** functions similarly to the Sales Book, but it is used to record credit purchases of goods. It is another important subsidiary book that helps businesses manage and track credit purchases, particularly in companies with high volumes of procurement.

Structure and Purpose

The Purchase Book is used exclusively for credit purchases, not for cash purchases, which are recorded directly in the Cash Book. The columns in a typical Purchase Book include:

- **Date:** The date of purchase.
- **Supplier's Name:** The name of the supplier from whom goods were purchased.
- **Invoice Number:** A reference to the purchase invoice.

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- **Ledger Account:** The corresponding account to which the purchase is related (e.g., Purchases, Accounts Payable).
- **Amount:** The value of the purchase.

Entries in the Purchase Book

When a business makes a credit purchase, the relevant details are entered into the Purchase Book. Subsequently, the purchases are posted to the **Purchases Account** and **Accounts Payable** (or **Creditors**) ledger.

Entry for Credit Purchase: When goods are purchased on credit, the entry in the Purchase Book is:

- Date | Particulars | Invoice Number | Amount
- 02/01/2025 | Purchase from ABC Ltd. | INV-002 | 3000

The corresponding general ledger entry would be:
Purchases Account Dr. 3000 To Accounts Payable (ABC Ltd.) 3000

Key Differences between Sales and Purchase Book Entries

The primary distinction between sales and purchase book entries lies in their role in the accounting cycle. Sales transactions contribute to the revenue of the business,

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and thus affect the income statement (profit and loss), whereas purchase transactions impact the cost of goods sold (COGS) and affect the financial position by increasing liabilities.



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2.4 PREPARATION OF TRIAL BALANCE

A **trial balance** is a statement that lists all the ledger accounts of a business and their respective debit or credit balances at a particular point in time. It ensures that the sum of all debits equals the sum of all credits, which is a fundamental rule in the double-entry bookkeeping system. The preparation of a trial balance marks the point in the accounting cycle where the records are reviewed for arithmetic accuracy, prior to the preparation of the final accounts.

The trial balance has several key functions:

1. **Verification of Accuracy:** The primary purpose of the trial balance is to ensure that the total of debit balances matches the total of credit balances. This confirms that the basic rule of double-entry accounting has been maintained.
2. **Assisting in Financial Statement Preparation:** The trial balance is a precursor to the preparation of the financial statements. It organizes and categorizes the accounts that will appear in the final reports, such as the profit and loss statement and balance sheet.
3. **Error Detection:** Although the trial balance is not foolproof, it helps in detecting errors in the accounting system. If the trial balance does not balance, it signals the need for further investigation into the journal entries or ledger accounts to identify the cause of the discrepancy.

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4. **Internal Control:** It serves as a tool for internal control and helps auditors, both internal and external, verify that the books of accounts are kept accurately.

Structure of the Trial Balance

The trial balance is typically presented in a **two-column format**, listing accounts on the left side with their debit balances and the right side with their credit balances. The following accounts generally appear in a trial balance:

1. **Asset Accounts:** These accounts usually carry debit balances and include cash, accounts receivable, inventory, and fixed assets.
2. **Liability Accounts:** These accounts typically carry credit balances and include accounts payable, loans, and accrued expenses.
3. **Equity Accounts:** These include owner's equity or capital, retained earnings, and other similar accounts, often appearing on the credit side of the trial balance.
4. **Revenue Accounts:** These accounts usually carry credit balances and include sales, service income, and other operating revenue.

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5. **Expense Accounts:** These accounts generally carry debit balances and include wages, rent, utilities, and depreciation.

It is important to note that while the trial balance helps in verifying the balance of accounts, it does not confirm that the accounting records are free from errors. For example, it cannot detect errors of omission, errors of commission, or errors of principle, which may still result in the trial balance balancing, even though the accounts are incorrect.

Purpose of the Trial Balance

The preparation of a trial balance serves several key purposes in the accounting process:

- **Error Detection:** The trial balance helps identify errors in the double-entry accounting system. If the sum of the debits does not equal the sum of the credits, it indicates that there has been a mistake in the journal entries or ledger postings.
- **Financial Statement Preparation:** The trial balance provides the initial data required for preparing financial statements, particularly the balance sheet and profit and loss account. Each item listed in the trial balance corresponds to elements in the financial statements.

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- **Verification of Accounting Records:** The primary purpose of a trial balance is to ensure that the accounting equation (Assets = Liabilities + Equity) is in balance. This is accomplished by confirming that the total of debit entries equals the total of credit entries.

Types of Trial Balances

There are three main types of trial balances that accountants may prepare depending on the specific stage of the accounting cycle:

1. **Unadjusted Trial Balance:** Prepared before any adjustments are made to the ledger accounts. It is used primarily to ensure that the total debits and credits are equal, before proceeding with the adjustments.
2. **Adjusted Trial Balance:** Prepared after all adjustments, such as accruals and deferrals, have been made. This version of the trial balance reflects more accurate financial information that will be used to prepare the financial statements.
3. **Post-Closing Trial Balance:** Prepared after the closing entries have been made. It reflects the balances of permanent accounts only, such as assets, liabilities, and equity.

Principles in Trial Balance Preparation

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The preparation of the trial balance is grounded in several core accounting concepts and principles, these principles ensure that the trial balance reflects the true and fair view of the financial position of an entity. Some of these key principles include:

1. **The Dual Aspect Concept:**

The trial balance is based on the double-entry accounting system, where every transaction affects at least two accounts—one account is debited, and the other is credited. This ensures that the trial balance remains balanced if all entries are made correctly.

2. **The Going Concern Concept:**

This concept assumes that the business will continue to operate for the foreseeable future. Therefore, trial balances are prepared under the assumption that the business will continue its operations, and the financial statements will reflect this ongoing nature.

3. **The Accrual Concept:**

Under this concept, revenues and expenses are recognized when they are earned or incurred, not when cash is received or paid. This is reflected in the trial balance after necessary adjustments for accrued income and expenses, prepaid items, etc.

Process of Preparing the Trial Balance

The preparation of the trial balance follows a methodical approach, typically involving the following steps:

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Posting to Ledger Accounts: After transactions are recorded in the journals, they are posted to the relevant ledger accounts. This is the first stage in the process, as the ledger serves as the primary source for preparing the trial balance.

Balancing the Ledger Accounts: Each ledger account must be balanced, meaning that the total of the debit and credit entries in each account is calculated. The balance of each account is either a debit balance or a credit balance.

Transferring Balances to the Trial Balance: The balances from the ledger accounts are transferred to the trial balance. Debit balances are listed on the left-hand side, while credit balances are listed on the right-hand side.

Ensuring the Trial Balance Balances: The total of the debit column is compared with the total of the credit column. If the two totals match, the trial balance is said to be "balanced." If they do not, an error has occurred, and the accountant must investigate and correct the discrepancy.

Identifying and Correcting Errors: If the trial balance does not balance, the accountant must identify and correct errors. These errors can include:

- **Transposition Errors:** When digits are reversed (e.g., entering \$1,200 as \$2,100).

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- **Single Entry Errors:** Where a transaction is recorded in only one account, either on the debit or the credit side.
- **Double Posting:** Where the same amount is posted twice in one account.
- **Incorrect Classification:** Where accounts are misclassified as debit or credit accounts.

Illustrative Example

Consider the following simple example of a trial balance for a small business. The ledger balances at the end of the accounting period are as follows:

- **Cash Account:** Debit balance of \$5,000
- **Accounts Payable:** Credit balance of \$2,000
- **Owner's Capital:** Credit balance of \$3,000
- **Sales Revenue:** Credit balance of \$4,000
- **Rent Expense:** Debit balance of \$1,000
- **Wages Expense:** Debit balance of \$500

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The trial balance would be prepared as follows:

Account Name	Debit (\$)	Credit (\$)
Cash	5,000	
Accounts Payable		2,000
Owner's Capital		3,000
Sales Revenue		4,000
Rent Expense	1,000	
Wages Expense	500	
Total	6,500	9,000

In this case, the trial balance is **not balanced**, as the total debits of \$6,500 do not equal the total credits of \$9,000. The accountant would need to investigate the entries to locate and correct the discrepancy.

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2.6 COMPANY FINAL ACCOUNTS: PREPARATION OF FINAL ACCOUNTS WITH ADJUSTMENTS, TRADING ACCOUNTS

The final accounts of a company are the culmination of a business's financial activities, typically prepared at the end of a financial period to provide a comprehensive overview of the company's financial position and performance. These accounts are critical for stakeholders such as shareholders, creditors, regulators, and management, as they offer insights into the company's financial health, profitability, and the efficiency with which it operates.

The preparation of company final accounts involves various steps and processes in line with statutory requirements, accounting standards, and best practices. These accounts include the **Balance Sheet, Profit and Loss Account**, and additional schedules and notes that provide further details on specific transactions. Companies are required to adhere to well-established frameworks such as the **Companies Act 2013** in India, **International Financial Reporting Standards (IFRS)**, or **Generally Accepted Accounting Principles (GAAP)**, depending on the jurisdiction in which they operate.

Key Components of Company Final Accounts

The final accounts of a company comprise three primary financial statements, each serving a distinct purpose in

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providing a complete picture of the company's financial performance and position:

- **Profit and Loss Account (Income Statement):**

The Profit and Loss Account, or Income Statement, is designed to provide a detailed summary of the company's revenues, expenses, and profits or losses over a specific accounting period. This statement is a reflection of the company's operational performance and is used to assess its profitability.

Structure of the Profit and Loss Account:

The Profit and Loss Account typically follows a standard structure, which includes:

- **Revenue from Operations:** Represents income generated through the core business activities, such as sales of goods or services.
- **Other Income:** Includes non-operating income such as interest income, dividends, or gains from the sale of assets.
- **Cost of Goods Sold (COGS):** Includes the direct costs incurred in producing goods or services sold by the company.
- **Gross Profit:** The difference between revenue from operations and the cost of goods sold.

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- **Operating Expenses:** These are the costs incurred in the day-to-day operations, such as selling, general, and administrative expenses (SG&A).
- **Operating Profit (EBIT):** Earnings Before Interest and Taxes (EBIT) represent the profit from core operations.
- **Interest Expenses:** Interest paid on borrowings and loans.
- **Profit Before Tax (PBT):** Calculated by subtracting interest expenses from operating profit.
- **Tax Expenses:** Reflects the tax obligations based on the applicable tax laws.
- **Net Profit (After Tax):** The final profit or loss after tax expenses, representing the company's bottom line.

Significance:

The Profit and Loss Account provides a detailed view of how effectively a company generates profit from its revenue, manages its expenses, and the overall profitability during a specific period. This statement is crucial for stakeholders as it helps in assessing the operational efficiency and sustainability of the business model.

- **Balance Sheet (Statement of Financial Position):**

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The Balance Sheet provides a snapshot of a company's financial position at a given point in time. It outlines the company's assets, liabilities, and equity, offering insights into its solvency and liquidity. The Balance Sheet is governed by the basic accounting equation:

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

Structure of the Balance Sheet:

The Balance Sheet is divided into two main sections:

- **Assets:**
 - **Non-Current Assets:** Also known as fixed assets, these include long-term assets such as property, plant, equipment, intangible assets (e.g., patents), and investments intended for long-term use.
 - **Current Assets:** These are assets expected to be converted into cash or used within one year, such as cash and cash equivalents, receivables, and inventories.
- **Liabilities:**
 - **Non-Current Liabilities:** These include long-term debts, deferred tax liabilities, and other obligations that are due beyond one year.

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- **Current Liabilities:** Short-term obligations due within one year, such as payables, short-term loans, and accrued expenses.
- **Equity:**
 - **Share Capital:** The total value of shares issued by the company.
 - **Reserves and Surplus:** These include retained earnings, capital reserves, and any other reserves accumulated by the company over time.
 - **Retained Earnings:** The portion of profit not distributed as dividends but retained for reinvestment in the business.

Significance:

The Balance Sheet provides a clear picture of the company's financial health and its ability to meet both short-term and long-term obligations. It also indicates the proportion of financing that comes from equity and debt, which is critical in assessing the company's financial risk and stability.

● Cash Flow Statement:

The Cash Flow Statement is a financial statement that summarizes the inflows and outflows of cash during a specific period, classified into three main categories: operating activities, investing activities, and financing activities. While not part of the core final accounts under

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traditional frameworks, the Cash Flow Statement is an essential document for understanding a company's liquidity and cash management.

Structure of the Cash Flow Statement:

- **Cash Flows from Operating Activities:** These include cash receipts from customers, cash payments to suppliers and employees, and other operating cash flows.
- **Cash Flows from Investing Activities:** Involves cash used for or received from investments in assets like property, plant, equipment, or securities.
- **Cash Flows from Financing Activities:** Involves cash inflows from issuing shares or borrowing and cash outflows from repaying debt or dividends paid.

Significance:

The Cash Flow Statement is crucial for assessing the company's liquidity and its ability to generate cash from operations, which is vital for sustaining ongoing business activities, meeting obligations, and making future investments.

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ADJUSTMENTS TO FINAL ACCOUNTS

Adjustments to final accounts are crucial in ensuring that the accounts reflect the true and fair view of the financial position of a business. These adjustments account for items that may not be directly recorded during the routine preparation of trial balances, but which are necessary to achieve an accurate representation of the company's financial performance.

1. Accruals and Prepayments

- **Accruals:** Accruals are expenses or revenues that have been incurred or earned but not yet recorded in the accounts. For example, if a company has incurred utility expenses for the current period but the bill has not been received, an accrual is necessary to record this expense.
- **Prepayments:** Prepayments refer to expenses that have been paid in advance for goods or services that will be received in future periods. For instance, if rent is paid in advance for the next year, it must be treated as a prepayment and adjusted in the financial statements to reflect only the portion relevant to the current period.

2. Depreciation

Depreciation is the systematic allocation of the cost of a tangible fixed asset over its useful life. Adjustments for depreciation are necessary to reflect the reduction in the value of fixed assets over time. The depreciation expense

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is deducted from the asset's value on the balance sheet, and the corresponding depreciation charge is included in the profit and loss account.

There are several methods of depreciation, including:

- **Straight-Line Method:** This method allocates an equal depreciation expense over the useful life of the asset.
- **Reducing Balance Method:** This method applies a fixed percentage of depreciation to the diminishing book value of the asset each year.

The chosen method must be consistent with the nature of the asset and the business's accounting policy.

3. Provision for Bad Debts

A provision for bad debts is an estimated amount set aside to account for receivables that may not be collected. This adjustment is important because it ensures that the revenue reported in the profit and loss account is realistic, reflecting only those amounts that are expected to be received. The provision is recorded as an expense in the profit and loss account and a liability in the balance sheet.

4. Inventory Adjustments

Adjustments for inventory are essential in ensuring that the financial statements reflect the correct cost of goods

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sold (COGS) and the value of closing stock. The closing stock must be adjusted to reflect its accurate value at the end of the accounting period. Inventory valuation methods, such as **FIFO (First In, First Out)** or **LIFO (Last In, First Out)**, can affect the final accounts' presentation of profit and the balance sheet.

5. Interest on Capital and Drawings

Interest on capital is often paid to owners or partners in a business as a return on the funds they have invested. Similarly, interest on drawings refers to the interest charged on money withdrawn by the owners for personal use. Both of these are adjustments that affect the profit and loss account and, depending on the accounting treatment, may also impact the balance sheet.

6. Outstanding Expenses

Outstanding expenses are those expenses that have been incurred but not yet paid. These must be adjusted in the final accounts to ensure that the profit or loss reflects all the costs incurred during the accounting period. These expenses are recorded as liabilities in the balance sheet and as expenses in the profit and loss account.

7. Income Received in Advance

Income received in advance refers to revenue that has been collected but pertains to a future accounting period. For example, rent received for a period that extends beyond the current year should be recognized as income

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in the period it relates to, and an adjustment must be made to treat it as a liability until earned.

Preparation of Company Final Accounts

The preparation of company final accounts involves the systematic compilation and presentation of financial data in compliance with accounting standards, legal requirements, and business practices. The process typically involves the following steps:

1. Recording of Transactions:

All business transactions, including sales, purchases, expenses, and income, are recorded in the books of accounts using the double-entry accounting system. These transactions are captured in journals and subsequently posted to the ledger accounts.

2. Trial Balance:

After all transactions are recorded, a trial balance is prepared to ensure that debits equal credits. This step is essential for verifying the accuracy of the recording process and identifying any errors before the final accounts are prepared.

3. Adjustments:

Adjustments are made to account for various items such as depreciation, provisions for bad debts, accrued income, and expenses. These adjustments ensure that the

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financial statements reflect a true and fair view of the company's financial position.

4. Preparation of the Financial Statements:

Based on the trial balance and adjustments, the final financial statements—Profit and Loss Account, Balance Sheet, and Cash Flow Statement—are prepared. The Profit and Loss Account shows the company's performance, while the Balance Sheet presents its financial position at the end of the period.

5. Audit and Finalization:

The final accounts are subject to audit by external auditors who review the accuracy and compliance with accounting standards. Once the audit is complete, the final accounts are approved by the board of directors and submitted to regulatory authorities for filing.

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TRADING ACCOUNT

The trading account is a financial statement that is prepared by a business to determine the gross profit or gross loss generated from its trading activities. Essentially, it calculates the difference between the revenue earned from the sale of goods (or services) and the direct costs associated with producing or purchasing those goods (or services). This account serves as the starting point for the preparation of the profit and loss account, which provides further insight into a company's overall profitability after considering operating expenses, taxes, and other factors.

In terms of purpose, the trading account primarily serves the following functions:

- **Gross Profit or Loss Calculation:** It identifies the gross profit or loss from trading activities by comparing the cost of goods sold (COGS) with sales revenue. A gross profit indicates that the business is generating sufficient revenue from its core activities to cover its direct costs, while a gross loss suggests the opposite.
- **Determination of Efficiency:** The trading account helps assess the efficiency of a company's operational activities. A high gross profit margin indicates effective management of production costs, while a low or negative margin may suggest inefficiencies or pricing issues.

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- **Insight into Profitability:** By segregating direct costs from operating and administrative expenses, the trading account provides a clear picture of the profitability generated by core trading activities, separate from other income or expenses.

Structure of the Trading Account

The structure of the trading account is straightforward, focusing on the revenue from sales and the costs directly related to generating those sales. In general, the trading account is divided into two main sections: the **credit side** and the **debit side**.

The Credit Side

On the credit side, the primary focus is on the income generated from the company's sales activities. The credit side typically includes the following entries:

- **Sales Revenue:** The total amount of revenue earned by selling goods or services. This figure should represent the sales made during the period and is recorded at its full value, excluding any sales returns or allowances.
- **Sales Returns (if applicable):** Sales returns represent the goods that customers have returned after purchasing. This amount is deducted from the sales revenue to determine the net sales figure. It is

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important to subtract this figure to prevent overstatement of income.

- **Other Income Related to Trading:** If a business generates any income directly related to its trading activities, such as commission from selling goods on behalf of another entity, it is recorded on the credit side. However, such income is typically minor and may not appear in every trading account.

The Debit Side

The debit side of the trading account lists all direct expenses incurred in the process of producing or procuring goods for sale. These costs are referred to as the **cost of goods sold (COGS)**, and they generally include:

- **Opening Stock:** The value of the inventory (goods or raw materials) that remains unsold from the previous accounting period. This figure is derived from the closing stock of the prior period and is carried over as part of the cost of goods sold.
- **Purchases:** The total cost of goods bought for resale or materials purchased for manufacturing purposes. This includes both the cost of raw materials and goods purchased for resale.
- **Direct Expenses:** These are expenses that are directly associated with the production of goods or services, such as direct labor costs, factory overheads, and freight charges. Direct expenses are those that

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vary in direct proportion to the volume of production or sales.

- **Closing Stock:** The inventory or stock of unsold goods at the end of the accounting period. Closing stock is subtracted from the total of opening stock and purchases to arrive at the final cost of goods sold. The valuation of closing stock is typically based on either the cost or market value, whichever is lower (the lower of cost or market rule).

The cost of goods sold is calculated as follows:

Cost of Goods Sold (COGS) = Opening Stock + Purchases
+ Direct Expenses – Closing Stock

This calculation represents the total cost incurred in producing or acquiring the goods that were sold during the accounting period.

Gross Profit or Gross Loss

Once the revenue (sales) and the direct costs (COGS) are recorded in the trading account, the next step is to calculate the gross profit or gross loss. This is done by comparing the total sales with the cost of goods sold:

Gross Profit = Sales – Cost of Goods Sold (COGS)

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If sales exceed COGS, the result is a gross profit, indicating that the business was able to generate a surplus from its core activities. On the other hand, if COGS exceeds sales, the result is a gross loss, suggesting that the business's trading activities were not profitable during the period.



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2.7 PROFIT AND LOSS ACCOUNT, BALANCE SHEET AS PER SCHEDULE-III OF THE NEW COMPANIES ACT 2013

PROFIT AND LOSS ACCOUNT

The Profit and Loss Account, commonly referred to as the Income Statement, is one of the core financial statements used by organizations to track their financial performance over a specific period, typically a fiscal quarter or year. Its primary purpose is to summarize the revenues, costs, and expenses incurred by a business during a given period, ultimately resulting in the net profit or loss for that period. This statement is crucial for assessing the operational efficiency, profitability, and sustainability of a business. It provides vital information to stakeholders such as investors, creditors, and management to make informed decisions regarding the company's financial health and future prospects.

The Profit and Loss Account reflects the performance of a business and serves as an essential tool for financial analysis and strategic planning. It plays a significant role in the decision-making process, helping stakeholders understand how well the company is performing in terms of generating profit from its core business activities.

Purpose and Importance

The Profit and Loss Account serves as a vital tool for understanding the financial health of an entity. It enables the users of financial statements to ascertain the

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profitability of a business, which is essential for evaluating its operational success. The statement is particularly valuable for:

- **Assessing Profitability:** The Profit and Loss Account gives a clear picture of how much profit or loss a company has generated over a specific period. This is crucial for decision-making by investors, creditors, and management.
- **Performance Measurement:** It provides insight into how well the business is managing its revenues and expenses, which is key to evaluating the effectiveness of its operational strategies.
- **Regulatory Requirement:** Companies are often legally required to prepare a Profit and Loss Account as part of their financial reporting obligations. This ensures transparency and accountability, especially for publicly listed companies.
- **Taxation Purposes:** The account also plays a role in calculating taxable income, as tax authorities rely on the Profit and Loss Account to determine the appropriate tax liabilities.

In essence, the Profit and Loss Account is a snapshot of an entity's financial performance over a period, and its significance extends far beyond simple profit

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calculation—it is integral to financial planning, analysis, and decision-making.

Structure of the Profit and Loss Account

The Profit and Loss Account typically follows a structured format, organized into distinct sections that trace the journey from revenue generation to net profit or loss. The exact structure can vary depending on the complexity of the business and the regulatory framework in place (e.g., Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS)). However, the basic framework remains consistent across most forms of financial reporting.

1. Revenue (Sales or Income)

The first line of the Profit and Loss Account typically reflects the total revenue generated by the business during the accounting period. This includes income from the core business activities, such as sales of goods or services, and is sometimes referred to as "turnover" or "gross income." Revenue is typically recognized according to the accrual basis of accounting, meaning that it is recorded when earned, not when received.

Example:

For a retailer, the revenue would include the total sales of products during the accounting period. It excludes taxes

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collected from customers, as these are not considered part of the business's revenue but rather liabilities.

2. Cost of Goods Sold (COGS)

The next key section of the Profit and Loss Account is the Cost of Goods Sold, often referred to as COGS or cost of sales. COGS refers to the direct costs incurred in the production of goods sold by the company. This includes costs such as raw materials, direct labor, and manufacturing expenses. The purpose of this section is to calculate the gross profit, which represents the difference between total revenue and the direct costs of production.

Example:

In a manufacturing company, COGS would include the costs of raw materials used in production, wages of production workers, and direct factory overheads. However, indirect costs such as administrative salaries and marketing expenses are not included in COGS.

3. Gross Profit

Gross profit is derived by subtracting COGS from total revenue. It provides an early indication of the business's profitability, focusing solely on the efficiency of its core operations. A high gross profit margin generally indicates that the company is efficient in producing and selling its products.

Formula:

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Gross Profit = Revenue – Cost of Goods Sold (COGS)

4. Operating Expenses

After calculating the gross profit, the next step is to account for operating expenses. These are the indirect costs associated with running the business, including administrative expenses, marketing, research and development (R&D), and depreciation. Operating expenses are typically divided into two broad categories: selling, general, and administrative expenses (SG&A) and depreciation/amortization.

Example:

A technology company may incur operating expenses in the form of salaries for administrative staff, marketing campaigns, and depreciation of its office equipment.

5. Operating Profit (EBIT)

Operating profit, also known as Earnings Before Interest and Taxes (EBIT), is calculated by subtracting operating expenses from gross profit. This measure is essential because it reflects the profitability of a business based on its core operations, without accounting for financial and tax influences.

Formula:

$$\text{Operating Profit (EBIT)} = \text{Gross Profit} - \text{Operating Expenses}$$

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6. Other Income/Expenses

In addition to the core business operations, a company may have income or expenses that are not directly related to its primary business activities. These could include gains or losses from the sale of assets, interest income, or foreign exchange gains. The inclusion of these items provides a more comprehensive view of the company's overall financial performance.

Example:

If the company sells a piece of machinery, the gain from the sale would be recorded here. Similarly, interest income earned on bank deposits would also be included in this section.

7. Finance Costs (Interest Expense)

Finance costs refer to the costs of borrowing, including interest expenses on loans, bonds, and other forms of debt. These costs are subtracted from operating profit to arrive at the pre-tax profit. Finance costs are a critical component in understanding how well a company manages its debt obligations.

Example:

If a company has a long-term loan, the interest paid on that loan is considered a finance cost and is subtracted from EBIT to arrive at the net profit before tax.

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8. Profit Before Tax (PBT)

Profit before tax (PBT) is calculated by subtracting finance costs and adding any other income or expenses from operating profit. This figure represents the company's profitability before accounting for tax liabilities and is a key figure for evaluating the business's operational performance.

Formula:

$$\text{Profit Before Tax (PBT)} = \text{Operating Profit (EBIT)} - \text{Finance Costs} + \text{Other Income}$$

9. Income Tax Expense

The income tax expense reflects the company's liability for taxes based on its profit before tax. This section considers the applicable tax rates, adjustments, and any tax credits or deductions the company may be entitled to. The tax expense is calculated based on the tax laws and regulations of the jurisdiction in which the company operates.

Example:

In many countries, corporate income tax is assessed based on the profit before tax (PBT) and the relevant tax rates. For instance, if the company has a PBT of \$100,000 and the tax rate is 30%, the tax expense would be \$30,000.

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10. Net Profit (or Loss)

The final figure in the Profit and Loss Account is the net profit or loss, which is derived by subtracting income tax expense from profit before tax. This figure represents the company's overall profitability during the accounting period and is often used to evaluate the company's financial health.

Formula:

Net Profit (or Loss) = Profit Before Tax (PBT) – Income Tax Expense

BALANCE SHEET AS PER SCHEDULE-III OF THE NEW COMPANIES ACT 2013

The balance sheet is one of the primary financial statements used by companies to depict their financial position at a specific point in time. As per the Companies Act, 2013, Schedule III outlines the framework for the preparation and presentation of financial statements, which includes the balance sheet. This framework is crucial for ensuring transparency, consistency, and comparability in financial reporting across all Indian companies, in alignment with the regulatory requirements set by the Ministry of Corporate Affairs (MCA).

The **Schedule III of the Companies Act, 2013**, prescribes the format for the balance sheet of a company. It is mandatory for companies to prepare their balance sheet in this prescribed format, as it facilitates uniformity

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in financial reporting and enables stakeholders to easily interpret and compare financial data.

Purpose of the Balance Sheet

The primary purpose of the Balance Sheet is to provide users (including investors, creditors, analysts, and regulators) with detailed information about a company's assets, liabilities, and equity. It is a fundamental component for assessing the financial health of an organization. Specifically, it allows stakeholders to analyze:

- **Liquidity:** The ability of the company to meet its short-term obligations.
- **Solvency:** The ability to meet long-term obligations.
- **Financial structure:** The distribution between debt and equity financing.

The **Schedule III** prescribes a specific format for the presentation of financial statements in India, aimed at improving clarity, consistency, and comparability across different companies. The balance sheet format specified in this schedule is mandatory for all companies, except those following **Ind AS (Indian Accounting Standards)**, which require a slightly modified presentation.

Key Components of the Balance Sheet as per Schedule III

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Schedule III provides a standardized layout for the balance sheet that divides the assets, liabilities, and equity into distinct categories. This structure is designed to offer greater transparency in financial reporting.

1. Equity and Liabilities

This section outlines the sources of funds available to the company, divided into the following major sub-headings:

A. Shareholder's Funds

- **Share Capital:** Represents the funds raised by issuing shares to shareholders. It includes **Equity Share Capital, Preference Share Capital,** and **Other Equity** (e.g., Securities Premium, Reserves, and Surplus).
- **Reserves and Surplus:** Includes accumulated profits, reserves, and other forms of equity not paid as dividends to shareholders. This section also includes statutory reserves, general reserves, and retained earnings.

B. Non-Current Liabilities

- **Long-term Borrowings:** This includes debt securities and long-term loans payable after a period of 12 months.

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- **Deferred Tax Liabilities:** Any tax obligations due in future periods, arising from temporary differences between the carrying amounts of assets and liabilities in the balance sheet and their tax bases.
- **Other Long-term Liabilities:** Other liabilities that do not require settlement within the next 12 months.
- **Long-term Provisions:** These are provisions made for obligations that are not expected to be settled within the next 12 months, such as pension liabilities, warranties, or long-term leave.

C. Current Liabilities

- **Short-term Borrowings:** This includes borrowings due for settlement within the next 12 months, such as short-term loans and bank overdrafts.
- **Trade Payables:** Amounts owed by the company to its suppliers for goods and services received, generally due for payment within a short period.
- **Other Current Liabilities:** Includes liabilities such as short-term provisions, dividends payable, and other financial obligations due within 12 months.

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- **Short-term Provisions:** Includes provisions for liabilities expected to be settled within the next 12 months, such as tax provisions, employee benefits, and other current obligations.

2. Assets

The Assets section of the Balance Sheet is divided into two categories: **Non-Current Assets** and **Current Assets**.

A. Non-Current Assets

- **Property, Plant, and Equipment (PPE):** These are tangible fixed assets that are used in the production or supply of goods and services, such as buildings, machinery, and equipment. They are expected to provide economic benefits for more than one year.
- **Intangible Assets:** Assets with no physical substance, such as patents, trademarks, goodwill, and software, which provide long-term value to the company.
- **Capital Work-in-Progress:** Costs incurred on projects or assets under construction or development that have not yet been completed or put into use.
- **Investment Property:** Properties held for rental income or capital appreciation, rather than for use in production or supply of goods and services.

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- **Financial Assets:** Investments that are not held for short-term trading, including long-term investments in subsidiaries, associates, joint ventures, and other non-current investments.
- **Other Non-Current Assets:** This can include items such as long-term receivables, advances, or prepayments that are not expected to be realized within the next year.

B. Current Assets

- **Inventories:** These include raw materials, work-in-progress, and finished goods that are held for sale in the ordinary course of business. The valuation of inventories is typically done at lower of cost or net realizable value.
- **Trade Receivables:** Amounts owed to the company by customers for goods or services provided, generally due within a year.
- **Cash and Cash Equivalents:** Cash in hand, cash at bank, and other highly liquid investments that can be readily converted into cash within 3 months.
- **Short-term Loans and Advances:** Amounts due from employees, tax authorities, and other

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parties that are expected to be received within the next 12 months.

- **Other Current Assets:** Includes other assets that are expected to be realized within the next year, such as prepaid expenses or short-term investments.

Illustration: Company ABC Ltd.

Suppose **ABC Ltd.**, a manufacturing company, has assets such as machinery worth ₹5 crores, land valued at ₹2 crores, and inventories worth ₹50 lakhs. It has liabilities like long-term loans of ₹1 crore and trade payables of ₹30 lakhs. The company's balance sheet as per Schedule III would display:

- **Non-Current Assets:** ₹7.5 crores (comprising machinery and land)
- **Current Assets:** ₹50 lakhs (inventory)
- **Non-Current Liabilities:** ₹1 crore (long-term loans)
- **Current Liabilities:** ₹30 lakhs (trade payables)
- **Equity:** ₹6 crores (including share capital, retained earnings, and reserves)

This example highlights the simplicity of Schedule III's framework and how it categorizes assets, liabilities, and equity in a way that ensures transparency and accessibility for financial statement users.

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Key Accounting Principles Relevant to Schedule-III of the Companies Act, 2013

The balance sheet under Schedule III is governed by several key accounting principles and standards that guide its preparation and presentation. These principles ensure that the financial statements are accurate, reliable, and comparable. Some of the important accounting principles relevant to the preparation of the balance sheet include:

- **Accrual Basis of Accounting:** Under the accrual basis, revenue is recognized when earned, and expenses are recognized when incurred, regardless of when cash transactions occur. This ensures that the balance sheet reflects the true financial position of the company.
- **Conservatism:** This principle requires accountants to record expenses and liabilities as soon as they are anticipated, but to record revenues only when they are realized. It helps to avoid overstatement of assets and income.
- **Going Concern:** The balance sheet assumes that the company will continue its operations for the foreseeable future unless there is evidence to the contrary.
- **Consistency:** The use of consistent accounting policies from one period to the next ensures that the financial statements are comparable over time.

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- **Materiality:** This principle allows companies to overlook minor details or inaccuracies that do not significantly affect the financial statements' overall accuracy and reliability.



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UNIT 3

DEPRECIATION PROVISIONS AND RESERVES

3.1 CONCEPT OF DEPRECIATION

Depreciation is a fundamental concept in financial accounting, particularly for businesses that invest in fixed assets. It reflects the gradual reduction in the value of tangible fixed assets over time due to usage, wear and tear, or obsolescence. This process, essential for matching the cost of assets with their revenue-generating capabilities, enables businesses to allocate the expense of assets over their useful lives. Depreciation, therefore, plays a vital role in providing a true and fair view of a company's financial position by ensuring that its financial statements accurately reflect the reality of asset value and expenses.

Nature and Characteristics of Depreciation

The concept of depreciation arises from the assumption that assets lose value as they are utilized in business operations. Over time, their utility declines, and as a result, the expense associated with these assets must be recognized in the income statement to accurately allocate costs. This expense is recorded over the asset's useful life, not all at once, to avoid distorting the financial

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statements and ensure that the asset's cost is matched with the revenue it generates over time.

Core Principles Governing Depreciation

- **Cost Principle:** Depreciation is based on the asset's total capitalized cost—everything necessary to acquire and ready the asset for use (purchase price, transportation, installation, and other preparation costs).
- **Useful Life:** The expected period the asset will contribute to operations, estimated using the asset's nature, anticipated usage, and relevant industry norms.
- **Residual (Salvage) Value:** The estimated value at the end of the asset's useful life; this is excluded from depreciation.
- **Depreciable Base:** The portion of cost to be depreciated, calculated as $\text{Cost} - \text{Residual Value}$; this is the amount allocated over the asset's useful life.
- **Systematic Allocation:** Depreciation is recognized using a consistent method over the useful life. Different methods (e.g., straight-line, declining-balance, units-of-production) change the timing and

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amounts of expense recognized each period but not the total depreciable base.

Economic Life and Wear and Tear

Depreciation is closely linked to the concept of an asset's economic life. An asset's economic life refers to the period over which it is expected to provide value to the organization. During this period, the asset undergoes physical or functional wear and tear, making it less valuable as time progresses. In financial accounting, depreciation allocates the asset's cost over this economic life, considering both its usage and its reduced productivity.

In the context of tangible fixed assets such as machinery, vehicles, and buildings, depreciation is inevitable, as these assets experience a reduction in their utility with use. Whether an asset's value decreases due to technological advancements, physical deterioration, or changes in market conditions, depreciation ensures that this decrease is reflected in the financial statements.

Depreciation and the Matching Principle

One of the key principles guiding the calculation and recognition of depreciation is the **matching principle** of accounting. According to this principle, expenses should be matched with the revenues they help generate in the same period. Depreciation ensures that the expense of acquiring an asset is spread over its useful life, aligning the cost with the revenue generated by the asset. Without

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depreciation, financial statements would show inflated profits, as the full cost of an asset would be recorded as an expense in the year it was purchased, rather than over the years it is in use.

For example, if a company buys machinery for ₹1,000,000 and expects it to be used for 10 years, it would be unrealistic to show the entire ₹1,000,000 expense in the first year, as the machine is expected to generate revenue over the next 10 years. Instead, the depreciation method ensures that a portion of this ₹1,000,000 is expensed each year, providing a more accurate representation of the company's financial health.

Impact on Financial Statements

Depreciation impacts both the balance sheet and the income statement. On the balance sheet, depreciation reduces the value of fixed assets over time. The accumulated depreciation is recorded as a contra-asset, which is subtracted from the original cost of the asset to determine its book value or carrying amount. On the income statement, depreciation is recognized as an expense, reducing taxable income and, consequently, the company's tax liability.

By accounting for depreciation, a company ensures that its financial statements reflect not only the historical cost of assets but also the decline in their value as they are used in business operations. This process ensures that the

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financial statements provide a more accurate view of the company's economic reality.

Relevance of Depreciation in Financial Reporting

Depreciation is critical for financial reporting as it helps achieve accuracy in the valuation of assets and expenses. Without accounting for depreciation, companies could present an inflated value for their assets, leading to misleading financial results. Furthermore, depreciation provides investors, creditors, and other stakeholders with a more realistic understanding of the company's financial performance and asset management.

The concept of depreciation is particularly important for businesses involved in capital-intensive industries, where fixed assets constitute a significant portion of the total assets. In such cases, a proper understanding of depreciation ensures that the true value of assets is recorded and that the company's profitability is not overstated.

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3.2 CAUSES OF DEPRECIATION, BASIC FEATURES OF DEPRECIATION,

Depreciation occurs as a result of various factors that diminish the value of an asset over time. These factors can broadly be classified into physical, economic, and environmental causes.

1. Wear and Tear from Use

The most commonly understood cause of depreciation is the physical wear and tear that results from the regular use of an asset. Over time, machinery, vehicles, buildings, and other physical assets undergo wear due to their continuous usage in daily operations. For example, a delivery truck that is used for transporting goods will gradually lose its efficiency and value due to the strain placed on its engine, tires, and overall structure. This reduction in value is often predictable and follows a pattern that can be estimated by companies when applying depreciation methods like straight-line depreciation or declining balance.

The amount of depreciation due to wear and tear depends on:

- **Frequency of use:** The more frequently an asset is used, the faster its wear and tear.
- **Type of usage:** Intense or rough usage accelerates the depreciation process.

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- **Duration of use:** The longer an asset is used, the more significant the depreciation.

2. Obsolescence

Obsolescence refers to the reduction in the value of an asset due to advancements in technology, changes in consumer preferences, or the development of superior products. Unlike wear and tear, obsolescence occurs even if the asset is still in good working condition. It is particularly relevant in industries like electronics, automobiles, and machinery, where newer, more efficient models are continuously being developed. For example, a computer system might still be functional, but its value has significantly decreased because newer, faster systems have become available in the market.

Obsolescence can be categorized into:

- **Technological obsolescence:** Where innovations in technology render older equipment less desirable or less efficient.
- **Market obsolescence:** Occurs when changes in consumer demand or preferences make an asset less valuable, even if it is still functional.

3. Physical Deterioration

Over time, even when an asset is not in use, it can still lose value due to environmental conditions, which result in physical deterioration. For example, buildings may suffer from the effects of weather, moisture, and humidity,

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leading to rust, rot, and other forms of degradation. Similarly, machinery may experience a reduction in value due to corrosion or structural weaknesses caused by exposure to harsh environments.

Factors contributing to physical deterioration include:

- **Exposure to harsh weather conditions:** Assets like buildings, vehicles, and machinery exposed to extreme conditions (such as humidity, rain, or salt air) are prone to quicker deterioration.
- **Age of the asset:** Older assets are naturally more susceptible to deterioration, even if they are not being used.

4. Depletion

Depletion is a form of depreciation specific to natural resources such as minerals, oil, and timber. As these resources are extracted and used, their value decreases because the total quantity available diminishes over time. Unlike traditional depreciation, which applies to physical assets, depletion accounts for the reduction in the amount of a natural resource available for extraction.

The process of depletion involves:

- **Extraction of the resource:** As the resource is removed from the earth, it becomes less available for future use.

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- **Rate of extraction:** The faster the extraction rate, the faster the depletion of the resource.

5. Legal and Contractual Limitations

Legal and contractual factors can also lead to depreciation. For instance, certain assets may become obsolete or lose value because of changes in regulations, legal restrictions, or the expiration of contracts. A common example is the expiration of lease agreements, where a leased asset's value is affected by the terms of the lease or the potential termination of the lease contract. Additionally, changes in laws, such as environmental regulations, can force businesses to devalue or even discard certain assets that no longer comply with legal standards.

6. External Market Factors

External factors, such as fluctuations in the economy, competition, and market conditions, can influence depreciation. For example, during periods of economic downturn, the demand for certain goods and services may drop, thereby reducing the value of related assets. Similarly, increased competition can lead to a decrease in the value of a company's assets, as newer and better alternatives capture market share.

External market factors may include:

- **Economic cycles:** Depreciation may accelerate during recessions when demand for goods and services falls.

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- **Competition:** New market entrants or technological advancements by competitors can render assets less valuable.

BASIC FEATURES OF DEPRECIATION

Depreciation is a fundamental concept in financial accounting that pertains to the allocation of the cost of tangible fixed assets over their useful life. It serves as a systematic process to account for the wearing out, obsolescence, or decline in the value of an asset as it is used over time. Understanding the basic features of depreciation is essential for accurate financial reporting and tax calculations.

1. Systematic Allocation of Cost

One of the primary features of depreciation is the systematic allocation of the cost of an asset over its estimated useful life. The cost of an asset is not expensed immediately upon acquisition, but instead, it is distributed across several accounting periods to match the asset's usage and the benefits it generates. This allocation helps in providing a more accurate financial picture by spreading the financial impact of an asset over the periods in which it is used, ensuring that revenues and expenses are properly matched. The rationale behind this allocation is grounded in the **matching principle**, a fundamental accounting concept.

2. Estimation of Useful Life

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The determination of an asset's useful life is central to the process of depreciation. Useful life refers to the period during which an asset is expected to be economically viable for its intended use. This period varies based on the nature of the asset, technological advancements, wear and tear, and even legal or regulatory restrictions. Estimating the useful life requires professional judgment, based on historical experience, industry standards, and other relevant factors. Different types of assets may have vastly different useful lives, such as buildings, which could last for several decades, and computer equipment, which may become obsolete within a few years.

3. Depreciable Base

The depreciable base is the amount of an asset's cost that will be depreciated over its useful life. It is calculated by subtracting any estimated residual (salvage) value from the original cost of the asset. The residual value is the expected value of the asset at the end of its useful life, which may be zero or any amount that the company expects to recover upon disposal. The depreciable base is critical because it determines the amount of depreciation expense that will be allocated over the asset's life. For instance, if an asset is purchased for ₹1,000,000 with an expected residual value of ₹100,000, the depreciable base would be ₹900,000.

4. Depreciation Methods

Various methods are used to calculate depreciation, and the choice of method can significantly impact the expense

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recognized each period. The most commonly used methods include:

- **Straight-Line Depreciation:** This method allocates an equal depreciation expense each year over the asset's useful life. It is the simplest and most widely used method, suitable for assets that provide consistent service throughout their useful life.
- **Declining Balance Method:** This method accelerates the recognition of depreciation in the earlier years of the asset's life. It is based on applying a fixed percentage rate to the book value of the asset at the beginning of each period. This method is often used for assets that lose their value more rapidly in the initial years.
- **Sum-of-the-Years' Digits:** Similar to the declining balance method, this method also accelerates depreciation but with a different formula. It allocates a higher depreciation expense in the earlier years and less in the later years.
- **Units of Production Method:** This method ties depreciation to the actual usage of the asset. Depreciation is calculated based on the number of units produced or hours used, making it ideal for machinery or equipment where wear and tear are closely linked to output or usage.

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Each method has its implications for the financial statements, especially for profit and loss reporting and tax calculations.

5. Non-Cash Expense

Depreciation is classified as a **non-cash expense** because it does not involve any outflow of cash. The cash outflow occurs when the asset is purchased, but depreciation merely reflects the gradual consumption of the asset's value. While depreciation reduces the book value of assets on the balance sheet, it does not directly affect cash flow. This feature is significant in the context of cash flow analysis and in the preparation of the **cash flow statement**, where depreciation is added back to net income in the operating activities section, because it had already been subtracted as an expense.

6. Impact on Profitability

Depreciation directly impacts the reported profitability of a company. Since depreciation is an expense, it reduces taxable income and, consequently, the income tax liability. However, the depreciation expense does not involve any cash payment, so it can be seen as a "tax shield." On the balance sheet, the depreciation of an asset reduces its carrying value (or book value), which impacts the overall equity of the company. The recognition of depreciation allows companies to allocate their capital expenditures over time and smooth out profit fluctuations that would occur if the entire cost of the asset were expensed immediately.

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3.3 MEANING OF DEPRECIATION **ACCOUNTING**

Depreciation accounting refers to the systematic allocation of the cost of tangible fixed assets over their useful life. This process is essential for reflecting the consumption or diminution in value of an asset as it is used over time. Depreciation ensures that a company's financial statements accurately mirror the gradual wear and tear of its fixed assets, while simultaneously providing tax relief. Depreciation accounting is governed by both national and international accounting standards, with regulations aimed at enhancing consistency and transparency.

Unlike other costs, which are typically expensed immediately, depreciation involves spreading the cost of an asset over several periods, thus aligning the expense with the revenue generated by the asset. This allocation process is crucial not only for proper financial reporting but also for tax purposes, where depreciation often serves as a deductible expense, reducing taxable income.

Depreciation in Tax Accounting

In addition to its role in financial reporting, depreciation has significant implications for tax accounting. Depreciation acts as a deductible expense, reducing taxable income and, consequently, lowering the company's tax liability. The specific tax treatment of depreciation depends on the jurisdiction and the type of asset in question. Many countries, including India, offer

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different depreciation rates and methods for tax purposes compared to those used in financial reporting, making the interaction between financial and tax depreciation critical to a company's overall tax strategy.

1. Tax Depreciation under Indian Tax Laws (Income Tax Act, 1961)

In India, depreciation for tax purposes is governed by the **Income Tax Act, 1961**, and is calculated on the **Written Down Value (WDV)** method. This method allows businesses to depreciate their assets based on their net book value, unlike the straight-line method used in financial reporting. The WDV method accelerates depreciation compared to the straight-line method, as depreciation in the earlier years is higher, with the amounts gradually decreasing in subsequent years.

Under the Income Tax Act, certain assets, such as plant and machinery, computers, and vehicles, are eligible for accelerated depreciation under the provisions of the **Section 32** of the Act. For instance, certain plant and machinery can be depreciated at 15% per annum, while computers may be eligible for depreciation at 40% per annum. This accelerated depreciation reduces taxable income more significantly in the early years of an asset's life, thereby providing tax relief during periods of high investment or capital expenditure.

2. Capital Gains Tax and Depreciation

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When an asset is sold or disposed of, depreciation plays a role in determining the **capital gains** tax liability. The concept of **depreciation recapture** arises when the sale price of an asset exceeds its book value (after depreciation) but is still lower than its original cost. In such cases, the company may be required to pay taxes on the depreciation previously claimed, depending on the jurisdiction's tax rules.

For example, if a company purchased machinery for ₹1,000,000 and claimed ₹400,000 in depreciation over several years, but later sold it for ₹700,000, the company would need to consider the impact of the depreciation on its capital gains tax liability. The company may face a tax liability on the ₹400,000 depreciation already claimed, even if the asset was sold at a price lower than its original purchase price.

Thus, careful consideration of depreciation is crucial not only for proper financial reporting but also for managing tax liabilities and ensuring compliance with tax laws.

Accounting for Depreciation in the Context of Financial Statements

The proper accounting for depreciation ensures that financial statements reflect the true value of a company's assets. There are a few key considerations when accounting for depreciation in the context of financial statements:

1. Balance Sheet Impact

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On the balance sheet, the cost of an asset is initially recorded as part of the fixed assets. Over time, depreciation reduces the value of these assets. The **accumulated depreciation** account, which is a contra-asset account, reflects the cumulative depreciation that has been recognized for an asset. It is subtracted from the asset's original cost to report the net book value on the balance sheet.

For example, if a company purchases a machine for ₹500,000, and after three years, the accumulated depreciation is ₹150,000, the asset's net book value will be ₹350,000 on the balance sheet. This process provides a more accurate depiction of the asset's value, reflecting its usage and wear over time.

2. Income Statement Impact

The depreciation expense recorded on the income statement reflects the periodic allocation of the asset's cost over its useful life. This expense reduces the company's taxable income and, by extension, its tax liability. Depreciation is generally included under operating expenses, as it is directly related to the company's ongoing business activities.

For example, if a company records ₹50,000 of depreciation expense for a piece of equipment, this amount is deducted from its gross income, reducing the

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company's overall taxable income. Over time, depreciation expenses accumulate, and the impact on profitability is significant, especially for businesses with large investments in capital-intensive assets.

3. Cash Flow Statement Impact

While depreciation does not directly affect the company's cash flow, it is an important element in the **cash flow statement**. Since depreciation is a non-cash expense, it is added back to the cash flow from operating activities. This ensures that the operating cash flow reflects only actual cash inflows and outflows.

For instance, if a company records ₹100,000 in depreciation expense, it will add this amount back to the cash flow from operations. This adjustment is necessary because, while depreciation reduces net income, it does not impact the actual cash position of the company.

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3.4 OBJECTIVES OF PROVIDING DEPRECIATION

The objectives of providing depreciation extend far beyond mere compliance; they touch on several key aspects of accounting, taxation, and financial management.

1. Matching Expense with Revenue

One of the primary objectives of depreciation is the matching principle, which ensures that expenses are recognized in the same period as the revenues they help generate. This principle, foundational in accrual accounting, helps businesses allocate a portion of an asset's cost as an expense each year, mirroring the asset's contribution to income generation.

For example, if a company purchases a machine that will be used for several years, the cost of the machine should be spread over its useful life. Instead of reporting the entire cost in the year of purchase, depreciation allows the company to record a portion of the machine's cost as an expense each year, corresponding with the machine's usage in generating revenue.

This approach improves the accuracy of financial statements by aligning the timing of expenses with the revenues earned through the use of the asset, thereby providing a more precise measurement of profit.

2. Reflecting the Decrease in Asset Value

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Another critical objective of providing depreciation is to account for the natural wear and tear or obsolescence of physical assets over time. As assets are used in business operations, they typically lose value due to physical deterioration, technological advancements, or changes in market conditions. Depreciation serves as a systematic way to reflect this decrease in asset value.

For instance, a delivery truck used by a logistics company will lose value each year due to usage and wear. Depreciation helps account for this reduction in value, ensuring that the company's balance sheet reflects the realistic worth of its assets rather than overstating their value by listing them at historical cost without adjustments.

3. Tax Benefits and Cash Flow Management

Depreciation offers significant tax advantages to businesses. In many jurisdictions, including India, the depreciation expense is tax-deductible. By reducing taxable income, depreciation lowers the amount of tax a company owes, thus providing tax relief.

In practice, depreciation acts as a non-cash expense, which means that while it reduces taxable income, it does not represent an actual cash outflow. As such, depreciation facilitates better cash flow management by allowing businesses to retain more capital for reinvestment or operational use.

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The tax benefits of depreciation are particularly valuable for companies with substantial investments in capital assets, as they can defer taxes and potentially improve liquidity. By effectively managing depreciation, a company can optimize its tax position and enhance its overall financial flexibility.

4. Accurate Financial Reporting

Financial accounting aims to provide stakeholders—including investors, creditors, and management—with a true and fair view of a company's financial position and performance. Without depreciation, the asset values recorded on the balance sheet would be inflated, potentially misleading stakeholders about the company's real financial health.

Depreciation ensures that the balance sheet reflects the reality of asset ownership and usage over time. By reducing the book value of assets systematically, depreciation provides a more accurate representation of the company's net worth and financial standing.

Moreover, depreciation affects the income statement by reflecting the consumption of an asset's value as an expense, which directly impacts reported profit. This contributes to the reliability and transparency of financial reporting, enabling stakeholders to make informed decisions.

5. Cost Allocation and Capital Investment Planning

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Depreciation is not only an accounting tool but also an essential mechanism for internal financial management. By allocating the cost of fixed assets over their useful lives, businesses can gain insights into the total cost of asset ownership, including the costs of maintenance, repair, and eventual replacement.

Understanding depreciation allows management to plan for future capital expenditures and replacements. If a company knows that its assets will require significant reinvestment in the coming years, depreciation helps forecast the need for capital to replace or upgrade aging assets. This enables businesses to budget and plan effectively for capital investments, minimizing the financial impact of replacing assets at the end of their useful lives.

Furthermore, depreciation plays a crucial role in pricing decisions, particularly in industries where assets are critical to production. By factoring in depreciation costs, companies can ensure that their product pricing reflects the full cost of ownership, which includes the consumption of capital assets.

6. Improving Comparability Between Entities

Depreciation also plays a crucial role in making financial statements comparable across different businesses. Since companies in similar industries often invest in similar types of assets, depreciation helps standardize how

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businesses report the cost allocation of their assets. This consistency allows for more meaningful comparisons between firms of different sizes and structures.

For instance, if one company uses a straight-line depreciation method while another uses an accelerated depreciation method, their financial statements would reflect different asset values and profit margins. Therefore, the method of depreciation can have a significant impact on reported earnings, which in turn affects financial ratios and key performance indicators. By ensuring that depreciation is applied consistently and in accordance with accounting standards, businesses enable investors, analysts, and stakeholders to compare financial performance more accurately.

This comparability extends to industry benchmarks and sector averages, which often rely on depreciation figures to assess the financial health and operational efficiency of businesses in specific sectors. Depreciation, by providing a standardized approach, allows analysts to adjust financial data and achieve more meaningful comparisons, aiding in investment and financial decision-making.

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3.5 FIXATION OF DEPRECIATION AMOUNT

The "Fixation of Depreciation Amount" refers to the process of determining the precise amount of depreciation expense that should be allocated for a particular asset in each accounting period.

This process involves understanding various methods, regulations, and factors that influence the depreciation calculation. The fixation of depreciation is not merely a mechanical process, but a combination of theoretical considerations and practical approaches that ensure the accurate reflection of the asset's wear and tear, obsolescence, and overall reduction in value.

Methods of Depreciation

There are several methods used to calculate depreciation, each with its own approach to how the asset's cost is allocated over time. The choice of method depends on the nature of the asset and how it is used in the business. The most common methods include:

1. **Straight-Line Method:** The straight-line method allocates an equal amount of depreciation expense each year over the asset's useful life. It is the most widely used method, particularly for assets that experience a uniform rate of wear and tear. The formula for straight-line depreciation is:

$$\text{Depreciation Expense} = \frac{(\text{Cost of Asset} - \text{Residual Value})}{\text{Useful Life}}$$

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This method results in a consistent expense each period, making it simple to calculate and understand.

2. **Declining Balance Method:** The declining balance method is an accelerated depreciation method that recognizes higher depreciation expenses in the earlier years of an asset's life. This method is appropriate for assets that lose their value more quickly in the initial stages of usage. The formula for declining balance depreciation is:

Depreciation Expense = Book Value at Beginning of Period \times Depreciation Rate

In this method, the depreciation rate is usually a fixed percentage, and the depreciation expense decreases each year as the book value of the asset declines.

3. **Sum-of-the-Years'-Digits (SYD) Method:** The SYD method is another form of accelerated depreciation. In this method, more depreciation expense is recognized in the earlier years of an asset's useful life, similar to the declining balance method. However, the calculation involves summing the years of the asset's useful life and allocating the depreciation in a way that reflects this total sum.
4. **Units of Production Method:** The units of production method allocates depreciation based on the actual usage or output of the asset. This method is ideal for assets whose wear and tear are directly tied

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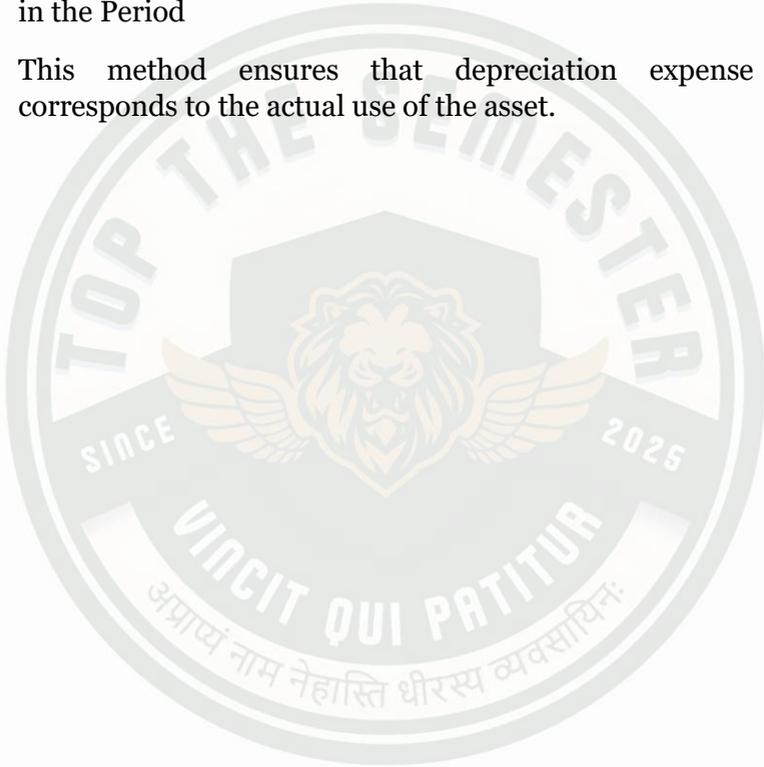
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to their usage, such as machinery in manufacturing.
The formula for the units of production method is:

Depreciation Expense = [(Cost of Asset–Residual Value)
/ Total Estimated Units of Production] × Units Produced
in the Period

This method ensures that depreciation expense
corresponds to the actual use of the asset.



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Factors Influencing Depreciation Amount

In addition to the chosen depreciation method, several other factors influence the fixation of the depreciation amount. These factors include:

1. Cost of the Asset

The initial cost of the asset, including the purchase price, installation costs, and any other expenses incurred to bring the asset into working condition, forms the basis for calculating depreciation. Higher initial costs result in higher depreciation amounts, provided that the asset has a significant useful life.

2. Useful Life of the Asset

The useful life refers to the period over which an asset is expected to be economically beneficial to the company. The determination of useful life is based on factors such as technological advancements, obsolescence, physical wear and tear, and the asset's intended usage.

Estimating useful life accurately is critical because it directly influences the amount of depreciation expense recognized over time. An incorrect estimate of useful life can lead to either excessive or insufficient depreciation.

3. Residual Value

Residual value (also known as salvage value) refers to the estimated amount an asset will be worth at the end of its useful life. This value is subtracted from the initial cost to determine the total amount that can be depreciated. A

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higher residual value results in lower depreciation charges, as less of the asset's cost is allocated to depreciation.

4. Depreciation Rate

The depreciation rate is determined based on the method selected and the estimated useful life of the asset. The rate plays a crucial role in determining the depreciation expense for each period. For example, the rate in the Reducing Balance Method is usually higher than in the Straight-Line Method, reflecting a faster allocation of cost in earlier years.

5. Economic Factors

The economic environment in which an asset operates can also impact its depreciation. For instance, changes in market demand, regulatory changes, and economic conditions such as inflation can affect both the asset's useful life and its residual value, thus influencing the depreciation calculation.

Regulatory Considerations

In India, the fixation of depreciation amount is governed by various regulations, most notably the **Income Tax Act, 1961** and the **Companies Act, 2013**. According to these acts, businesses must adhere to specific guidelines for depreciation calculation, including the use of

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prescribed depreciation rates for different classes of assets.

For example, the Income Tax Act allows businesses to use the **Written Down Value (WDV)** method for tax purposes, while the Companies Act mandates the use of the **Straight-Line Method** or the **Reducing Balance Method**. Additionally, the **Schedule II** of the Companies Act specifies the useful life for various types of assets, which businesses must follow unless they can justify a different estimate.



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3.6 METHOD OF RECORDING DEPRECIATION, METHODS OF PROVIDING DEPRECIATION,

GENERAL APPROACH TO RECORDING DEPRECIATION

Regardless of the depreciation method applied, the general approach for recording depreciation remains consistent: it involves recognizing a **depreciation expense** in the **income statement** and a corresponding **accumulated depreciation** account in the **balance sheet**.

Accounting for Depreciation in the Income Statement

The depreciation expense is a non-cash charge that is deducted from the company's revenues to arrive at the net income. It reduces the taxable income, thus lowering the tax burden. The depreciation expense reflects the portion of the asset's cost that has been allocated for the accounting period. It is included in the operating expenses section of the income statement.

Accounting for Depreciation in the Balance Sheet

On the balance sheet, depreciation is recorded as **accumulated depreciation**, a contra-asset account. This account is used to accumulate the total depreciation charged on an asset from the date of acquisition until the present period. As a contra-asset, accumulated

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depreciation reduces the gross value of the asset, reflecting the asset's net book value or carrying value.

The net book value is calculated as:

$$\text{Net Book Value} = \text{Cost of Asset} - \text{Accumulated Depreciation}$$

This net value provides a more accurate picture of the asset's current worth as compared to its original cost.

Journal Entries for Recording Depreciation

To understand the method of recording depreciation, it is essential to consider the journal entries required to capture the depreciation expense and the accumulated depreciation. The journal entries depend on the depreciation method used.

General Journal Entries

For most methods of depreciation, the journal entries for recording depreciation will look as follows:

At the end of each accounting period:

- **Debit** the **Depreciation Expense** account (which appears in the income statement).
- **Credit** the **Accumulated Depreciation** account (which appears in the balance sheet).

The journal entry typically takes the form:

Debit: Depreciation Expense (Income Statement)

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Credit: Accumulated Depreciation (Balance Sheet)

This entry reflects the allocation of the asset's cost over the accounting period, reducing its carrying amount on the balance sheet while recognizing the expense in the income statement.

Example: Straight-Line Method

Consider an asset purchased for ₹100,000 with a residual value of ₹10,000 and a useful life of 10 years. Under the **Straight-Line Method**, the annual depreciation expense would be:

$$\text{Depreciation Expense} = \frac{\text{₹}100,000 - \text{₹}10,000}{10} = \text{₹}9,000 \text{ per year}$$

The journal entry for the first year of depreciation would be:

Debit: Depreciation Expense ₹9,000

Credit: Accumulated Depreciation ₹9,000

Recording Depreciation for Different Depreciation Methods

The method of recording depreciation varies based on the chosen depreciation approach. Below, we explore how depreciation is recorded under different methods.

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Straight-Line Method (SLM)

Under the Straight-Line Method, depreciation expense is recorded uniformly over the asset's useful life. The journal entries are simple and consistent every year:

- **Debit:** Depreciation Expense
- **Credit:** Accumulated Depreciation

The depreciation expense remains constant for each year of the asset's useful life, as the cost is allocated evenly.

Declining Balance Method

The Declining Balance Method involves accelerated depreciation, where a higher expense is recorded in the earlier years of an asset's life. The journal entry is similar to the straight-line method but with varying depreciation amounts depending on the asset's book value.

The journal entry for each period is:

- **Debit:** Depreciation Expense (calculated based on the declining balance of the asset)
- **Credit:** Accumulated Depreciation

In the first year, the depreciation expense is higher compared to subsequent years because the asset's book value is higher at the beginning. As the asset's book value decreases, the depreciation expense declines accordingly.

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Units-of-Production Method

In the Units-of-Production Method, the depreciation expense is tied to the actual usage of the asset, so the journal entries will vary depending on the number of units produced or hours used.

For each period:

- **Debit:** Depreciation Expense (calculated based on actual usage in the period)
- **Credit:** Accumulated Depreciation

The depreciation expense fluctuates with the asset's usage, meaning the entry will be higher in periods of greater usage and lower in periods of lesser usage.

Sum-of-the-Years'-Digits Method

The Sum-of-the-Years'-Digits (SYD) Method is another accelerated depreciation method. The journal entries under this method follow a similar format but involve a higher depreciation charge in the early years, which decreases as the asset ages.

Each year's depreciation expense is calculated based on the sum of the years' digits, and the journal entry is as follows:

- **Debit:** Depreciation Expense (calculated for the period)
- **Credit:** Accumulated Depreciation

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The journal entry for each period will reflect the decreasing amount of depreciation over time as the asset's remaining useful life reduces.

Depreciation in Financial Statements

Impact on the Income Statement

In the income statement, depreciation is treated as an operating expense. This reduces the net income reported by the company. It is a non-cash charge, meaning that although it reduces the reported income, it does not involve an actual outflow of cash during the period. The treatment of depreciation is particularly significant in industries where significant capital investments are made, as it affects profitability and tax liability.

Impact on the Balance Sheet

On the balance sheet, depreciation reduces the carrying value of the asset. Over time, accumulated depreciation increases, reducing the asset's net book value. This reflects the fact that the company no longer has the full utility of the asset, and its remaining value is less than its initial cost.

In this context, depreciation helps to provide an accurate and conservative estimate of an asset's current worth. It also ensures that the financial statements reflect the consumption of the economic benefits of the asset.

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Special Considerations in Recording Depreciation

Impairment of Assets

If an asset's carrying value exceeds its recoverable amount due to factors such as physical damage or obsolescence, an impairment loss must be recognized. The impairment is recorded by writing down the asset's value, and future depreciation expenses will be based on the impaired value.

The journal entry for impairment is:

- **Debit:** Impairment Loss (Income Statement)
- **Credit:** Asset (Balance Sheet)

After impairment, depreciation is recalculated based on the new reduced value.

Disposal of Assets

When an asset is sold, disposed of, or no longer in use, any accumulated depreciation must be adjusted. The carrying amount is removed from the balance sheet, and any gain or loss on disposal is recognized in the income statement.

The journal entry for the disposal of an asset is as follows:

- **Debit:** Accumulated Depreciation
- **Credit:** Asset Account (e.g., Equipment, Vehicle)

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- **Debit or Credit:** Gain or Loss on Disposal (Income Statement)

METHODS OF PROVIDING DEPRECIATION

The methods of providing depreciation serve to allocate the cost of the asset more realistically and in a manner that reflects the consumption of the asset's economic benefits. Several methods are commonly employed, each with unique implications for financial reporting and tax calculations.

1. Straight-Line Method (SLM)

The Straight-Line Method (SLM) is the most commonly used and simplest method of depreciation. In this approach, the cost of an asset is depreciated evenly over its useful life. The assumption here is that the asset's utility is consumed at a consistent rate, making it suitable for assets whose economic value decreases evenly.

Calculation of Depreciation

Under the Straight-Line Method, the annual depreciation expense is calculated by the formula:

$$\text{Annual Depreciation Expense} = \frac{(\text{Cost of Asset} - \text{Residual Value})}{\text{Useful Life of Asset}}$$

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- **Cost of Asset** refers to the original purchase price of the asset, including any directly attributable costs such as installation and delivery charges.
- **Residual Value** (also called salvage value) is the estimated value of the asset at the end of its useful life, which represents the amount the company expects to recover from selling or disposing of the asset.
- **Useful Life** is the period over which the asset is expected to be used by the company.

Advantages of the Straight-Line Method

- **Simplicity:** The formula is straightforward and easy to apply, making it ideal for small businesses or situations where depreciation is not expected to vary.
- **Predictability:** Since the depreciation amount remains constant every year, it is easy to forecast financial statements, aiding in budgeting and planning.
- **Uniform Expense Recognition:** This method is particularly useful when the asset's economic utility is evenly spread over its life, as it reflects consistent wear and tear.

Disadvantages of the Straight-Line Method

- **Lack of Accuracy in Certain Cases:** For assets that lose value more rapidly in the earlier years of usage (such as machinery), the straight-

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line method may not reflect the true consumption of the asset's benefits.

- **Inflexibility:** This method may not align with tax depreciation rules in many jurisdictions, where tax authorities may require accelerated methods for tax purposes.

2. Declining Balance Method

The Declining Balance Method is an accelerated depreciation method in which the depreciation expense decreases over time. This method assumes that an asset's utility is higher in its earlier years, which is typical for many types of machinery or vehicles. As the asset ages, it generates less revenue or is used less, leading to lower depreciation in subsequent years.

Calculation of Depreciation

The Depreciation Expense under the Declining Balance Method is calculated using the formula:

$$\text{Depreciation Expense} = \text{Book Value at Beginning of Year} \times \text{Depreciation Rate}$$

The Depreciation Rate is typically a fixed percentage of the asset's book value at the beginning of each year, which results in a higher depreciation expense in the earlier years and gradually decreases over time. This rate can be determined by applying a multiple of the straight-line

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depreciation rate (e.g., double declining balance method).

For example, in the **Double Declining Balance Method**, the depreciation rate is double the straight-line rate. If the straight-line depreciation rate is 10%, the declining balance method would apply a rate of 20%.

Advantages of the Declining Balance Method

- **Reflects Actual Usage:** This method is more accurate for assets whose benefits are used up more rapidly in the initial years, such as vehicles, computers, and factory machinery.
- **Higher Early Depreciation:** The higher depreciation in the early years provides a tax shield, reducing taxable income more in the earlier years of the asset's life.
- **Realistic Allocation of Costs:** The method more closely matches the actual pattern of asset utilization, making it more suitable for certain asset types.

Disadvantages of the Declining Balance Method

- **Complexity:** The method involves more complex calculations than the straight-line method, requiring the tracking of the asset's book value each year.

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- **Decreasing Depreciation:** The depreciation expense diminishes over time, which may result in underestimating the expense in the later years of the asset's useful life.

3. Sum-of-the-Years'-Digits (SYD) Method

The Sum-of-the-Years'-Digits (SYD) Method is another form of accelerated depreciation, wherein more depreciation is recognized in the earlier years of an asset's useful life. This method recognizes that certain assets lose their value quickly at the beginning of their life.

Calculation of Depreciation

The formula for the SYD method is as follows:

$$\text{Depreciation Expense} = \left(\frac{\text{Remaining Life of Asset}}{\text{Sum of the Years' Digits}} \right) \times (\text{Cost of Asset} - \text{Residual Value})$$

To calculate the Sum of the Years' Digits, you first add up the digits for each year of the asset's expected useful life. For example, if an asset has a useful life of 5 years, the sum of the years' digits would be:

$$5+4+3+2+1=15$$

The remaining life of the asset decreases each year. The depreciation expense is allocated based on the ratio of the remaining life to the total sum of the years' digits.

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Advantages of the Sum-of-the-Years'-Digits Method

- **Accelerated Depreciation:** Like the Declining Balance Method, the SYD method allows for higher depreciation in the earlier years, which can provide significant tax benefits.
- **Accurate Matching:** It is suitable for assets whose usefulness diminishes more rapidly in the early years.

Disadvantages of the Sum-of-the-Years'-Digits Method

- **Complexity:** The method involves more complex calculations and record-keeping than the straight-line method, as it requires determining the sum of the years' digits and applying it each year.
- **Uneven Expense Recognition:** Some users may find the declining depreciation pattern less predictable than the straight-line method, especially for assets with a more even usage rate.

4. Units-of-Production Method

The Units-of-Production Method allocates depreciation based on the actual usage of the asset, rather than the passage of time. This method is best suited for manufacturing equipment or machinery where wear and tear depend on the number of units produced or hours used.

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Calculation of Depreciation

Under this method, depreciation is calculated based on the following formula:

Depreciation Expense = $\frac{\text{Cost of Asset} - \text{Residual Value}}{\text{Total Expected Units of Production}} \times \text{Units Produced in the Period}$

Here, the total expected units of production is the estimated number of units the asset will produce over its entire useful life, and the depreciation expense is based on the actual units produced in a given period.

Advantages of the Units-of-Production Method

- **Accurate Reflection of Asset Usage:** This method more accurately matches the expense with the actual use of the asset, making it ideal for assets that are used irregularly or based on output.
- **Customizable:** The method allows for flexibility in accounting for asset usage, especially in industries where machine hours or units of production are key performance indicators.

Disadvantages of the Units-of-Production Method

- **Complicated Calculation:** The method requires careful tracking of the asset's output or usage, which may complicate accounting processes, especially in businesses with varying production levels.

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- **Variable Depreciation Expense:** Depreciation can fluctuate significantly depending on the level of production, which can make it difficult to predict future expenses.



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3.7 DEPRECIATION POLICY, AS-6 **(REVISED) DEPRECIATION ACCOUNTING,** **PROVISIONS AND RESERVES**

Depreciation Policy

In the field of financial accounting, depreciation represents the systematic allocation of the cost of tangible fixed assets over their useful lives. The concept of depreciation is crucial for both financial reporting and tax purposes. It ensures that the cost of an asset is matched with the revenue it generates over time, reflecting a more accurate financial position of an entity. This concept becomes particularly important when businesses make significant investments in long-term assets such as machinery, buildings, and equipment, all of which lose value over time due to factors such as wear and tear, obsolescence, or other economic forces.

The Necessity of a Depreciation Policy

A depreciation policy is essential for any organization as it guides the process of determining the method, rate, and period for depreciating assets. It ensures consistency and uniformity in the financial statements and offers transparency to stakeholders, including investors, tax authorities, and creditors. Moreover, a clearly defined depreciation policy facilitates strategic financial planning by providing insights into the future cost structures and the timing of asset replacements.

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The policy is not only a statutory requirement but also a critical management tool that influences financial statements, affecting profitability, taxable income, and net asset values. The main objective of the policy is to allocate the cost of an asset efficiently, considering both the physical and economic factors that contribute to its decline in value.

Key Components of a Depreciation Policy

A comprehensive depreciation policy involves several crucial decisions that directly impact the financial reporting process. These components include the selection of depreciation methods, determination of useful life, residual value, and periodic review of the policy.

1. Depreciation Methods

The depreciation method refers to the way in which the asset's depreciation is calculated over its useful life. Various methods can be adopted depending on the nature of the asset and the intended usage of the financial statements.

2. Useful Life of the Asset

The useful life of an asset is the period over which the asset is expected to be used by the entity. Determining the useful life of an asset is one of the most critical aspects of a depreciation policy. It requires a blend of subjective

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judgment and objective data. Several factors influence the useful life, such as the nature of the asset, its expected wear and tear, industry practices, and technological advancements that may render the asset obsolete.

In some jurisdictions, the tax authorities may prescribe guidelines or standard useful life spans for different asset categories, which may affect how a business calculates depreciation for tax purposes. For example, under the Indian Income Tax Act, a list of prescribed rates for depreciation is provided under Schedule II. These rates serve as a guideline for determining the depreciation for different classes of assets. However, in the context of financial reporting, businesses may apply their judgment based on their experience with asset usage or industry standards.

Moreover, regular reviews of the asset's performance and condition should be conducted to ensure that the useful life is appropriately adjusted. For example, if an asset is underutilized, its useful life may be extended, whereas if it is being used more than initially anticipated, it may be necessary to shorten its useful life.

3. Residual Value

Residual value, also known as salvage value, is the estimated amount that the entity expects to recover from the asset at the end of its useful life, after accounting for any costs of disposal. This figure plays a vital role in determining the depreciation expense. A higher residual value results in a lower depreciation expense, as the cost

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that needs to be allocated is reduced. Conversely, a lower residual value leads to a higher depreciation expense.

The estimation of residual value is also an exercise in judgment, and it may be based on the historical experience with similar assets or industry benchmarks. In some cases, the residual value may be zero, especially for assets that have no value at the end of their useful life or those that are expected to be fully depreciated by the time they are disposed of.

4. **Review and Adjustment of the Depreciation Policy**

It is critical for an entity to periodically review its depreciation policy to ensure that it remains relevant and reflects changes in business operations, technological advancements, and market conditions. For instance, an asset's usage patterns may change over time due to shifts in production methods or alterations in the economic environment. These factors may require adjustments to the depreciation method or the useful life estimate.

For financial accounting purposes, any changes in the depreciation policy, including adjustments to the method, useful life, or residual value, should be accounted for prospectively. This means that the new policy should be applied from the point of change onward, and prior period financial statements should not be restated unless required by specific regulations or accounting standards.

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AS-6 (REVISED) DEPRECIATION ACCOUNTING

Accounting Standard 6 (Revised), issued by the Institute of Chartered Accountants of India (ICAI), governs the treatment of depreciation in financial accounting. Depreciation refers to the systematic allocation of the depreciable amount of an asset over its useful life. The revised version of AS-6, effective from April 1, 2003, introduced important changes to reflect the evolving practices in the recognition and measurement of depreciation. The standard is aligned with global accounting practices and focuses on maintaining consistency, transparency, and accuracy in the reporting of depreciation across various financial statements.

Depreciation accounting plays a pivotal role in determining the true and fair view of a company's financial position. Since depreciation affects the value of fixed assets, the net income, and the overall financial health of an entity, its treatment must adhere to recognized principles to ensure the integrity and reliability of financial statements.

Objective of AS-6 (Revised)

The primary objective of AS-6 (Revised) is to provide a clear framework for the recognition, measurement, and presentation of depreciation in the financial statements of a business. The standard aims to ensure that depreciation is charged systematically over the useful life

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of assets, reflecting their consumption and the corresponding reduction in value. The revised AS-6 also emphasizes consistency in the application of depreciation methods, ensuring that companies adhere to a uniform approach in determining the depreciation charge for different assets.

This standard lays down the accounting treatment for depreciation, including the recognition of the depreciable amount, determination of useful life, allocation of depreciation expense, and the disclosure requirements necessary for proper financial reporting.

Key Features of AS-6 (Revised)

1. Depreciable Amount:

Under AS-6 (Revised), the depreciable amount of an asset is defined as its original cost (or revalued amount, if applicable) less its residual value. This definition is central to the computation of depreciation, as it represents the amount that will be depreciated over the asset's useful life. The residual value is the estimated amount that the asset will be worth at the end of its useful life, and it should be based on realistic estimates that reflect the nature of the asset.

Formula:

$$\text{Depreciable Amount} = \text{Cost of Asset} - \text{Residual Value}$$

2. Useful Life:

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Depreciation is calculated over the asset's estimated useful life. AS-6 (Revised) emphasizes that the useful life should be based on technical, economic, and functional factors. The life expectancy of an asset may differ based on its usage, maintenance, and technological obsolescence. For example, machinery in a manufacturing plant may have a shorter useful life than machinery in a research and development facility.

The standard allows for management to estimate useful life based on industry norms, prior experiences, and guidance from relevant technical experts. These estimates should be reviewed periodically, and adjustments should be made if necessary, to reflect changes in the asset's expected usage.

3. Depreciation Methods:

AS-6 (Revised) allows for the application of various depreciation methods. The choice of method depends on the nature of the asset and how it is used in the business. Commonly used methods under the standard include:

- **Straight-Line Method (SLM):**

Under the Straight-Line Method, depreciation is charged uniformly over the asset's useful life. This method is ideal for assets that provide consistent utility over time, such as buildings or office furniture. The annual depreciation charge under this method is calculated as the depreciable amount divided by the useful life of the asset.

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Formula:

Annual Depreciation = Depreciable Amount / Useful Life

- **Written-Down Value Method (WDV):**

The Written-Down Value Method charges higher depreciation in the initial years of the asset's useful life and progressively reduces the amount charged over time. This method is appropriate for assets that lose their value more rapidly in the early years of their life, such as vehicles or computers. Under this method, the depreciation is calculated as a fixed percentage of the book value of the asset at the beginning of each period.

Formula:

Annual Depreciation = Depreciation Rate × Book Value at Beginning of Year

- **Units of Production Method:**

This method calculates depreciation based on the asset's actual usage or output during the period. It is suitable for assets whose wear and tear is directly related to the amount of usage, such as machinery in a production line. The depreciation charge is determined by dividing the depreciable amount by the total estimated production or usage during the asset's life and then multiplying it by the actual production or usage in the period.

Formula:

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Depreciation per Unit=Depreciable Amount / Total
Estimated Production

Annual Depreciation=Depreciation per Unit × Actual
Production in Year



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Accounting Treatment of Depreciation

1. Charge to Profit and Loss Account:

Depreciation is recognized as an expense in the Profit and Loss Account under the operating expenses section. The depreciation charge reflects the systematic allocation of the asset's cost over its useful life. For example, if a company uses the Straight-Line Method, the same amount of depreciation will be charged each year until the asset is fully depreciated.

2. Presentation in Balance Sheet:

The value of fixed assets in the balance sheet is reported net of accumulated depreciation. The accumulated depreciation is shown as a deduction from the asset's original cost to present the asset's book value, which represents its current value after considering depreciation. This helps provide a more accurate picture of the asset's worth and the company's financial position.

$$\text{Net Book Value of Asset} = \text{Original Cost of Asset} - \text{Accumulated Depreciation}$$

Disclosure Requirements

AS-6 (Revised) outlines specific disclosure requirements that companies must adhere to in their financial statements:

- The accounting policy adopted for depreciation must be disclosed.

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- The method used for calculating depreciation (SLM, WDV, or any other method) must be clearly stated.
- The useful life or the estimated period of usage for the assets must be disclosed.
- Any change in the method of depreciation or estimates of useful life should be disclosed, along with the reasons for the change.

Impact on Financial Statements

Depreciation directly influences a company's profitability, asset management, and overall financial health. The following impacts are notable:

- **Profitability:** Depreciation is a non-cash charge that reduces taxable income, which may provide tax benefits. However, excessive depreciation can result in lower profit margins, which might affect investor perception.
- **Asset Valuation:** Depreciation decreases the value of assets on the balance sheet, reflecting their wear and tear over time. This impacts the company's total asset base and equity.
- **Cash Flow:** Since depreciation is a non-cash expense, it does not directly affect cash flow. However, the lower taxable income due to depreciation leads to potential tax savings, thus improving operating cash flow.

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PROVISIONS AND RESERVES

In financial accounting, the concepts of provisions and reserves are integral to the accurate representation of a company's financial health. These elements serve distinct purposes, yet both influence the balance sheet and overall financial reporting. Provisions are amounts set aside to cover anticipated future liabilities or losses, while reserves are portions of profits retained for specific purposes, often related to future expansion or contingencies.

Provisions: Definition and Purpose

A provision, in accounting terms, is a liability of uncertain timing or amount. It is recognized when an entity has a present obligation, either legal or constructive, resulting from a past event, and when a reliable estimate of the amount can be made. The International Accounting Standard (IAS) 37, "Provisions, Contingent Liabilities and Contingent Assets," defines provisions as amounts recognized to meet anticipated future expenses or obligations, where the exact date or amount is uncertain.

The rationale behind creating provisions is to anticipate and account for liabilities that are expected to arise but whose amounts or timing are yet to be fully determined. By recognizing these anticipated obligations in the financial statements, a company ensures that its financial

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position is not overstated, providing a more accurate picture of its true financial health.

Types of Provisions

1. Provisions for Warranties:

A common example of provisions is the provision for warranties. When a company sells products with warranties, it may be required to repair or replace defective goods within a specified period. The company recognizes a provision for the expected costs of honoring these warranties.

2. Provisions for Bad Debts:

Another common provision is the provision for bad debts. This is made to account for the possibility that some receivables may not be collected in the future. A reliable estimate based on historical data and other relevant factors is used to calculate this provision.

3. Provisions for Taxes:

In the case of taxes, a company may create a provision to account for anticipated tax liabilities. The provision is based on the best estimate of the amount that will be payable to tax authorities, in accordance with tax laws.

4. Provisions for Restructuring:

Businesses undergoing restructuring activities, such as employee severance or closure of operations, may create

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provisions to reflect the expected costs associated with the restructuring process.

Recognition Criteria for Provisions

According to IAS 37 and the Indian Accounting Standards (Ind AS 37), a provision should only be recognized when:

- **A present obligation exists:** The obligation may arise from a legal contract or a constructive obligation resulting from a company's actions or practices.
- **It is probable that an outflow of resources will be required:** This refers to the likelihood that the company will need to settle the obligation with economic resources.
- **A reliable estimate can be made:** The amount of the obligation must be estimated reliably, which may involve some degree of judgment based on available data and future expectations.

Accounting Standards for Provisions

Under **Indian Accounting Standards (Ind AS 37)**, the treatment is largely consistent with IFRS, ensuring comparability of financial statements. According to Ind AS 37, a provision must be recognized when an entity has a present obligation resulting from a past event, and the amount of the obligation can be estimated reliably.

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The general rule is that provisions should not be created for future operating losses or to meet contingencies not arising from past events.

RESERVES: DEFINITION AND PURPOSE

In contrast to provisions, reserves are portions of profits that are set aside for specific purposes. These funds are typically retained to strengthen the financial position of the business, provide for future contingencies, or finance expansion. Reserves differ from provisions in that they are not created to cover future liabilities but rather represent retained earnings for various purposes, often related to the company's growth or stability.

Reserves play a crucial role in the capital structure of a company. By allocating a portion of profits to reserves, companies can ensure they have sufficient funds to meet potential needs such as future expansion, asset replacement, or financial contingencies. In essence, reserves help safeguard the long-term financial health of the organization.

Types of Reserves

1. General Reserves:

These are created out of profits for the general purpose of strengthening the financial position of the company. General reserves are not earmarked for any specific purpose and can be used at the company's discretion.

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2. **Specific Reserves:**

These are created for specific, predetermined purposes. For instance, a company might create a reserve for the replacement of machinery or for legal claims.

3. **Capital Reserves:**

These reserves arise from non-operating sources, such as the issuance of capital stock or the revaluation of assets. Capital reserves are typically not available for distribution as dividends but are instead used to fund expansion or other significant business activities.

4. **Revenue Reserves:**

These are created out of profits earned from the company's regular business activities. Revenue reserves may be utilized for a variety of purposes, including funding ongoing operations or dividend distribution.

Purpose and Importance of Reserves

Reserves play a critical role in the financial stability of a business, helping to cushion against unexpected events or business cycles. They provide a buffer to ensure that a company can weather financial difficulties or fund growth opportunities without relying entirely on external financing.

For example, during economic downturns, companies with significant reserves may be able to continue operations, invest in opportunities, or pay dividends, even if their profits are temporarily reduced.

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Provisions vs. Reserves: Key Differences

While both provisions and reserves are recorded on the balance sheet, their purpose, nature, and accounting treatment differ in several significant ways:

- **Nature:** Provisions represent liabilities or obligations that are expected to result in an outflow of resources. Reserves, on the other hand, represent retained earnings or profits set aside for future purposes but are not related to specific liabilities.
- **Creation:** Provisions are made based on specific obligations or expected outflows. Reserves are created voluntarily by management to strengthen the financial position of the company or for specific business needs.
- **Use:** Provisions are used to cover expected losses or expenses, while reserves are used for future growth, expansion, or contingencies.

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3.8 CHANGE OF METHOD OF DEPRECIATION (BY BOTH CURRENT AND RETROSPECTIVE EFFECT)

The change in the method of depreciation refers to a situation where a company decides to switch from one method of depreciation to another. Commonly used methods of depreciation include the **Straight-Line Method (SLM)**, **Declining Balance Method (DBM)**, **Units of Production Method (UPM)**, and **Sum-of-the-Years' Digits Method (SYD)**, each suited to different asset usage patterns and business scenarios.

The **Straight-Line Method (SLM)** is the most straightforward, allocating an equal amount of depreciation each year over an asset's useful life. The **Declining Balance Method (DBM)** accelerates depreciation in the earlier years of an asset's life. The **Units of Production Method (UPM)** ties depreciation to the actual usage of an asset, while the **Sum-of-the-Years' Digits Method (SYD)** provides an accelerated depreciation schedule but not as aggressive as DBM.

Regulatory Framework and Standards

Ind AS 16 (Property, Plant, and Equipment) stipulates that a company must apply a consistent depreciation method unless there is a clear reason to change it. Similarly, **IAS 16** under IFRS allows a change in the method of depreciation if it results in a more

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appropriate representation of the asset's usage and consumption. A key aspect here is the justification that the new method better reflects the consumption pattern of the asset.

Grounds for Change in Depreciation Method

A business might consider changing its method of depreciation for various reasons, including:

- 1. Change in the Pattern of Economic Benefits:** The most common reason for a change in the method of depreciation is a change in the pattern of how economic benefits are consumed from the asset. For example, if an asset's usage becomes more or less intense over time, a business might switch from an accelerated depreciation method (like DBM) to a straight-line method, or vice versa.
- 2. Changed Business Strategy or Operational Efficiency:** A company may choose to alter its approach based on new insights from operational changes. If a machine is being used more than anticipated, a company might switch to the **Units of Production** method to align depreciation with actual usage.
- 3. Legal or Tax Considerations:** A business may be prompted to change depreciation methods due to tax or legal requirements. For instance, a new tax law might favor a different method, or the company may

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seek a tax advantage through accelerated depreciation.

4. **Technological Advancements:** If a technological update leads to the depreciation of an asset being used more intensively, a company might find it appropriate to switch to a method that better reflects the asset's usage.
5. **Improved Financial Reporting:** A company may change its depreciation method to enhance the accuracy and transparency of its financial reporting. A more reflective depreciation method could provide stakeholders with a clearer picture of the asset's value and consumption.

Accounting Treatment of Change in Depreciation Method

When a company decides to change its method of depreciation, the adjustment is generally made prospectively, i.e., from the date of change going forward. According to **Ind AS 16** and **IAS 16**, any change in the method of depreciation is accounted for **prospectively**. This means that no restatement of prior periods' financial statements is necessary. The financial impact of the change is reflected in the depreciation charge of future periods, as the method applied from the date of change will be used to calculate depreciation.

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However, the company must disclose the change and explain the reasons for it in its financial statements. This ensures transparency, allowing users of the financial statements to understand why the change was made and its potential impact on future profitability and asset valuation.

Impact on Financial Statements

Changing the depreciation method can have a significant impact on both the **income statement** and the **balance sheet**.

1. **Income Statement:** The most immediate impact is on the expense recognized in the income statement. In the case of a switch to an accelerated method like DBM, depreciation expense will be higher in the initial years, reducing net income. Conversely, a switch to a more gradual method like SLM will lead to lower depreciation expense in the initial years and higher expense in the later years.
2. **Balance Sheet:** The carrying value of the asset on the balance sheet will also be affected. A higher depreciation charge in the early years of an asset's life will lead to a lower carrying amount of the asset. This impacts the overall financial position of the entity, especially when the change affects a significant portion of the assets in the balance sheet.
3. **Tax Impact:** Since depreciation is often tax-deductible, changes in the depreciation method can

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lead to differences in taxable income. For instance, a switch to an accelerated depreciation method could lead to lower taxes in the short term, as higher depreciation expenses reduce taxable profits.

Example

Consider a company that had been using the **Declining Balance Method** to depreciate its manufacturing equipment but decides to switch to the **Straight-Line Method** after realizing that the asset's usage pattern is now more uniform over time. The company will then begin applying the straight-line method to future depreciation expenses.

If the asset's cost is ₹1,000,000, with a useful life of 10 years, under the **Straight-Line Method**, the depreciation expense per year would be ₹100,000, calculated as:

$$\text{Annual Depreciation} = \text{Cost of the Asset} / \text{Useful Life} = 1,000,000 / 10 = 100,000$$

In contrast, under the **Declining Balance Method**, the depreciation expense is higher in the earlier years, and the asset would have been depreciated more in the first few years. By switching to the Straight-Line Method, the depreciation expenses would stabilize, impacting profit reporting and tax calculations.

Disclosure Requirements

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The disclosure of the change in depreciation method is mandatory under both **Ind AS** and **IAS 16**. A company is required to disclose:

- The nature and reason for the change
- The impact of the change on current and future periods
- The effect on the financial statements, especially in terms of profit and loss
- A justification for why the new method better reflects the asset's usage

Additionally, if the change in method leads to a material adjustment, this should also be reflected in the notes to the financial statements.

CHANGE OF METHOD OF DEPRECIATION: CURRENT AND RETROSPECTIVE EFFECT

Ind AS 8 under Indian standards outline the distinction between prospective and retrospective adjustments.

- **Prospective Effect:** This method applies the new depreciation method only to the current and future periods, leaving prior period financial statements unchanged. The rationale behind this approach is that the change is seen as a result of a revision in the estimate, not a correction of a past error.

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- **Retrospective Effect:** A retrospective change in the method of depreciation applies the new method to all prior periods, essentially restating the historical financial statements. This ensures comparability across periods, which may be necessary when the change is significant enough to alter the fundamental understanding of how depreciation affects asset values.

The decision between the two approaches depends on the nature of the change and the company's justification for adopting a new method of depreciation.

Current (Prospective) Effect of a Change in Depreciation Method

When a change in the method of depreciation is applied prospectively, it is implemented in the period in which the change is made, and the impact is reflected in future periods, not affecting the prior periods. The effect of the change is measured starting from the period in which the method change is adopted, with no restatement of the financial statements of prior years.

Rationale for Prospective Application:

1. **Change in Estimate:** A change in depreciation method is often viewed as a change in accounting estimate rather than a correction of error. The future pattern of depreciation reflects a better understanding of the asset's usage or value, and hence, it is applied to the current and future periods.

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2. **Practical Considerations:** Retrospective adjustments may require a complex and resource-intensive exercise of restating past financial statements, which may not provide significant benefits if the change is only marginal or based on new estimates that are inherently uncertain.

Accounting Treatment:

- **No Restatement:** Financial statements for previous periods are not restated, but only the current and future periods will reflect the new depreciation method.
- **Impact on Financial Statements:** The depreciation expense will be calculated using the new method for assets that are still in use. The carrying amount of the asset at the beginning of the period may be adjusted to reflect the new depreciation method.
- **Disclosure:** Companies must disclose the nature of the change and the reasons for adopting the new depreciation method. The disclosure should also include the financial impact of the change, including any adjustments made to the asset's carrying value.

Example: Prospective Change

If a company switches from the declining balance method to the straight-line method, the depreciation expense will decrease in the current period, but previous periods'

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depreciation expenses will remain unchanged. The future depreciation expense will be evenly spread over the remaining useful life of the asset.

For example, a machine with a useful life of 10 years is depreciated using the declining balance method for the first 5 years. In year 6, the company switches to the straight-line method, expecting the machine to last another 5 years. The depreciation expense from year 6 onward will be based on the straight-line method, while the expenses from years 1 to 5 remain based on the declining balance method.

Retrospective Effect of a Change in Depreciation Method

When a change in depreciation method is applied retrospectively, the financial statements for all prior periods are restated as though the new method had been used all along. This approach ensures consistency and comparability of financial information over time. The retrospective effect is particularly important when the change significantly alters the understanding of the financial position and performance of the company.

Rationale for Retrospective Application:

1. **Material Change:** If the change in depreciation method is substantial and impacts the fundamental presentation of financial results, applying it retrospectively ensures comparability and transparency. This is particularly relevant when the

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new method is deemed to reflect a more accurate depiction of the asset's consumption or wear.

2. **Consistency:** Retrospective application aligns past financial statements with the current accounting treatment, making it easier for users of the financial statements (such as investors and analysts) to compare results over time.

Accounting Treatment:

- **Restatement of Prior Periods:** Financial statements for prior periods are restated as if the new depreciation method had been applied from the beginning. This may involve recalculating the depreciation expense for each prior year, adjusting the accumulated depreciation, and revising the carrying amounts of affected assets.
- **Impact on Financial Statements:** The change in depreciation will impact both the income statement (due to altered depreciation expenses) and the balance sheet (due to changes in asset values). The cumulative effect of the change is adjusted in the opening balance of the retained earnings (or other equity account) for the earliest period presented.
- **Disclosure:** Detailed disclosures are required to explain the nature of the change, the reason for the change, and the financial impact on all periods presented. The company must also provide

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information on the cumulative effect of the change on its financial position and performance.

Example: Retrospective Change

Suppose a company has been using the straight-line depreciation method for an asset, but after five years, it decides that the asset's usage more accurately reflects an accelerated depreciation method, such as the declining balance method. The company must then restate the financial statements for the first five years to reflect the accelerated depreciation, adjust the accumulated depreciation balances, and amend the carrying value of the asset. The restatement will also impact the company's reported profit for each of those prior periods.

Practical Considerations in Choosing Between Current and Retrospective Effect

The choice between applying a depreciation method change prospectively or retrospectively hinges on various factors. The key considerations include:

1. **Significance of the Change:** If the change in method is significant enough to impact the company's financial position or profitability in a way that affects prior periods' comparability, retrospective application is more appropriate. However, if the

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impact is minor or a result of a better estimate of asset usage, a prospective application may suffice.

- 2. Resources and Complexity:** Restating prior period financial statements can be resource-intensive and time-consuming. It may require revising multiple years of financial data, recalculating tax liabilities, and revising disclosures. In some cases, prospective application may be more efficient, especially when the change is primarily based on new estimates rather than correcting a prior error.
- 3. Accounting and Regulatory Guidance:** Both **IFRS** and **Ind AS** emphasize that a retrospective application is not required unless it can be done without excessive cost or effort. Additionally, regulatory bodies may require retrospective adjustments when the change is deemed to have a material impact on the financial results.
- 4. Stakeholder Communication:** Retrospective changes require clear communication to investors, analysts, and other stakeholders, as they have a more significant impact on financial comparability. Retrospective adjustments can often trigger concerns or require additional explanation, especially when they lead to restatements of earnings or asset values.

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UNIT 4

CORPORATE ACCOUNTING

4.1 INTRODUCTION TO A JOINT STOCK COMPANY, SHARES

A **Joint Stock Company (JSC)** is a type of business entity that is recognized for its legal independence and distinct from the shareholders who own it. It is an organized structure where capital is raised through the sale of shares to the public or a set of private individuals, making it a common form for large-scale businesses. The concept of a Joint Stock Company has evolved over centuries and is regarded as one of the most efficient methods of organizing businesses due to its ability to pool large amounts of capital while distributing risk among a wide array of investors.

Definition and Characteristics of a Joint Stock Company

A Joint Stock Company can be defined as a business organization whose capital is divided into shares, and ownership is vested in shareholders who hold these shares. A company is formed and operated according to the laws of the jurisdiction in which it is incorporated.

The formal structure of a joint stock company typically consists of the following key components:

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- **Shareholders:** Owners of the company who hold shares representing their ownership.
- **Board of Directors:** A group of individuals elected by shareholders to oversee the management and operations of the company.
- **Company Secretary:** A key administrative role ensuring compliance with corporate laws and regulations.
- **Employees:** Individuals employed by the company to carry out the day-to-day operations.

The defining features of a Joint Stock Company include:

- **Separate Legal Entity:** A JSC is a legal person separate from its shareholders, which means that it can own property, enter contracts, sue, and be sued in its own name. This principle is enshrined in landmark cases like *Salomon v. A. Salomon & Co. Ltd.* (1897), where the House of Lords affirmed that a company is distinct from its shareholders, and its debts are not the personal debts of the shareholders.
- **Limited Liability:** The liability of shareholders is limited to the nominal value of the shares they hold. This is perhaps one of the most attractive features for investors, as it provides protection against personal loss beyond their investment in the company.
- **Transferability of Shares:** In a JSC, shares can generally be transferred from one shareholder to

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another. This provides flexibility in ownership, making the company more attractive for investors, as they can easily sell their shares without affecting the company's ongoing operations.

- **Perpetual Succession:** A Joint Stock Company continues to exist even if the ownership or management changes. The death, insolvency, or departure of shareholders or directors does not affect the company's existence.
- **Centralized Management:** A Joint Stock Company is managed by a board of directors who are elected by the shareholders. The directors make key decisions, whereas shareholders have the ultimate authority to approve major actions (like mergers, significant changes in the company's structure, or liquidation).
- **Regulated by Law:** A Joint Stock Company is subject to a range of regulations, including corporate law, tax law, and securities law, depending on the country of incorporation. For instance, in India, Joint Stock Companies are regulated under the Companies Act, 2013, which governs their formation, operations, and dissolution.

Types of Joint Stock Companies

There are primarily two types of Joint Stock Companies based on their liability structure and the ability to transfer shares:

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- **Private Limited Company:** A Private Limited Company (Ltd.) has restrictions on the transferability of its shares. The number of shareholders is typically restricted to 50, and it cannot invite the general public to subscribe to its shares. Private companies enjoy the benefits of limited liability while enjoying certain regulatory relaxations compared to public companies.
- **Public Limited Company:** A Public Limited Company (PLC) can offer shares to the public at large, typically through a public offering (Initial Public Offering or IPO). It must adhere to stricter regulations and must disclose more information to its shareholders and the public. A public company may have an unlimited number of shareholders, and its shares are listed on stock exchanges, facilitating their trade.

The Role and Importance of Shares in a Joint Stock Company

Shares are the fundamental unit of ownership in a Joint Stock Company. They represent a fractional ownership interest in the company, entitling shareholders to certain rights, such as the right to vote at shareholder meetings, the right to receive dividends, and the right to participate in the company's liquidation proceeds if applicable. Shares serve as the mechanism through which capital is raised from the public or private investors.

- **Definition of Shares:** A **share** is defined as a unit of ownership in a company that is sold to the public

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or private investors in exchange for capital. The ownership represented by a share confers specific rights to the shareholder, including voting rights, dividend rights, and rights in the event of liquidation.

- **Types of Shares:** Companies typically issue different types of shares, each conferring different rights on shareholders. The two primary types of shares are:
 - **Equity Shares:** Also known as common shares, equity shares provide voting rights and entitle shareholders to dividends. However, these dividends are not fixed, and shareholders receive them based on the company's performance and decisions made by the board. In the event of liquidation, equity shareholders are paid after debt holders and preferred shareholders.
 - **Preference Shares:** These shares provide no voting rights but guarantee a fixed dividend before equity shareholders are paid. Preference shareholders are also paid out before equity shareholders in case of liquidation. Preference shares offer lower risk but also limited upside potential compared to equity shares.
- **Authorized and Issued Capital:** A company's capital is divided into shares of a specific value, which is the authorized capital. This authorized capital represents the maximum amount of capital the company is authorized to raise by issuing shares. The

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issued capital refers to the actual number of shares issued to shareholders, which may be less than the authorized capital.

Share Capital

Share capital refers to the total value of the shares issued by the company. It is the primary source of funding for a joint stock company and is an essential component of its financial structure. Share capital can be raised through the following means:

- **Authorized Share Capital:** This refers to the maximum amount of capital that a company can raise through the issuance of shares, as defined in its Memorandum of Association. It is essentially the upper limit of share capital that the company can issue.
- **Issued Share Capital:** This is the portion of authorized capital that has actually been issued to shareholders in exchange for capital.
- **Subscribed Share Capital:** This is the portion of issued share capital that has been subscribed to by the shareholders.
- **Paid-up Share Capital:** This refers to the amount of capital that shareholders have actually paid for their shares. It is an essential indicator of a company's financial health and liquidity.

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Issuance and Valuation of Shares

The issuance of shares is one of the key ways that companies raise funds to finance their operations. Shares can be issued through various means:

- **Public Offerings:** Public companies may issue shares through an Initial Public Offering (IPO) or Follow-on Public Offering (FPO), allowing them to raise capital from the public.
- **Private Placements:** Companies may also issue shares privately to selected investors or institutional buyers.
- **Bonus Shares and Rights Issues:** Companies can issue additional shares to existing shareholders as a "bonus" or allow them to purchase shares at a discounted price through a rights issue. These mechanisms allow companies to raise capital without resorting to external investors.

The value of shares is primarily determined by the market, and their price fluctuates based on demand and supply dynamics. In some cases, shares may also be valued based on their net asset value (NAV) or their earnings potential as measured by metrics like the Price-to-Earnings (P/E) ratio.

Rights of Shareholders

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Shareholders, as owners of the company, are entitled to several key rights:

- **Voting Rights:** Shareholders can vote at annual general meetings (AGMs) or special general meetings (SGMs) to make decisions about the company's affairs, including electing directors, approving dividends, or making significant changes in the company structure.
- **Dividend Rights:** Shareholders are entitled to receive dividends from the company if declared by the board. The amount is usually determined by the company's profitability.
- **Right to Transfer Shares:** Shareholders have the right to transfer their shares to other individuals or institutions unless the company is a private limited company with restrictions on share transfers.
- **Right to Inspect Records:** Shareholders have the right to inspect the company's financial records and books.
- **Pre-Emptive Rights:** In certain cases, shareholders may have the right to buy additional shares before the company offers them to the public, thus maintaining their proportionate ownership.

Accounting for Shares in Financial Statements

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The issuance and transfer of shares affect the financial statements of a company. The primary accounting entries involve the balance sheet, income statement, and the statement of changes in equity.

- **Balance Sheet:** When a company issues shares, it receives cash or other assets in exchange. These assets are recorded as part of the company's assets. On the liabilities and equity side, the corresponding credit entry is made in the equity section under "Share Capital." The share capital is recorded at the nominal value of the shares issued, and any amount received above the nominal value is recorded under "Share Premium."

For example:

If a company issues 1,000 equity shares with a nominal value of ₹10 each at a price of ₹50 per share, the accounting entry would be:

- **Debit:** Cash/Bank ₹50,000 (1,000 shares × ₹50)
 - **Credit:** Share Capital ₹10,000 (1,000 shares × ₹10)
 - **Credit:** Share Premium ₹40,000 (1,000 shares × ₹40)
- **Income Statement:** Generally, the issuance of shares does not affect the income statement directly. However, any dividends declared and paid are recorded as an expense in the income statement,

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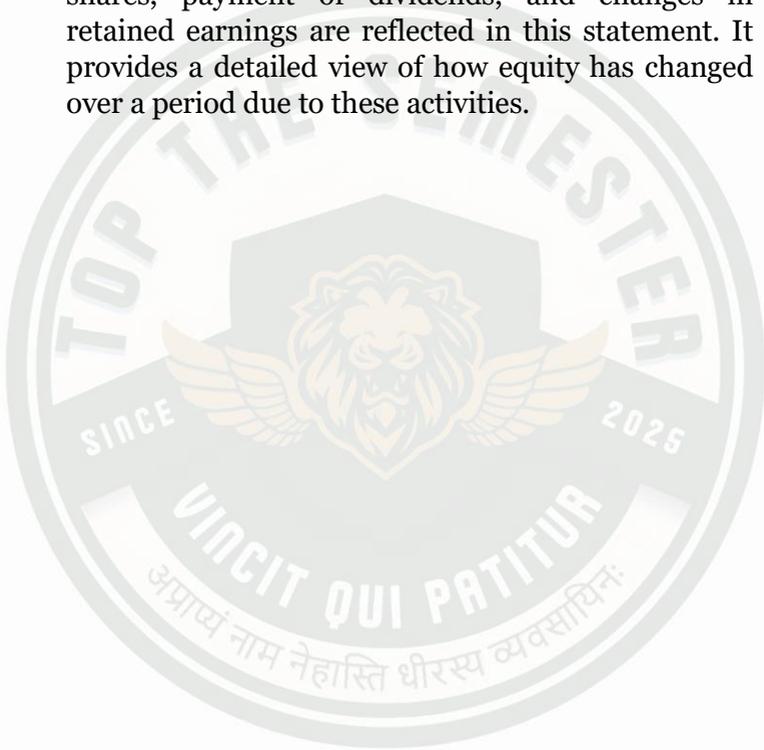
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reducing the retained earnings. The dividends themselves are not an operating expense but are considered an appropriation of profit.

- **Statement of Changes in Equity:** The issuance of shares, payment of dividends, and changes in retained earnings are reflected in this statement. It provides a detailed view of how equity has changed over a period due to these activities.



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4.2 SHARE CAPITAL

Share capital forms the foundational financial resource for a company, providing the essential funds to enable its operations and growth. Share capital refers to the funds raised by a company through the issuance of shares to investors, typically in the form of equity. These funds represent the ownership stakes held by shareholders in the company. The legal structure and nature of share capital play a crucial role in the financial stability, governance, and strategic direction of a company. In financial accounting, share capital is reflected on the balance sheet as part of the equity section, denoting the value invested by the shareholders in exchange for shares.

The definition of share capital and its various components is governed by accounting standards, laws, and regulations, which vary depending on the jurisdiction. In India, the legal framework for share capital is defined by the Companies Act, 2013

Types of Shares

The nature of share capital can vary based on the class of shares issued and the specific rights attached to those shares. The following are the primary types of share capital:

1. Equity Share Capital

Equity shares, also known as common shares, are the most common form of share capital. Holders of equity

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shares enjoy voting rights and are entitled to a share of the company's profits in the form of dividends. However, their claims on assets are subordinated to those of creditors and preference shareholders. In the event of liquidation, equity shareholders are entitled to the residual value of the company, after paying off all liabilities and preference share capital.

- **Rights of Equity Shareholders:** These include the right to vote at general meetings, the right to receive dividends, and the right to a portion of the company's assets upon its dissolution.
- **Issuance of Equity Shares:** Equity shares are typically issued in exchange for cash, but they may also be issued in exchange for assets, services, or as part of a stock-split or rights issue.

2. Preference Share Capital

Preference shares represent a class of shares that give shareholders priority over equity shareholders when it comes to dividend distribution and repayment of capital in case of liquidation. Preference shares typically do not carry voting rights, except in certain circumstances (such as when dividends are in arrears).

- **Types of Preference Shares:** These include cumulative preference shares, non-cumulative preference shares, convertible preference shares, and redeemable preference shares.

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- **Rights of Preference Shareholders:** These shareholders are entitled to receive fixed dividends before equity shareholders and have priority in the distribution of assets upon liquidation. However, they typically do not have voting rights, except in specific situations such as non-payment of dividends.

Classification of Share Capital

Share capital can be classified in several ways depending on various factors, such as the manner of payment, ownership, and the rights attached to the shares. Understanding these distinctions is crucial for accounting and financial analysis, as it impacts the valuation, rights of shareholders, and the overall structure of the company.

1. Authorized Share Capital

Authorized share capital, also known as "nominal" or "registered" share capital, refers to the maximum amount of capital a company is legally permitted to raise through the issuance of shares, as specified in its memorandum of association at the time of incorporation. This amount represents an upper limit set by the company for issuing shares and acts as a theoretical cap on the funds that can be raised from shareholders.

It is important to note that authorized share capital does not indicate the actual amount of capital raised; rather, it simply sets the maximum permissible limit for issuing

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shares. For example, a company may have an authorized share capital of ₹1,000,000 but may have issued only ₹200,000 worth of shares, leaving the remaining capital available for future issuance.

The authorized share capital can be increased by passing a special resolution with shareholder approval and following regulatory procedures. Until the limit is reached, the company can issue new shares without needing further approval, as long as it complies with its governing documents and relevant regulations.

2. Issued Share Capital

Issued share capital refers to the portion of the authorized capital that has actually been issued to shareholders, whether for cash or other consideration. This represents the total value of shares that have been allocated to investors in exchange for funds and forms a part of the company's equity base.

Unlike authorized share capital, which sets a ceiling, issued share capital is the actual amount of funds that a company has secured through the sale of shares. The issuance of shares can take place in multiple stages, depending on the company's capital requirements. For example, a company with authorized share capital of ₹1,000,000 may issue shares worth ₹500,000 to its shareholders, leaving ₹500,000 of authorized but unissued share capital.

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The value of issued capital is significant for investors and analysts as it provides insight into how much equity the company has raised and what portion of its authorized capital has been utilized. This value also affects the company's capital structure and can impact shareholder rights, dividends, and the ability to raise additional funds.

3. Subscribed Share Capital

Subscribed share capital is the part of the issued capital that has been subscribed to by investors, representing the total value of shares that shareholders have agreed to take up. When shares are issued to public or private investors, they subscribe to them, and the value of these subscriptions constitutes the subscribed capital. The company must allot the subscribed shares to investors in accordance with the terms of the share issue.

Subscribed capital can be fully or partly paid; if the shares are partly paid, the company has the right to demand further payments as required, up to the nominal value of the shares. It is important to distinguish between issued capital and subscribed capital: while issued capital represents the total value of shares issued by the company, subscribed capital reflects only the amount actually committed by investors. In many cases, especially with fully subscribed share issues, this difference may not exist.

Subscribed capital is particularly important for the company's financial health, as it represents the level of investor confidence and demand for its shares,

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influencing the company's ability to secure financing in the future.

4. **Paid-up Share Capital**

Paid-up capital refers to the portion of subscribed capital that shareholders have actually paid to the company. This amount may be less than or equal to the nominal value of the shares and represents the actual funds received by the company in exchange for its shares. When shares are issued, investors may pay in full or in part for them, and the amount paid constitutes the paid-up capital.

In cases where shares are issued on a partly paid basis, the balance of unpaid capital is noted as "calls-in-arrears" or "unpaid capital" until the investor pays the balance. Paid-up capital is a key measure of a company's financial stability, reflecting the amount of capital readily available for business operations, expansion, or investment.

For example, if a company issues 1,000 shares of ₹10 each, and investors pay ₹5 per share, the paid-up capital would be ₹5,000, while the total subscribed capital remains ₹10,000, with the remaining ₹5,000 representing unpaid capital still due from shareholders.

5. **Called-up Share Capital**

Called-up share capital represents the portion of the subscribed capital that the company has formally requested from shareholders. This capital is not necessarily required to be paid in full immediately, but shareholders are obliged to pay the balance when called

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upon by the company. The calling of capital is typically done in stages, as per the terms outlined in the share subscription agreement.

6. Reserve Capital

Reserve capital is the portion of the authorized capital that has not been issued to shareholders and is kept aside for future contingencies. This capital can only be used in specific circumstances, such as when the company is winding up, and cannot be used for regular operations.

Indian Companies Act, 2013

Under the Indian Companies Act, 2013, share capital regulations are explicitly outlined in Sections 43 to 47. Section 43 prescribes that a company can issue shares of different classes, including equity and preference shares. Further, it defines authorized capital and outlines the process of increasing or reducing capital.

The Act also includes provisions regarding the issuance of shares with differential voting rights, the alteration of capital structures, and the payment of dividends. Furthermore, it requires companies to maintain a share capital register and to issue share certificates to investors, providing proof of ownership.

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4.3 ACCOUNTING ENTRIES, UNDERSUBSCRIPTION, OVERSUBSCRIPTION

ACCOUNTING ENTRIES

In the practice of financial accounting, accounting entries are fundamental to the process of recording financial transactions. These entries reflect every financial transaction of a business, from the simplest to the most complex, including purchases, sales, expenses, income, liabilities, assets, and equity changes. They are the basis for preparing the financial statements of an entity and ensure that the double-entry bookkeeping system remains in balance.

Accounting entries are written records that capture the economic effects of a transaction, allowing businesses to track their financial activities and comply with regulatory standards. They serve to update the books of accounts, reflecting the increase or decrease in assets, liabilities, income, expenses, and equity. The recording process follows a standardized format to ensure consistency and transparency, playing a crucial role in financial reporting, compliance with accounting standards, and decision-making processes.

The key purpose of accounting entries is to maintain the dual aspect of accounting, which is based on the fundamental accounting equation. The accurate recording of these transactions ensures that the financial

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statements are reliable and compliant with applicable standards.

Assets = Liabilities + Equity

Every accounting entry adheres to this principle. For every debit entry, there must be a corresponding credit entry of equal value. This system, known as double-entry bookkeeping, ensures that the books are balanced and that the financial position of the entity is always accurately reflected.

Recording Accounting Entries

The process of recording accounting entries follows a systematic approach:

Identifying Transactions: The first step is to identify the financial event or transaction that has occurred.

Analyzing Transactions: Once a transaction is identified, the next step is to analyze which accounts are affected.

Making Journal Entries: After analyzing the transaction, a journal entry is made. Each journal entry consists of a debit and a credit of equal amounts. The entry must include the date, description, and amount of the transaction. For example:

- **Inventory Account (Dr):** ₹10,000
- **Accounts Payable (Cr):** ₹10,000

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Posting to Ledger Accounts: Journal entries are then posted to individual ledger accounts. Each account maintains a running total of the transactions affecting it. The ledger is the backbone of the accounting system, and the balances of the accounts are used to prepare the trial balance.

Trial Balance: After posting the entries to the ledger, the next step is to prepare a trial balance. The trial balance is a list of all ledger accounts with their balances. The sum of all debits must equal the sum of all credits, ensuring that the books are balanced.

The Double-Entry System of Bookkeeping

At the core of accounting entries lies the **double-entry system**, a method in which every financial transaction affects at least two accounts. One account is debited, and another is credited with an equal amount, ensuring that the accounting equation (Assets = Liabilities + Equity) remains balanced.

Example: When a company purchases inventory for cash, the transaction will be recorded as follows:

- Debit: Inventory (an asset account)
- Credit: Cash (an asset account)

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The transaction is balanced because the total value of the debits equals the total value of the credits. This symmetry ensures the accuracy and completeness of the financial records.

Components of an Accounting Entry

Every accounting entry typically consists of the following key components:

1. **Date:** The date of the transaction.
2. **Account Names:** The accounts that are affected by the transaction. These are usually classified into five main categories:
 - Assets
 - Liabilities
 - Equity
 - Revenues (Income)
 - Expenses (Costs)
3. **Debit Amount:** The amount to be debited from an account, signifying an increase in assets or a decrease in liabilities or equity.
4. **Credit Amount:** The amount to be credited to an account, indicating an increase in liabilities or equity or a decrease in assets.

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5. **Narration:** A brief description of the transaction, explaining its nature.

For example, if a business takes a loan of ₹100,000 from a bank, the accounting entry would be:

- **Date:** 01/01/2025
- **Account Names:** Cash (Asset), Loan Payable (Liability)
- **Debit Amount:** ₹100,000
- **Credit Amount:** ₹100,000
- **Narration:** Loan taken from XYZ Bank.

Types of Accounting Entries

There are various types of accounting entries, each serving specific purposes within the accounting cycle:

1. **Regular or Routine Entries:** These are the most common entries, recorded for everyday transactions such as sales, purchases, receipts, and payments. For example, a payment made to a supplier would involve a debit to the supplier account (or expense account) and a credit to the cash account.
2. **Adjusting Entries:** These entries are made at the end of an accounting period to ensure that the financial statements reflect the true financial position of the entity. Adjusting entries are required for:

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- Prepaid expenses (e.g., rent, insurance)
 - Accrued revenues and expenses
 - Depreciation
 - Allowance for doubtful accounts
 - Deferred revenue
3. **Closing Entries:** At the end of an accounting period, the temporary accounts (revenues, expenses, and dividends) are closed to the permanent equity accounts (retained earnings). This step is essential for preparing the accounts for the next accounting period. The entry involves transferring the balances from income and expense accounts to the retained earnings account.
 4. **Reversing Entries:** These are optional entries made at the beginning of a new accounting period to reverse certain adjusting entries made in the prior period. This helps to avoid errors in recording transactions related to the previous period's accruals or deferrals.
 5. **Compound Entries:** A compound entry involves more than two accounts. For example, a transaction may require debiting three accounts and crediting two. Compound entries are more complex but can be efficient in recording multifaceted transactions, such as the purchase of assets where multiple accounts are affected.

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6. **Error Correction Entries:** These entries are made when mistakes in previous journal entries are identified and need to be corrected. For instance, if an amount was posted to the wrong account, an error correction entry would reverse the incorrect entry and record the transaction in the proper account.

Key Principles Underpinning Accounting Entries

Accounting entries are guided by certain foundational principles of accounting that ensure consistency, accuracy, and reliability in financial reporting. These principles include:

1. **Accrual Basis of Accounting:** The accrual accounting method requires that revenues and expenses be recognized when they are earned or incurred, not when cash is exchanged. This principle leads to the creation of entries for accrued expenses, revenues, and deferred income.
2. **Conservatism Principle:** This principle dictates that accountants should err on the side of caution when making accounting entries. For instance, when estimating doubtful debts or impairments, accountants must recognize potential losses but only recognize gains when they are realized.
3. **Matching Principle:** This principle emphasizes that expenses should be recorded in the same period as the revenues they help to generate. This matching

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process ensures that the accounting entries reflect the relationship between costs and revenues accurately.

4. **Historical Cost Principle:** According to this principle, assets should be recorded at their original cost, rather than their current market value, unless specifically required to revalue them. This results in entries that reflect the acquisition cost, regardless of any changes in the asset's fair market value over time.
5. **Consistency Principle:** This principle ensures that the same accounting methods and principles are applied consistently across periods. As a result, accounting entries should follow the same approach over time to allow for comparability of financial statements.

Illustration: Retail Business Accounting Entries

A retail company purchases goods worth ₹100,000 on credit. The company then sells the goods for ₹150,000 in cash. The journal entries for these transactions are as follows:

Purchase of Goods:

- **Inventory (Dr):** ₹100,000
- **Accounts Payable (Cr):** ₹100,000

Sale of Goods:

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- **Cash (Dr):** ₹150,000
- **Sales Revenue (Cr):** ₹150,000

The above entries ensure that the company's inventory, cash, and sales are accurately reflected in its financial records.

UNDERSUBSCRIPTION

Undersubscription refers to a financial situation in which the demand for a financial instrument, such as shares or bonds, falls short of the available offering. This phenomenon is often observed in public offerings, where the number of shares or securities issued does not match the investor demand. In a business context, undersubscription typically arises during Initial Public Offerings (IPOs) or rights issues, where the offering does not attract sufficient investment from the intended market.

Definition and Key Characteristics

Undersubscription occurs when the subscriptions (or applications for shares or bonds) to a particular offering fail to meet the expected or targeted amounts. In simpler terms, it implies that the offering entity has failed to raise the anticipated capital from investors. This contrasts with

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oversubscription, where demand exceeds the available shares or bonds.

For example, consider a company that offers 1 million shares during an IPO. If only 700,000 shares are subscribed, the issue is undersubscribed by 300,000 shares.

The key characteristics of undersubscription are:

- **Investor Demand vs. Supply:** A situation where the investor demand is less than the total amount of securities offered.
- **Capital Shortfall:** It reflects a potential shortfall in the company's ability to raise the required capital, which could impact its financial plans.
- **Market Sentiment:** It may be indicative of low investor confidence in the company or the sector it operates in.
- **Impact on Pricing and Future Offerings:** Undersubscription can affect the pricing of future offerings, as it may suggest lower demand or investor skepticism.

Causes of Undersubscription

Several factors contribute to undersubscription in financial offerings. Understanding these causes is essential for investors, analysts, and companies involved in the offering process.

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- 1. Market Conditions:** Broader market trends, such as economic downturns, political instability, or unfavorable interest rates, can lead to a lack of investor confidence in new offerings.
 - *Example:* During periods of high market volatility, investors might prefer safer investments such as government bonds rather than investing in new or less-established companies.
- 2. Company Performance and Reputation:** Investors may perceive the offering company as underperforming, or they may lack confidence in its future prospects. This lack of trust can reduce demand for the shares or bonds being offered.
 - *Example:* A company with a history of poor financial results or management missteps may experience low subscription levels during its IPO.
- 3. Overpricing of the Offering:** If the offering price is perceived as too high relative to the expected performance of the company or its industry, it may discourage potential investors from participating.
 - *Example:* If a company's IPO price is significantly higher than comparable companies in the same sector, investors may choose not to subscribe.
- 4. Lack of Investor Awareness:** Insufficient marketing or communication surrounding the offering can lead to a lack of awareness, resulting in

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low participation. An under-publicized IPO or bond issuance is often susceptible to undersubscription.

- *Example:* If a company does not adequately inform its potential investors about the benefits and opportunities associated with the offering, it may fail to generate enough demand.

5. **Weak Sector or Industry Conditions:** Certain industries may face periods of stagnation or decline, leading to reduced investor enthusiasm for offerings in that particular sector.

- *Example:* During a recession, sectors such as consumer goods or real estate may face reduced investor interest, making it more likely for their IPOs to be undersubscribed.

6. **Legal or Regulatory Issues:** Any legal challenges, regulatory uncertainty, or ongoing investigations involving the company can result in undersubscription.

- *Example:* A company under investigation for accounting irregularities might see a reduced level of investor interest in its offerings.

Impact on Investor Sentiment and Capital Market Behavior

Undersubscription in an IPO or bond issuance can have a significant impact on investor sentiment. It may suggest

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that the market has doubts about the long-term profitability or prospects of the issuing company. This perception can further deter investors from participating in future offerings, leading to a cyclical effect of lower demand.

From a broader capital markets perspective, undersubscription can sometimes signal a shift in investor behavior, where investors are becoming more discerning and cautious. The decision to avoid investing in a perceived overvalued offering reflects a broader trend toward value-driven investment strategies. In some cases, however, undersubscription could also be a temporary phenomenon driven by market conditions and not necessarily an indicator of long-term investor sentiment.

Case Studies of Undersubscription

Google's IPO (2004): Google's IPO is one of the most famous examples of undersubscription. Despite being one of the most highly anticipated IPOs of the early 21st century, Google's offering was initially undersubscribed. The company used a Dutch auction system, which was relatively unconventional for IPOs. This pricing mechanism, combined with investor uncertainty, led to an undersubscription. However, the company ultimately succeeded in raising capital by revising the offer price and moving forward with the issue.

Facebook's IPO (2012): Facebook's IPO in 2012 also faced challenges related to undersubscription, although it

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was not as severe as other cases. The company's valuation was initially set very high, leading to skepticism in the investor community. Despite the strong brand recognition, the offering's pricing caused concern about whether the stock could live up to its projected value, leading to weaker-than-expected demand from retail investors.

Strategies to Address Undersubscription

When an offering is undersubscribed, companies and their advisors must take immediate steps to address the shortfall. These strategies aim to either rectify the situation during the offering process or ensure that future offerings are more successful. The following measures are commonly adopted:

1. **Repricing the Offering:** In the event of undersubscription, companies can consider adjusting the offering price to make it more attractive to investors. This may involve reducing the price of shares or bonds to a level that better reflects market sentiment and investor expectations.
 - *Example:* If the original IPO price is deemed too high, the company may opt to lower the price to attract more investors. However, this can have long-term repercussions on the company's perceived value.

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2. **Underwriting Agreements:** An underwriting agreement is a common mechanism to ensure that the company raises the required capital. Underwriters, typically investment banks, agree to purchase any unsold shares or bonds in the offering. This mitigates the risk of undersubscription for the company and ensures that the offering proceeds as planned, even if investor demand is lower than expected.
 - *Example:* In a rights issue, where existing shareholders are offered the chance to buy additional shares, underwriters can step in to purchase any unsold shares, thereby guaranteeing that the company reaches its target capital.
3. **Postponing or Delaying the Offering:** In cases where the market conditions are highly unfavorable, companies may choose to delay or postpone the offering. By doing so, they hope to capitalize on a more favorable market environment where investor demand may be stronger.
 - *Example:* A company planning an IPO in the midst of a recession may decide to delay its offering until market conditions improve, thereby avoiding the risk of undersubscription.
4. **Alternative Financing Methods:** If an IPO or bond issuance fails to attract sufficient investor demand, the company may explore other avenues of financing. This could include private placements, venture capital, or the issuance of convertible bonds.

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These alternatives provide the company with flexibility in raising capital without relying solely on public offerings.

- *Example:* A company may consider private equity investment or venture capital funding to raise capital, particularly if public market conditions are unfavorable.

5. Improving Investor Relations and

Communication: Often, undersubscription is a result of insufficient communication between the company and potential investors. A lack of clarity regarding the company's financial position, future plans, or growth prospects can deter investors. To address this, companies can improve their investor relations efforts by providing more comprehensive and transparent disclosures, engaging with potential investors through roadshows, and offering greater insights into the company's long-term strategy.

- *Example:* A company may hold additional investor meetings, distribute detailed prospectuses, or offer one-on-one sessions with key executives to increase investor confidence in the offering.

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OVERSUBSCRIPTION

In the field of financial accounting, the term "oversubscription" primarily refers to a scenario where the demand for a particular financial instrument, such as shares or bonds, exceeds the supply available for issuance. This phenomenon typically occurs during public offerings of securities, including initial public offerings (IPOs), where the number of shares or bonds offered to the public surpasses the number of securities available. The concept of oversubscription plays a significant role in financial markets, especially in determining the success and price of the offering.

Definition of Oversubscription

Oversubscription, in the context of securities offerings, occurs when the demand for a company's shares or bonds during an issuance exceeds the number of securities offered. This situation results in an allocation process where the applicants may not receive the full amount of securities they requested. The amount of oversubscription is usually expressed as a ratio, such as 1.5x, 2x, or even higher, indicating that the demand for the securities is 1.5, 2, or more times the amount offered.

For example, in an IPO, if a company offers 1 million shares and receives applications for 2 million shares, the offering is considered to be oversubscribed by a factor of 2. This demand can arise from various factors, such as market optimism, investor confidence, or the perceived attractiveness of the company's prospects.

Key Points:

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- Oversubscription arises when demand exceeds the supply of securities.
- It is typically expressed as a ratio indicating the level of excess demand.
- Investors may not receive the full number of securities they applied for.

Mechanics of Oversubscription

Oversubscription typically happens during the initial offering of securities, particularly in IPOs, where a company offers its shares to the public for the first time. However, oversubscription can also occur during other offerings, such as rights issues or bond issues.

a. IPO Oversubscription

In an IPO, oversubscription occurs when more investors apply for shares than the company is offering. The result is that the company must allocate the shares among the applicants, often on a pro-rata basis, where each applicant receives a proportion of the shares they applied for based on the level of oversubscription.

For instance, if an investor applies for 1,000 shares in an IPO offering 100,000 shares and the oversubscription ratio is 2:1, the investor would only receive 500 shares. The allocation process can sometimes be based on the amount invested or through a lottery system, depending on the rules set by the underwriters or regulatory authorities.

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b. Rights Issues

In rights issues, companies offer additional shares to existing shareholders, often at a discount. Oversubscription occurs when the demand for these additional shares exceeds the amount available. Shareholders may be given the opportunity to apply for more shares than their entitlement, but the excess demand typically results in partial allocations or a proportional reduction.

c. Bond Issues

In the case of bond offerings, oversubscription happens when investors apply for more bonds than the issuer has available. Similar to equity offerings, the issuer must then decide how to allocate the bonds among the investors, often leading to partial allotments.

Implications of Oversubscription

Oversubscription carries significant implications for both the company issuing the securities and the investors who participate in the offering.

For Companies:

- **Price Stability and Demand Indicators:** Oversubscription generally signals strong investor interest and confidence in the company's future prospects. This can enhance the reputation of the company, making it easier to raise funds in future

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offerings. It also provides an indication of demand elasticity, helping the company gauge investor sentiment.

- **Pricing Pressure:** While oversubscription may be seen as a positive sign, it can also lead to pricing pressure. In cases of extreme oversubscription, the underwriters may opt to increase the offer price to match the demand. This can result in a higher valuation for the company, but it can also increase the risk of overvaluation.
- **Post-Offer Performance:** Historically, oversubscribed IPOs have often experienced strong initial trading performance. However, the impact of oversubscription on post-offer performance varies. While some companies experience strong growth, others may face a "pop-and-drop" scenario, where the price jumps significantly on the first day only to fall thereafter.

For Investors:

- **Limited Allocation:** Investors may not receive the full allocation of securities they applied for. In such cases, they may need to re-evaluate their investment strategies, especially if they were relying on receiving a large number of shares.
- **Increased Competition:** Oversubscription increases the competition for a limited number of securities, which can result in reduced potential

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returns for investors if they are only able to secure a small portion of the offered securities.

- **Market Liquidity and Volatility:** Oversubscription can contribute to higher market volatility post-offer. While the initial demand for shares is high, this can sometimes result in rapid fluctuations in the share price as investors reassess the value of the securities post-offer.

Impact of Oversubscription on Market Sentiment

The occurrence of oversubscription in an offering often has significant effects on market sentiment. Oversubscription can act as a positive indicator of market optimism and confidence, but it can also lead to a speculative frenzy, which may result in volatility post-offering. Investors often interpret oversubscription as a signal that the company is well-regarded in the market, leading to further buying interest. However, this must be evaluated critically, as not all oversubscriptions result in sustained market success.

a. Positive Sentiment and Market Confidence:

- **High Demand:** When an IPO or securities offering is oversubscribed, it demonstrates strong demand, which may reflect positively on the company's perceived value. The excitement surrounding oversubscription can help elevate the company's public image and establish it as a market leader. This positive sentiment can drive

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additional interest in the company's stock after the offering.

- **Increased Investor Participation:** The news of oversubscription can attract more investors, not only those who are participating in the offering but also others who may wish to buy shares in the open market once the stock begins trading. This increased participation can contribute to the liquidity and stability of the stock in the initial stages.

b. Speculative Behavior and Post-Offer Volatility:

While oversubscription may appear as an indication of success, it is also important to consider the potential for speculative behavior. The demand for oversubscribed shares may not always be driven by the company's fundamentals, but rather by investor speculation or the "fear of missing out" (FOMO). As a result, oversubscription can lead to volatile price movements post-offering, with the price of the shares initially spiking only to later experience a sharp correction.

This phenomenon is often referred to as the "IPO pop," where the stock price soars above the offering price in the first few days of trading, only to fall back to more reasonable levels. Investors who bought in at the inflated price may face losses when the market corrects. As such, oversubscription can sometimes mask underlying risks and lead to volatility in the market.

Case Study:

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A famous example of post-offer volatility due to oversubscription was the IPO of *Snap Inc.* in 2017. The offering was oversubscribed, and the initial public offering price was set higher than the market expectations. The stock surged in the initial days but then dropped significantly, leading to a reassessment of its long-term market value. This event highlighted how oversubscription could lead to an initial surge in price, but also a potential for future correction.

SEBI and Oversubscription:

A notable example of regulatory oversight in the case of oversubscription in India occurred during the IPO of *IRCTC* in 2019. The offering was oversubscribed by over 100 times, leading to massive demand. SEBI's regulations ensured that the allocation was fair, and no preferential treatment was given to any specific group of investors. This case highlighted the importance of maintaining transparency and equity during oversubscription, ensuring that small investors were not at a disadvantage.

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4.4 CALLS IN ADVANCE, CALLS IN ARREARS

CALLS IN ADVANCE

Calls in advance represent a significant concept in financial accounting, particularly in relation to the structure of companies and their capital raising activities. They occur within the context of share capital and are closely tied to the process of issuing shares, where a company may receive payments from shareholders ahead of the formal allotment of shares. Understanding calls in advance requires a deep dive into their accounting treatment, regulatory framework, implications for the company's financial position, and broader corporate governance concerns.

Understanding Calls in Advance

A "call in advance" refers to the amount received by a company from its shareholders, which is paid over and above the amount already called on the shares but is not yet due for payment. In simpler terms, shareholders voluntarily pay their dues before the company formally demands it. It is essentially a pre-payment for future calls on share capital.

For example, if a company issues shares with a total nominal value of ₹10 per share, it may call ₹2 per share initially, and the remaining ₹8 per share can be called in installments over time. If a shareholder chooses to pay

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the remaining ₹8 in advance, this payment constitutes a "call in advance."

The primary distinction between "calls in advance" and "paid-up capital" lies in the fact that the amount received as calls in advance is not a permanent addition to the capital but is refundable under specific conditions (i.e., if not required by the company). Therefore, it is a temporary liability.

In terms of financial accounting, calls in advance are usually recorded in the **share capital account** under a specific head known as "**Calls in Advance**" or "**Advance against Calls**". The rationale for this classification is that the company has an obligation to either return the advance if not required, or apply it against future calls, depending on the terms set out in the shareholder agreement.

It is essential to note that **calls in advance** are not classified as part of the company's **equity** at the time of receipt but remain a liability until the calls are formally made. As such, the company must disclose the calls in advance separately on the balance sheet to ensure transparency for stakeholders.

Key Features of Calls in Advance

Voluntary Payment: Calls in advance are typically voluntary. Shareholders may choose to pay more than the required call amount before the due date, which helps the company in securing additional funds.

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Interest Implications: In many jurisdictions, companies may offer interest on calls in advance as an incentive for shareholders to pay their dues early. Alternatively, the company may not pay interest, in which case the excess payment remains as an advance against future calls.

Accounting Treatment: From an accounting perspective, calls in advance are classified as a liability on the balance sheet of the company, specifically under the "Shareholders' Equity" section. This liability is eventually cleared when the company calls the remaining balance on the shares, at which point the call in advance is adjusted or refunded if the shareholder opts for such an arrangement.

Temporary Nature: The advance payment is not permanent; it is eventually utilized to settle future calls or refunded. Therefore, calls in advance do not permanently impact the company's capital structure, but instead, serve as a temporary measure to secure liquidity in the short term.

Impact on Dividend: In some cases, the payment of calls in advance may affect the calculation of dividends. If interest is offered on the advance, the company may also be liable to distribute a dividend on the full paid-up capital, which could include the amount paid in advance.

Impact of Calls in Advance on Shareholder Relations

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Calls in advance also have an impact on the relationship between the company and its shareholders. On the one hand, calls in advance allow shareholders to pay for shares before they are due, which can be advantageous for investors looking to increase their stake in the company. On the other hand, there are concerns regarding liquidity as shareholders might feel that they are paying more than necessary upfront.

Additionally, calls in advance can serve as a way for the company to raise capital more quickly, especially during periods of financial need, without issuing new shares or taking on debt. However, this method of funding comes with certain risks. If the company is unable to use the calls in advance as anticipated, it may need to refund the advance to the shareholders, which could result in complications in financial planning and reporting.

Significance and Practical Considerations

The receipt of calls in advance offers several benefits to companies:

1. Improved Liquidity:

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Calls in advance provide companies with additional liquidity in the short term. This can be crucial for businesses that require working capital but do not wish to issue debt or undertake other financing mechanisms.

2. Flexibility in Fund Management:

Calls in advance allow companies flexibility in managing their capital requirements. They can determine when to make a formal call for the capital while receiving the funds earlier. This gives the company the option to better align its funding requirements with operational needs.

3. Investor Engagement:

For shareholders, paying calls in advance might offer benefits, such as earning interest on their advanced capital or simply ensuring that they do not miss future capital calls. However, shareholders must be cautious, as such payments may not be refundable immediately, depending on the company's cash flow needs or the board's discretion.

Despite these advantages, calls in advance also carry risks:

• Potential Liability to Shareholders:

The company is under an obligation to return the call in advance to the shareholder if the amount is not called for within a reasonable time. This potential refund creates an additional liability for the company, which must be carefully monitored in financial reporting.

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- **Accounting Complexity:**

Calls in advance require careful attention in accounting. Companies must track amounts received, interest payments, refunds, and ensure that the amounts are appropriately classified in the financial statements, particularly under IFRS or Indian GAAP.

Section 39 of the Companies Act, 2013:

Under the Companies Act, 2013, a company may receive money on account of calls in advance before such calls are actually made. However, it is important to note that this money is not classified as part of the share capital immediately, and it must be disclosed as a liability until the relevant call is made and the funds are appropriated.

For a company to receive calls in advance:

1. The articles of association must allow such an arrangement.
2. The shareholder must give consent to the company to make such an advance payment.
3. The advance amount cannot exceed the total unpaid amount on the shares, i.e., it cannot exceed the total face value of the shares minus the amount already paid.
4. A shareholder is entitled to receive interest on calls in advance, unless the company's articles of association

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specifically state otherwise. This interest rate is typically subject to board approval.

Distinction Between Calls in Advance and Paid-Up Capital

A key distinction in the treatment of calls in advance lies in its nature. Calls in advance are **not** considered part of the company's **paid-up capital** until the company actually makes the call. **Paid-up capital**, on the other hand, represents the actual capital that the company has received from its shareholders in return for the shares issued.

The distinction becomes particularly important when evaluating the **shareholders' equity** in the company's balance sheet. Paid-up capital contributes to the company's ownership structure, while calls in advance reflect an obligation that the company will eventually need to fulfill. Therefore, until the company issues a formal call, the advance payment cannot be classified as equity.

CALLS IN ARREARS

In the context of financial accounting, "calls in arrears" refers to the unpaid portion of a company's share capital that shareholders are obligated to pay in response to a "call" made by the company, but which remains

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outstanding. Calls in arrears are typically seen in the issuance of shares by companies, particularly in cases where shares are issued for a price payable in installments, known as "calls." When shareholders fail to make the required payments by the due date, the unpaid amount becomes classified as "calls in arrears."

This issue primarily arises in companies that issue partly paid shares or offer shares on an installment basis. The failure of a shareholder to pay the amount due on these calls leads to the creation of calls in arrears, which the company may later take legal or financial action to recover, depending on its policies.

Calls on Shares

Before understanding calls in arrears, it is important to comprehend the broader context of calls on shares. In many jurisdictions, when a company issues shares, it may not ask for the full payment of the share price upfront. Instead, the company may collect the price in stages or installments. These installments are referred to as "calls."

The procedure for calling installments is as follows:

- The company issues a notice to shareholders informing them of the due date and the amount payable for the particular call.
- Shareholders are expected to pay this amount by the specified date. These calls may be made by the company on the basis of the share capital, which can be paid in full or partly paid shares.

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Typically, the company can make multiple calls on a shareholder until the total amount due on the share is paid. Once all the calls are paid, the shareholder becomes a fully paid shareholder.

Definition and Explanation of Calls in Arrears

Calls in arrears specifically refer to the unpaid amount on shares for which a "call" has been made but not paid by the shareholder. In other words, it is the portion of the share capital that shareholders owe to the company but have not yet remitted.

For example, if a company issues 1,000 shares with a face value of ₹10 each and requires two calls of ₹5 per share, the total share capital would be ₹10,000 ($1,000 \times ₹10$). If a shareholder has paid the first call of ₹5 per share but has failed to pay the second call of ₹5 per share, the amount of ₹5 per share remains outstanding, or in arrears.

Financial Implications of Calls in Arrears

The failure to pay calls has several financial implications for the company, which can affect both its short-term and long-term financial health. While calls in arrears do not impact the company's income statement directly, they can influence its balance sheet and, subsequently, its cash flow. Some of the key implications include:

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- **Liquidity Constraints:** The company's ability to fulfill its immediate financial obligations may be hampered by the unpaid calls. This can lead to a cash crunch, affecting operational activities or hindering the company's ability to pay dividends to shareholders.
- **Dilution of Control:** If a shareholder fails to pay the calls and the company decides to forfeit their shares, this may dilute the control of the original shareholder base. This can also impact voting rights, especially in companies where shares confer significant voting power.
- **Dividend Distribution:** Shareholders with calls in arrears may not be entitled to dividends until their arrears are settled. This can reduce the expected dividend payout and affect shareholder morale.
- **Legal Consequences:** The failure to pay calls on time can lead to legal actions by the company, including the forfeiture of shares and the potential for legal claims to recover the outstanding amount.

Financial Implications and Consequences of Calls in Arrears

The failure to pay calls in arrears has several financial and legal implications for both the company and the shareholder, affecting short-term and long-term financial health.

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For the Company:

- Calls in arrears do not directly impact the company's income statement but can influence its balance sheet and cash flow, potentially leading to liquidity constraints. The company's ability to fulfill immediate financial obligations may be hampered, resulting in a cash crunch that can affect operational activities or hinder the payment of dividends to shareholders.
- Unpaid calls can negatively affect the company's capital structure and its ability to raise further funds, as investors may perceive unpaid calls as a sign of financial instability.
- If calls in arrears remain unpaid, the company may initiate the forfeiture of shares, meaning the shareholder loses their rights and the company may resell those shares to recover unpaid amounts. If the shares are not easily resold, it may result in financial difficulties for the company.
- The failure to pay calls on time can also lead to legal actions, including forfeiture of shares and potential legal claims to recover outstanding amounts.

For the Shareholder:

- Shareholders with calls in arrears may not be entitled to dividends or voting rights until their arrears are settled, reducing expected dividend payouts and impacting shareholder morale.

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- Unpaid calls can lead to the forfeiture of shares, causing the shareholder to lose all rights to dividends, voting, or the ability to sell the shares on the market.
- If forfeiture occurs, the shareholder could face a financial loss if they are unable to recover any portion of the paid-up capital.



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4.5 ISSUE OF SHARE AT PREMIUM, ISSUE OF SHARE AT DISCOUNT

ISSUE OF SHARE AT PREMIUM

The issue of shares at a premium is a crucial aspect of corporate finance and financial accounting, particularly for companies that seek to raise capital from the public. This process involves the issuance of shares at a price higher than their nominal or par value. The premium represents the additional amount investors are willing to pay for the shares due to the perceived future growth potential, brand value, and profitability of the issuing company. The concept of issuing shares at a premium is deeply embedded within the regulatory framework governing corporate finance, specifically under the provisions outlined in the Companies Act, 2013, and relevant accounting standards such as IFRS and Indian GAAP.

Definition of Share Premium

Share premium refers to the amount by which the issue price of a company's shares exceeds their nominal or par value. The premium is recorded separately in the financial records, typically in the 'Securities Premium Account' under the equity section of the balance sheet. For example, if a company issues shares with a par value of ₹10 at ₹15 per share, the ₹5 difference per share would be credited to the share premium account.

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It is important to note that share premium is a non-distributable reserve, meaning it cannot be used to pay dividends or for any other purposes except those permitted by law. The Companies Act, 2013, under Section 52, specifies that the premium on shares can be utilized only for specific purposes, including:

- Issuing fully paid-up bonus shares to shareholders.
- Writing off preliminary expenses.
- Writing off the expenses of the issue of shares or debentures.
- Providing for the redemption of preference shares or debentures.

Conditions for Issuing Shares at a Premium

There are specific conditions and criteria that a company must fulfill before it can issue shares at a premium. These conditions are designed to ensure that the premium amount is justifiable and that the shareholders are not misled. These include:

- **Authorization in the Articles of Association:** The company's Articles of Association (AoA) must permit the issuance of shares at a premium.
- **Board Resolution:** The board of directors must pass a resolution authorizing the issuance of shares at a premium.

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- **Subscription of Shares:** The shares must be subscribed to at the premium price by investors who are willing to pay the premium.
- **Availability of Funds:** The funds received from the premium must be carefully tracked and used in compliance with the provisions of the Companies Act, 2013.

Further, the pricing of shares issued at a premium must be fair and based on sound financial principles. This often requires independent valuations or assessments to ensure that the premium is not excessively high and that it reflects the intrinsic value of the company.

Advantages and Disadvantages of Issuing Shares at a Premium

Advantages:

- **Capital Generation:** Issuing shares at a premium allows companies to raise capital without increasing debt, providing a more flexible and less risky way of financing.
- **Attracting Investors:** A premium price often reflects a company's strong brand value, growth prospects, and profitability, which can attract more investors.
- **No Impact on Debt Levels:** Since the funds raised are through equity rather than debt, issuing

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shares at a premium does not increase a company's debt burden.

Disadvantages:

- **Potential for Dilution:** Issuing shares, even at a premium, dilutes the ownership of existing shareholders, which can affect control of the company.
- **Perception of Overvaluation:** If the premium is perceived as excessive or unjustified, it may lead to negative market reactions, potentially harming the company's reputation.

Significance and Implications of Share Premium

1. Corporate Governance and Market Perception

The issue of shares at a premium generally reflects positively on a company's financial health. It often indicates strong investor confidence in the company's prospects, which is reflected in the price at which the shares are issued. Issuing shares at a premium allows the company to raise additional funds without diluting its equity base in proportion to the capital raised. It enables the company to maintain control over its operations while also benefiting from higher capital infusion.

The premium amount also provides an indicator of how the market values the company beyond its nominal share capital. A high premium may suggest strong market prospects or valuable intangible assets such as brand

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recognition or intellectual property, whereas a low or negligible premium may indicate weaker market perceptions.

2. Use of Premium for Bonus Shares

Issuing bonus shares is a common use of the share premium. This is when a company distributes additional shares to its existing shareholders at no extra cost, using the funds accumulated in the securities premium account. This practice helps maintain the company's capital structure and reflects its profitability. However, bonus shares do not result in an increase in total capital, as they simply convert reserves (including share premium) into share capital.

3. Investor Confidence and Corporate Strategy

From a strategic perspective, issuing shares at a premium can help the company attract long-term investors who are willing to invest based on the perceived growth potential. The premium often correlates with investor expectations about future profitability, growth opportunities, and the overall health of the business.

4. Legal and Ethical Considerations

While the share premium is an important financial tool, companies must comply with regulatory frameworks to avoid misuse. Improper handling of the share premium, such as using it for non-permitted purposes, can lead to legal penalties and a loss of investor trust. This underscores the importance of adhering to established

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legal and accounting frameworks, such as the Indian Companies Act or IFRS, to maintain transparency and corporate accountability.

SURRENDER OF SHARES

The surrender of shares is a concept that arises primarily in the context of corporate governance and financial accounting when a shareholder voluntarily returns shares to the company. This is a procedure that may occur under various circumstances such as a company's buy-back scheme, the reduction of capital, or in cases where the shareholder defaults on payment for the shares they subscribed to. The surrender of shares is a crucial topic in corporate finance and has substantial implications for both the company and the shareholder.

Definition of Surrender of Shares

The surrender of shares refers to the voluntary return of shares by a shareholder to the company, with the company agreeing to cancel the shares. Unlike a sale of shares, where ownership is transferred to another investor or entity, in the case of surrender, the shares are effectively withdrawn from circulation. This may occur for reasons such as unpaid calls or as part of a formal reduction of capital by the company.

The surrender of shares may result in the following outcomes:

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- Reduction in the number of shares in circulation.
- Alteration of the share capital of the company.
- Potential adjustment in the ownership and voting structure of the company.

Key Features of the Surrender of Shares

Voluntary Exit and Limited Market Liquidity

One of the primary reasons for share surrender is when shareholders wish to exit the company but face difficulties in finding buyers, especially in privately held or closely-held companies where the market for shares is limited. In such cases, rather than attempting to sell the shares on an illiquid market, shareholders may opt to directly surrender their shares back to the company. This allows them to liquidate their investment without the need for third-party buyers, providing a more efficient and less time-consuming solution.

Capital Reduction Strategy

In some instances, companies may actively request shareholders to surrender their shares as part of a broader capital reduction strategy. This process typically involves reducing the nominal value of shares or eliminating excess capital from the company's balance sheet. A capital reduction is often employed as a tool to adjust the company's capital structure, improve financial ratios, or enhance shareholder value by streamlining

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equity. Surrendering shares in this context helps the company simplify its financial structure and ensures that capital is better aligned with the company's current needs.

Failure to Meet Conditions

Shareholders may also be compelled to surrender their shares if they fail to meet the conditions outlined in the company's articles of association. Common reasons include the non-payment of calls or failure to meet ownership thresholds or other specific conditions imposed by the company. For example, if a shareholder has not paid the required calls on their shares, or if the company's bylaws stipulate that shareholders must maintain a minimum holding to retain their shares, failure to comply with these terms could lead to the compulsory surrender of shares. In this case, the company ensures compliance with its regulations while preventing financial complications.

Internal Reorganization and Corporate Restructuring

Companies undergoing internal reorganizations, such as mergers, demergers, or recapitalizations, may request shareholders to surrender their shares as part of the restructuring process. These efforts typically aim to streamline ownership, adjust the capital structure, or align the company's shareholding base with the new strategic direction of the company. In such cases, surrendering shares becomes a necessary step for the

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company to realign its equity structure in preparation for the forthcoming changes in the business environment. It is also a practical solution for companies needing to reduce the number of shareholders or restructure their capital base efficiently.

Dispute Resolution Among Shareholders

In certain situations, where disagreements arise among shareholders concerning the management or direction of the company, share surrender can serve as a means of resolving disputes. This may occur when parties involved in a conflict agree that the return of shares to the company would facilitate smoother governance or reduce conflicts within the organization. In cases where shareholder disputes are particularly contentious, surrendering shares can provide a neutral ground for resolving tensions, particularly when one or more parties wish to exit the company without resorting to more formal legal measures.

Board and Legal Approval

Regardless of the reason for share surrender, the process must generally be approved by the company's board of directors. This ensures that the surrender is in line with the company's broader financial goals and corporate governance structure. Furthermore, surrendering shares is not permissible for fully paid-up shares. Once a shareholder has paid in full for their shares, those shares are considered permanent holdings, and surrendering them is legally restricted. This ensures that shares, once

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fully paid, cannot be easily reversed, which could undermine the company's financial stability.

The Companies Act, 2013

In India, the surrender of shares is primarily governed by the *Companies Act, 2013*, which provides a clear legal framework for corporate governance, including regulations related to the surrender of shares. Section 56 of the Companies Act, 2013, prohibits the surrender of fully paid-up shares. However, the surrender of unpaid or partly paid shares is permissible under specific conditions.

The surrender of shares can only occur under the following circumstances:

1. **Unpaid or Partly Paid Shares:** According to Section 45 of the Companies Act, 2013, shares that are unpaid or partly paid may be surrendered to the company with the approval of the board of directors. Once a shareholder surrenders the shares, they are deemed to have abandoned any rights associated with them, including dividend entitlement and voting rights.
2. **Board of Directors' Approval:** A key feature of the surrender process is the requirement for approval from the company's board of directors. The board must pass a resolution approving the surrender, and this must be done in accordance with the company's

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articles of association and applicable corporate governance standards.

- 3. Conditions for Surrender:** The surrender of shares must comply with the company's articles of association, which may specify the procedure for surrender. The shareholder must submit a written request to surrender their shares, and the board must authorize the surrender in a formal meeting. It is important to note that a shareholder cannot compel the company to accept a surrender, and the decision rests solely with the company's board.
- 4. Non-Payment of Calls:** Another scenario in which shares may be surrendered is when a shareholder fails to pay the calls on partly paid shares. If the shareholder does not pay the call within the prescribed period, the company may opt to accept the surrender of such shares.

RIGHT SHARES

In corporate finance, a company may seek additional capital to fund expansion, repay debts, or for other operational needs. One such mechanism used by companies to raise additional equity capital is through the issuance of **right shares**. Right shares represent an offer made to existing shareholders of a company, granting them the option to purchase additional shares at

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a predetermined price, often at a discount to the market price. The purpose of this chapter is to explore the concept of right shares in-depth, the regulatory framework that governs their issuance, and the practical implications for both the company and its shareholders.

Defining Right Shares

Right shares are those shares offered by a company to its existing shareholders in proportion to their existing holdings, at a price typically lower than the prevailing market price. These shares are issued by companies to raise funds for various corporate purposes, such as expansion, debt repayment, or to improve working capital. The issuance of right shares provides existing shareholders the **right**, but not the **obligation**, to purchase additional shares.

This is a method of raising equity capital, which preserves the proportional ownership of current shareholders and prevents undue dilution of their stakes in the company. It allows shareholders to maintain their influence and voting power within the company by purchasing new shares before the offer is made available to the public.

Key Characteristics of Right Shares

The distinctive features of right shares can be understood by examining the following characteristics:

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Proportionality: Rights shares are offered to existing shareholders in proportion to their current holdings. This ensures that shareholders retain their relative ownership in the company. For example, a shareholder holding 10% of the company's shares would be entitled to purchase 10% of the newly issued shares.

Discounted Price: The company usually offers the right shares at a price lower than the current market price to encourage existing shareholders to take up the offer. This discount compensates for the fact that the shareholder may have to make an immediate investment and forgo any potential price appreciation in the stock during the subscription period.

Fixed Timeframe: The company sets a time period during which shareholders can exercise their rights to purchase additional shares. After the expiry of the rights offer, any unclaimed shares are typically offered to the public through a **public offering**.

Non-Transferability: In many cases, the rights issued to the shareholders are non-transferable, meaning that shareholders cannot sell or transfer the right to others. However, in some instances, rights may be tradable on the stock exchange.

Renounceable vs. Non-Renounceable Rights:

- **Renounceable Rights:** Shareholders have the ability to sell or transfer their rights to other

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investors, thereby providing liquidity to the rights issue.

- **Non-Renounceable Rights:** Shareholders cannot transfer their rights to anyone else. If the shareholder does not exercise the right, the right expires.

Purpose of Right Shares

The issuance of right shares serves several critical purposes for a company:

Raising Capital: Companies utilize right shares as a means to raise additional capital without resorting to external financing or borrowing. This method is often preferred during periods when market conditions may make borrowing expensive or when a company seeks to avoid increasing its debt burden.

Preserving Shareholder Control: Since the issuance is offered exclusively to existing shareholders, it allows the company to raise capital while minimizing the dilution of control over the business. Shareholders who exercise their rights retain their proportional ownership in the company.

Debt Reduction: Companies may issue right shares to reduce outstanding debt, thereby improving their capital structure and reducing the financial leverage. This is particularly important for companies facing liquidity issues or struggling with high debt levels.

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Financing Expansion or New Projects: Right shares are often issued to finance expansion, acquisitions, or capital-intensive projects without seeking external investors or entering the public market.

Maintaining Financial Flexibility: By issuing right shares, a company can maintain financial flexibility in the face of economic downturns or uncertain market conditions. This capital injection can be used for operational needs, research and development, or to enhance working capital.

Advantages of Rights Issue

The rights issue mechanism offers several advantages to both companies and their shareholders.

a. For Companies:

- **Cost-Effective:** Rights issues are generally less expensive compared to other forms of capital raising, such as public offerings, as they do not involve underwriting or advertising fees.
- **No Control Dilution:** Since the issue is directed only to existing shareholders, it avoids the dilution of control to external investors.
- **Preservation of Shareholder Loyalty:** By offering shares to existing shareholders first, the company strengthens its relationship with its base of investors.

b. For Shareholders:

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- **Opportunity to Maintain Ownership:** Shareholders can maintain their proportionate shareholding by exercising their rights, which helps them avoid dilution of their voting power and influence in the company.
- **Discounted Purchase Price:** Rights shares are often offered at a discount, providing an opportunity for shareholders to purchase additional shares at a favorable price.
- **Flexibility:** Shareholders can decide whether or not to exercise the rights. They can choose to sell their rights in the market or let them lapse.

Disadvantages of Rights Issue

Despite their benefits, rights issues also carry some drawbacks, particularly for shareholders who do not have the liquidity to participate.

a. For Companies:

- **Limited Appeal:** Rights issues are often seen as a sign that a company is in need of capital, which can sometimes negatively affect investor sentiment.
- **Potential Market Volatility:** The offering price may be below the market price, which could lead to a drop in the company's stock price as the market adjusts to the dilution of shares.

b. For Shareholders:

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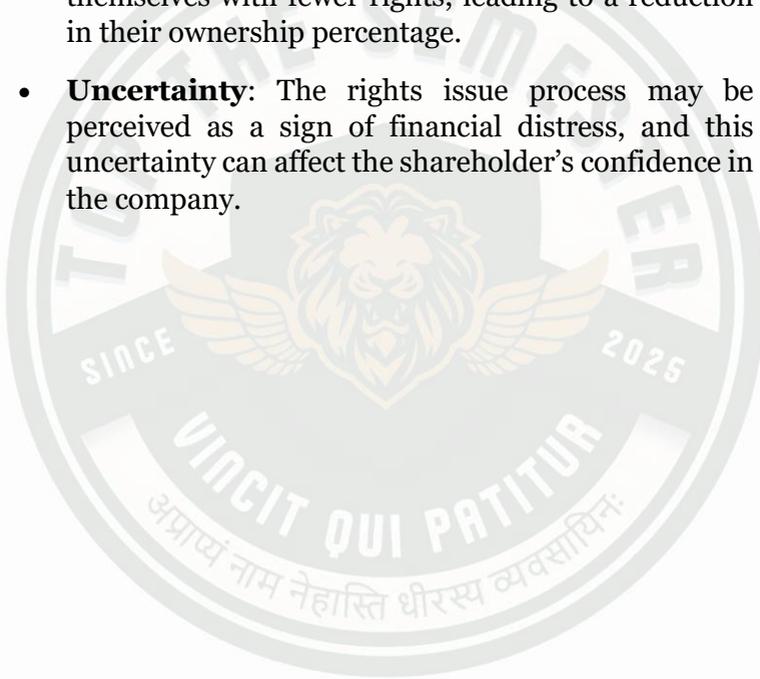
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- **Risk of Dilution:** Shareholders who choose not to exercise their rights may face dilution of their ownership, as new shares are issued to other investors who did participate.
- **Liquidity Constraints:** Shareholders who cannot afford to purchase additional shares may find themselves with fewer rights, leading to a reduction in their ownership percentage.
- **Uncertainty:** The rights issue process may be perceived as a sign of financial distress, and this uncertainty can affect the shareholder's confidence in the company.



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4.7 ISSUE OF DEBENTURES

Debentures represent a form of long-term debt instrument that corporations use to raise capital. They are essentially unsecured loans that a company issues to investors, promising to pay back the principal amount with interest over a specified period. The concept of debenture issuance plays a critical role in corporate financing, enabling businesses to access large-scale funding without relinquishing ownership or control, as is the case with equity financing.

Definition and Characteristics of Debentures

Debentures are defined as debt instruments that are not secured by any specific asset but rather rely on the general creditworthiness and reputation of the issuing company. Typically, debentures are issued for a longer duration than short-term loans, often ranging from 5 to 30 years, depending on the needs of the issuer and market conditions.

The primary characteristics of debentures include:

- **Fixed Interest:** Debentures offer a fixed rate of interest to the investors. This interest is paid periodically, typically semi-annually or annually, and is often higher than that of a secured loan to compensate for the lack of asset backing.
- **Unsecured Nature:** Most debentures are unsecured, meaning they are not backed by any

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specific collateral. Instead, they are backed only by the issuer's creditworthiness.

- **Convertibility:** Some debentures are convertible into equity shares after a certain period, allowing investors the potential for capital appreciation. These are known as convertible debentures.
- **Repayment:** Debentures have a fixed maturity period after which the principal amount is repaid. Companies may repay the debentures either in a lump sum or in instalments, depending on the terms of issuance.
- **Transferability:** Debentures are typically transferable, allowing investors to sell them in secondary markets, thus providing liquidity to the holders.

Types of Debentures

Debentures can be classified based on various criteria:

1. Based on Security:

Secured Debentures

Secured debentures are backed by a specific asset or pool of assets, providing a degree of security to investors in the event of a default by the issuer. These debentures tend to offer lower interest rates because of the added security.

Unsecured Debentures

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Unsecured debentures, as previously mentioned, are not backed by any asset and rely solely on the issuer's creditworthiness. These tend to offer higher interest rates as compensation for the higher risk involved.

2. Based on Convertibility:

Convertible Debentures

Convertible debentures can be converted into equity shares of the issuing company after a predetermined period. This gives investors the flexibility to convert their debt holdings into ownership stakes, potentially benefiting from the company's future growth.

Non-Convertible Debentures (NCDs)

Non-convertible debentures do not have the option to be converted into equity. These are purely debt instruments that are repaid with interest at maturity. They are more common in the market compared to convertible debentures due to their fixed-income nature.

3. Based on Redemption:

Redeemable Debentures

Redeemable debentures can be redeemed (paid off) by the company before the maturity date, as per the terms set at the time of issuance. These are commonly issued by companies to provide more flexibility in managing their debt.

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Irredeemable Debentures

Irredeemable debentures, on the other hand, cannot be redeemed before the maturity date. They are repaid only at the end of the tenure.

The Process of Issuing Debentures

The issuance of debentures follows a systematic process, requiring careful planning and regulatory compliance. The key steps involved in the process include:

Decision to Issue Debentures

The first step in the debenture issuance process involves the company's management and board of directors deciding to raise funds through debentures. This decision is often influenced by the company's capital structure needs, interest rates, and market conditions.

Approval and Authorization

Before issuing debentures, companies must seek approval from shareholders in the form of a special resolution passed during the annual general meeting (AGM). Additionally, a company must ensure compliance with the relevant regulations, such as the provisions of the Companies Act, 2013 in India or similar legislation in other jurisdictions.

Preparation of Debenture Prospectus

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The company must prepare and file a debenture prospectus or offer document with the relevant regulatory authorities (such as the Securities and Exchange Board of India (SEBI) in India). The prospectus outlines the terms of the issue, including the interest rate, repayment schedule, and any other relevant details. It serves as a key document for potential investors.

Pricing and Underwriting

The company, in consultation with investment banks and financial advisors, determines the price of the debentures and the interest rate to be offered. In some cases, the company may also choose to engage underwriters to guarantee the sale of debentures in case of insufficient demand in the market.

Public Offering and Subscription

Once all regulatory approvals are obtained, the debentures are offered to the public or institutional investors. Interested investors subscribe to the debenture issue, indicating the amount they wish to invest.

Allotment and Issue of Debentures

After the subscription period ends, the company allocates the debentures to the investors based on the subscription received. The debenture certificates are issued to investors as evidence of their holdings.

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4.8 METHODS OF REDEMPTION, REDEMPTION OF DEBENTURES

The concept of "redemption" refers to the process by which a company repays the debt or purchases back its preference shares or debentures from the shareholders or debenture holders. This repayment can occur either at maturity or before the maturity date, depending on the terms set forth by the issuing company. Redemption is a significant financial event for both the issuing company and its investors, influencing the company's capital structure and liquidity.

The redemption process is guided by the terms mentioned in the issue document, which includes features such as the redemption date, redemption premium, and method of redemption. Redemption, especially in the case of bonds and debentures, impacts the company's balance sheet, as it reduces liabilities. Several methods exist to redeem financial instruments, each serving different strategic and financial objectives of the company. These methods include **lump sum redemption, call and put option redemptions, and sinking fund method**, among others.

1. Lump Sum Redemption

The lump sum method, also known as **bullet redemption**, is the most straightforward method. Under this method, the company repays the entire face value of the financial instrument (such as debentures or preference shares) at once, at the end of the specified

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term. The lump sum redemption does not require any periodic payments and is typically associated with debentures or preference shares with a fixed redemption date.

Key Features:

- **No Interim Payments:** There are no periodic payments, such as interest or principal, before the redemption date.
- **Risk for the Company:** If the company is unable to meet the lump sum redemption at maturity, it may face a liquidity crisis or even insolvency. This is especially a concern for companies with weaker financial standing.
- **Impact on Financial Statements:** The liability of the redeemed debenture or preference share is removed from the balance sheet on the redemption date, reducing the total liabilities and the company's debt equity ratio.

Financial Implications:

- For **debt securities**, lump-sum redemption can lead to large cash outflows in the redemption period, which may impact the company's financial position, particularly in terms of its working capital and liquidity ratios.

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- **Investors** benefit from this method as they receive the full redemption amount at once, which may allow them to reinvest the proceeds elsewhere.

Example:

A company issues debentures worth ₹1,00,000 at a fixed rate of interest of 8% for a 5-year term, with a maturity date. At the end of the term, the company will redeem the debentures in full, repaying ₹1,00,000 plus interest accrued. There are no intermediate payments during the 5 years.

2. Call Option Redemption

A **call option redemption** allows the issuing company to redeem the financial instrument before its maturity date, typically at a predetermined price or at a premium over the face value. This method gives the company flexibility to buy back its securities early, especially if interest rates fall or if it wishes to restructure its debt earlier than anticipated.

Key Features:

- **Issuer's Option:** The redemption is at the issuer's discretion, meaning the company can decide whether to redeem early or allow the security to continue to maturity.

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- **Premium Payment:** Typically, the company will pay a premium over the face value for early redemption, compensating investors for the loss of future interest payments.
- **Investor Impact:** Investors may be impacted by the early redemption if they are unable to reinvest at similar interest rates.

Financial Implications:

- **Interest Rate Risk Mitigation:** The company can take advantage of favorable market conditions (e.g., lower interest rates) to refinance debt at a lower cost.
- **Investor Impact:** Investors may face reinvestment risk if their bonds or securities are called early, as they may not be able to reinvest the proceeds at the same rate.

Example:

A company issues bonds with a 10-year maturity, but after 5 years, it calls the bonds at a premium (say 5%) because of favorable market conditions (falling interest rates). The company redeems the bonds at ₹1,05,000 for every ₹1,00,000 face value bond.

3. Put Option Redemption

In contrast to the call option, a **put option redemption** allows the bondholder or shareholder the right to force the company to redeem the securities at a specified price before maturity. This method is usually beneficial for the

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investor as it provides the option to exit the investment early, particularly if interest rates rise or if the issuer's creditworthiness declines.

Key Features:

- **Investor's Option:** The option to redeem early rests with the investor, not the issuing company. Investors may exercise this right if they believe the issuer's financial position has weakened.
- **Redemption Price:** The company may be obligated to redeem the securities at a fixed price, often at par or at a premium, depending on the terms.
- **Company's Liability:** If the put option is exercised, the company may face unexpected cash outflows, which could strain its liquidity, especially if it was not prepared for early redemption.

Financial Implications:

- **Liquidity for Investors:** This method provides investors with an exit strategy, particularly in volatile markets. If they choose to exercise the put option, they can sell the securities back to the issuer, ensuring a predictable return.
- **Issuer's Risk:** For the issuer, the put option represents a risk that they may need to redeem

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securities prematurely, potentially at a higher cost if the securities are put to them at a premium.

Example:

A bondholder holding ₹1,00,000 in bonds with a put option can, after 5 years, choose to redeem the bond early at ₹1,05,000 (the predetermined price). The bondholder may choose to exercise this option if market conditions are unfavorable for continued investment in the bond.

4. Sinking Fund Method

The **sinking fund method** involves the company setting aside funds periodically (usually annually) to accumulate enough capital to redeem the bonds or debentures at maturity. This method spreads out the redemption burden over several years, making it less risky for the company by gradually reducing the total liability.

Key Features:

- **Periodic Payments:** The company contributes a set amount to a sinking fund each year, which is used to redeem a portion of the total outstanding securities. These contributions are often invested in low-risk, interest-bearing securities.
- **Flexibility in Redemption:** The company may choose to redeem some or all of the outstanding securities in various installments, depending on the funds available in the sinking fund.

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- **Investor Assurance:** Since the company is gradually setting aside funds for redemption, investors are assured of the company's ability to meet its redemption obligations at maturity.

Financial Implications:

- **Management of Liability:** This method reduces the financial burden at the time of redemption, as the company has accumulated the necessary funds over time.
- **Company's Creditworthiness:** Investors may view the use of a sinking fund as a positive indication of the company's ability to meet its obligations, which can improve its credit rating.

Example:

A company issues debentures of ₹10,00,000 and sets up a sinking fund. The company decides to set aside ₹1,00,000 every year in the sinking fund. By the end of the 10th year, the accumulated fund will be enough to redeem all the debentures at face value, ensuring a smoother redemption process.

5. Conversion into Equity

The **conversion method** involves the conversion of preference shares or convertible debentures into equity shares of the issuing company, rather than redeeming them in cash. This method is particularly beneficial for companies that wish to reduce their debt without having

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to part with cash, and it is an attractive option for investors when the company's stock price is expected to rise.

Key Features:

- **Debt to Equity Swap:** The investors' holding in debt is converted into equity shares, which gives them ownership in the company.
- **Dilution of Equity:** This method may result in the dilution of existing shareholders' equity, as new shares are issued to the investors.
- **No Immediate Cash Outflow:** For the issuing company, this method does not involve an immediate cash outflow, which helps maintain liquidity, especially for companies in financial distress.

Financial Implications:

- **Equity Dilution:** The conversion of securities into equity increases the company's share capital, leading to potential dilution of existing shareholders' stakes.
- **Debt Reduction:** By converting debt into equity, the company reduces its debt burden, which can improve its debt-to-equity ratio.

Example:

A company issues ₹1,00,000 worth of convertible debentures with a conversion rate of ₹100 per share. After 5 years, the debenture holders opt to convert their

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debentures into equity shares at the agreed conversion rate. This results in the issuance of 1,000 shares to the debenture holders, who no longer hold the debt.

Redemption of debentures

The redemption of debentures can occur through various methods, each of which has different financial and operational implications for the company. The most common methods of redemption include:

1. Redemption at Par

Redemption at par refers to the repurchase of debentures by the issuing company at their nominal value, or face value, upon maturity. This method is often used when the debenture terms do not specify a premium or discount. For example, if a company issues debentures at ₹100 each, the redemption would occur at ₹100 per debenture, with no additional payment to the debenture holders beyond the face value.

Advantages of Redemption at Par:

- **Simplicity:** This method is straightforward, requiring only the repayment of the face value, with no complex calculations for premium or discount.
- **Financial Predictability:** It is easy for the company to calculate the total outflow since the amount to be repaid is fixed.

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Disadvantages of Redemption at Par:

- **Limited Incentive for Investors:** Redemption at par does not offer any additional benefit to investors, such as a premium. This might make the debentures less attractive to potential investors.

2. Redemption at a Premium

Redemption at a premium involves the company repurchasing its debentures at a price above the nominal value. The premium is usually a percentage of the face value and is specified in the debenture agreement. This method serves as an incentive for debenture holders, particularly when the debentures are redeemed before the maturity date.

For example, a company might issue debentures at ₹100, but redeem them at ₹105, providing a 5% premium to the debenture holders. This method is often used to encourage early redemption or to make the debentures more attractive to investors in a low-interest-rate environment.

Advantages of Redemption at a Premium:

- **Increased Appeal:** The premium provides an added incentive for investors, making the debentures more attractive.

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- **Flexibility:** Companies can use this method to redeem their debt before maturity, which can help manage cash flows more effectively.

Disadvantages of Redemption at a Premium:

- **Higher Financial Burden:** Companies must be prepared to pay more than the face value, which could result in a higher financial outflow than originally anticipated.
- **Potential for Increased Interest Costs:** If the company chooses to redeem the debentures early, it may be required to pay both the principal and the premium before planned.

3. Redemption at a Discount

In some cases, companies may choose to redeem debentures at a price lower than the face value, which is known as redemption at a discount. This method is less common but may be employed as a means of managing cash flows during financially challenging periods.

For instance, a company may issue debentures at ₹100 but redeem them at ₹90, providing a discount of 10%. This method is typically used when a company is unable to meet the full repayment and needs to manage its financial obligations more effectively.

Advantages of Redemption at a Discount:

- **Cash Flow Management:** Redemption at a discount allows companies to pay less than the

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face value, which can be particularly helpful during cash shortages.

- **Less Financial Outlay:** Since the redemption price is lower than the face value, the company can conserve capital, potentially helping it manage liquidity during financial distress.

Disadvantages of Redemption at a Discount:

- **Negative Perception:** Redemption at a discount may signal to investors that the company is experiencing financial difficulties, which could harm its reputation in the market.
- **Investor Reluctance:** Investors may be hesitant to buy debentures that are likely to be redeemed at a discount, which could make it harder for the company to raise funds.

4. Sinking Fund Method

A sinking fund is a dedicated reserve fund established by the company to accumulate funds over time for the purpose of redeeming debentures. Under this method, the company sets aside a fixed amount of money periodically, which is then invested in low-risk securities. The funds accumulated in the sinking fund are used to redeem debentures at maturity or earlier, depending on the terms of the debenture issue.

This method is particularly useful for companies with long-term debt obligations, as it ensures that the

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company has the necessary funds to redeem the debentures without straining its cash flow at maturity.

Advantages of the Sinking Fund Method:

- **Planned Redemption:** Companies can manage their debt obligations more efficiently by systematically setting aside funds.
- **Reduced Financial Stress:** By accumulating funds over time, the company avoids a large outflow at the time of redemption.

Disadvantages of the Sinking Fund Method:

- **Administrative Complexity:** Setting up and managing a sinking fund can be administratively complex and may require significant oversight.
- **Opportunity Cost:** The funds in the sinking fund are typically invested in low-risk securities, which may not generate high returns, leading to a potential opportunity cost for the company.

5. Call Option Method

The call option method allows the company to redeem its debentures before the maturity date at the discretion of the company. This method is typically included in the terms of the debenture issue and provides the company with the flexibility to call (or redeem) the debentures when it is financially advantageous to do so.

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Advantages of the Call Option Method:

- **Flexibility:** The company can redeem the debentures when it has sufficient funds, offering flexibility in cash flow management.
- **Early Debt Retirement:** If the company's financial position improves, it can redeem the debentures early, reducing future interest obligations.

Disadvantages of the Call Option Method:

- **Investor Uncertainty:** Investors may be uncertain about the timing of redemption, which could affect the marketability of the debentures.
- **Potential for Early Redemption Penalties:** Companies may be required to pay a penalty if they redeem the debentures early, particularly if the debenture was issued at a premium.

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PREVIOUS YEAR QUESTION PAPERS (PYQs) SOLUTIONS

PAPER 1

PART A

**QUESTION 1: WRITE SHORT NOTES ON THE
FOLLOWING:**

**QUESTION: MENTION ANY THREE
OBJECTIVES OF ACCOUNTING**

Accounting, as a discipline, serves a multifaceted role within the financial ecosystem of an organization or entity. It provides a structured approach to recording, summarizing, analyzing, and interpreting financial data. The main objectives of accounting are integral to achieving transparency, ensuring effective decision-making, and maintaining the operational integrity of a business. Below, three core objectives of accounting are discussed in detail.

Recording Financial Transactions (Accuracy and Reliability)

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The foremost objective of accounting is to systematically record all financial transactions made by an entity. This objective ensures that all economic activities, whether inflows or outflows, are documented accurately and comprehensively. This process forms the foundation of financial reporting, as it guarantees that data is readily available for analysis and reporting.

Importance:

The accuracy in recording transactions is vital for several reasons. First, it ensures that the financial statements, such as the balance sheet and income statement, reflect the true and fair view of the business's financial position. Without accurate records, the reliability of these statements would be compromised, leading to misinformed business decisions, potential legal issues, and loss of stakeholder trust.

Accounting utilizes double-entry bookkeeping to maintain this accuracy, wherein every transaction affects at least two accounts. This approach helps ensure the balance and correctness of the recorded data.

Example:

Consider a company that purchases inventory worth ₹50,000. This transaction would be recorded in both the "Inventory" and "Accounts Payable" accounts, ensuring that both the assets and liabilities are updated in the financial records.

Providing Information for Decision-Making

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A key objective of accounting is to provide relevant, timely, and accurate information to internal and external users to aid in decision-making. This includes providing data on the company's financial health, profitability, liquidity, and cash flow. Decision-makers, including management, investors, creditors, and regulatory authorities, rely on this information to make informed decisions.

Importance:

The information provided by accounting helps in a wide array of decisions, including:

- **Investment Decisions:** Investors and analysts examine financial reports to determine the profitability, risk, and sustainability of a business. The ability to predict future earnings and assess risk is crucial for investing decisions.
- **Credit Decisions:** Creditors utilize financial data to assess the ability of a company to meet its debt obligations. A strong accounting system provides evidence of solvency and liquidity.
- **Internal Management Decisions:** Management utilizes accounting information to guide operational decisions, such as budgeting, pricing strategies, and performance evaluation.

Example:

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A company's income statement provides insight into the company's profitability over a period. A manager can use this information to decide whether to expand operations or if cost-cutting measures are necessary.

Ensuring Compliance with Legal and Regulatory Requirements

An essential objective of accounting is to ensure that businesses comply with legal and regulatory standards. Financial reporting is governed by various accounting standards and frameworks such as the Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or country-specific regulations. Adhering to these standards is crucial for maintaining transparency and ensuring that the financial data presented is consistent, reliable, and comparable.

Importance:

Compliance with accounting standards and regulations is vital not only for the legal and regulatory oversight but also for maintaining the trust of stakeholders, including investors, regulators, and the general public. Failure to comply can lead to legal penalties, loss of investor confidence, and potentially severe financial consequences.

Example:

A publicly traded company must prepare its financial statements in accordance with IFRS, ensuring that all

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accounting practices are transparent and meet the requirements of regulatory bodies like the Securities and Exchange Board of India (SEBI). This compliance provides assurance to investors and regulators that the financial statements are presented fairly.



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QUESTION: EXPLAIN THE PRINCIPLE OF CONSERVATISM

The **principle of conservatism**, also known as the principle of prudence, is a key accounting principle that guides accountants to choose lower values for assets and revenues, and higher values for liabilities and expenses when there are alternatives that are approximately equally likely. The principle advocates for the policy of "anticipate no profit, but anticipate all losses".

The principle of conservatism has its roots in the legal notion of prudence, where it is better to be safe than sorry. In the realm of accounting, this has translated into an inclination towards a more cautious and conservative approach when faced with uncertainty.

This principle operates under the fundamental premise that it's better to understate than overstate income and economic position. It provides a safety cushion against possible future losses and uncertainties.

For instance, when there is a probability of losses in the future, an accountant will record it immediately. However, if there is a probability of gains or profits, they will not be recorded until they are realized. This prevents the overstatement of financial position and earnings of the business.

However, it's important to note that the principle of conservatism does not advocate for the deliberate understatement of assets or income or the overstatement

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of liabilities or expenses. It only asks to err on the side of caution in cases of reasonable doubt and uncertainty.

Recent developments in International Financial Reporting Standards (IFRS) indicate a movement away from the principle of conservatism towards a more neutral stance. This shift has raised various debates in accounting and legal academia about the role of conservatism in accounting, which future law and accounting students will undoubtedly find intriguing.

The principle of conservatism holds significance in the financial accounting world due to several reasons:

Protection against Legal Claims: By not recognizing profits until they are realized, businesses can safeguard against legal claims that may arise from profit distributions. The principle of conservatism can prevent the premature distribution of earnings, thus protecting the company from potential lawsuits or breaches of fiduciary duty.

Tax Planning: The principle of conservatism can help in tax planning as underestimating income or overestimating expenses can lead to a reduction in tax liability. However, this must be done within the law's boundaries to prevent any legal repercussions for tax evasion.

Investor Confidence: The principle of conservatism builds investor confidence, as investors prefer to invest in a company that reports lower profits than actual rather

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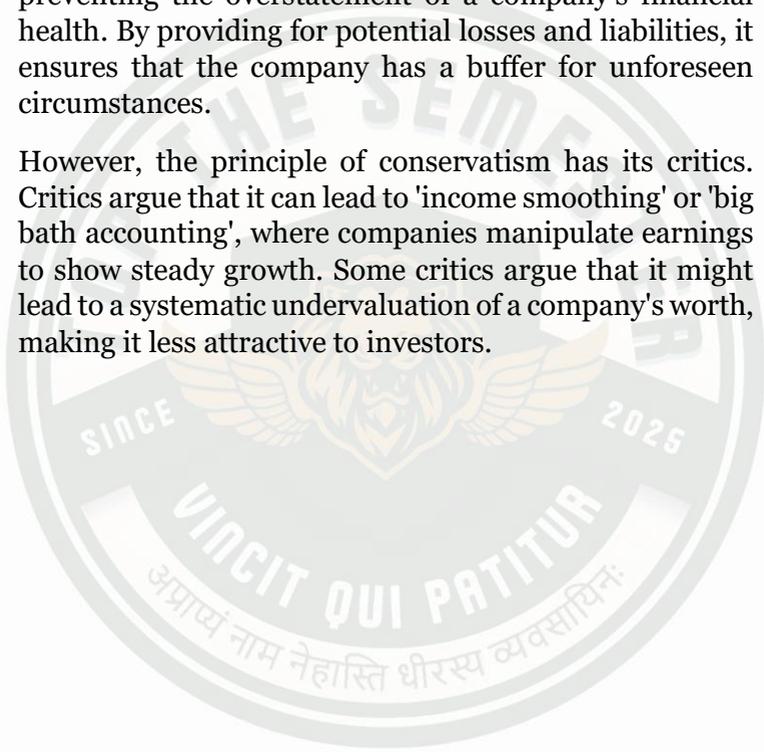
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than a company that inflates their profits. When gains are finally realized and reported, it gives investors a pleasant surprise and boosts their confidence in the company.

Risk Management: It helps in risk management by preventing the overstatement of a company's financial health. By providing for potential losses and liabilities, it ensures that the company has a buffer for unforeseen circumstances.

However, the principle of conservatism has its critics. Critics argue that it can lead to 'income smoothing' or 'big bath accounting', where companies manipulate earnings to show steady growth. Some critics argue that it might lead to a systematic undervaluation of a company's worth, making it less attractive to investors.



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QUESTION: EXPLAIN THE MEANING OF DOUBLE ENTRY SYSTEM

The double entry system is the cornerstone of modern accounting and bookkeeping, providing the framework for the recording of financial transactions. It is a fundamental principle that ensures the accounting equation—Assets = Liabilities + Equity—remains balanced after each transaction. Under the double entry system, every financial transaction impacts at least two accounts in such a way that the total debits equal the total credits, maintaining the integrity and accuracy of financial records.

Fundamental Concept of the Double Entry System

At its core, the double entry system is based on the concept that every transaction has a dual effect. That is, for every debit entry recorded in one account, there must be a corresponding credit entry in another. This dual effect is what keeps the accounting equation in balance.

For example, when a business purchases equipment using cash, the cash account (an asset) will decrease (a credit entry), while the equipment account (also an asset) will increase (a debit entry). The total value of the debits and credits must be equal, thereby ensuring that the accounting records are accurate and that the equation holds true.

Debits and Credits: The Core of the System

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In the double entry system, two types of entries are recorded: debits and credits. The rules for applying these entries depend on the type of account being affected. Generally:

- **Debit entries** increase asset and expense accounts, and decrease liability, equity, and revenue accounts.
- **Credit entries** decrease asset and expense accounts, and increase liability, equity, and revenue accounts.

For instance, if a company makes a sale on credit, the revenue account (which is a part of equity) will be credited, and the accounts receivable (asset) will be debited. This ensures that the company's financial position is reflected accurately.

The Accounting Equation

The double entry system is designed to keep the basic accounting equation—**Assets = Liabilities + Equity**—balanced. Every financial transaction results in a change to at least two accounts, but the sum of debits will always equal the sum of credits, ensuring that the equation remains in equilibrium.

- **Assets:** Resources owned by the business, such as cash, inventory, or equipment.

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- **Liabilities:** Obligations or debts that the business owes to external parties, such as loans or accounts payable.
- **Equity:** The residual interest in the assets of the entity after deducting liabilities, representing the ownership interest in the business.

A practical example would be when a company borrows \$5,000 from a bank. The cash account (an asset) will increase by \$5,000 (debit), and the loan payable account (a liability) will also increase by \$5,000 (credit), ensuring that the equation stays balanced.

The Role of the Ledger and Trial Balance

In the double entry system, all transactions are first recorded in a **journal**, where they are noted in chronological order. Afterward, these journal entries are posted to the **ledger**, where transactions are grouped by account. This organization allows for a clear understanding of each account's changes over time.

To ensure the accuracy of the ledger and journal entries, accountants prepare a **trial balance**. This document lists all ledger accounts and their respective debit and credit balances. The trial balance serves as a tool for verifying that the total of all debit balances equals the total of all credit balances. If the two totals do not match, it indicates that an error has occurred in the recording process.

Advantages of the Double Entry System

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The double entry system offers several significant advantages, which make it the preferred method of accounting for businesses of all sizes. Some of the key benefits include:

- **Accuracy and Reliability:** By ensuring that every transaction is recorded in two accounts, the double entry system provides a high degree of accuracy. The system's built-in checks and balances help identify errors and discrepancies quickly.
- **Financial Statement Preparation:** The double entry system directly supports the preparation of essential financial statements, including the balance sheet and income statement. The system's structure ensures that the balance sheet remains in equilibrium, where assets equal the sum of liabilities and equity.
- **Error Detection:** Since the system requires that debits and credits always balance, errors such as omissions, duplications, or incorrect amounts can be quickly identified. If the total of debits does not equal the total of credits, it signals that something is amiss, prompting a review of the accounts.
- **Comprehensive Financial Reporting:** The double entry system enables the tracking of detailed financial transactions across multiple accounts, which facilitates a more comprehensive and thorough analysis of a company's financial health.

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QUESTION: MEANING OF FORFEITURE OF SHARES

Forfeiture of shares occurs when a shareholder fails to pay the required installment (call money) on shares they have subscribed to. A company, in such a scenario, may cancel the shares after following the procedures outlined in its Articles of Association and the relevant company laws. The forfeited shares become the property of the company, which can subsequently dispose of them, either by reissuing the shares to another party or by canceling them completely. The main purpose behind the forfeiture process is to ensure that the company maintains its capital base and prevents defaults that might affect its financial health.

The forfeiture of shares is usually exercised in cases where the shareholder fails to pay the calls made on shares after a stipulated period, and the company has already made attempts to remind the shareholder of their obligation to make such payments. If the shareholder continues to default despite such notices, the company can proceed with forfeiture.

Legal Framework and Conditions for Forfeiture

Forfeiture of shares is governed by company law, specifically the provisions under the Companies Act, 2013 (India), and similar legislation in other jurisdictions. The process is typically outlined in the company's Articles of Association, which may specify conditions under which forfeiture can occur. Some common conditions include:

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1. **Non-payment of Calls:** A shareholder who fails to pay the call money on shares within the prescribed time limit is typically subject to forfeiture. The company may issue a notice of default and give the shareholder a final chance to pay the outstanding amount.
2. **Non-compliance with Other Obligations:** While non-payment of calls is the most common reason for forfeiture, other grounds for forfeiture could include violations of certain terms and conditions of the share agreement, such as non-compliance with regulations regarding the transfer of shares or non-disclosure of necessary information when requested by the company.
3. **Notice of Forfeiture:** Before the forfeiture is executed, the company must issue a notice to the defaulting shareholder, stating the amount due and the consequences of failure to pay, including the potential forfeiture of the shares.
4. **Resolution of the Board:** In many cases, the decision to forfeit shares must be approved by the board of directors, in accordance with the provisions laid out in the company's Articles of Association.
5. **Procedure for Forfeiture:** Once the decision is made, a resolution must be passed by the board of directors to approve the forfeiture. A formal entry in the company's share register is also required to record the forfeiture.

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6. **Reissue or Cancellation:** After the shares are forfeited, the company has the option to either cancel them or reissue them to another party. The reissue process may occur at a discount or at a higher price, depending on the market conditions and the company's capital requirements.

Impact on the Shareholder

1. **Loss of Ownership Rights:** Once shares are forfeited, the shareholder loses all rights associated with the shares, including voting rights, dividend rights, and the right to participate in any future distributions of the company.
2. **Loss of Investment:** The shareholder effectively loses the amount paid for the shares, as the unpaid amount is not refunded. The investment in those shares is forfeited.
3. **No Liability for Unpaid Amounts:** While the shareholder loses their investment, they are typically not liable to pay any further amounts on the forfeited shares. However, in certain jurisdictions, the shareholder may be liable for the unpaid calls on the shares up to the value of the shares.

Impact on the Company

1. **Regain Control of Shares:** Forfeiture allows the company to regain control over the shares. The company can then either cancel the shares or reissue

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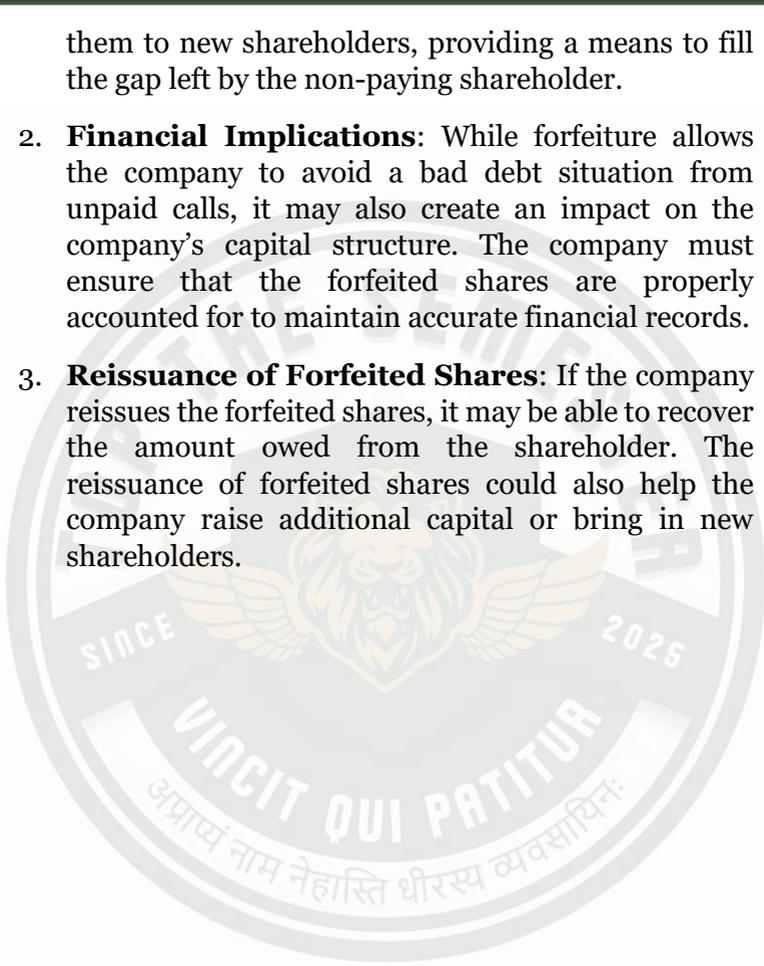
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them to new shareholders, providing a means to fill the gap left by the non-paying shareholder.

- 2. Financial Implications:** While forfeiture allows the company to avoid a bad debt situation from unpaid calls, it may also create an impact on the company's capital structure. The company must ensure that the forfeited shares are properly accounted for to maintain accurate financial records.
- 3. Reissuance of Forfeited Shares:** If the company reissues the forfeited shares, it may be able to recover the amount owed from the shareholder. The reissuance of forfeited shares could also help the company raise additional capital or bring in new shareholders.



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QUESTION: WHAT IS DEPRECIATION?

Depreciation refers to the systematic allocation of the cost of a tangible fixed asset over its useful life. In financial accounting, depreciation is a process used to match the expense of an asset to the revenue it generates over time, aligning with the accrual basis of accounting. Depreciation is particularly important for businesses as it allows for the gradual recognition of the cost of an asset rather than an immediate full expense in the year of acquisition, which provides a more accurate representation of the asset's contribution to generating income.

A tangible fixed asset is defined as an item that has a useful life exceeding one year and is used in the operations of a business. Examples include machinery, vehicles, buildings, office equipment, and computers. Depreciation ensures that the financial statements reflect the gradual wear and tear, obsolescence, or reduction in value of these assets due to factors such as usage, time, and technology advancements.

Purpose and Importance of Depreciation

The main objective of depreciation is to allocate the cost of an asset over its useful life in a manner that reflects its consumption and reduces the book value over time. Without depreciation, a company's financial statements would provide an inaccurate view of its profitability, as large expenditures for fixed assets would be recorded entirely in the year of purchase, resulting in inflated

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expenses and profits. By systematically reducing the asset's value, depreciation ensures that the expense aligns with the asset's economic contribution to the business.

There are several critical reasons for recognizing depreciation in financial accounting:

1. **Accurate Profit Calculation:** Depreciation helps in matching expenses with the revenue generated by the asset during its useful life, thereby ensuring accurate profit measurement.
2. **Tax Deductibility:** Depreciation is a non-cash expense that reduces taxable income. By recognizing depreciation, businesses can reduce their tax liabilities.
3. **Reflecting Asset Usage:** Depreciation represents the actual usage and gradual decline in value of the asset over time, ensuring that the asset is correctly valued on the balance sheet.
4. **Capital Maintenance:** By recognizing depreciation, companies can build up reserves to replace or upgrade their fixed assets when necessary.

Methods of Depreciation

There are several methods to calculate depreciation, and the choice of method can significantly impact a company's financial statements. The most common methods include:

1. Straight-Line Depreciation (SLD)

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This is the simplest and most widely used method. Under straight-line depreciation, the same amount of depreciation expense is allocated each year over the asset's useful life. The formula for calculating straight-line depreciation is:

$$\text{Depreciation Expense} = \frac{\text{Cost of Asset} - \text{Residual Value}}{\text{Useful Life of Asset}}$$

This method is appropriate when the asset's usage is expected to be uniform over its life, such as office furniture or buildings.

2. Declining Balance Method

This method calculates depreciation based on a fixed percentage of the asset's book value at the beginning of each period. The depreciation expense is higher in the earlier years and decreases over time, reflecting the assumption that an asset loses more value in its early years of use. The most commonly used variation is the **Double Declining Balance (DDB)** method, which accelerates the depreciation by using double the straight-line rate. The formula for the DDB method is:

$$\text{Depreciation Expense} = 2 \times \{(\text{Cost of Asset} - \text{Accumulated Depreciation}) / \text{Useful Life}\}$$

This method is suitable for assets that lose value more rapidly in their initial years, such as computers or vehicles.

3. Units of Production Method

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This method allocates depreciation based on the actual usage or output of the asset rather than time. It is particularly useful for manufacturing equipment where wear and tear is more closely related to the number of units produced or the hours the machine operates, rather than the passage of time. The formula for units of production depreciation is:

$$\text{Depreciation Expense} = \left\{ \frac{\text{Cost of Asset} - \text{Residual Value}}{\text{Total Estimated Units of Production}} \right\} \times \text{Units Produced in the Period}$$

This method is ideal for assets where production or usage varies from period to period.

4. Sum-of-the-Years'-Digits (SYD) Method

This is another accelerated depreciation method, which results in larger depreciation expenses in the earlier years of the asset's life. The total number of years of the asset's useful life is summed to produce a fraction for each year. The depreciation expense for each year is based on this fraction. The formula for SYD is:

$$\text{Depreciation Expense for Year} = \left(\frac{\text{Remaining Life}}{\text{Sum of the Years Digits}} \right) \times (\text{Cost of Asset} - \text{Residual Value})$$

Where the **sum of the years digits** is the sum of the numbers from 1 to the asset's useful life, and the **remaining life** is the number of years left.

Factors Affecting Depreciation

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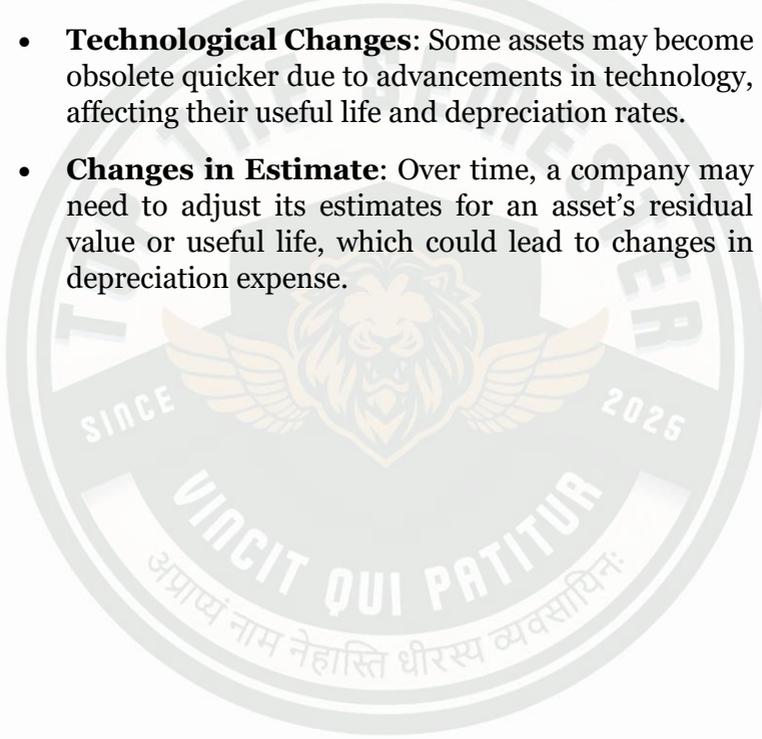
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Several factors can influence the amount of depreciation recognized over time, including:

- **Asset Usage:** If an asset is used more heavily in the earlier years of its life, methods like declining balance or units of production may be more appropriate.
- **Technological Changes:** Some assets may become obsolete quicker due to advancements in technology, affecting their useful life and depreciation rates.
- **Changes in Estimate:** Over time, a company may need to adjust its estimates for an asset's residual value or useful life, which could lead to changes in depreciation expense.



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PART B

QUESTION: WHAT DO YOU MEAN BY ACCOUNTING? EXPLAIN ITS NATURE, SIGNIFICANCE, AND LIMITATIONS.

Accounting is a systematic process of recording, classifying, summarizing, and interpreting financial transactions of a business or entity to provide relevant and reliable financial information. This information aids stakeholders, including management, investors, regulators, and creditors, in making informed decisions regarding the allocation of resources. The core objective of accounting is to provide a clear, structured picture of the financial performance and position of a business, allowing for accountability, transparency, and effective decision-making.

At its core, accounting is often referred to as the "language of business," as it provides a framework for communicating financial data and ensuring that business operations are conducted with fiscal responsibility.

Nature of Accounting

The nature of accounting can be characterized by several distinct features:

1. **Recording:** One of the primary functions of accounting is to systematically record financial transactions. This is done using various accounting systems, primarily through journals and ledgers. Every financial event, from the sale of goods to the

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payment of expenses, is documented in a chronological manner.

2. **Classification:** After transactions are recorded, they are classified into relevant categories (such as assets, liabilities, revenue, and expenses). This step helps in organizing financial data, making it easier for analysts and stakeholders to interpret.
3. **Summarization:** The data recorded and classified is then summarized in financial statements, including the balance sheet, income statement, and cash flow statement. These summaries provide a snapshot of the financial position and performance of the entity at a particular point in time.
4. **Interpretation and Analysis:** Accounting does not stop at the preparation of financial statements; it also involves interpreting these statements to assess the financial health and performance of an entity. This step helps in making strategic business decisions and evaluating potential risks and opportunities.
5. **Communication:** Accounting serves as a means of communicating financial information to various stakeholders. The financial reports produced provide insight into an organization's financial health, profitability, and risk profile, aiding in decision-making and the allocation of capital.
6. **Regulatory and Ethical Framework:** Accounting is governed by established principles and standards,

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such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). These frameworks ensure consistency, transparency, and comparability of financial data across different organizations and industries.

Significance of Accounting

The significance of accounting is immense in the functioning of any organization, whether it is a small business, a multinational corporation, or a non-profit organization. Some of the key aspects of its significance include:

1. **Facilitates Decision-Making:** Accounting provides stakeholders, especially management, with the financial information needed to make informed business decisions. By analyzing financial statements, managers can assess performance, evaluate the viability of new projects, and make strategic decisions regarding investment, cost-cutting, or expansion.
2. **Ensures Transparency and Accountability:** By adhering to accounting principles and standards, organizations ensure that their financial operations are transparent and can be scrutinized by stakeholders. This fosters trust and confidence in the organization, which is particularly important for investors, regulators, and creditors.

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- 3. Regulatory Compliance:** Accounting ensures that businesses comply with financial regulations and laws. Accurate financial records are essential for meeting tax obligations, fulfilling legal requirements, and maintaining the integrity of financial markets. Non-compliance with accounting regulations can result in penalties, fines, and a loss of reputation.
- 4. Facilitates Performance Evaluation:** Accounting helps in evaluating the financial performance of an organization by providing key indicators such as profitability, liquidity, and solvency. These insights enable businesses to identify areas of improvement, track progress, and compare performance against competitors or industry benchmarks.
- 5. Attracts Investment:** Accurate and reliable financial reporting is crucial for attracting external investment. Investors and lenders assess the financial health of an organization before committing capital. Financial statements provide them with the necessary data to make decisions on whether to buy shares, lend money, or invest in the company.
- 6. Helps in Planning and Budgeting:** Accounting plays a key role in the financial planning and budgeting process. By analyzing historical financial data, businesses can forecast future performance, set realistic financial goals, and plan for various scenarios. This process ensures that resources are allocated efficiently and strategically.

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7. **Acts as a Historical Record:** Accounting provides an ongoing record of financial transactions, creating a historical financial timeline for the organization. This history is valuable for future planning and can be referred to in case of audits, disputes, or investigations.

Limitations of Accounting

Despite its significance, accounting has inherent limitations that may affect the accuracy and reliability of the financial information it provides. Some of the key limitations include:

1. **Historical Nature:** Accounting is inherently historical in nature. It records and reports financial data based on past transactions, which may not always reflect the current market conditions or future economic trends. This limits the ability of accounting to predict future performance or adapt to real-time changes in the market.
2. **Subjectivity in Judgment:** Many aspects of accounting involve subjective judgment, such as determining the value of assets, estimating the useful life of property, plant, and equipment, or recognizing revenue. Different accounting policies and assumptions may lead to variations in the way financial data is presented, potentially affecting comparability across organizations.

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3. **Excludes Non-Financial Information:** Accounting primarily focuses on financial data and does not include qualitative information such as employee satisfaction, brand reputation, or customer loyalty. While these factors can have a significant impact on the success of an organization, they are not captured in traditional accounting statements.
4. **Reliance on Estimates:** Accounting often requires estimates, such as in the case of bad debt provisions, depreciation, and inventory valuation. These estimates are based on historical data, assumptions, and judgment calls, which can introduce uncertainty and potential errors in financial reporting.
5. **Does Not Reflect Market Value:** In many cases, accounting uses historical cost for asset valuation, which may not reflect the current market value. This is particularly relevant for long-lived assets, such as property or machinery, where the market value may be significantly different from the original purchase price.
6. **Manipulation of Financial Statements:** While accounting is based on well-established standards, there is always the possibility of manipulation or "creative accounting." Companies may use certain accounting practices to present a more favorable financial picture than is actually the case. This can mislead stakeholders and create an illusion of financial health.

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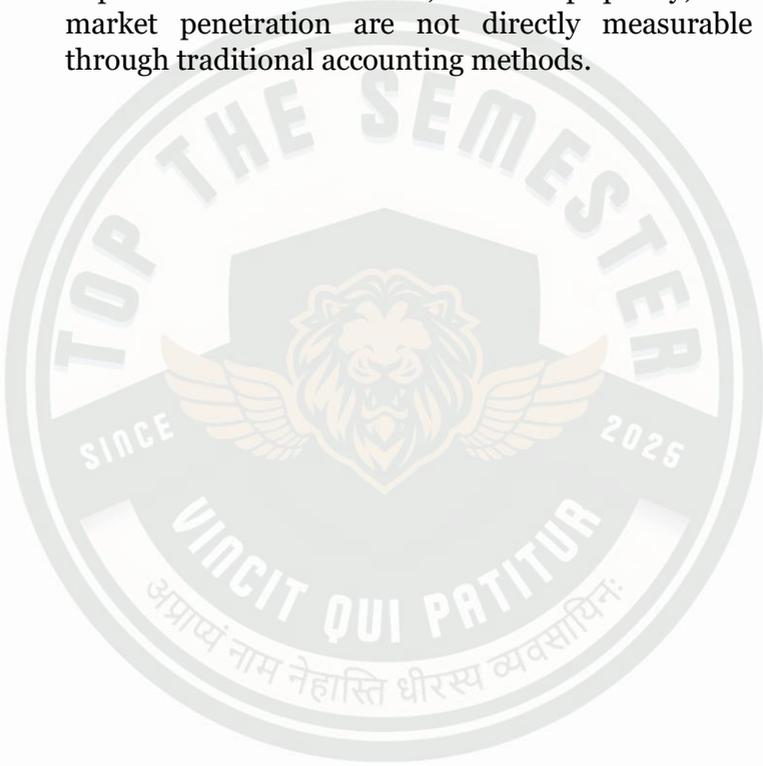
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7. **Not a Complete Measure of Performance:** Accounting focuses primarily on financial performance and does not fully capture an organization's operational or strategic performance. Aspects such as innovation, leadership quality, and market penetration are not directly measurable through traditional accounting methods.



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QUESTION: WHAT ARE ACCOUNTING STANDARDS? EXPLAIN ANY THREE ACCOUNTING STANDARDS IN DETAILS.

Accounting Standards are a set of guidelines and principles that dictate how financial transactions, events, and operations should be recorded, measured, and presented in financial statements. These standards ensure consistency, transparency, and comparability in the financial reporting process across different organizations, industries, and jurisdictions. By adhering to these standards, companies can provide stakeholders—such as investors, creditors, regulators, and auditors—with reliable and accurate financial information that is both understandable and comparable over time.

Development of Accounting Standards

The origins of accounting standards can be traced back to the early 20th century when business practices began to become more complex, especially in large, publicly traded companies. Prior to the establishment of formal standards, companies could use a variety of accounting methods, which made it difficult for stakeholders to compare financial statements and assess the financial performance of different entities.

The need for standardized accounting practices became more urgent as businesses grew and capital markets expanded. This led to the formation of several key organizations and regulatory bodies that sought to

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establish uniform accounting principles. The development of these standards took shape through the establishment of accounting boards and committees, both at the national and international levels.

Classification of Accounting Standards

Accounting standards can be broadly classified into two major categories:

1. **National Accounting Standards:** These standards are specific to individual countries and are often tailored to the economic, legal, and business environments of that country. In the United States, the most commonly used set of accounting standards is GAAP, developed and overseen by the FASB. GAAP is designed to address the unique financial reporting needs of American companies and stakeholders.

In India, accounting standards are set by the Institute of Chartered Accountants of India (ICAI). These standards are termed as Indian Accounting Standards (Ind AS), which are largely converged with International Financial Reporting Standards (IFRS). The adoption of Ind AS aims to improve the transparency and comparability of financial statements across the globe, especially for companies operating internationally.

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2. **International Accounting Standards (IFRS):**

IFRS are issued by the IASB and are designed to provide a global standard for financial reporting. These standards are aimed at ensuring that financial statements are comparable across different countries, thus facilitating global trade and investment. IFRS is used in over 140 countries, including European Union member states, Australia, and Canada. While some countries, such as the United States, still use GAAP, the trend is toward convergence between IFRS and national standards to enhance comparability.

Core Principles of Accounting Standards

At the heart of accounting standards lie several fundamental principles that guide the preparation of financial statements. These principles are designed to ensure that financial reporting is clear, accurate, and reflective of the underlying financial realities of a company.

1. **Accrual Basis of Accounting:** This principle requires that revenues and expenses be recorded when they are earned or incurred, rather than when cash is received or paid. This method ensures that financial statements accurately reflect the financial position of a company at any given time, regardless of cash flow movements.

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2. **Consistency:** Accounting standards require consistency in the application of accounting principles across reporting periods. Once a company adopts a particular accounting method, it should continue to use the same method in subsequent periods unless there is a valid reason to change. This consistency allows for meaningful comparisons between financial statements over time.
3. **Going Concern:** This principle assumes that a company will continue its operations indefinitely, unless there is evidence to the contrary. This assumption is important because it influences the way assets and liabilities are valued. For example, assets are generally recorded at historical cost rather than liquidation value, reflecting the ongoing nature of the company.
4. **Relevance:** Financial information must be relevant to the users of financial statements. This means that it should have the capacity to influence the decisions of users, such as investors, creditors, and managers. Relevant information is timely, complete, and useful for decision-making.
5. **Reliability:** Accounting information should be reliable, meaning it must be complete, neutral, and free from error or bias. The reliability of financial statements is essential for building trust among stakeholders and ensuring that the financial data reflects the true state of the company.

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The core purpose of accounting standards is to:

- **Promote uniformity:** By ensuring that similar transactions are accounted for in the same way, accounting standards prevent ambiguity and confusion.
- **Enhance comparability:** By using the same set of rules, financial statements from different companies can be compared on a like-for-like basis.
- **Build trust:** With consistent and reliable financial reporting, users of financial statements can have confidence in the accuracy and integrity of financial information.
- **Transparency and Accountability:** These standards increase transparency in financial reporting, thus holding companies accountable for their financial activities. Transparent financial reporting builds trust with stakeholders and helps prevent fraudulent practices.

Indian Accounting Standards (Ind AS)

Ind AS refers to a set of accounting standards issued by the ICAI for entities in India, which are largely aligned with IFRS. These standards are aimed at providing a common accounting framework that enhances the comparability, reliability, and transparency of financial statements. Ind AS replaced the previous set of accounting standards known as **AS (Accounting**

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Standards), with the transition aiming to improve the quality of financial reporting in India.

The transition to Ind AS was implemented in phases, beginning with large listed companies and gradually extending to other companies based on their size and industry sector. This change was intended to align India's accounting practices with global standards, facilitating cross-border investments and improving the quality of financial reporting.

Three Key Accounting Standards

1. Ind AS 1: Presentation of Financial Statements

Overview: Ind AS 1 prescribes the overall framework for the presentation of financial statements, including their structure, contents, and the required disclosures. It ensures that financial statements present a true and fair view of the financial performance and position of an entity. This standard establishes guidelines for the presentation of the balance sheet, income statement, cash flow statement, and statement of changes in equity.

Key Features:

- **True and Fair View:** The financial statements must provide a true and fair representation of the entity's financial position, performance, and cash flows.
- **Component of Financial Statements:** Ind AS 1 outlines the components of financial statements,

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including the balance sheet, statement of profit and loss, statement of changes in equity, and cash flow statement.

- **Current and Non-Current Distinction:** It requires companies to classify assets and liabilities into current and non-current categories, ensuring that financial information is presented clearly and consistently.
- **Going Concern Assumption:** Financial statements should be prepared on the assumption that the company will continue as a going concern, i.e., it will not cease its operations in the foreseeable future.

Example:

If a company is preparing its financial statements as of 31st March 2023, it must include a balance sheet showing the financial position as of that date, a profit and loss statement summarizing the revenues and expenses for the period, and a cash flow statement outlining the cash inflows and outflows during the period. The company must also disclose any significant events that might affect its ability to continue as a going concern.

2. Ind AS 16: Property, Plant and Equipment (PPE)

Overview: Ind AS 16 outlines the accounting treatment for property, plant, and equipment, focusing on their recognition, measurement, depreciation, and

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impairment. This standard ensures that companies account for their tangible fixed assets in a consistent and transparent manner.

Key Features:

- **Initial Recognition:** An asset is recognized as PPE if it is intended for use in production, supply of goods or services, or for rental to others. It must be expected to be used for more than one period.
- **Measurement at Cost:** PPE is initially recognized at cost, which includes all costs directly attributable to bringing the asset into working condition for its intended use.
- **Subsequent Measurement:** After initial recognition, companies can choose between two models for subsequent measurement: the cost model or the revaluation model. The cost model carries the asset at cost less accumulated depreciation and impairment losses, while the revaluation model allows companies to carry the asset at its fair value, provided that revaluations are done regularly.
- **Depreciation:** Ind AS 16 requires that PPE assets be depreciated over their useful life, and the depreciation method should reflect the pattern of consumption of the asset's economic benefits.
- **Impairment:** If the carrying amount of an asset exceeds its recoverable amount, the asset must be written down to its recoverable amount, resulting in an impairment loss.

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Example:

A company purchases machinery for ₹10,00,000, including installation costs, which will be used in its production process for 10 years. Under Ind AS 16, the company must recognize the machinery at ₹10,00,000 and depreciate it over its useful life. If the machinery's value decreases due to obsolescence or other factors, the company must assess whether an impairment loss is necessary.

3. Ind AS 18: Revenue

Overview: Ind AS 18 provides guidance on recognizing and measuring revenue arising from the sale of goods, rendering of services, and the use of entity assets by others yielding interest, royalties, and dividends. Revenue recognition is a fundamental aspect of financial accounting, as it impacts the company's reported performance and financial position.

Key Features:

- **Sale of Goods:** Revenue from the sale of goods is recognized when the significant risks and rewards of ownership have been transferred to the buyer, usually when the goods are delivered.
- **Rendering of Services:** Revenue from services is recognized by reference to the stage of completion of the transaction at the reporting

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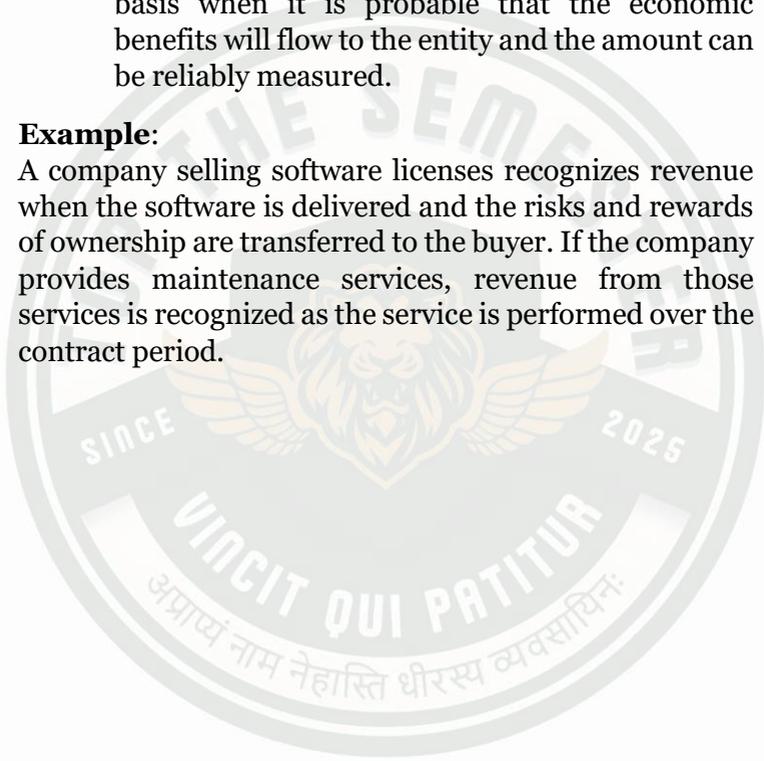
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date, often measured by the proportion of services performed.

- **Interest, Royalties, and Dividends:** Revenue from these sources is recognized on an accrual basis when it is probable that the economic benefits will flow to the entity and the amount can be reliably measured.

Example:

A company selling software licenses recognizes revenue when the software is delivered and the risks and rewards of ownership are transferred to the buyer. If the company provides maintenance services, revenue from those services is recognized as the service is performed over the contract period.



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Q4. CREATE JOURNAL ENTRIES FOR THE FOLLOWING TRANSACTIONS:-

- 1. MR. HARISH STARTED BUSINESS WITH CASH RS. 10,000**
- 2. BOUGHT GOODS FROM MR. MANOHAR RS. 5000**
- 3. PURCHASE FITTINGS FOR CASH RS. 800**
- 4. SOLD GOODS TO MR. CHARANJEET RS. 1600**
- 5. PAID MR. MANOHAR RS. 3000**
- 6. SOLD GOODS MR. VADVA RAM RS. 2000**
- 7. RECEIVED FROM MR. CHARANJEET RS. 1540 AND ALLOWED HIM DISCOUNT RS. 1540 AND ALLOWED HIM DISCOUNT RS. 60**
- 8. PAID WAGES RS. 80**
- 9. BOUGHT GOODS FOR CASH RS. 600**
- 10. SOLD GOODS TO MR. RAMESH RS. 3400**
- 11. PURCHASE GOODS FROM MR. PURSHOTTAM RS. 2600**
- 12. PAID MANOHAR IN SETTLEMENT RS. 1900 AND DISCOUNT ALLOWED BY HIM RS. 100**

Journal entries are the first step in the accounting cycle and are used to record all business transactions in the

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accounting system of a business. As per the double-entry system, every transaction affects at least two accounts. The journal entries for the given transactions are as follows:

1. Mr. Harish Started Business with Cash Rs. 10,000

This transaction reflects the owner's investment in the business, and thus cash is being injected into the business. In accounting, the business entity is considered separate from its owner, meaning this is a capital transaction.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Cash	10,000	
	To Capital Account		10,000

Explanation:

- **Cash** is debited because the business is receiving cash, which increases the asset.
- **Capital Account** is credited because the owner's investment is increasing the equity of the business.

2. Bought Goods from Mr. Manohar Rs. 5,000

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This transaction involves purchasing goods on credit, meaning the business now owes Mr. Manohar Rs. 5,000.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Purchases	5,000	
	To Mr. Manohar (Creditor)		5,000

Explanation:

- **Purchases** is debited because goods are being acquired, which is an expense and increases inventory.
- **Mr. Manohar (Creditor)** is credited, representing the liability to pay for the goods.

3. Purchased Fittings for Cash Rs. 800

In this case, the business acquires fittings by paying cash. This transaction affects both the asset (fittings) and the cash account.

Date Particulars Debit (Rs.) Credit (Rs.)

	Fittings	800	
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Date Particulars Debit (Rs.) Credit (Rs.)

To Cash 800

Explanation:

- **Fittings** is debited to show the increase in fixed assets.
- **Cash** is credited to reflect the outflow of cash for the purchase.

4. Sold Goods to Mr. Charanjeet Rs. 1,600

Here, goods are sold to Mr. Charanjeet on credit. The revenue from sales increases, and an accounts receivable is created.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Accounts Receivable (Mr. Charanjeet)	1,600	
	To Sales		1,600

Explanation:

- **Accounts Receivable** is debited because the business expects to receive the payment in the future, which increases the asset.

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- **Sales** is credited, indicating that revenue has been earned by selling goods.

5. Paid Mr. Manohar Rs. 3,000

This transaction involves a payment to Mr. Manohar, reducing the liability towards him.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Mr. Manohar (Creditor)	3,000	
	To Cash		3,000

Explanation:

- **Mr. Manohar (Creditor)** is debited to reduce the liability, as the amount owed to him is being paid off.
- **Cash** is credited because cash is being used to make the payment.

6. Sold Goods to Mr. Vadva Ram Rs. 2,000

Similar to the previous sale, goods are sold to Mr. Vadva Ram on credit.

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Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Accounts Receivable (Mr. Vadva Ram)	2,000	
	To Sales		2,000

Explanation:

- **Accounts Receivable** is debited, reflecting the business's claim to receive payment in the future.
- **Sales** is credited, showing that revenue has been generated from the sale.

7. Received from Mr. Charanjeet Rs. 1,540 and Allowed Him Discount Rs. 60

In this transaction, the business receives payment from Mr. Charanjeet, but a discount is given. The receipt reduces the accounts receivable, and the discount is treated as a reduction in revenue.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Cash	1,540	
	Discount Allowed	60	

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Date	Particulars	Debit (Rs.)	Credit (Rs.)
	To Accounts Receivable (Mr. Charanjeet)	1,600	

Explanation:

- **Cash** is debited, representing the receipt of money from Mr. Charanjeet.
- **Discount Allowed** is debited, which reduces the total revenue from the sale.
- **Accounts Receivable** is credited, indicating that the outstanding balance with Mr. Charanjeet is now settled.

8. Paid Wages Rs. 80

This transaction involves paying wages, an expense that reduces the business's cash balance.

Date Particulars Debit (Rs.) Credit (Rs.)

	Wages Expense	80	
	To Cash		80

Explanation:

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- **Wages Expense** is debited, as the payment of wages is an expense for the business.
- **Cash** is credited to show the outflow of funds.

9. Bought Goods for Cash Rs. 600

This transaction reflects a cash purchase of goods, which increases inventory and decreases cash.

Date Particulars Debit (Rs.) Credit (Rs.)

Purchases	600	
To Cash		600

Explanation:

- **Purchases** is debited because goods are being acquired, which increases inventory.
- **Cash** is credited because cash is used to pay for the goods.

10. Sold Goods to Mr. Ramesh Rs. 3,400

Goods are sold to Mr. Ramesh on credit, which increases sales revenue and creates an accounts receivable.

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Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Accounts Receivable (Mr. Ramesh)	3,400	
	To Sales		3,400

Explanation:

- **Accounts Receivable** is debited, reflecting the amount the business expects to receive from Mr. Ramesh.
- **Sales** is credited, recording the revenue generated from the sale.

11. Purchased Goods from Mr. Purshottam Rs. 2,600

Goods are purchased from Mr. Purshottam on credit, resulting in an increase in inventory and a liability to pay Mr. Purshottam.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Purchases	2,600	
	To Mr. Purshottam (Creditor)		2,600

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Explanation:

- **Purchases** is debited to reflect the increase in inventory.
- **Mr. Purshottam (Creditor)** is credited to show the outstanding liability.

12. Paid Mr. Manohar in Settlement Rs. 1,900 and Discount Allowed by Him Rs. 100

In this final transaction, Mr. Manohar is paid Rs. 1,900 in settlement of his account, and a discount of Rs. 100 is allowed by him. The settlement reduces the liability and the discount reduces the expense associated with the original purchase.

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Mr. Manohar (Creditor)	2,000	
	Discount Received	100	
	To Cash		1,900

Explanation:

- **Mr. Manohar (Creditor)** is debited to reduce the liability as the account is being settled.

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- **Discount Received** is debited because the business is receiving a discount, which reduces the purchase cost.
- **Cash** is credited to reflect the payment made to Mr. Manohar.

(AN ALTERNATIVE WAY)

1. **Mr. Harish started business with cash Rs. 10,000**

Journal Entry:

Cash A/C Dr. 10,000

To, Harish's Capital A/C 10,000

(Business started by Mr. Harish with cash)

2. **Bought goods from Mr. Manohar Rs. 5,000**

Journal Entry:

Purchases A/C Dr. 5,000

To, Manohar A/C 5,000

(Goods purchased on credit from Mr. Manohar)

3. **Purchase fittings for cash Rs. 800**

Journal Entry:

Fittings A/C Dr. 800

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To, Cash A/C 800

(Fittings purchased for cash)

4. **Sold goods to Mr. Charanjeet Rs. 1,600**

Journal Entry:

Charanjeet A/C Dr. 1,600

To, Sales A/C 1,600

(Goods sold on credit to Mr. Charanjeet)

5. **Paid Mr. Manohar Rs. 3,000**

Journal Entry:

Manohar A/C Dr. 3,000

To, Cash A/C 3,000

(Payment made to Mr. Manohar)

6. **Sold goods Mr. Vadva Ram Rs. 2,000**

Journal Entry:

Vadva Ram A/C Dr. 2,000

To, Sales A/C 2,000

(Goods sold on credit to Mr. Vadva Ram)

7. **Received from Mr. Charanjeet Rs. 1,540 and allowed him discount Rs. 60**

Journal Entry:

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Cash A/C Dr. 1,540

Discount Allowed A/C Dr. 60

To, Charanjeet A/C 1,600

(Cash received from Mr. Charanjeet, discount allowed)

8. Paid wages Rs. 80

Journal Entry:

Wages A/C Dr. 80

To, Cash A/C 80

(Wages paid in cash)

9. Bought goods for cash Rs. 600

Journal Entry:

Purchases A/C Dr. 600

To, Cash A/C 600

(Goods purchased for cash)

10. Sold goods to Mr. Ramesh Rs. 3,400

Journal Entry:

Ramesh A/C Dr. 3,400

To, Sales A/C 3,400

(Goods sold on credit to Mr. Ramesh)

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11. **Purchase goods from Mr. Purshottam Rs. 2,600**

Journal Entry:

Purchases A/C Dr. 2,600

To, Purshottam A/C 2,600

(Goods purchased on credit from Mr. Purshottam)

12. **Paid Manohar in settlement Rs. 1,900 and discount allowed by him Rs. 100**

Journal Entry:

Manohar A/C Dr. 2,000

To, Cash A/C 1,900

To, Discount Received A/C 100

(Settlement made to Manohar, discount received)

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Q5. HOW DO YOU PREPARE TRADING ACCOUNTS, PROFIT AND LOSS ACCOUNTS AND BALANCE SHEETS AS PER SCHEDULE-III (THREE) OF COMPANIES ACT 2013.

The **Companies Act, 2013** provides a comprehensive legal framework for accounting and financial reporting in India. A key feature of the Act is **Schedule-III**, which outlines the **format and preparation of financial statements** for companies. This schedule applies to **both listed and unlisted companies** operating in India, and its provisions ensure uniformity in the presentation of financial statements, enhancing the clarity and comparability of financial reporting.

The **Schedule-III** of the Companies Act, 2013 consists of two parts:

1. **Part I:** Applies to companies that are required to prepare financial statements in accordance with the prescribed accounting standards under the Act.
2. **Part II:** Provides formats for the **balance sheet, profit and loss account, and notes to accounts** for a company.

The financial statements required to be prepared under Schedule-III are:

1. **Trading Account**
2. **Profit and Loss Account**
3. **Balance Sheet**

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Trading Account Preparation:

A Trading Account is prepared to determine the gross profit or loss of a company from its core business activities, primarily involving the buying and selling of goods. This account essentially focuses on direct revenue and costs, excluding operational and non-operational expenses.

Trading Account Structure:

Key Components of the Trading Account:

- **Sales (Revenue from Operations):** The total revenue earned from the sale of goods or services. For a manufacturing company, this would also include the sale of finished goods produced by the company.
- **Cost of Goods Sold (COGS):** This includes the direct costs associated with the production or purchase of goods sold. The formula for COGS is:
- **Gross Profit or Loss:** The difference between *Sales* and *COGS* leads to the *Gross Profit* or *Gross Loss*. If *Sales* exceed *COGS*, the company records a *Gross Profit*, whereas if *COGS* exceeds *Sales*, it records a *Gross Loss*.

Trading Account Structure

The formula used for preparing the trading account is:

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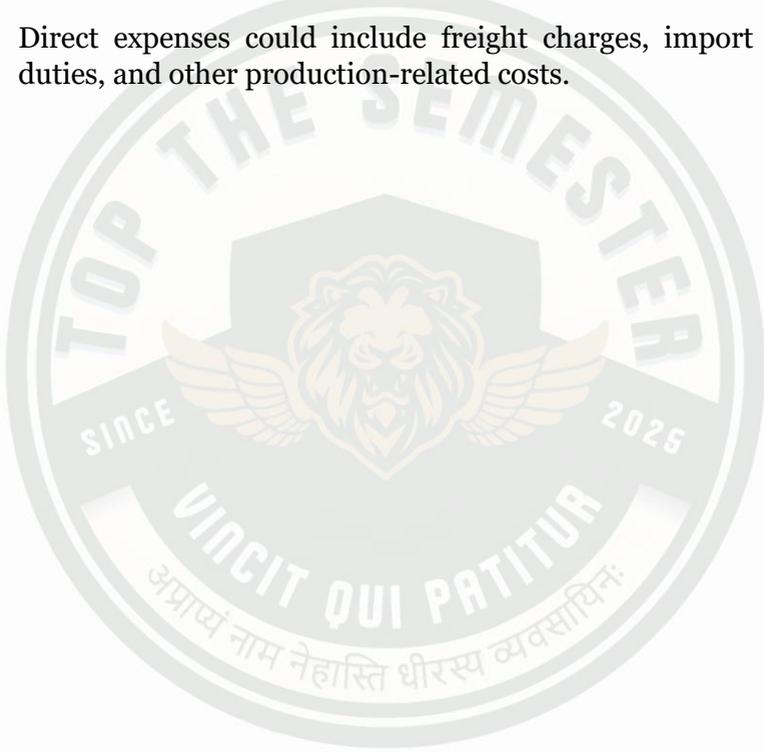
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Gross Profit or Loss = Sales – Cost of Goods Sold

Where,

COGS = Opening Stock + Purchases + Direct
Expenses – Closing Stock

Direct expenses could include freight charges, import duties, and other production-related costs.



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Format of Trading Account as per Schedule III:

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	XXXX	By Sales	XXXX
To Purchases	XXXX	By Closing Stock	XXXX
To Direct Expenses	XXXX		
To Gross Profit c/d	XXXX		
Total	XXXX	Total	XXXX

Profit and Loss Account Preparation:

After preparing the Trading Account, the next step is the Profit and Loss Account, which measures the company's operating efficiency by accounting for indirect revenues and expenses. The Profit and Loss Account provides an overall view of the company's profit or loss after considering both direct and indirect costs.

Key Components of the Profit and Loss Account:

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- **Indirect Expenses:** These expenses are not directly related to the production of goods and services but are essential for the operations of the business. Examples include administrative expenses, selling expenses, and depreciation.
- **Other Income:** This includes revenue that does not arise from core business operations, such as interest income, dividend income, or profit from the sale of assets.
- **Net Profit or Loss:** The difference between the total income (including *Other Income*) and total expenses (including *Indirect Expenses*) results in the net profit or net loss for the accounting period.

Format of Profit and Loss Account as per Schedule III:

Particulars	Amount (₹)	Particulars	Amount (₹)
To Office and Administrative Expenses	XXXX	By Gross Profit b/d	XXXX
To Selling Expenses	XXXX	By Other Income	XXXX

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Particulars	Amount (₹)	Particulars	Amount (₹)
To Depreciation	XXXX	By Profit on Sale of Assets	XXXX
To Finance Costs	XXXX		
To Net Profit (or Loss)	XXXX		
Total	XXXX	Total	XXXX

The *Net Profit* or *Net Loss* calculated in the Profit and Loss Account is carried forward to the *Balance Sheet* under "Surplus" in the equity section.

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Balance Sheet Preparation:

The Balance Sheet is a snapshot of a company's financial position at the end of an accounting period. It provides a detailed listing of the company's assets, liabilities, and equity.

The format as per Schedule III of the Companies Act, 2013 for a Balance Sheet is:

A. ASSETS

1. Non-current assets
 - Fixed assets
 - Non-current investments
 - Deferred tax assets
 - Long term loans and advances
 - Other non-current assets
2. Current assets
 - Current investments
 - Inventories
 - Trade receivables
 - Cash and cash equivalents
 - Short-term loans and advances
 - Other current assets

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B. EQUITY AND LIABILITIES

1. Shareholders' funds
 - Share capital
 - Reserves and surplus
2. Share application money pending allotment
3. Non-current liabilities
 - Long-term borrowings
 - Deferred tax liabilities
 - Other Long term liabilities
 - Long-term provisions
4. Current liabilities
 - Short-term borrowings
 - Trade payables
 - Other current liabilities
 - Short-term provisions

The Balance Sheet must always satisfy the equation:

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

Key Components of the Balance Sheet:

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- **Assets:** These are the resources controlled by the company, divided into two categories:
 - *Non-Current Assets (Fixed Assets):* These include tangible assets like property, plant, equipment, intangible assets like patents, and long-term investments.
 - *Current Assets:* These include assets that are expected to be realized within a year, such as inventories, trade receivables, and cash equivalents.
- **Liabilities:** These are the obligations of the company, also divided into two categories:
 - *Non-Current Liabilities (Long-Term Liabilities):* These are obligations not due within a year, like long-term loans or bonds payable.
 - *Current Liabilities:* These are short-term obligations expected to be settled within a year, such as trade payables, short-term borrowings, and accrued expenses.
- **Equity:** This represents the owner's residual interest in the assets of the company after deducting liabilities. It includes share capital, reserves, and surplus, including the *Net Profit* carried from the Profit and Loss Account.

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Format of Balance Sheet as per Schedule III:

Equity and Liabilities:

Particulars	Amount (₹)	Particulars	Amount (₹)
Shareholders' Funds		Non-Current Liabilities	
- Share Capital	XXXX	- Long-Term Borrowings	XXXX
- Reserves and Surplus	XXXX	- Deferred Tax Liabilities	XXXX
Non-Current Liabilities		Current Liabilities	
- Long-Term Borrowings	XXXX	- Short-Term Borrowings	XXXX
- Other Non-Current Liabilities	XXXX	- Trade Payables	XXXX
Current Liabilities		Total Liabilities	XXXX
- Short-Term Borrowings	XXXX		
- Trade Payables	XXXX		

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Assets:

Particulars	Amount (₹)	Particulars	Amount (₹)
Non-Current Assets		Current Assets	
- Fixed Assets	XXXX	- Inventories	XXXX
- Intangible Assets	XXXX	- Trade Receivables	XXXX
Current Assets		- Cash and Bank Balances	XXXX
- Inventories	XXXX	Total Assets	XXXX
- Trade Receivables	XXXX		
- Cash and Cash Equivalents	XXXX		

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WHAT ARE THE CAUSES OF DEPRECIATION AND THE OBJECTIVES OF PROVIDING DEPRECIATION? EXPLAIN THE TWO METHODS OF PROVIDING DEPRECIATION

Causes of Depreciation

Depreciation is the process by which an asset's value is allocated over its useful life. The reduction in value arises from a combination of factors that affect the asset's physical or economic life. These causes can be classified into several broad categories:

1. **Wear and Tear:** The physical deterioration of assets over time is one of the most common causes of depreciation. This is especially true for tangible assets like machinery, vehicles, and buildings, which are used in daily operations. As these assets are subjected to operational stress, their value declines. For instance, a factory machine used for production may lose efficiency or break down due to prolonged use.
2. **Obsolescence:** Technological advances can render certain assets obsolete, even if they are still in usable condition. For example, the advent of newer, more efficient machinery or vehicles may decrease the value of older models, even though they are still functional. This is particularly relevant in industries like electronics or manufacturing, where innovation happens rapidly.

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3. **Natural Factors:** Assets exposed to environmental factors such as harsh weather conditions, pollution, or seismic activity can deteriorate more quickly. For example, a building exposed to high humidity or coastal environments may suffer from faster deterioration, reducing its market value.
4. **Age of the Asset:** As an asset ages, the efficiency and utility it offers often decrease, leading to depreciation. This is a natural process that affects all physical assets. For instance, over time, a vehicle's engine may lose performance, and its operational lifespan shortens.
5. **Usage:** The extent of use of an asset also plays a role in depreciation. The more an asset is used, the faster it tends to depreciate. For example, a delivery truck used for heavy loads on rough roads will experience greater wear and tear compared to a truck used sparingly or on smooth highways.

Objectives of Providing Depreciation

The provision of depreciation serves several key objectives, primarily aimed at reflecting the true financial position of an entity. These objectives include:

1. **Accurate Matching of Expenses and Revenues:** Depreciation allows businesses to match the cost of using an asset with the revenue generated from it over time. Without depreciation, expenses would be incurred only when the asset is purchased,

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while the corresponding benefit (revenue) would be realized over a much longer period. This would result in mismatched financial statements. By recognizing depreciation, businesses can allocate a portion of the asset's cost to each period in which it contributes to revenue.

- 2. Reflecting the True Value of Assets:** Depreciation helps maintain the accuracy of asset valuations on the balance sheet. As assets lose value over time, depreciation ensures that their carrying value is updated to reflect this reduction, rather than overstating their worth.
- 3. Tax Deductibility:** In most tax systems, including India, depreciation is considered an allowable expense that reduces taxable income. By accounting for depreciation, a company lowers its taxable income, which in turn reduces its tax liability. This is an important consideration for businesses seeking to manage their tax burdens effectively.
- 4. Sustainable Financial Planning:** Depreciation helps businesses plan for future capital expenditures. Since assets depreciate, it is important for businesses to set aside funds for replacing assets when they reach the end of their useful lives. By systematically accounting for depreciation, companies can better anticipate future cash needs.
- 5. Compliance with Accounting Standards:** Depreciation ensures that businesses comply with

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generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), both of which require depreciation to be calculated and reported for long-term assets.

Methods of Providing Depreciation

There are several methods available for providing depreciation, but two of the most commonly used methods are the **Straight-Line Method** and the **Declining Balance Method**. These methods are widely accepted in accounting practices, including in India, and each has its specific use cases and impact on financial statements.

1. Straight-Line Method

The straight-line method of depreciation is the most simple and widely used method. Under this method, depreciation is allocated evenly over the useful life of the asset. It assumes that the asset will lose its value at a consistent rate over its lifetime.

Formula:

$$\text{Depreciation Expense} = \frac{(\text{Cost of Asset} - \text{Salvage Value})}{\text{Useful life of the asset}}$$

Where:

- **Cost of the asset** is the initial purchase cost.
- **Salvage value** is the estimated residual value of the asset at the end of its useful life.

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- **Useful life** is the expected number of years the asset will be in use.

Merits

- Simplicity in calculation.
- Ensures stable and predictable charges.
- Suitable where asset utility is uniform over time.

Limitations

- Ignores the time value of money.
- Does not reflect higher utility in earlier years of asset life.
- Asset replacement fund may be inadequate if inflation is high.

Written-Down Value Method (WDV) / Diminishing Balance Method

The Written-Down Value Method, also known as the **Declining Balance Method** or **Reducing Balance Method**, charges depreciation at a fixed percentage on the **book value** of the asset at the beginning of each

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accounting period. Because the base (book value) decreases annually, the depreciation expense is higher in the earlier years and progressively lower in the later years.

Mathematically:

Annual Depreciation = Depreciation Rate \times Book Value at Beginning of Year

Features

1. Depreciation is computed on the diminishing balance, not the original cost.
2. The annual depreciation charge declines over the asset's life.
3. The asset's book value never falls exactly to zero, though in practice, it is written off to residual value after useful life.
4. This method better reflects the **Matching Concept** where assets yield higher benefits in earlier years and declining benefits thereafter.

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Merits

- Conforms to actual asset usage patterns where efficiency declines over time.
- Provides tax advantages in early years (because of higher depreciation deductions).
- Reflects a more conservative view, ensuring early recognition of expenses.

Limitations

- Complex compared to SLM.
- Does not reduce asset value to zero within a finite number of years.
- Less suitable for assets with uniform utility across years (e.g., buildings).

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ON 1ST APRIL 2017, ZENITH LTD. PURCHASED A BUILDING FOR RS. 20,00,000. IT WAS DECIDED TO CHARGE DEPRECIATION @10% P.A. USING THE WRITTEN DOWN VALUE, METHOD (WDV). HOWEVER, ON 31ST MARCH 2020, IT WAS DECIDED TO CHANGE THE METHOD OF DEPRECIATION TO STRAIGHT-LINE METHOD. THE REMAINING USEFUL LIFE OF THE BUILDING IS ESTIMATED TO BE 5 YEARS WITH A RESIDUAL VALUE OF RS. 100000. YOU ARE REQUIRED TO PREPARE BUILDING A/C.

Depreciation in Accounting

Depreciation is the **systematic allocation of the depreciable amount of an asset over its useful life**. According to **Ind AS 16 (Property, Plant and Equipment)** and **IAS 16 (under IFRS)**, depreciation reflects the consumption of the economic benefits embodied in the asset rather than a fall in its market value.

Two widely accepted methods are:

1. **Written Down Value Method (WDV)** – also called **Diminishing Balance Method**, where depreciation is charged at a fixed percentage on the reducing balance of the asset.

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2. **Straight Line Method (SLM)** – where depreciation is charged uniformly every year on the depreciable amount.

Regulatory Framework

- **Section 123 of the Indian Companies Act, 2013**, read with **Schedule II**, provides the basis for calculating depreciation.
- **Ind AS 8: Accounting Policies, Changes in Accounting Estimates and Errors** governs the treatment when there is a change in depreciation method. As per this standard:
 - A change in depreciation method is considered a **change in accounting estimate**, not a change in policy.
 - It must be applied **prospectively** from the date of change.
 - The carrying amount of the asset as on the date of change is depreciated over the remaining useful life.

Case Illustration – Zenith Ltd.

- **Date of Purchase:** 1st April 2017
- **Cost of Building:** ₹20,00,000
- **Depreciation Rate (initially):** 10% per annum WDV

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- **Change:** On 31st March 2020, switch to **SLM**.
- **Remaining Useful Life:** 5 years
- **Residual Value:** ₹1,00,000

We must:

1. Compute depreciation under WDV for 2017–18, 2018–19, and 2019–20.
2. Ascertain the **book value as on 31st March 2020**.
3. Switch to SLM for the remaining 5 years.
4. Prepare the **Building Account** accordingly.

Depreciation under WDV @ 10%

- **2017–18:**

Depreciation = 10% of 20,00,000 = ₹2,00,000

Closing Balance = 20,00,000 - 2,00,000 = ₹18,00,000

- **2018–19:**

Depreciation = 10% of 18,00,000 = ₹1,80,000

Closing Balance = 18,00,000 - 1,80,000 = ₹16,20,000

- **2019–20:**

Depreciation = 10% of 16,20,000 = ₹1,62,000

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Closing Balance = 16,20,000 - 1,62,000 =
₹14,58,000

**Carrying Amount on 31st March 2020 =
₹14,58,000**

**Depreciation under SLM (from 2020-21
onwards)**

- Depreciable Amount = Carrying Amount -
Residual Value
= 14,58,000 - 1,00,000 = ₹13,58,000
- Useful Life = 5 years
- Annual Depreciation = 13,58,000 ÷ 5 = ₹2,71,600

Thus, from 2020-21 to 2024-25, depreciation =
₹2,71,600 annually.

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Building Account (Ledger Format)

Building Account

(Showing depreciation under WDV up to 2019–20, thereafter SLM)

Date	Particulars	Debit (₹)	Credit (₹)	Balance (₹)
01-04-2017	To Bank A/c (Purchase)	20,00,000	–	20,00,000
31-03-2018	By Depreciation A/c	–	2,00,000	18,00,000
31-03-2019	By Depreciation A/c	–	1,80,000	16,20,000
31-03-2020	By Depreciation A/c	–	1,62,000	14,58,000

Change to SLM method

31-03-2021	By Depreciation A/c	– 2,71,600	11,86,400
31-03-2022	By Depreciation A/c	– 2,71,600	9,14,800

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31-03-2023	By Depreciation A/c	- 2,71,600	6,43,200
31-03-2024	By Depreciation A/c	- 2,71,600	3,71,600
31-03-2025	By Depreciation A/c	- 2,71,600	1,00,000 (Residual Value)

(FOR UNDERSTANDING PURPOSE ONLY)

Year-wise Journal Entries

(1) Year Ended 31 March 2018

1. To record depreciation (WDV 10%)

Depreciation A/c Dr ₹2,00,000
 To Building A/c ₹2,00,000

(Being depreciation provided on building @10% WDV)

2. To close depreciation to P&L

Profit & Loss A/c Dr ₹2,00,000
 To Depreciation A/c ₹2,00,000

(Being depreciation transferred to P&L)

(2) Year Ended 31 March 2019

1. To record depreciation (WDV on ₹18,00,000)

Depreciation A/c Dr ₹1,80,000

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To Building A/c ₹1,80,000

(Being depreciation provided @10% on WDV)

2. To close depreciation to P&L

Profit & Loss A/c Dr ₹1,80,000

To Depreciation A/c ₹1,80,000

(Being depreciation transferred to P&L)



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(3) Year Ended 31 March 2020

1. To record depreciation (WDV on ₹16,20,000)

Depreciation A/c Dr ₹1,62,000

To Building A/c ₹1,62,000

(Being depreciation provided @10% on WDV)

2. To close depreciation to P&L

Profit & Loss A/c Dr ₹1,62,000

To Depreciation A/c ₹1,62,000

(Being depreciation transferred to P&L)

Important: On **31 March 2020**, the decision to change the method to SLM is a **change in estimate** under **Ind AS 8**. **No journal entry** is passed to “restate” prior years. The carrying amount ₹14,58,000 becomes the new basis for future depreciation.

how the balance of the building asset reduced:

- **Original cost (1 April 2017): ₹20,00,000**
- After 2017–18 depreciation (₹2,00,000):
₹18,00,000
- After 2018–19 depreciation (₹1,80,000):
₹16,20,000
- After 2019–20 depreciation (₹1,62,000):
₹14,58,000

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So on **31 March 2020**, just before changing the method, the **book value (carrying amount) of the building** in the ledger is **₹14,58,000**.

From this point onward, when the method changes to **Straight Line Method (SLM)**, that **₹14,58,000 becomes the opening balance** (the base value) on which we calculate depreciation for the next 5 years. We then deduct the residual value (₹1,00,000) and spread the remaining depreciable amount equally ($₹13,58,000 \div 5 = ₹2,71,600$ per year).

(4) Year Ended 31 March 2021 (First year under SLM)

1. To record depreciation (SLM: ₹2,71,600)

Depreciation A/c Dr ₹2,71,600

To Building A/c ₹2,71,600

(Being depreciation provided on carrying amount over remaining useful life by SLM)

2. To close depreciation to P&L

Profit & Loss A/c Dr ₹2,71,600

To Depreciation A/c ₹2,71,600

(Being depreciation transferred to P&L)

(5) Year Ended 31 March 2022

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1. *Depreciation A/c* Dr ₹2,71,600
 To Building A/c ₹2,71,600
2. *Profit & Loss A/c* Dr ₹2,71,600
 To Depreciation A/c ₹2,71,600

(6) Year Ended 31 March 2023

1. *Depreciation A/c* Dr ₹2,71,600
 To Building A/c ₹2,71,600
2. *Profit & Loss A/c* Dr ₹2,71,600
 To Depreciation A/c ₹2,71,600

(7) Year Ended 31 March 2024

1. *Depreciation A/c* Dr ₹2,71,600
 To Building A/c ₹2,71,600
2. *Profit & Loss A/c* Dr ₹2,71,600
 To Depreciation A/c ₹2,71,600

(8) Year Ended 31 March 2025 (Final year to reach residual value)

1. *Depreciation A/c* Dr ₹2,71,600
 To Building A/c ₹2,71,600
2. *Profit & Loss A/c* Dr ₹2,71,600
 To Depreciation A/c ₹2,71,600

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After the 2024–25 charge, the **carrying amount** equals the **residual value** ₹1,00,000, aligning with Ind AS 16's requirement that assets not be depreciated below residual value.



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EXPLAIN THE DIFFERENT TYPES OF SHARE CAPITAL. WHAT IS THE DIFFERENCE BETWEEN SHARES AND DEBENTURES? WHAT ARE THE VARIOUS METHODS OF REDEMPTION?

Concept of Share Capital

1. Authorized Share Capital (Nominal Capital)

Definition and **Nature**
Authorized share capital, also known as **nominal capital**, refers to the maximum amount of share capital that a company is legally permitted to issue, as stated in its Memorandum of Association. It establishes an upper ceiling but does not necessarily represent the amount of capital actually raised.

Regulatory Framework

- Under the **Companies Act, 2013 (India)**, authorized capital is a mandatory disclosure in the Memorandum of Association.
- The **ICAI's Guidance Notes** emphasize its importance as the legal limit of share issuance unless formally altered through shareholder and regulatory approval.

Practical Illustration

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If a company's authorized share capital is ₹10 crore divided into 1 crore equity shares of ₹10 each, it cannot issue shares beyond this limit without amending its Memorandum and paying requisite fees to the Registrar of Companies.

2. Issued Share Capital

Definition and Nature

Issued share capital represents that portion of the authorized share capital which is actually offered to investors for subscription, either privately or through public issuance.

Accounting Relevance

Issued capital indicates the extent to which a company has sought to mobilize funds from the market. It may be less than or equal to the authorized capital.

Illustrative Case

If out of the above authorized capital of ₹10 crore, the company issues shares worth ₹6 crore to the public, then the issued capital is ₹6 crore.

3. Subscribed Share Capital

Definition and Nature

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Subscribed capital is the portion of issued capital that investors agree to purchase. Subscription reflects the commitment of investors and the effective inflow of funds or receivables to the company.

Practical Example

If a company issues 60 lakh shares but the public subscribes only to 55 lakh shares, then the subscribed capital is 55 lakh shares \times ₹10 = ₹5.5 crore.

Accounting Treatment

Subscribed capital is disclosed in the balance sheet under the head "Share Capital." Any unsubscribed portion is separately noted for transparency.

4. Called-Up Share Capital

Definition and Nature

Called-up capital denotes that part of the subscribed share capital that the company has formally demanded from shareholders. Since companies may issue shares with payments due in installments (application, allotment, first call, final call), called-up capital reflects the aggregate liability created on shareholders at any given time.

Example

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If ₹8 per share is called upon 55 lakh subscribed shares of ₹10 each, the called-up capital is ₹4.4 crore. The uncalled portion remains a potential future resource.

5. Paid-Up Share Capital

Definition and Nature

Paid-up capital is the portion of called-up capital actually received from shareholders. It represents the real equity contribution available for business operations.

Case Illustration

If shareholders pay ₹4.3 crore out of the called-up capital of ₹4.4 crore, the paid-up capital is ₹4.3 crore. The unpaid balance is termed as “calls in arrears.”

Standard Treatment

According to **Schedule III of the Companies Act, 2013**, paid-up share capital is the figure reported on the face of the balance sheet under shareholders’ funds.

6. Reserve Capital

Definition and Nature

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Reserve capital is a unique category where a company, through a special resolution, decides that a portion of its uncalled capital will not be called up during its lifetime except in the event of liquidation. It serves as a safeguard for creditors.

Legal Basis

- Recognized under Section 65 of the Indian Companies Act, 2013.
- Landmark case: *Re India Electric Works Ltd.* (1929), which clarified that reserve capital can only be created by special resolution and not by board discretion.

Sweat Equity and ESOP-Related Share Capital

Sweat Equity

Sweat equity shares are issued to directors or employees in recognition of their intellectual property, know-how, or other contributions.

Employee Stock Option Plans (ESOPs)

ESOP-related share capital arises when employees exercise their stock options, resulting in fresh issue of

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shares. These instruments align employee incentives with shareholder value.

Regulation

- Governed by Section 54 of the Companies Act, 2013 and SEBI (Share Based Employee Benefits) Regulations, 2014.

Key Differences between Shares and Debentures

Nature of Instrument (Ownership vs. Borrowing)

A fundamental difference between shares and debentures lies in the type of capital they represent:

- **Shares** are a form of **equity** capital. By issuing shares, a company invites investors to become partial owners of the business. Shareholders, therefore, have ownership rights, including the right to vote at annual general meetings (AGMs) and the potential to receive dividends based on company profits.
- **Debentures**, conversely, represent a form of **debt** capital. When a company issues debentures, it is borrowing funds from investors. Debenture holders do not own a part of the company and have no voting rights. Their primary concern is the fixed return on investment in the form of interest and the eventual repayment of the principal.

Risk and Return

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The risk and return profile for shares and debentures differs significantly:

- **Shares** offer a **variable return** in the form of dividends, which depend on the company's performance. The return can be high if the company performs well but is uncertain if the company faces financial difficulties. Additionally, in the event of liquidation, shareholders are paid after debenture holders and other creditors, making shares a riskier investment. However, they have the potential for capital gains if the company's stock price increases.
- **Debentures** offer a **fixed return** in the form of interest, which must be paid regularly, irrespective of the company's financial health. Debenture holders are entitled to receive their interest payments before any dividends are paid to shareholders. Thus, debentures are less risky compared to shares, as the return is fixed and predictable. However, the potential for capital appreciation is absent in most cases.

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Voting Rights

- **Shares**, especially **equity shares**, grant shareholders **voting rights** at the company's annual general meetings (AGMs). This means that shareholders can participate in major decisions of the company, such as the election of the board of directors, approval of financial statements, and other strategic matters.
- **Debenture holders** do not have any voting rights in the company. Their relationship with the company is purely financial, and they are concerned primarily with receiving their interest payments and the return of their principal upon maturity.

Claim on Assets in Case of Liquidation

One of the crucial distinctions between shares and debentures arises in the case of **liquidation** or **insolvency**:

- In the event of liquidation, **debenture holders** have a **priority claim** on the company's assets. This means that before any payments are made to shareholders, the company must settle its debts, including those owed to debenture holders. If any assets remain after paying off the liabilities, shareholders are then entitled to the remaining value, but this is often only a fraction of the total equity, especially in the case of financial distress.

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- **Shareholders** are the **last** to receive payment in the event of liquidation. They bear the residual risk of the company's failure, meaning that if the company does not have enough assets to cover all its liabilities, shareholders may receive nothing.

Convertibility

- **Shares:** Non-convertible in nature.
- **Debentures:** May be issued as convertible or non-convertible, enabling flexibility.

Regulatory Treatment

- **Shares:** Governed under provisions relating to share capital in the Companies Act and accounting standards on equity.
- **Debentures:** Governed under debt provisions, with interest classified as expense in financial reporting (Ind AS 23, borrowing costs).

WHAT ARE THE VARIOUS METHODS OF REDEMPTION?

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Redemption at Par

Redemption at par refers to the process where a company redeems its securities (such as bonds, debentures, or preference shares) at their nominal or face value. This method is typically employed when the company wants to settle its obligations without incurring a premium or discount.

Key Characteristics:

- **Nominal Value:** The redemption occurs at the face value of the security, which means no additional payment beyond the principal amount is required.
- **No Premium or Discount:** In this case, the investor receives exactly the amount they initially invested in the security.
- **Common for Debentures and Preference Shares:** This method is frequently used in the redemption of preference shares or fixed-rate debentures.

Illustrative

A company issues debentures with a face value of ₹1,000 each. If the company redeems the debentures at par, it

Example:

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will pay ₹1,000 to the debenture holders, regardless of the market value at the time of redemption.

Accounting Treatment:

Under both **Ind AS 32** and **IAS 32** (International Financial Reporting Standards), redemption at par is straightforward. The liability (debenture or preference share) is extinguished from the balance sheet, and the corresponding payment is debited from the cash or bank account.

Redemption at a Premium

Redemption at a premium occurs when a company repurchases its securities at a price higher than their nominal or face value. This method is common in cases where the company wants to incentivize investors to redeem their securities earlier or where the interest rates have decreased, making it advantageous for the company to redeem the securities early.

Key Characteristics:

- **Premium Payment:** The company pays a premium over and above the face value of the security.
- **Investor Incentive:** This method often encourages investors to redeem their securities early or at a specified date.

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- **Used for Long-term Securities:** It is more common with long-term debt securities like bonds or debentures that have high coupon rates.

Illustrative

A company issues ₹1,000 debentures but offers a redemption price of ₹1,100 (a 10% premium) for early redemption. This means that for every ₹1,000 debenture, the company will pay ₹1,100 to redeem it.

Example:

Accounting Treatment:

In the case of redemption at a premium, the company must recognize the premium as an expense. The amount of premium paid is recorded in the financial statements under the category of "finance costs" or "expenses related to debt extinguishment." The corresponding liability is removed from the balance sheet, and the payment of the redemption premium is reflected in the cash flow statement.

Under **IFRS 9** (Financial Instruments), the premium is included in the amortization schedule of the debt, and any adjustment is made to the liability accordingly.

Redemption at a Discount

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Redemption at a discount is the opposite of redemption at a premium. In this method, the company repurchases its securities at a price lower than their nominal value. This is typically used when the company is facing financial difficulties, or market conditions have made the securities less valuable than their face value.

Key Characteristics:

- **Discounted Repurchase:** The company buys back securities at a price lower than their nominal or face value.
- **Investor Risk:** Investors who hold such securities will receive less than their original investment, which can be a point of contention.
- **Less Common:** This method is relatively uncommon and may be seen during financial restructuring or in cases where the company is struggling with liquidity issues.

Illustrative

A company issues ₹1,000 debentures but buys them back at ₹900. In this case, the company is repurchasing the securities at a discount of ₹100 per debenture.

Example:

Accounting Treatment:

When redeeming securities at a discount, the company records the payment made to the investor and recognizes a gain on the redemption. The gain is the difference between the face value of the security and the amount

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paid for its redemption. This is typically recorded in the income statement as a gain on debt extinguishment. However, this discount may also lead to the reclassification of the debt under the "current liabilities" section in the balance sheet if it is associated with short-term redemption.

Sinking Fund Method

A **sinking fund** is a specific amount of money set aside by a company for the purpose of redeeming its securities in the future. This method is often used for long-term debt securities, and it is designed to ensure that the company has sufficient funds available when the securities mature.

Key Characteristics:

- **Systematic Savings:** The company sets aside a fixed amount each year into a fund, which accumulates over time and is used to redeem the securities.
- **Reduces Future Liability:** This method reduces the burden of a large redemption payment at the end of the term.
- **Safe for Investors:** The existence of a sinking fund assures investors that their securities will be redeemed on time.

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Illustrative

A company issues ₹10,000,000 in debentures, with a sinking fund requirement to accumulate ₹1,000,000 per year for 10 years. At the end of 10 years, the company uses the sinking fund to redeem the debentures at par.

Example:

Accounting Treatment:

The company records the annual contributions to the sinking fund as an expense, with the fund's balance accumulating on the asset side of the balance sheet. Upon redemption, the sinking fund is used to settle the liability. The sinking fund method also has implications for the company's cash flow, as it involves periodic payments into the fund.

Call and Put Option Redemption

In some cases, companies and investors negotiate **call** and **put options** for redemption. These options provide either the company (call option) or the investor (put option) with the right to redeem the securities under specified conditions.

Key Characteristics:

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- **Call Option:** The company has the right to redeem the securities before the maturity date at a predetermined price.
- **Put Option:** The investor has the right to require the company to redeem the securities before the maturity date at a predetermined price.

These methods are common in convertible debentures and preference shares, where investors or the company may wish to terminate the arrangement before the security's maturity.

Illustrative

Example:

A company issues convertible debentures with a call option that allows the company to redeem the debentures at ₹1,050 each before the maturity date. Similarly, the investor may have the right to put the debentures back to the company at ₹1,100.

Accounting Treatment:

Call and put options involve complex accounting, particularly when the exercise of the options affects the liability structure. In practice, the option price is often amortized over the life of the bond or debenture, with the redemption recorded when the option is exercised.

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Q9. ABC LTD. ISSUED A PROSPECTUS INVITING APPLICATIONS FOR RS. 1,04,000 SHARES OF RS. 10 EACH AT A PREMIUM OF RS.2 PER SHARE PAYABLE AS SHARES OF RS. 10 EACH AT A PREMIUM OF RS.2 PER SHARE PAYABLE AS FOLLOWS:

- (A) APPLICATION- RS. 2**
- (B) ALLOTMENT- RS. 5 (INCLUDING PREMIUM)**
- (C) FIRST CALL – RS. 3**
- (D) FINAL CALL – RS. 2**

APPLICATIONS WERE RECEIVED FOR RS. 1,56,000 SHARES AND PRO RATA ALLOTMENT WAS MADE ON THE APPLICATION FOR 1,24,800 SHARES. IT WAS DECIDED TO UTILIZE EXCESS APPLICATION MONEY TOWARDS THE AMOUNT DUE ON ALLOTMENT. RAMESH TO WHOM 2,080 SHARES WERE ALLOTTED FAILED TO PAY THE ALLOTMENT MONEY. CALCULATE THE AMOUNT DUE BUT NOT RECEIVED ON ALLOTMENT FROM RAMESH AND ALSO CALCULATE ALLOTMENT MONEY RECEIVED ON ALLOTMENT FROM RAMESH AND ALSO CALCULATE ALLOTMENT MONEY RECEIVED AN LATER ON.

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Issue terms: 1,04,000 equity shares of ₹10 each at a premium of ₹2 per share.

Payment schedule:

- (a) Application ₹2;
- (b) Allotment ₹5 (including premium);
- (c) First Call ₹3;
- (d) Final Call ₹2.

Applications received: for 1,56,000 shares.

Pro-rata allotment on applications for **1,24,800** shares; balance **31,200** applications rejected (refunded).

Excess application money on the pro-rata pool to be **adjusted towards allotment**.

Default: Ramesh, allotted **2,080** shares, **failed to pay the allotment money**.

Note on the pro-rata ratio. Pro-rata was applied on 1,24,800 applications to allot 1,04,000 shares. Thus the **applications : allotment** ratio is **1,24,800 : 1,04,000 = 6 : 5**.

Mechanics of Pro-Rata and Adjustment

Under a 6:5 pro-rata, an applicant who is ultimately **allotted 5 shares must have applied for 6**. Accordingly:

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- **Application money actually paid** by a successful applicant = ₹2 × (shares applied).
- **Application money “needed”** for the shares ultimately allotted (had allotment been at par with application quantity) = ₹2 × (shares allotted).
- **Excess application money** per allottee = ₹2 × (shares applied – shares allotted). This excess is **transferred** (not refunded) from **Share Application A/c** to **Share Allotment A/c**, reducing the cash call at allotment.

Ramesh’s Position

(a) Shares applied for by Ramesh

Given the ratio 6:5 and **allotted** = 2,080,

the **applied** shares = $2,080 \times \frac{6}{5} = 2,496 = 2,496$ shares.

(b) Application money paid by Ramesh

$$= ₹2 \times 2,496 = ₹4,992.$$

(c) Allotment due from Ramesh (gross)

Allotment is ₹5 (including premium) per share allotted.

$$= ₹5 \times 2,080 = ₹10,400.$$

(d) Excess application money available for adjustment (Ramesh)

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Needed for allotted quantity at application rate = ₹2 × 2,080 = ₹4,160.

Excess = Actual paid ₹4,992 – Needed ₹4,160 = **₹832**.

(e) Net amount due but not received on allotment from Ramesh

The company has a right to adjust the surplus application money against the sum due on allotment; this credit is a **non-cash settlement** of part of the allotment dues. Since Ramesh failed to pay the allotment **in cash**, only the adjusted portion stands “received” by transfer; the balance remains unpaid.

Unpaid on allotment = **Allotment due ₹10,400 – Adjusted surplus ₹832 = ₹9,568.**

Answer (1): Amount due but not received on allotment from Ramesh = ₹9,568.

Allotment Money Received on Allotment from Ramesh

Step 1: Amount Received by Transfer

- **Excess application money** of ₹832 is transferred to the allotment account, as it was used to partially pay the allotment due.

Step 2: Cash Received on Allotment

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Since **Ramesh failed to pay the allotment money** at the time of allotment, the **cash received** from Ramesh on the allotment date is:

₹0

Summary of Allotment Money Received:

- **By transfer from application money:** ₹832
- **Cash received on allotment from Ramesh:**
₹0

Allotment Money Received Later on (If Applicable)

Scenario 1: If Ramesh Pays Later

If Ramesh subsequently clears the arrears on allotment (which is common, and often done with the **First Call**), the cash received later towards the allotment would be:

₹9,568

This is the amount that Ramesh would need to pay to settle the allotment.

Scenario 2: If Ramesh Never Pays

If Ramesh does not pay the arrears, the allotment money received later is:

₹0

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This amount would remain as **calls-in-arrears**, and the company may choose to **forfeit** the shares if the amount remains unpaid.

4) Company-Wide Cash Received on Allotment Date

For the sake of completeness, let's calculate the **total cash received** by the company on the allotment date from all allottees, not just Ramesh.

Total Allotment Due:

- **Total allotment money due** for all 1,04,000 shares (at ₹5 per share):

$$1,04,000 \times ₹5 = ₹5,20,000$$

Excess Application Money Adjusted:

- The **total excess application money** from all applicants is:

$$(\text{Total shares applied} - \text{Total shares allotted}) \times ₹2$$

$$(1,24,800 - 1,04,000) \times ₹2 = 20,800 \times ₹2 = ₹41,600$$

This amount of ₹41,600 is transferred to the **Share Allotment A/c**.

Ramesh's Unpaid Portion on Allotment:

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- **Ramesh's unpaid portion** = ₹9,568 (as calculated above).

Total Cash Received on Allotment Date:

- The total cash received from all allottees, after adjusting for the excess application money and Ramesh's arrears, is:

$$₹5,20,000 - ₹41,600 - ₹9,568 = ₹4,68,832$$

Final Answers:

1. **Amount due but not received on allotment from Ramesh** = ₹9,568
2. **Allotment money received on allotment from Ramesh:**
 - By transfer (excess application): ₹832
 - Cash received: ₹0
3. **Allotment money received later on from Ramesh:**
 - If he pays the arrears: ₹9,568
 - If he does not pay: ₹0
4. **Company-wide cash received on allotment date** = ₹4,68,832

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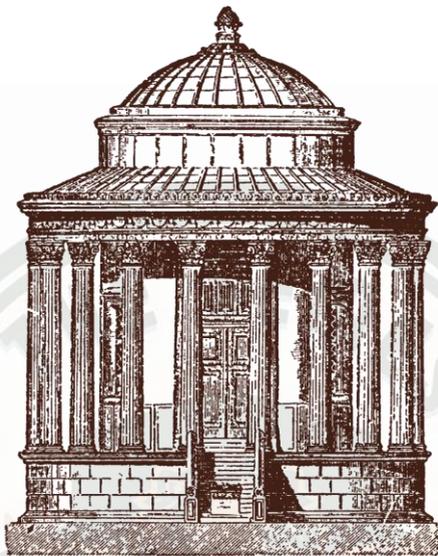
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MIND MAPS

FOR OPTIMAL INFORMATION RETENTION AND EFFECTIVE LAST-MINUTE REVISIONS, WE INTRODUCE THE MIND MAPPING & TRAINING MODULE. THIS UNIQUE FEATURE PRESENTS TABLES AND FLOWCHARTS RELATED TO THE SUBJECTS, ENABLING YOU TO GRASP AND MEMORIZE KEY CONCEPTS MORE EFFICIENTLY.

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UNIT 1

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DEFINITION, MEANING, NATURE OF ACCOUNTING

DEFINITION

- Systematic recording, summarizing, analyzing, reporting of financial transactions
- Provides relevant, accurate information to stakeholders

MEANING

- "Language of business"
- Communicates financial health, performance

NATURE

- Identifying economic events, transactions
- Measuring monetary values
- Recording systematically, chronologically

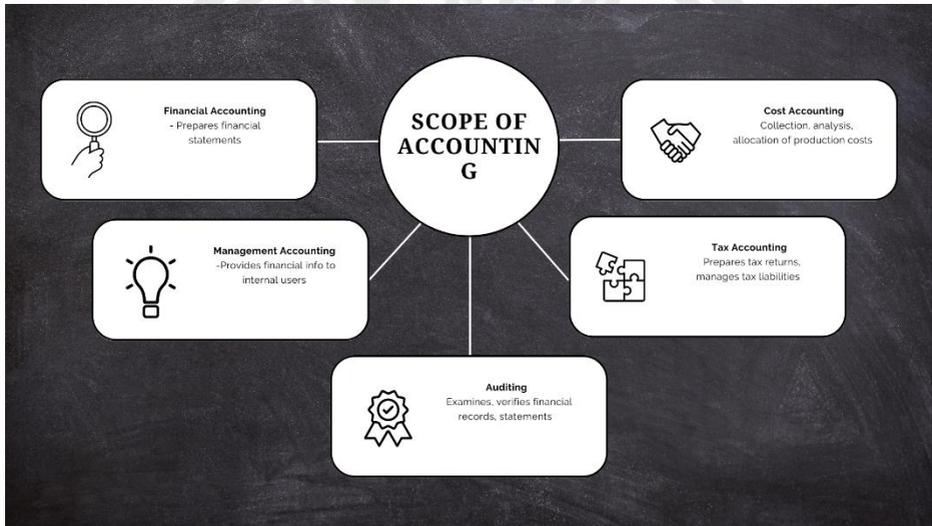
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FUNCTIONS OF FINANCIAL ACCOUNTING

1. Recording Financial Transactions

Systematic, chronological
recording

Captures sales, purchases,
expenses, etc.

Entries in general ledger,
subsidiary ledgers

2. Classifying Financial Transactions

Categorization into assets,
liabilities, equity, revenue,
expenses

Organizes data for analysis
and reporting

3. Summarizing Financial Data

Compilation of financial
statements

Balance sheet, income
statement, cash flow
statement

4. Communicating Financial Information

Conveys data to shareholders

Investors, creditors,
regulators, management

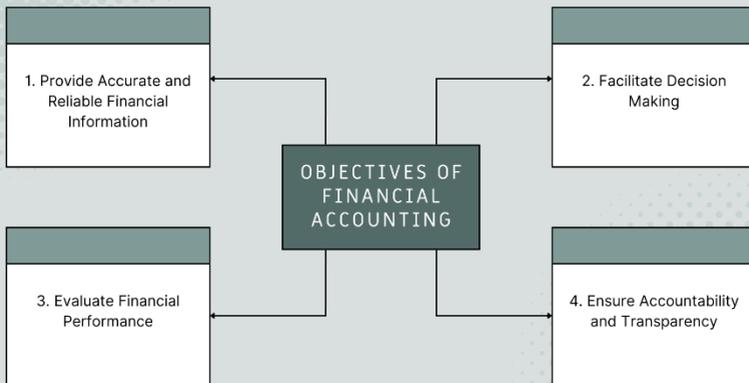
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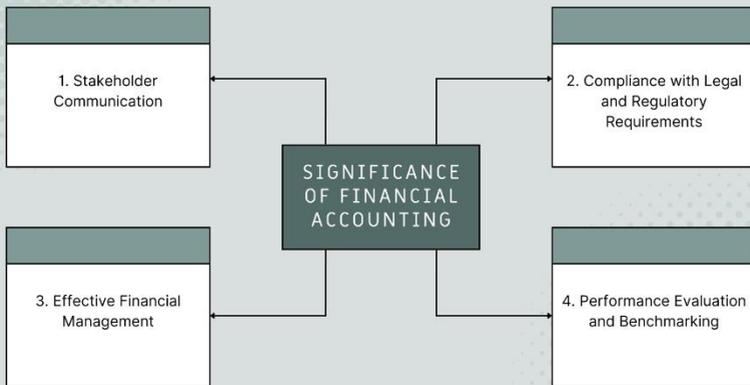
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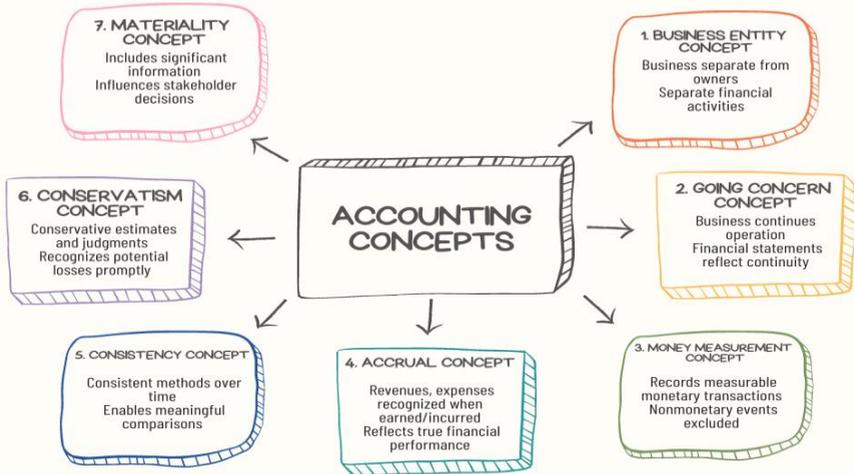
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BOOKS OF ACCOUNTING

1. General Journal

Chronological record of financial transactions

Journal entries: date, accounts, debit/credit

2. General Ledger

Summary of accounts (assets, liabilities, equity, etc.)

Used for financial statements

3. Subsidiary Ledgers

Detailed records for specific accounts

Supports accuracy of general ledger

4. Trial Balance

Lists accounts, balances at period end

Verifies debit = credit (balances)

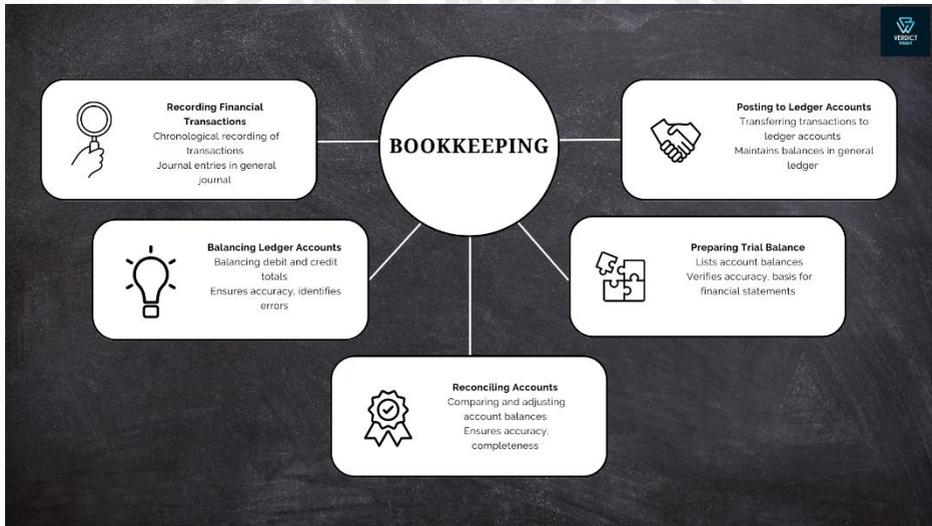
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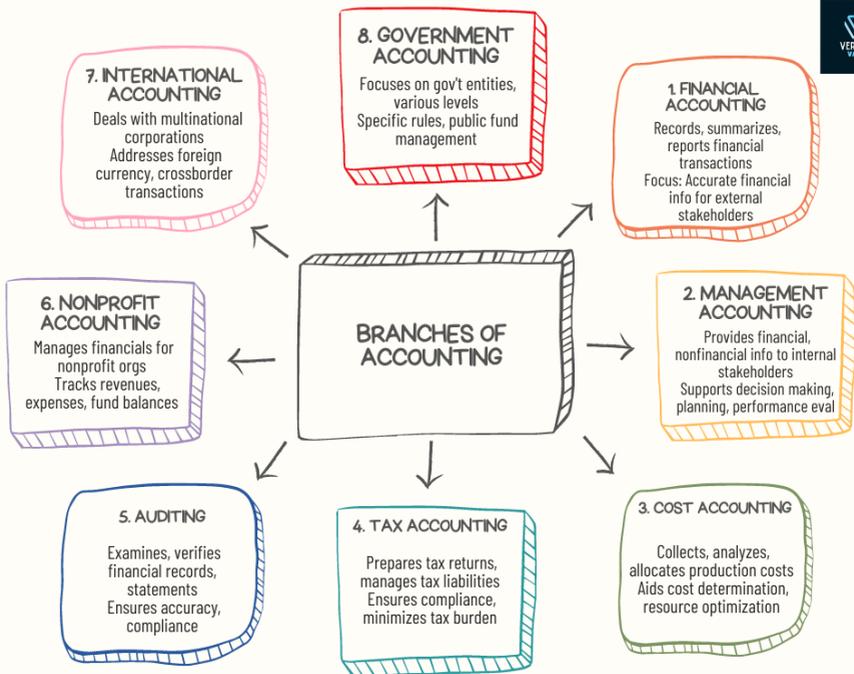
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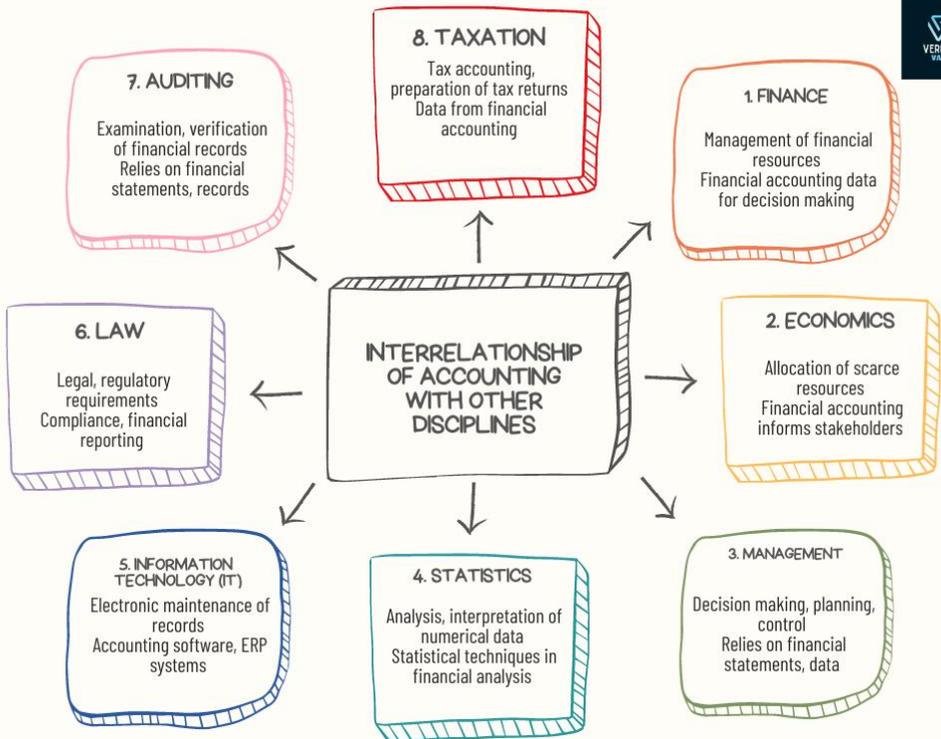
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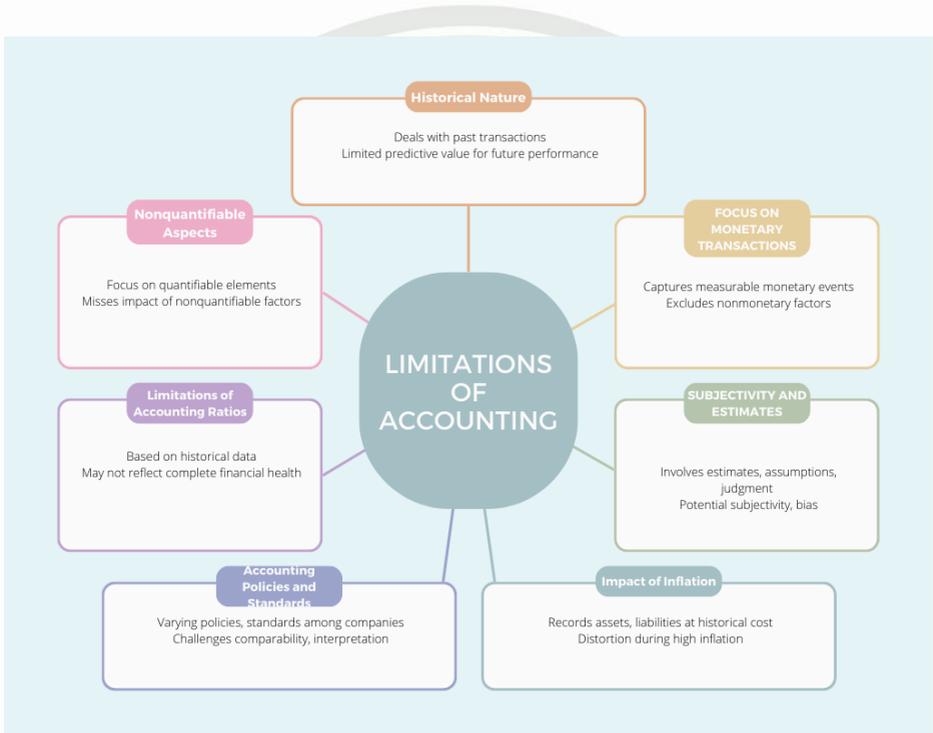
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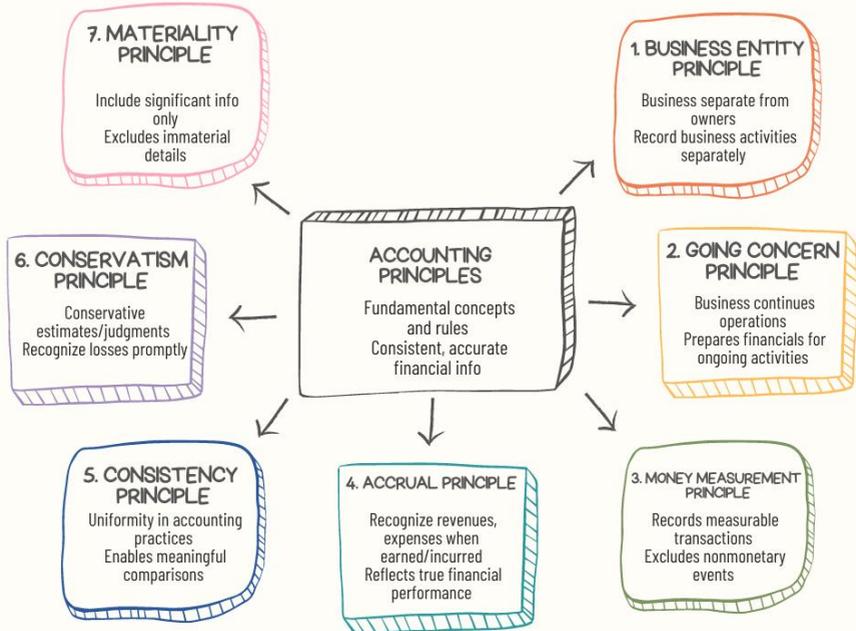
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ACCOUNTING STANDARDS BY ICAI

1

ACCOUNTING STANDARDS (AS):

- Rules, guidelines for financial accounting
- Ensure consistency, comparability, transparency
- Issued by ICAI's Accounting Standards Board

(ASB)

2

KEY AS ISSUED BY ICAI:

- AS 1: Disclosure of Accounting Policies
- AS 2: Valuation of Inventories
- AS 3: Cash Flow Statements
- AS 10: Property, Plant, and Equipment
- AS 11: Effects of Changes in Foreign Exchange Rates

3

CONVERGENCE WITH IFRS:

- Aligning Indian Accounting Standards with IFRS
- Development of Ind AS (Indian Accounting Standards)
- Aims for consistency, transparency, global integration

4

MANDATORY ADOPTION OF INDIAN AS:

- Certain classes of companies
- Listed companies, unlisted with high net worth
- Enhances credibility, international comparability

5

ICAI'S ROLE:

- Shapes financial accounting landscape in India
- Ensures consistency, transparency in financial reporting
- Facilitates informed decisions by stakeholders
- Enhances credibility, international integration

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UNIT 2

01

JOURNALIZING TRANSACTIONS

- Uniform financial info presentation
- Meaningful comparisons of statements
- Assess financial health, performance



02

DOUBLE-ENTRY BOOKKEEPING

- Every transaction involves at least two accounts
- Debit one account, credit another
- Maintains balance in accounting equation



06

BENEFITS OF JOURNAL ENTRIES

- Tracks financial flow
- Supports auditing process
- Facilitates error detection
- Maintains accounting equation balance



JOURNALIZING TRANSACTIONS

03

JOURNAL ENTRY

- Journal Entry
- Record of a financial transaction
- Contains:
 - Date of transaction
 - Account titles
 - Debit and credit amounts
 - Brief description of transaction



05

IMPORTANCE OF JOURNAL ENTRIES

- Chronological record of transactions
- Provides audit trail for accuracy
- Helps detect errors and inconsistencies
- Foundation for double-entry bookkeeping



04

COMPONENTS OF JOURNAL ENTRY

1. Date
2. Account Titles
3. Debit and Credit Amounts
4. Description



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COMPOUND JOURNAL ENTRIES

1

RECORDING COMPLEX TRANSACTIONS

- Rules, guidelines for financial accounting
- Ensure consistency, comparability, transparency
- Issued by ICAI's Accounting Standards Board (ASB)

2

KEY AS ISSUED BY ICAI:

- AS 1: Disclosure of Accounting Policies
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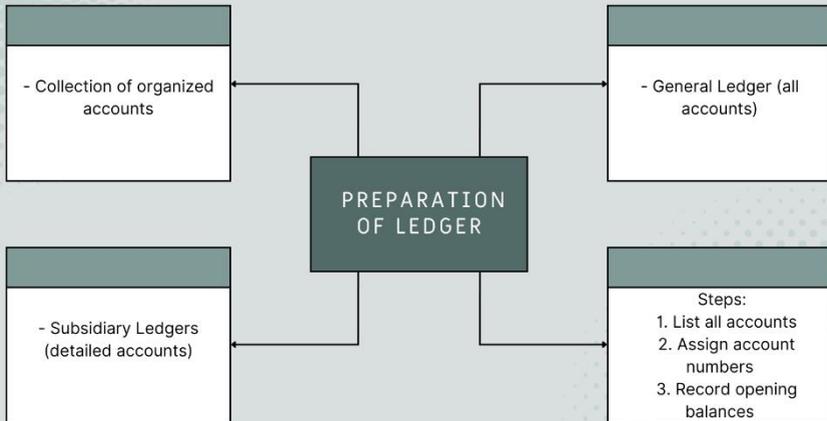
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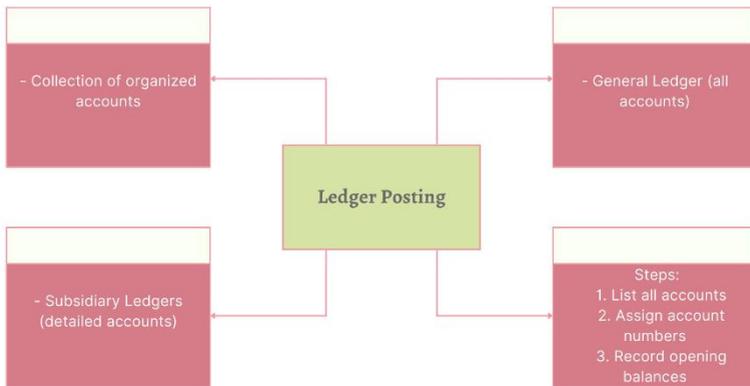
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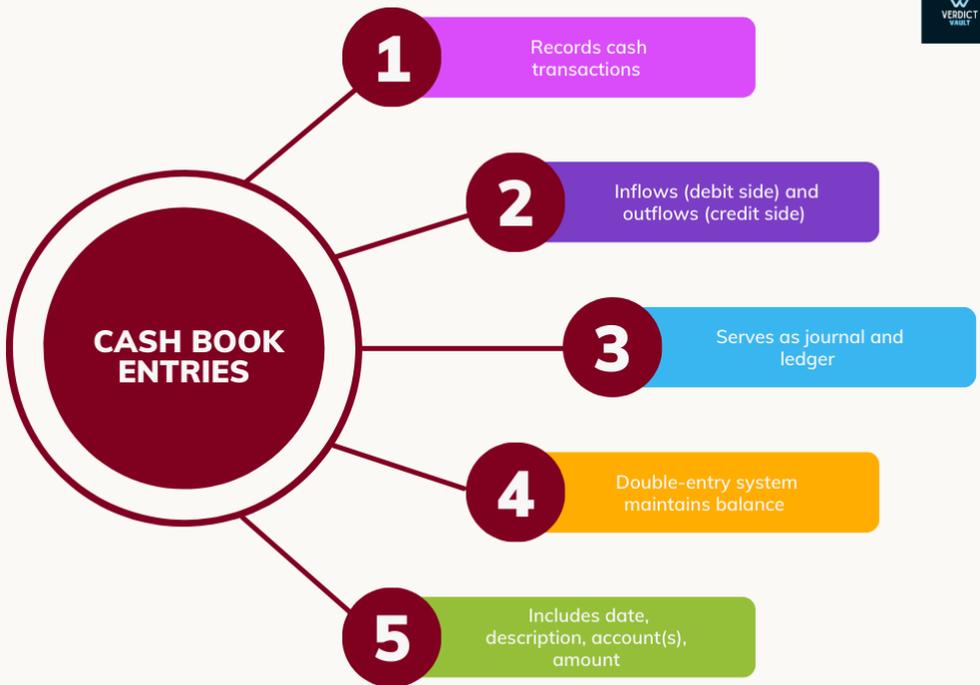
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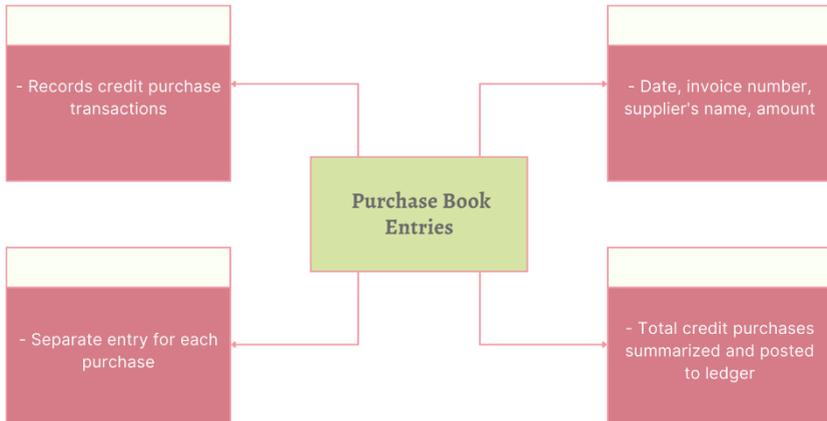
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PREPARATION OF TRIAL BALANCE



1. Trial Balance

- Summary of general ledger accounts
- Shows debit and credit balances
- Ensures total debits = total credits
- Validates accuracy of journal entries
- Starting point for financial statements



2. Steps to Prepare Trial Balance

- List all accounts
- Record account balances
- Calculate total debits and credits
- Check for balance equality



3. Purpose of Trial Balance

- Validates mathematical accuracy
- Identifies errors in journal entries or postings
- Assists in preparing financial statements
- Confirms adherence to double-entry system

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COMPANY FINAL ACCOUNTS

Summarize financial performance and position
Include income statement, balance sheet, cash flow
statement

Preparation of Final Accounts with Adjustments

1. Adjust for accruals and prepayments
2. Record depreciation of fixed assets
3. Adjust for bad debts and allowances
4. Make other necessary adjustments
 - Inventory write-downs, provisions, etc.

Trading Accounts (Part of Income Statement):

- Focuses on gross profit or loss from trading activities
- Reflects core operational profitability

Steps to Prepare a Trading Account:

1. Record total sales revenue
2. Calculate Cost of Goods Sold (COGS):
Opening Inventory +
Purchases - Closing Inventory
3. Determine Gross Profit (or
Gross Loss):
Sales Revenue - Cost of
Goods Sold (COGS)

Importance of Final Accounts:

- Provides accurate financial summary
- Supports decision-making
- Assists in financial planning

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PROFIT AND LOSS ACCOUNT, BALANCE SHEET (SCHEDULE III)

Profit and Loss Account

- Summarizes revenues, expenses, profits, and losses
- Assesses financial performance and operational efficiency

Preparation of Profit and Loss Account (As per Schedule III)

1. Revenue Section: Includes revenue from operations and other income
2. Expenses Section: Lists various expenses categories
3. Profit or Loss Calculation: Total Revenue - Total Expenses
4. Exceptional and Extraordinary Items Adjustment
5. Net Profit or Loss Calculation

Balance Sheet

- Presents financial position at a specific point in time
- Reflects assets, liabilities, and equity

Preparation of Balance Sheet (As per Schedule III)

1. Equity and Liabilities Section:
 - Shareholders' Funds
 - Share Application Money Pending Allotment
 - Non-Current Liabilities
 - Current Liabilities
2. Assets Section:
 - Non-Current Assets
 - Current Assets

Compliance with New Companies Act 2013 (India)

- Schedule III provides instructions for financial statement preparation
- Ensures consistency, comparability, and transparency

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UNIT 3

BASIC FEATURES OF DEPRECIATION



Systematic Allocation
- Allocate cost over asset's useful life
- Matches expense with revenues



Choice of Depreciation Method
- Straight-line, declining balance, units-of-production
- Affects depreciation amount and asset's carrying amount



Non-Cash Expense
- No cash outflow
- Indirectly affects cash flow, taxes



Estimation of Useful Life and Residual Value
- Subjective estimates
- Periodic review and potential revisions



Periodic Expense
- Recognized in each period
- Matches cost with revenues



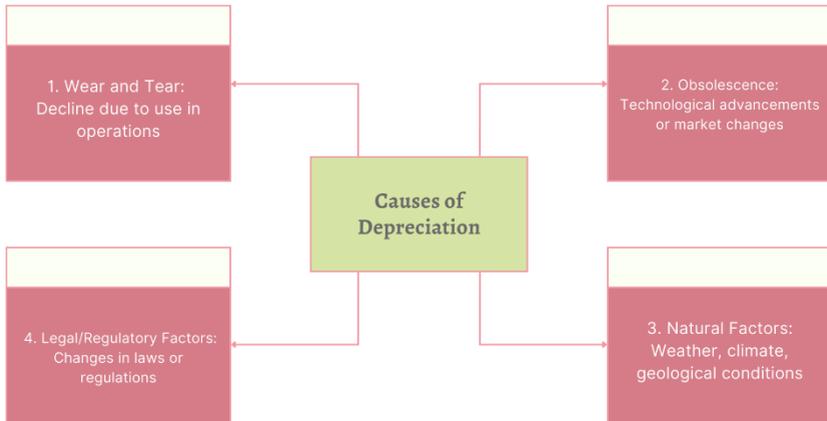
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BASIC FEATURES OF DEPRECIATION



Systematic Allocation
- Allocate cost over asset's useful life
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DEPRECIATION ACCOUNTING MEANING AND IMPORTANCE

Depreciation Accounting

- Systematic process
- Records, measures, allocates asset cost
- Tangible and intangible assets
- Over useful lives

Purpose of Depreciation Accounting

1

Expense
Recognition

- Matches cost with revenues
- Accurate financial performance

2

Asset Valuation

- Reduces carrying amount
- Reflects economic value decline

3

Tax Implications

- Deductible expense
- Taxable income, liability impact

4

Decision-Making

- Financial performance assessment
- Operational efficiency evaluation

5

Key Steps

1. Identify Depreciable Assets
2. Determine Asset Cost
3. Estimate Useful Life, Residual Value
4. Choose Depreciation Method
5. Record, Report Depreciation

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DEPRECIATION ACCOUNTING MEANING AND IMPORTANCE



1

ACCURATE EXPENSE RECOGNITION

- ALLOCATE COST OVER USEFUL LIFE
- MATCH EXPENSE WITH REVENUES
- ACCRUAL BASIS, MATCHING PRINCIPLE

2

PROPER ASSET VALUATION

- MAINTAIN ACCURATE BOOK VALUE
- REFLECT REDUCED ECONOMIC VALUE

3

ALLOCATION OF ASSET COST

- SPREAD COST OVER PERIODS
- AVOID OVERSTATEMENT OF EXPENSES

4

TAX COMPLIANCE

- DEDUCTIBLE EXPENSE FOR TAX
- IMPACT ON TAXABLE INCOME, LIABILITY

5

DECISION-MAKING

- ASSESS FINANCIAL PERFORMANCE
- EVALUATE OPERATIONAL EFFICIENCY

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Methods of Providing Depreciation

1. STRAIGHT-LINE METHOD

- Equal depreciation over useful life.
- Formula: $(\text{Cost} - \text{Residual Value}) / \text{Useful Life}$

2. DECLINING BALANCE METHOD

- Higher depreciation early, lower later.
- Formula: $\text{Carrying Amount} * \text{Depreciation Rate}$

3. UNITS-OF-PRODUCTION METHOD

- Based on actual usage or output.
- Formula: $(\text{Cost} - \text{Residual Value}) / \text{Total Units} * \text{Actual Units}$

4. SUM-OF-THE-YEARS'-DIGITS METHOD

- Fraction of sum of digits of useful life.
- Formula: $(\text{Remaining Life} / \text{Sum of Digits}) * (\text{Cost} - \text{Residual Value})$

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DEPRECIATION POLICY



Depreciation Policy

- Defines approach to calculate, record, and report depreciation.
- Includes methods, useful lives, and residual values.
- Ensures consistency, compliance, and accurate reporting.



AS-6 (Revised) Depreciation Accounting

- Accounting standard by ICAI for depreciation.
- Covers depreciable assets, methods, estimates, changes.
- Requires disclosures on method, useful lives, rates, amounts.



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DEPRECIATION POLICY Provisions and Reserves



PROVISIONS

- Recognize uncertain obligations from past events.
- Examples: warranties, employee benefits, legal disputes.
- Criteria: present obligation, probable outflow, reliable estimate.
- Periodic review and adjustment.



RESERVES

- Set aside profits for future contingencies.
- General and specific reserves.
- Maintain financial position and flexibility.
- Created by transferring profits, reported in equity.



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CHANGE OF METHOD OF DEPRECIATION



1. Current Effect

- Impact on depreciation expense and accumulated depreciation
- Apply new method prospectively
- Calculate depreciation using new method for current and future periods
 - Difference recognized as adjustment in current period's profit or loss account

2. Retrospective Effect:

- Impact on depreciation in prior periods if new method used from asset inception
 - Generally not allowed by accounting standards
- Restate financial statements if required by specific regulation
- Recalculate depreciation for prior periods using new method
- Adjust opening balances of assets and retained earnings
- Cumulative effect recognized in earliest period's opening balance sheet

Reasons for Change:

- Business circumstances
 - Technological advancements
- More accurate asset information



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UNIT 4

JOINT STOCK COMPANY



JOINT STOCK COMPANY

Owned by shareholders, governed by directors.



KEY TRAITS:

1. Separate Legal Entity
2. Limited Liability
3. Transferable Shares
4. Perpetual Succession
5. Capital Raising (IPO, Private Placement)



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SHARE CAPITAL

1

AUTHORIZED CAPITAL

- MAX. SHARE CAPITAL ALLOWED BY COMPANY'S CONSTITUTION.
- UPPER LIMIT FOR TOTAL VALUE & NUMBER OF SHARES.
- CAN BE CHANGED THROUGH LEGAL PROCEDURES.

2

ISSUED CAPITAL

- PORTION OF AUTHORIZED CAPITAL ISSUED TO SHAREHOLDERS.
- TOTAL VALUE OF SHARES HELD BY SHAREHOLDERS.
- INCREASED THROUGH PUBLIC/PRIVATE OFFERINGS.

3

SUBSCRIBED CAPITAL

- PART OF ISSUED CAPITAL APPLIED & COMMITTED BY SHAREHOLDERS.
- TOTAL VALUE OF SHARES TO BE PURCHASED.
- MAY NOT FULLY MATCH ISSUED CAPITAL.

4

PAID-UP CAPITAL

- PORTION OF SUBSCRIBED CAPITAL FULLY PAID BY SHAREHOLDERS.
- REPRESENTS ACTUAL FUNDS AVAILABLE FOR OPERATIONS.
- INDICATOR OF FINANCIAL STRENGTH & LIQUIDITY.

5

CALLED-UP CAPITAL

- PORTION OF SUBSCRIBED CAPITAL DEMANDED FROM SHAREHOLDERS.
- INCLUDES PAID-UP & UNPAID AMOUNTS.
- REFLECTS ABILITY TO MEET FINANCIAL OBLIGATIONS.

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SHARE CAPITAL TYPES



1. EQUITY SHARE CAPITAL

- Ownership interest of equity shareholders.
- Residual claims, voting rights.



2. PREFERENCE SHARE CAPITAL

- Ownership interest with preferential rights.
- Fixed dividends, priority in liquidation.



VERDICT
VAULT

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UNDERSUBSCRIPTION



UNDERSUBSCRIPTION

- Investors apply for fewer shares than offered.
- May re-open subscription or issue subscribed shares.



ACCOUNTING ENTRIES

- Share Application A/c Dr. (Amount Applied)
- To Share Capital A/c
- To Calls-in-Arrears A/c (if applicable)

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OVERSUBSCRIPTION

OVERSUBSCRIPTION

- Investors apply for more shares than offered.
- May allot pro-rata or return excess application money.

ACCOUNTING ENTRIES (REFUND OF EXCESS)

- Share Application A/c Dr. (Amount Applied)
- To Share Capital A/c
- To Bank A/c (Refund Amount)

ACCOUNTING ENTRIES (ALLOTMENT, PRO-RATA)

- Share Application A/c Dr. (Amount Applied)
- To Share Capital A/c
- To Share Allotment A/c (Amount Adjusted)

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UNDERSUBSCRIPTION, OVERSUBSCRIPTION ACCOUNTING ENTRIES

COMMON STEPS



SHARES APPLIED FOR

Bank A/c Dr. (Amount Received)
To Share Application A/c



SHARES ALLOTTED

Share Application A/c Dr.
(Amount Applied)
To Share Capital A/c



SHARE CAPITAL CALLED UP & RECEIVED

Bank A/c Dr. (Amount Called Up)
To Share Capital A/c

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CALLS IN ADVANCE

CALLS IN ADVANCE

- Shareholders pay installments before due date.
- Liability for company, applied towards future calls.

ACCOUNTING ENTRIES

- Bank A/c Dr. (Amount Received)
- To Calls in Advance A/c

ADJUSTING ADVANCE PAYMENT

- Calls in Advance A/c Dr. (Amount Adjusted)
- To Share Capital A/c

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CALLS IN ARREARS

CALLS IN ARREARS

- Shareholders default on call payments by due date.
- Asset for company, collect outstanding amount.

ACCOUNTING ENTRIES (DEFAULT)

- Calls-in-Arrears A/c Dr.
(Amount Due)
- To Share Capital A/c

WHEN PAYMENT RECEIVED

- Bank A/c Dr. (Amount Received)
- To Calls-in-Arrears A/c

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CALLS IN ADVANCE CALLS IN ARREARS

SHARE FORFEITURE



SHARE FORFEITURE

- Company forfeits shares due to non-payment.
- Shareholders lose ownership, paid amount forfeited.



ACCOUNTING ENTRIES (FORFEITURE)

- Share Capital A/c Dr. (Paid-up Capital on Forfeited Shares)
- To Share Forfeiture A/c
- To Calls-in-Arrears A/c (Amount Due)



REISSUING FORFEITED SHARES

- Bank A/c Dr. (Amount Received)
- Share Forfeiture A/c Dr. (Amount Forfeited)
- To Share Capital A/c (Nominal Value of Reissued Shares)

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ISSUE OF SHARES AT A PREMIUM

ISSUE OF SHARES AT A PREMIUM

- Shares issued above nominal value.
- Excess amount = Premium.
- Credited to Securities Premium Account.

ACCOUNTING ENTRIES:

- Bank A/c Dr. (Amount Received, incl. premium)
- To Share Application A/c

WHEN SHARES ALLOTTED

- Share Application A/c Dr. (Amount Applied, incl. premium)
- To Share Capital A/c (Nominal Value)
- To Securities Premium A/c (Premium Amount)

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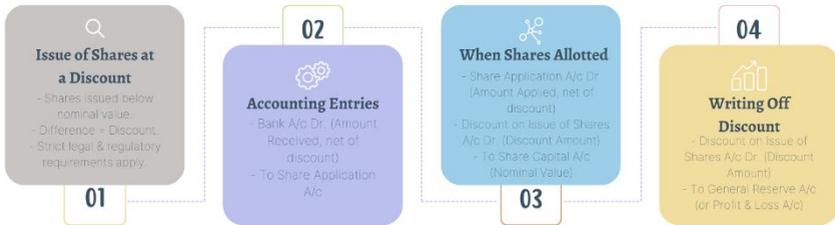
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ISSUE OF SHARES AT A DISCOUNT



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FORFEITURE OF SHARES



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SURRENDER OF SHARES RIGHT SHARES



Surrender of Shares

- Shareholder voluntarily relinquishes shares back to company.
- Requires board of directors' approval.
- Accounting Entries: Similar to forfeited shares.

Right Shares

- Issued to existing shareholders in proportion to current shareholding.
- Purpose: Raise additional capital, maintain ownership percentage.
- Issued at discount to market price.

Accounting Entries - When Right Shares Applied For

- Bank A/c Dr. (Amount received)
- To Share Application A/c

Accounting Entries - When Right Shares Allotted

- Share Application A/c Dr. (Amount applied)
- To Share Capital A/c (Nominal value)
- To Securities Premium A/c (if issued at premium)

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ISSUE OF SHARES AT A PREMIUM

Debentures

- Long-term debt instruments issued by companies.
- Purpose: Raise funds for capital, refinancing, working capital.
- Features: Fixed interest rate, specified maturity date.
- Interest paid on debentures is tax-deductible.

Issuing Debentures

- Determine terms & conditions, obtain approvals.
- Market debentures to investors, collect funds.

Types of Debenture Issue

- - Issued at Par: Nominal value
- Issued at Premium: Higher than nominal value
- Issued at Discount: Lower than nominal value

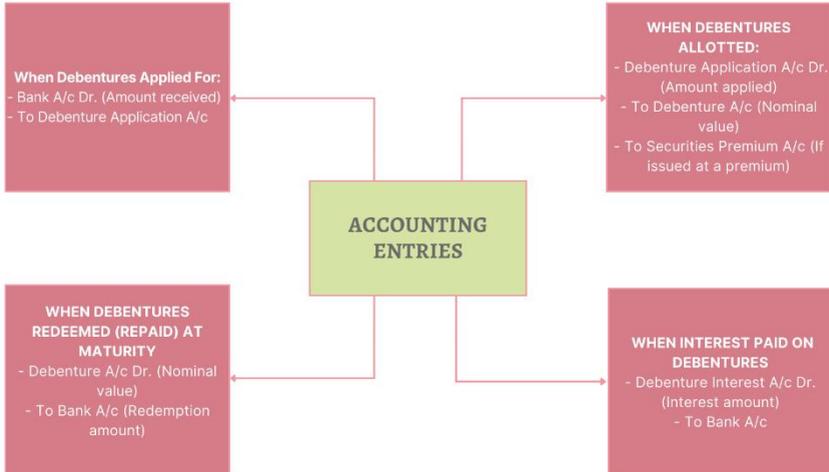
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REDEMPTION OF DEBENTURES

- REPAYMENT OF PRINCIPAL TO DEBENTURE HOLDERS AT MATURITY.
- METHODS DEPEND ON TERMS, FINANCIAL POSITION, FACTORS.

COMMON METHODS OF REDEMPTION

1. REDEMPTION AT MATURITY

- Lump sum repayment on maturity date.
- Accounting Entries:
 - Debenture A/c Dr. (Nominal value)
 - To Bank A/c (Redemption amount)

2. REDEMPTION BY INSTALLMENTS

- Periodic principal repayments over debenture life.
- Accounting Entries:
 - Debenture A/c Dr. (Nominal value)
 - To Bank A/c (Redemption amount)

3. REDEMPTION BY PURCHASE IN THE OPEN MARKET

- Buy back debentures at a price below nominal value.
- Accounting Entries:
 - Debenture A/c Dr. (Nominal value)
 - To Bank A/c (Purchase price)
 - To Profit on Redemption of Debentures A/c

4. REDEMPTION BY CONVERSION

- Convert debentures to shares (wholly/partially).
- Accounting Entries:
 - Debenture A/c Dr. (Nominal value)
 - To Share Capital A/c (Nominal value of shares)



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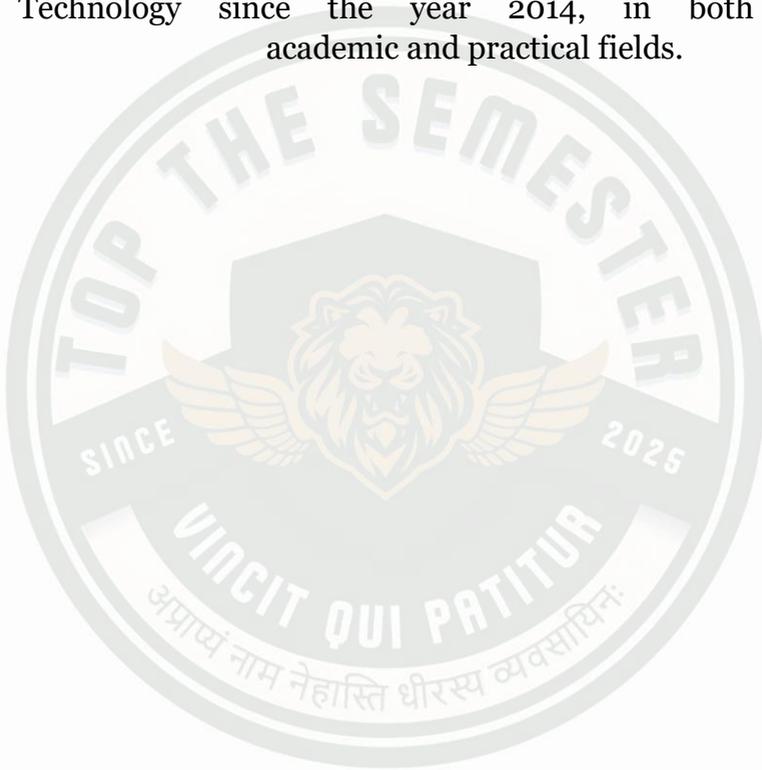
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