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PLEASE NOTE:

- **These notes are amended for June 2021 Exams**
- **Amendments upto 31.12.2020 are incorporated in these notes**
- **In case of any doubt or clarification required regarding these notes, you can email us at amittalada@gmail.com**

CHAPTER 1: INTRODUCTION TO FINANCIAL ACCOUNTING

MEANING & SCOPE OF ACCOUNTING:

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

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

RECORDING	All business transactions are evidenced by some documents like sale bill, purchase bill, voucher, salary slips, etc. and are recorded in the books of accounts from such documentary evidences generated in normal course of business. Recording is done in **Journal** which is further divided in subsidiary books according to nature and size of the business. The process of recording transactions and events in Journal is known as **Journalizing**.
CLASSIFYING	This stage deals with classification of **similar** transactions or entries under one group or account so as to put information in compact and usable form.
SUMMARISING	This process leads to the preparation of following financial statements: a) Trial Balance b) Profit and Loss A/c c) Balance Sheet d) Cash Flow statement.
ANALYSING	It means methodical classification of the data given in the financial statements and it forms the basis for interpretation. It is the establishment of relationship between the items of the Profit & Loss A/c and Balance sheet. The technique of **Ratio Analysis** is often used for this purpose.
INTERPRETATION	It is concerned with explaining the meaning and significance of the relationships as established by the analysis of the accounting data. This financial data is interpreted in a manner that enables various end users to **understand the financial condition and profitability** of the business concern. The interpretation helps various stakeholders to take their respective decision rationally.
COMMUNICATING	It is concerned with the transmission of summarized, analysed and interpreted information to the end-users to enable them to make rational decisions. This is done through preparation and distribution of accounting reports, which include besides the usual profit and loss account and the balance sheet, additional information in the form of **accounting ratios, graphs, diagrams, fund flow statements** etc.

SYSTEMS OF ACCOUNTING:

ACCRUAL BASIS OF ACCOUNTING: **(BASIS OF ACCOUNTING BENEFITS RECEVIED OR GIVEN)**	The method of recording transaction by which revenues, cost, assets and liabilities are reflected in the accounts *in the period in which they accrue*. This basis is also referred to as "Mercantile basis of accounting". The purpose of accrual basis accounting is to *relate the revenue earned to cost incurred* so that reported net income measures an enterprise performance during a period *instead of merely listing its cash receipts and payments*. Accrual basis of accounting recognizes assets, liabilities or components of revenue and expenses received or paid in cash in past and expected to be received or paid in cash in future.

	The following are essential features of accrual system: ❖ Revenue is recognised as it is earned irrespective of whether cash is received or not; ❖ Cost are matched against revenue on the basis of relevant time period to determine periodic income and ❖ Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written off as a loss.
CASH BASIS OF ACCOUNTING **(BASIS OF ACCOUNTING IS CASH RECEIVED OR PAID)**	The method of recording transaction by which revenues, costs and Assets and liabilities are reflected in the accounts in the period in which *actual receipts or actual payments are made*. Cash system is suitable in the following situations: ❖ Where the organization is very small; ❖ Where credit transactions are almost negligible and collections are uncertain e.g. accounting in case of professionals like doctors, lawyers, CAs, CSs. But while recording expenses they take into account the outstanding expenses also. In such a case, the financial statement prepared by them for determination of their income is termed as Receipt and expenditure account.

ELEMENTS OF FINANCIAL STATEMENTS:

ASSETS	An Asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
LIABILITY	A liability is a **present** obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
EQUITY	Equity is the **residual** interest in the assets of the entity after deducting all its liabilities.
INCOME	Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increase in equity, other than those relating to contributions from equity participants.
EXPENSES	Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrences of liabilities that result in decrease in equity, other than those relating to distribution to equity participants.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS:

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

1. **GOING CONCERN:** The enterprise is normally viewed as a going concern, i.e. as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations.

2. **CONSISTENCY:** It is assumed that accounting policies are consistent from one period to another.

3. **<u>ACCRUAL</u>:** Revenue and cost are accrued that is recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statement of the period to which they relate.

BOOK KEEPING:

- Book-keeping is an activity concerned with the recording of financial data relating to business operation in a **significant and orderly manner**. It covers procedural aspects of accounting work and embraces record keeping function.

- Book Keeping is done for the end product i.e. "Financial Statements" which includes Profit & Loss A/c, Balance Sheet including schedules and notes to account.

- Book Keeping requires suitable classification of transactions and events which is determined by the requirement relating to financial statements.

- A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as position of the customers' accounts in a departmental store. A substantial portion of the book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronic devices. Accounting is based on a careful and efficient book-keeping system.

- The essential idea behind maintaining book-keeping records is to show correct position regarding each head of income and expenditure.

- Maintenance of books of accounts and the preparation of financial statements of a company are guided by the Companies Act, 2013, of a co-operative society by Co-operative Societies Act, of banks and insurance companies by special Acts governing these institutions and so on. However, for sole-proprietorship and partnership business, there is no specific legislation regarding maintenance of books of accounts and preparation of financial statements. The Income-tax Act, 1961 requires maintenance of books of accounts in some cases.

- Companies Act, 2013 mandates all companies to keep & maintain the books of accounts.

OBJECTIVES OF BOOK KEEPING:

1. **<u>Systematic recording of Transactions</u>** – Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping.

2. **<u>Ascertainment of results of above recorded Transactions</u>**– Accountant prepares profit and loss account to know the results of business operations for a particular period of time.

3. **<u>Ascertainment of the financial position of the business</u>** – Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date.

4. **<u>Providing information to the users for rational Decision-Making</u>**– Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.

5. **<u>To know the Solvency position</u>:** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information

regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long run as and when they fall due.

BOOK KEEPING VS ACCOUNTING:

Book Keeping	Accounting
It is a process concerned with the recording of transactions.	It is a process concerned with the summarizing of the recorded transactions.
It constitutes the base of accounting	It is considered as the language of the business.
Financial statements do not form part of this process	Financial statements are prepared in this process on the basis of the book keeping records.
Managerial decisions cannot be taken on the basis of these records.	Management takes decisions on the basis of these records.
There is no sub field of book keeping	It has several sub fields of accounting like cost accounting, financial accounting, management accounting, etc.
Financial position of the business cannot be ascertained through book keeping records.	Financial position of the business is ascertained on the basis of accounting reports.

SUB FIELDS OF ACCOUNTING:

FINANCIAL ACCOUNTING	• It covers the preparation and interpretation of financial statements and communication to the users of accounts. • It is **historical in nature** as it records transactions which had already been occurred. • The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. • It primarily helps in determination of the net result for an accounting period and the financial position as on a given date.
MANAGEMENT ACCOUNTING	• It is concerned with **internal reporting** to the managers of a business unit. • To discharge the functions of stewardship, planning, control and decision-making, the management needs variety of information. • The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting.
COST ACCOUNTING	• The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as: "*the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.*"
SOCIAL RESPONSIBILITY ACCOUNTING	• The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. • As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

HUMAN RESOURCE ACCOUNTING	• Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organization that are not presently accounted for under conventional accounting practice.

USERS OF ACCOUNTING INFORMATION:

INVESTORS	They provide risk capital to the business. They need information to assess whether to **buy, hold or sell their investment**. Also they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.
EMPLOYEES	Growth of the employees is directly related to the growth of the organization and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide **remuneration, retirement and other benefits** and to enhance employment opportunities.
LENDERS	They are interested to know whether their loan-principal and interest **will be paid** when due.
SUPPLIERS AND CREDITORS	They are also interested to know the ability of the enterprise to **pay their dues** that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometimes, they also become interested in long-term continuation of the enterprise if their existence becomes dependent on the survival of that business. Suppose, small ancillary units supply their products to a big enterprise, if the big enterprise collapses, the fate of the small units also becomes sealed.
CUSTOMERS	Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent in a vertical chain, suppose, a company produces some chemicals used by pharmaceutical companies. It supplies chemicals on three month's credit. If all of a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.
GOVERNMENT AND THEIR AGENCIES	They regulate the functioning of business enterprises for public good, allocate scarce resources among competing enterprises, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.
PUBLIC	The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

DOUBLE ENTRY SYSTEM

Double entry system of book-keeping has emerged in the process of evolution of various accounting techniques. It is the only scientific system of accounting. According to it, every transaction has two-fold aspects–debit and credit and both the aspects are to be recorded in the books of accounts. For example, if a business acquires something then either it must have been given by someone or it must have been acquired by giving up something. On purchase of furniture either the cash balance will be reduced or a liability to the supplier will arise. This has been made clear already; the Double Entry System is so named since it records both the aspects. We may define the Double Entry System as the system which recognizes and records both the aspects of transactions. This system has proved to be systematic and has been found of great use for recording the financial affairs for all institutions requiring use of money.

It was in **1494** that **Luca Pacioli**, the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System.

ADVANTAGES OF DOUBLE ENTRY SYSTEM

This system affords the under mentioned advantages:
(i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.
(ii) The profit earned or loss suffered during a period can be ascertained together with details.
(iii) The financial position of the firm or the institution concerned can be ascertained at the end of each period, through preparation of the balance sheet.
(iv) The system permits accounts to be kept in as much details as necessary and, therefore affords significant information for the purposes of control etc.
(v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.
It is because of these advantages that the system has been used extensively in all countries.

TRANSACTIONS

In the system of book-keeping, students can notice that transactions are recorded in the books of accounts. A transaction is a *type of event*, which is generally ***external in nature*** and can be determined in ***terms of money***. In an accounting period, every business has huge number of transactions which are analysed in financial terms and then recorded individually, followed by classification and summarization process, to know their impact on the financial statements.

A transaction is a ***two way process*** in which value is transferred from one party to another. In it either a party receives a value in terms of goods etc. and passes the value in terms of money or vice versa. Therefore, one can easily make out that in a transaction, a party receives as well as passes the value to other party. For recording transaction it is very important that they are supported by a substantial document like purchasing invoices, bills, pay-slips, cash-memos, passbook etc.

Transactions analysed in terms of money and supported by proper documents are recorded in the books of accounts under double entry system. To analyse the dual aspect of each transaction two approaches can be followed:
(1) American Approach.
(2) Traditional Approach.

AMERICAN APPROACH OR MODERN APPRAOCH:

According to this approached the rules of debit and credit transactions are divided into the following five categories:
(a) Transactions relating to owner, e.g., Capital – these are personal accounts.
(b) Transactions relating to other liabilities, e.g., suppliers of goods – these are mostly personal accounts.
(c) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, and bills receivable – these are basically real accounts.
(d) Transactions relating to expenses, e.g., rent, salary, commission, wages, and cartage – These are nominal accounts.
(e) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – these are nominal accounts.

TRADITIONAL APPROACH OR BRITISH APPROACH:

Under traditional approach of recording transactions one should first understand the term debit and credit and their rules.

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

(i) Personal transactions.
(ii) Transactions related to assets and properties.
(iii) Transactions related to expenses, losses, income and gains.

CLASSIFICATION OF ACCOUNTS

(i)**Personal Accounts**: Personal accounts relate to persons, debtors or creditors. Example would be; the account of Ram & Co., a credit customer or the account of Jhaveri & Co., a supplier of goods. The capital account is the account of the proprietor and, therefore, it is also personal but adjustment on account of profits and losses are made in it. This account is further classified into three categories:

(a) **Natural** personal accounts: It relates to transactions of human beings like Ram, Rita, etc.

(b) **Artificial (legal)** personal account: For business purpose, business entities are treated to have separate entity. They are recognised as persons in the eye of law for dealing with other persons. For example: Government, Companies (private or limited), Clubs, Co-operative societies etc.

(c) **Representative personal accounts:** These are not in the name of any person or organization but are represented as personal accounts. For example: outstanding liability account or prepaid account, capital account, drawings account.

(ii)**Impersonal Accounts**: Accounts which are not personal such as machinery account, cash account, rent account etc. These can be further sub-divided as follows:

(a) **Real Accounts:** Accounts which relate to assets of the firm but not debt. For example, accounts regarding land, building, investment, fixed deposits etc., are real accounts. Cash in hand and Cash at the bank accounts are also real.

(b) **Nominal Accounts:** Accounts which relate to expenses, losses, gains, revenue, etc. like salary account, interest paid account, and commission received account. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary.

Classify the below mentioned accounts:

PROFIT & LOSS ACCOUNT

Particular	Type	Particulars	Type
Opening Stock	Real	Sales	Nominal
Purchases	Nominal	Closing Stock	Real
Direct Expenses	Nominal		
Gross Profit			
Salary	Nominal	**Gross Profit**	
Rent	Nominal	Discount Received	Nominal
Legal Fees	Nominal	Interest Received	Nominal
Travelling	Nominal	Commission Received	Nominal
Printing & Stationery	Nominal	Rent Received	Nominal
Electricity Expense	Nominal	Dividend Received	Nominal

Telephone Expense	Nominal		
Office Expense	Nominal		
Interest Paid	Nominal		
Repairs & Maintenance	Nominal		
Insurance Expense	Nominal		
Advertisement Expense	Nominal		
Discount Allowed	Nominal		
Accounting Charges	Nominal		
Bad Debts	Nominal		
Depreciation	Nominal		
Net Profit			

BALANCE SHEET

Liabilities	Type	Assets	Type
Non-Current Liabilities		**Non-Current Assets**	
Share Capital	Personal	Goodwill & Patent	Real
Reserves & Surplus	Personal	Plant and Machinery	Real
Bank Loan	Personal	Land and Building	Real
Debentures	Personal	Furniture and Fixtures	Real
Public Deposits	Personal	Vehicles	Real
Unsecured Loans	Personal	Long term investments	Real
Current Liabilities		**Current Assets**	
Sundry Creditors	Personal	Sundry Debtors	Personal
Dividend Payable	Personal	Loans and Advances	Personal
Bill Payable	Personal	Cash and Bank balance	Real
Bank Overdraft	Personal	Bill Receivable	Real
Outstanding Expenses	Personal	Stock	Real
		Prepaid Expenses	Personal

1. Nominal Account: Debit Balance: Debit Side of Trading & P & L Account
Credit Balance: Credit Side of Trading & P & L Account

2. Real Account: Asset Side of Balance Sheet

3. Personal Account: Debit Balance: Asset Side of Balance Sheet
Credit Balance: Liability Side of Balance Sheet

GOLDEN RULES OF ACCOUNTING

All the above classified accounts have two rules each, one related to Debit and one related to Credit for recording the transactions which are termed as golden rules of accounting, as transactions are recorded on the basis of double entry system.

1. Personal account is governed by the following two rules:
Debit the receiver; Credit the giver

2. Real account is governed by the following two rules:
Debit what comes in; Credit what goes out

3. Nominal account is governed by the following two rules:
Debit all expenses and losses; Credit all incomes and gains.

JOURNAL

Transactions are *first* entered in this book to show which accounts should be debited and which credited. Journal is also called ***subsidiary book***. Recording of transactions in journal is termed as ***journalizing*** the entries.

A journal contains the following columns:

i. Date: The date on which the transaction took place.
ii. Particulars: The two aspects (debit and credit) are recorded here.
iii. Ledger Folio (LF): it records the page number in the ledger in which the accounts are given entry are posted.
iv. Amount (Debit): debit amount is recorded in the Dr. Column
v. Amount (Credit): Credit amount is recorded in Cr. Column

FORMAT OF JOURNAL

Date	Particulars	L/f	Dr. Amount	Cr. Amount

Process of Journalizing:

1. Ascertain what accounts are affected in the transaction
2. Ascertain the nature of the account (i.e. Real, Personal & Nominal)
3. Apply the rules of debit and credit to each type of account.
4. Pass the entry.

Points to be taken into consideration while recording a transaction in the Journal:

1. Journal entries can be ***Simple Entry*** (i.e. one debit and one credit) or ***Compound entry*** (i.e. one debit and two or more credits or two or more debits and one credit or two or more debits and credits). In such cases, it is important to check that the total of both debits and credits are equal.

2. If journal entries are recorded in several pages then both the amount column of each page should be totalled and the balance should be written at the end of that page and also that the same total should be carried forward at the beginning of the next page. *However, this total is only for checking arithmetical accuracy & does not serve any other purpose*.

3. When journal entries for two or more transactions are combined, it is called ***Composite journal entry***.

SUBSIDIARY BOOKS:

In a Business most of the transactions generally relate to receipts and payments of cash, sale of goods and their purchase. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. A register of this type is called a book of original entry or of prime entry. For transactions recorded in such books there will be no journal entry. The system by which transactions of a class are first recorded in the book, specially meant for it and on the basis of which ledger accounts are then prepared is known as the Practical System of Book keeping or even the English System. It should be noted that in this system, there is no departure from the rules of the double entry system.

TYPES OF SUBSIDIARY BOOKS:

PURCHASE BOOK	It records the *credit* purchase of *goods* traded in. Example: stationery dealer purchased stationery in credit from Ram.
SALES DAY BOOK	It records the *credit* sale of *goods* dealt in (traded in) Example: Furniture dealer sold furniture on credit.
PURCHASE RETURN BOOK	It records the goods or material returned to the suppliers that have been purchased on credit. When goods are returned to supplier a debit note is issued to him indicating that his account has been debited with the amount mentioned in the debit note.
SALES RETURN BOOK	It records the goods or material returned by the purchaser that had been sold on credit. When goods are returned by a customer a credit note is sent to him mentioning that his account has been credited with the value of goods returned.
BILLS RECEIVABLE BOOK	It records the bills of exchange or promissory note received by a business entity.
BILLS PAYABLE BOOK	It records the acceptances given to the creditor in the form of bills or promissory notes.
CASH BOOK	It is used to record *all cash* transactions of the business. Example: Sale of goods in cash, Sale of Fixed Assets in cash, Purchase of goods in cash, Purchase of Fixed Asset in cash, Payment of Expenses, Receipt from Debtors, Payment to creditors, etc.
JOURNAL PROPER (BALANCING JOURNAL)	All entries which cannot be recorded in the above subsidiary books are recorded in this book. Example: opening entries, Closing entries, rectification entries, Depreciation, Credit purchase of Fixed Assets, Credit Sale of Fixed Assets, etc.

JOURNAL PROPER:

OPENING ENTRIES	When books are started for the New Year, the opening balance of assets and liabilities are journalized.
CLOSING ENTRIES	At the end of the year the profit and loss account has to be prepared. For this purpose, the nominal accounts are transferred to this account. This is done through journal entries called closing entries.
RECTIFICATION ENTRIES	If an error has been committed, it is rectified through a journal entry.
TRANSFER ENTRIES	If some amount is to be transferred from one account to another, the transfer will be made through a journal entry.
ADJUSTING ENTRIES	At the end of the year the amount of expenses or income may have to be adjusted for amounts received in advance or for amounts not yet settled in cash. Such an adjustment is also made through journal entries. Usually, the entries pertain to the following:

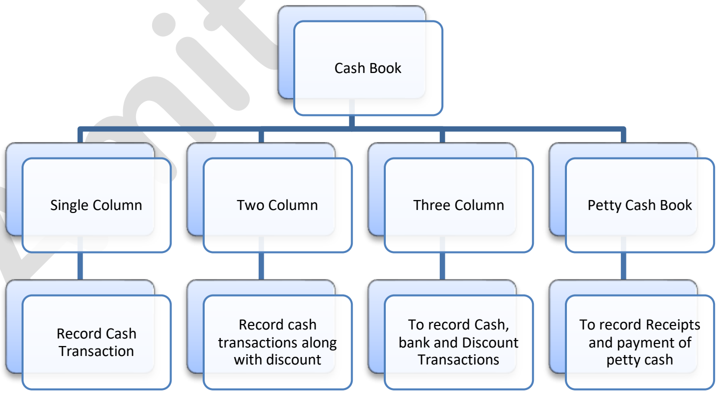
	(a) Outstanding expenses, i.e., expenses incurred but not yet paid; (b) Prepared expenses, i.e., expenses paid in advance for some period in the future; (c) Interest on capital, i.e., the interest which the proprietor thinks proper to allow on his investment; and (d) Depreciation, i.e., fall in the value of the assets used on account of wear and tear. For all these, journal entries are necessary.
ENTRIES ON DISHONOUR OF BILLS	If someone who accepted a promissory note (or bill) and is not able to pay in on the due date, a journal entry will be necessary to record the non-payment or dishonour.
MISCELLANEOUS ENTRIES	The following entries will also require journalizing: (a) Credit purchase of things other than goods dealt in or materials required for production of goods e.g. credit purchase of furniture or machinery will be journalized. (b) An allowance to be given to the customers or a charge to be made to them after the issue of the invoice. (c) Receipt of promissory notes or issue to them if separate bill books have not been maintained. (d) On an amount becoming irrecoverable, say, because, of the customer becoming insolvent. (e) Effects of accidents such as loss of property by fire. (f) Transfer of net profit to capital account.

CASH BOOK:

CASH BOOK - A Subsidiary Book as well as Principal Book

Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.

KINDS OF CASH BOOK:



The main Cash Book may be of the three types:
(i) Simple Cash Book;
(ii) Two-column Cash Book;
(iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

SIMPLE CASH BOOK:

Date	Particulars	J/f	Amount	Date	Particulars	J/f	Amount

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right hand side the payments. Balancing of the Cash Book: The cash book is balanced like other accounts. The receipts column is always bigger than payments column. The difference is written on the credit side as 'By balance c/d'. The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

DOUBLE COLUMN CASH BOOK

Date	Particulars	J/f	Cash	Bank/Disc	Date	Particulars	J/f	Cash	Bank/Disc

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

Cash discount is an allowance which often accompanies cash payments. For example, if a customer owes ₹ 500 but is promised that 2% will be deducted if payment is made within a certain period, the customer can clear his account by paying promptly ₹ 490. Cash received will be ₹ 490 and ₹ 10 will be the discount for the firm receiving the payment discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipt side of the cashbook and a column for discount received on the payment side of the cash book.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

Balancing: It should be noted that the discount columns are not balanced. They are merely totalled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

THREE COLUMN CASH BOOK

Date	Particulars	J/f	Cash	Bank	Disc	Date	Particulars	J/f	Cash	Bank	Disc

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

Distinction	Trade Discount	Cash Discount
Meaning	It is a reduction granted by a supplier from the list price (MRP) of goods or services on business considerations (such as quantity bought, etc.) other than for prompt payment.	A reduction granted by a supplier from the invoice price in consideration of immediate payment or payment within a stipulated period of time.
Purpose	It is allowed to promote the sale or as a trade practice.	It is allowed to encourage the prompt payment.
Time when allowed	It is allowed on purchase of goods	It is allowed on immediate payment or payment within specified period.
Disclosure in the invoice	It is shown by way of deduction in the invoice itself.	It is not shown in the invoice.
Ledger Account	Trade discount account is not opened in the ledger	Cash discount account is opened in the ledger
Variation	It may vary with the quantity purchased	It may vary with the period within which the payment is made.

PETTY CASH BOOK

In a business house a number of small payments, such as for telegrams, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below ₹ 25, to him. Of course he will be reimbursed for the payments made. Later, on an analysis, the respective account may be debited.

IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period. Thus, he will have again the fixed amount in the beginning of the new period. Such a system is known as the ***Imprest system of petty cash***.

The system is very useful especially if an analytical Petty Cash Book is used. The book has one column to record receipt of cash (which is only from the main cashier) and other columns to record payments of various types. The total of the various columns show why payments have been made and then the relevant accounts can be debited.

(i) The amount fixed for petty cash should be sufficient for the likely small payments for a relatively short period, say for a week or a fortnight.

(ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e., documentary evidence and should be limited to the amount of actual disbursements.

(iii) The vouchers should be filed in order.

(iv) No payment should be made without proper authorization. Also, payments above a certain specified limit should be made only by the main cashier

(v) The petty cashier should not be allowed to receive any cash except for reimbursement. In the petty cash book the extreme left-hand column records receipts of cash. The money column towards the right hand shows total payments for various purposes; a column is usually provided for sundries to record infrequent payments. The sundries column is analysed. At the end of the week or the fortnight the petty cash book is balanced. The method of balancing is the same as for the simple cash book.

LEDGER ACCOUNTING:

INTRODUCTION:

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

SPECIMEN OF LEDGER ACCOUNTS

A ledger account has two sides-debit (left part of the account) and credit (right part of the account). Each of the debit and credit side has four columns. (i) Date (ii) Particulars (iii) Journal folio i.e. page from where the entries are taken for posting and (iv) Amount.

Date	Particulars	J/f	Amount	Date	Particulars	J/f	Amount

POSTING:

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

RULES REGARDING POSTING OF ENTRIES IN THE LEDGER

1. Separate account is opened in ledger book for each account and entries from ledger posted to respective account accordingly.
2. It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'by' do not have any meanings but are used to represent the account debited and credited.
3. The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.

BALANCING AN ACCOUNT

At the end of the each month or year or any particular day it may be necessary to ascertain the balance in an account. This is not a too difficult thing to do; suppose a person has bought goods worth ₹ 1,000 and has paid only ₹ 850; he owes ₹ 150 and that is balance in his account. To ascertain the balance in any account, what is done is to total the sides and ascertain the difference; the difference is the balance. If the credit side is bigger than the debit side, it is a credit balance. In the other case it is a debit balance. The credit balance is written on the debit side as, "To Balance c/d"; c/d means "carried down". By doing this, two sides will be equal. The totals are written on the two sides opposite one another.

Then the credit balance is written on the credit side as "By balance b/d (i.e., brought down)".This is the opening balance for the new period. The debit balance similarly is written on the credit side as "By Balance c/d", the totals then are written on the two sides as shown above as then the debit balance written on the debit side as, "To Balance b/d", as the opening balance of the new period.

It should be noted that *nominal accounts are not balanced*; the balance in the end are transferred to the *profit and loss account*. Only personal and real accounts ultimately show balances. In the illustration given above, one will have noticed that the capital account, the purchases account, sales account, the discount account, the rent account and the salary account have not been balanced. The capital account will have to be adjusted for profit or loss and that is why it has not been balanced yet.

Unit 3: TRIAL BALANCE:

INTRODUCTION:

Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates reasonable accuracy of the accounting work; if the two sides do not agree, then there is simply an arithmetic error(s).

This follows from the fact that under the Double Entry System, the amount written on the debit sides of various accounts is always equal to the amounts entered on the credit sides of other accounts and vice versa. Hence the totals of the debit sides must be equal to the totals of the credit sides. Also total of the debit balances will be equal to the total of the credit balances. Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though is not proof of cent per cent accuracy, because some errors of principle and compensating errors may still remain. Generally, to check the arithmetic accuracy of accounts, trial balance is prepared at monthly intervals. But because double entry system is followed, one can prepare a trial balance any time. Though a trial balance can be prepared any time but it is preferable to prepare it at the end of the accounting year to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. *It may be noted that trial balance is a statement and not an account*.

If Trial Balance does not tally, then it is artificially tallied by ***opening Suspense Account***. Later on, errors are rectified and Suspense Accounts get closed automatically.

OBJECTIVES OF PREPARING THE TRIAL BALANCE:

The preparation of trial balance has the following objectives:
(i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books.

(ii) Financial statements are normally prepared on the basic of agreed trial balance; otherwise the work may be cumbersome. Preparation of financial statements, therefore, is the second objective.

(iii) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.
The form of the trial balance is simple as shown below:

Trial balance of ____________
As on ______________

Sr. No	Name of Account	L/F	Debit Amount	Credit Amount

METHODS OF PREPARATION OF TRIAL BALANCE

1. TOTAL METHOD
Under this method, every ledger account is totalled and that total amount (both of debit side and credit side) is transferred to trial balance. In this method, trial balance can be prepared as soon as ledger account is totalled. Time taken to balance the ledger accounts is saved under this method as balance can be found out in the trial balance itself. The difference of totals of each ledger account is the balance of that particular account. This method is **not commonly used** as it cannot help in the preparation of the financial statements.

2. BALANCE METHOD
Under this method, every ledger account is balanced and those balances only are carried forward to the trial balance. This method is **used commonly** by the accountants and helps in the preparation of the financial statements. Financial statements are prepared on the basis of the balances of the ledger accounts.

3. COMPOUND METHOD:
Under this method, totals of both the sides of the accounts are written in the separate columns. Along with this, the balances are also written in the separate columns. Debit balances are written in the debit column and credit balances are written in the credit column of the trial balance. This method also is **not commonly used**.

CHAPTER 2: INTRODUCTION TO CORPORATE ACCOUNTING

SCHEDULE III TO COMPANIES ACT, 2013

FINANCIAL STATEMENTS FOR A COMPANY WHOSE FINANCIAL STATEMENTS ARE REQUIRED TO COMPLY WITH THE COMPANIES (ACCOUNTING STANDARDS) RULES, 2006.

PART 1: BALANCE SHEET FORMAT

I. EQUITY AND LIABILITIES		
1. Shareholder's Fund		
a) Share Capital		
b) Reserves and Surplus		
c) Money received against share warrants		
2) Share Application Money Pending allotment		
3) Non-Current Liabilities:		
a) Long Term Borrowings		
b) Deferred Tax Liabilities (Net)		
c) Other Long term Liabilities		
d) Long term provisions		
4) Current Liabilities		
a) Short Term Borrowings		
b) Trade Payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises		
c) Other Current Liabilities		
d) Short Term Provisions		
II. ASSETS		
1) Non-Current Assets		
a) Property, Plant & Equipment		
i) Tangible Assets		
ii) Intangible Assets		
iii) Capital WIP		
iv) Intangible Assets under development		
b) Non-Current Investments		
c) Deferred Tax Assets (Net)		
d) Long Term Loans and Advances		

e) Other Non-Current Assets		
<u>2) Current Assets:</u>		
a) Current Investments		
b) Inventories		
c) Trade Receivables		
d) Cash and Cash Equivalents		
e) Short term loans and advances		
f) Other current Assets		

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as <u>current</u> when it satisfies any of the following criteria:—
(a) It is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
(b) It is held primarily for the purpose of being traded;
(c) It is expected to be realized within twelve months after the reporting date; or
(d) It is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.
<u>All other assets shall be classified as non-current.</u>

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of twelve months.

3. A liability shall be classified as <u>current</u> when it satisfies any of the following criteria:—
(a) It is expected to be settled in the company's normal operating cycle;
(b) It is held primarily for the purpose of being traded;
(c) It is due to be settled within twelve months after the reporting date; or
(d) The company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.
<u>All other liabilities shall be classified as non-current.</u>

4. A receivable shall be classified as a "trade receivable" if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a "trade payable" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the <u>notes to accounts</u>.

KEY FEATURES OF BALANCE SHEET SCHEDULE III	1) The Schedule III permits only Vertical form of presentation. 2) It uses "Equity and Liabilities" and "Assets" as headings. 3) All assets and liabilities classified into current and non-current and presented separately on the face of the Balance Sheet. 4) Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.

	5) Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date. 6) Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet. 7) Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under "Other current liabilities." 8) The term "sundry debtors" has been replaced with the term "trade receivables." 'Trade receivables' are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables. 9) It requires separate disclosure of "trade receivables" outstanding for a period exceeding six months from the date the bill/invoice is due for payment." 10) "Capital advances" are specifically required to be presented separately under the head "Loans & advances" rather than including elsewhere. 11) Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee. 12) Under the Schedule III, other commitments also need to be disclosed.
A. SHARE CAPITAL	For each class of share capital (different classes of preference shares to be treated separately): (a) The number and amount of shares authorized; (b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid; (c) Par value per share; (d) A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period; (e) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the

	repayment of capital; (f) Shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate; (g) Shares in the company held by each shareholder holding more than5 per cent. shares specifying the number of shares held; (h) Shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts; (i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared: (A) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash. (B) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares. (C) Aggregate number and class of shares bought back. (j) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date; (k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers); (l) Forfeited shares (amount originally paid-up).
B. RESERVES AND SURPLUS	(i) Reserves and Surplus shall be classified as: (a) Capital Reserves; (b) Capital Redemption Reserve; (c) Securities Premium Reserve; (d) Debenture Redemption Reserve; (e) Revaluation Reserve; (f) Share Options Outstanding Account; (g) Other Reserves–(specify the nature and purpose of each reserve and the amount in respect thereof); (h) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.; (Additions and deductions since last balance sheet to be shown under each of the specified heads); (ii) A reserve specifically represented by earmarked investments shall be termed as a “fund”. (iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head “Surplus”. Similarly, the balance of

	"Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.
C. LONG-TERM BORROWINGS	(i) Long-term borrowings shall be classified as: (a) Bonds/debentures; (b) Term loans: (A) From banks. (B) From other parties. (c) Deferred payment liabilities; (d) Deposits; (e) Loans and advances from related parties; (f) Long term maturities of finance lease obligations; (g) Other loans and advances (specify nature). (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case. (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. (iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due. (v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed. (vi) Terms of repayment of term loans and other loans shall be stated. (vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.
D. OTHER LONG-TERM LIABILITIES	Other Long-term Liabilities shall be classified as: (a) Trade payables; (b) Others.
E. LONG-TERM PROVISIONS	The amounts shall be classified as: (a) Provision for employee benefits; (b) Others (specify nature).
F. SHORT-TERM BORROWINGS	(i) Short-term borrowings shall be classified as: (a) Loans repayable on demand;

	(A) From banks. (B) From other parties. (b) Loans and advances from related parties; (c) Deposits; (d) Other loans and advances (specify nature). (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case. (iii) Where loans have been guaranteed by directors or others, the aggregate Amount of such loans under each head shall be disclosed. (iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.
FA. TRADE PAYABLES	The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year; (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year; (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006; (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. Explanation.-The terms' appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006
G. OTHER CURRENT LIABILITIES	The amounts shall be classified as: (a) Current maturities of long-term debt; (b) Current maturities of finance lease obligations; (c) Interest accrued but not due on borrowings; (d) Interest accrued and due on borrowings;

	(e) Income received in advance; (f) Unpaid dividends; (g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application For shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities"; (h) Unpaid matured deposits and interest accrued thereon; (i) Unpaid matured debentures and interest accrued thereon; (j) Other payables (specify nature).
H. SHORT-TERM PROVISIONS	The amounts shall be classified as: (a) Provision for employee benefits. (b) Others (specify nature).
I. TANGIBLE ASSETS	(i) Classification shall be given as: (a) Land; (b) Buildings; (c) Plant and Equipment; (d) Furniture and Fixtures; (e) Vehicles; (f) Office equipment; (g) Others (specify nature). (ii) Assets under lease shall be separately specified under each class of asset. (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related Depreciation and impairment losses/reversals shall be disclosed separately. (iv) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five

	years subsequent to the date of such reduction or increase.
J. INTANGIBLE ASSETS	(i) Classification shall be given as: (a) Goodwill; (b) Brands /trademarks; (c) Computer software; (d) Mastheads and publishing titles; (e) Mining rights; (f) Copyrights, and patents and other intellectual property rights, services and operating rights; (g) Recipes, formulae, models, designs and prototypes; (h) Licenses and franchise; (i) Others (specify nature). (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately. (iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.
K. NON-CURRENT INVESTMENTS	(i) Non-current investments shall be classified as trade investments and other investments and further classified as: (a) Investment property; (b) Investments in Equity Instruments; (c) Investments in preference shares; (d) Investments in Government or trust securities; (e) Investments in debentures or bonds; (f) Investments in Mutual Funds; (g) Investments in partnership firms; (h) Other non-current investments (specify nature). Under each classification, details shall be given of names of the bodies corporate indicating separately whether such bodies are (i) subsidiaries, (ii) associates,(iii) joint ventures, or (iv) controlled special purpose entities in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given. (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof; (iii) The following shall also be disclosed: (a) Aggregate amount of quoted investments and market value thereof;

	(b) Aggregate amount of unquoted investments; (c) Aggregate provision for diminution in value of investments.
L. LONG-TERM LOANS AND ADVANCES	(i) Long-term loans and advances shall be classified as: (a) Capital Advances; (b) Security Deposits; (c) Loans and advances to related parties (giving details thereof); (d) Other loans and advances (specify nature). (ii) The above shall also be separately sub-classified as: (a) Secured, considered good; (b) Unsecured, considered good; (c) Doubtful. (iii) Allowance for bad and doubtful loans and advances shall be disclosed Under the relevant heads separately. (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.
M. OTHER NON-CURRENT ASSETS	Other non-current assets shall be classified as: (i) Long-term Trade Receivables (including trade receivables on deferred credit terms); (ii) Others (specify nature); (iii) Long term Trade Receivables, shall be sub-classified as: (A) (a) Secured, considered good; (B) Unsecured, considered good; (C) Doubtful. (b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately. (c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.
N. CURRENT INVESTMENTS	(i) Current investments shall be classified as: (a) Investments in Equity Instruments; (b) Investment in Preference Shares; (c) Investments in Government or trust securities; (d) Investments in debentures or bonds; (e) Investments in Mutual Funds; (f) Investments in partnership firms; (g) Other investments (specify nature). Under each classification, details shall be given of names of the bodies corporate[indicating separately whether such bodies are: (i) subsidiaries, (ii) associates,(iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature

	and extent of the investment so made in each such body corporate (showing separately investments which are partly paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given. (ii) The following shall also be disclosed: (a) The basis of valuation of individual investments; (b) Aggregate amount of quoted investments and market value thereof; (c) Aggregate amount of unquoted investments; (d) Aggregate provision made for diminution in value of investments.
O. INVENTORIES	(i) Inventories shall be classified as: (a) Raw materials; (b) Work-in-progress; (c) Finished goods; (d) Stock-in-trade (in respect of goods acquired for trading); (e) Stores and spares; (f) Loose tools; (g) Others (specify nature). (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories. (iii) Mode of valuation shall be stated.
P. TRADE RECEIVABLES	(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated. (ii) Trade receivables shall be sub-classified as: (a) Secured, considered good; (b) Unsecured, considered good; (c) Doubtful. (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately. (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated..
Q. CASH AND CASH EQUIVALENTS	(i) Cash and cash equivalents shall be classified as: (a) Balances with banks; (b) Cheque, drafts on hand; (c) Cash on hand; (d) Others (specify nature). (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated. (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

	(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated. (v) Bank deposits with more than twelve months maturity shall be disclosed separately.
R. SHORT-TERM LOANS AND ADVANCES	(i) Short-term loans and advances shall be classified as: (a) Loans and advances to related parties (giving details thereof); (b) Others (specify nature). (ii) The above shall also be sub-classified as: (a) Secured, considered good; (b) Unsecured, considered good; (c) Doubtful. (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately. (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.
S. OTHER CURRENT ASSETS (SPECIFY NATURE)	This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.
T. CONTINGENT LIABILITIES AND COMMITMENTS (TO THE EXTENT NOT PROVIDED FOR)	(i) Contingent liabilities shall be classified as: (a) Claims against the company not acknowledged as debt; (b) Guarantees; (c) Other money for which the company is contingently liable. (ii) Commitments shall be classified as: (a) Estimated amount of contracts remaining to be executed on capital account and not provided for; (b) Uncalled liability on shares and other investments partly paid; (c) Other commitments (specify nature).
U. THE AMOUNT OF DIVIDENDS PROPOSED TO BE DISTRIBUTED TO EQUITY AND PREFERENCE SHAREHOLDERS FOR THE PERIOD AND THE RELATED AMOUNT PER SHARE SHALL BE DISCLOSED SEPARATELY. ARREARS OF FIXED CUMULATIVE DIVIDENDS ON PREFERENCE SHARES SHALL ALSO BEDISCLOSED SEPARATELY.	
V. WHERE IN RESPECT OF AN ISSUE OF SECURITIES MADE FOR A SPECIFIC PURPOSE, THEWHOLE OR PART OF THE AMOUNT HAS NOT BEEN USED FOR THE SPECIFIC PURPOSE AT THE BALANCESHEET DATE, THERE SHALL BE INDICATED BY WAY OF NOTE HOW SUCH UNUTILISED AMOUNTS HAVEBEEN USED OR INVESTED.	
W. IF, IN THE OPINION OF THE BOARD, ANY OF THE ASSETS OTHER THAN PROPERTY PLANT & EQUIPMENT AND NON-CURRENT INVESTMENTS DO NOT HAVE A VALUE ON REALISATION IN THE ORDINARY COURSE OF BUSINESS AT LEAST EQUAL TO THE	

AMOUNT AT WHICH THEY ARE STATED, THE FACT THAT THE BOARDIS OF THAT OPINION, SHALL BE STATED

PART 2: STATEMENT OF PROFIT AND LOSS

I. Revenue from Operations		
II. Other Income		
III. Total Revenue (I + II)		
IV. Expenses:		
a) Cost of Material Consumed		
b) Purchases of Stock in Trade		
c) Changes in Inventories:		
i) Finished Goods		
ii) WIP		
iii) Stock in Trade		
d) Employee Benefit Expense		
e) Finance Cost		
f) Depreciation and Amortization		
g) Other Expenses		
V. Profit before exceptional and Extraordinary Items and Tax		
VI. Exceptional Items		
VII. Profit before Extraordinary Items		
VIII. Extraordinary Items		
IX. Profit before Tax		
X. Tax Expense:		
i) Current Tax		
ii) Deferred Tax		
XI. Profit from Continuing Operations		
XII. Profit from Discontinuing Operations		
XIII. Tax Expense for discontinuing operations		
XIV. Profit for the period		
XV. EPS		
i) Basic		
ii) Diluted		

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

KEY FEATURES OF PROFIT & LOSS SCHEDULE III	1) The name of 'Profit and Loss Account' has been changed to "Statement of Profit and Loss". 2) This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, 'below the line' adjustments to be presented under "Reserves and Surplus" in the Balance Sheet. 3) Any item of income or expense which exceeds one per cent of the revenue from operations or ₹ 100,000 (earlier 1 % of total revenue or ₹ 5,000), whichever is higher, needs to be disclosed separately. 4) In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues. 5) Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost. 6) Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with the disclosure of "broad heads" only. The broad heads need to be decided based on materiality and presentation of true and fair view of the financial statements.
REVENUE FROM OPERATIONS	(A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from— (a) Sale of products; (b) Sale of services; (c) Other operating revenues; Less: (d) Excise duty. (B) In respect of a finance company, revenue from operations shall include revenue from— (a) Interest; and (b) Other financial services. Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.
FINANCE COSTS	Finance costs shall be classified as: (a) Interest expense; (b) Other borrowing costs; (c) Applicable net gain/loss on foreign currency transactions and translation.
OTHER INCOME	Other income shall be classified as: (a) Interest Income (in case of a company other than a finance company); (b) Dividend Income; (c) Net gain/loss on sale of investments; (d) Other non-operating income (net of expenses directly attributable

	to such income).
ADDITIONAL INFORMATION	A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:— (i) (a) **Employee Benefits Expense** [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) Staff welfare expenses]. (b) **Depreciation and amortization** expense; (c) Any item of income or expenditure which exceeds one per cent. of the revenue from operations or ₹1,00,000, whichever is higher; (d) **Interest** Income; (e) **Interest** expense; (f) **Dividend** income; (g) Net gain/loss on sale of investments; (h) Adjustments to the carrying amount of investments; (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost); (j) **Payments to the auditor** as (a) auditor; (b) for taxation matters; (c) for company law matters; (d) for management services; (e) for other services; and (f) for reimbursement of expenses; (k) In case of Companies covered under section 135, amount of expenditure incurred on **corporate social responsibility** activities; (l) Details of items of **exceptional and extraordinary nature**; (m) **Prior period items**; (ii) (a) In the case of **manufacturing companies**,— (1) Raw materials under broad heads. (2) Goods purchased under broad heads. (b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads. (c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

	(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered are shown under broad heads. (e) In the case of other companies, gross income derived under broad heads. (iii) In the case of all concerns having works in progress, works-in-progress under broad heads. (iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up. (b) The aggregate, if material, of any amounts withdrawn from such reserves.(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments. (b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required. (vi) Expenditure incurred on each of the following items, separately for each item:— (a) Consumption of stores and spare parts; (b) Power and fuel; (c) Rent; (d) Repairs to buildings; (e) Repairs to machinery; (f) Insurance; (g) Rates and taxes, excluding, taxes on income; (h) Miscellaneous expenses, (vii) (a) Dividends from subsidiary companies. (b) Provisions for losses of subsidiary companies. (viii) The profit and loss account shall also contain by way of a note the following information, namely:— (a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of— I. Raw materials; II. Components and spare parts; III. Capital goods; (b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters; (c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly

	consumed and the percentage of each to the total consumption; (d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related; (e) Earnings in foreign exchange classified under the following heads, namely:— I. Export of goods calculated on F.O.B. basis; II. Royalty, know-how, professional and consultation fees; III. Interest and dividend; IV. Other income, indicating the nature thereof.

CHAPTER 3 & 5: ACCOUNTING FOR SHARE CAPITAL & RELATED ASPECTS OF COMPANY ACCOUNTS
UNIT 1: INTRODUCTION

FEATURES OF A COMPANY:

a) **Incorporated Association**: A company comes into existence through the operation of law. Therefore, incorporation of company under Companies Act is a must. Without such registration, no company can come into existence. Being created by Law, it is regarded as Artificial Legal Person.

b) **Separate Legal Entity**: A company has a separate legal entity and is not affected by changes in its membership. Therefore, being a separate business entity, a company can contract, sue and be sued in its incorporated name and capacity.

c) **Perpetual Existence**: Since company has existence independent of its members, it continues to be in existence despite the death, insolvency or change of members.

d) **Common Seal**: Company is not a natural person; therefore, it cannot sign the documents in the manner as a natural person would do. In order to enable a company to sign its documents, it is provided with a legal tool called as Common Seal. The common seal is affixed on all documents by the person authorized to do so who in turn puts its signature for and on behalf of company.

e) **Limited Liability**: The liability of every shareholder of a company is limited to the amount he has agreed to pay to the company on the shares allotted to him. If such shares are fully paid up, he is subject to no further liability.

f) **Ownership and Management are in separate hands**: Since the number of shareholders is very large and may be distributed at different geographical locations, it becomes difficult for them to carry on operational management of company on a day to day basis. This gives rise to need of separation of management and ownership.

g) **Transferability of Shares**: The capital is contributed by the shareholders through the subscription of shares. Such shares are transferable by its members except in case of private limited company, which may have certain restrictions on the transferability.

h) **Maintenance of Books**: A Limited Company is required by law to keep a prescribed set of account books and any failure in this regard attracts penalties.

TYPES OF COMPANIES:

(i) **Statutory Company**: All companies which are governed under the special act passed by the parliament or state legislature are called as statutory company. They are formed for special purpose by a special act of parliament. Examples being Reserve bank of India, Unit trust of India, Life Insurance Corporation, etc. such companies are not required to use the word “Limited” as part of their name. Such companies are required to get their accounts audited by comptroller and auditor general of India.

(ii) **Government Company**: a company in which **not less than 51%** of paid up share capital is held by Central government, or by any state government or partly by central government and partly by state government and includes a company which is a subsidiary of Government Company.

(iii) **Foreign Company**: a company that is incorporated outside India but has place of business or business operations in India

(iv) **Registered Companies**: All companies registered under Companies Act 2013 are called as registered companies.

(v) **Holding company**: a company is deemed to be a holding company if the other company is its subsidiary company. A company becomes a subsidiary company when other company controls 50% or more of its paid up share capital or Voting Power, has right to appoint directors on their board, or is a subsidiary of another subsidiary company.

(vi) **Subsidiary Company**: A company in which holding company holds more than 50% of total share capital either on its own or together with one or more subsidiary.

(vii) **Private company**: According to Section 2(68) of Companies Act, 2013, a private company means a company which has a ~~minimum paid-up capital of one lakh rupees or such higher paid-up capital as may be prescribed~~, and by its articles:
  (a) Restricts the rights of members to transfer its shares.
  (b) Limits the number of its member to 200 excluding: (i) persons who are in employment of the company; and (ii) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased. For this purpose joint holders of shares will be counted as single members.
  (c) Prohibits any invitation to the public to subscribe to any shares in, or debentures of, the company.
  (d) Prohibits any invitation or acceptance of deposits from persons other than its member, directors, and relatives.
  Private companies do not involve participation of public in general.

(viii) **Public Company**: According to Section 2(72) of Companies Act, 2013, a company which is:
  ❖ Not a private company
  ❖ Has a minimum paid up share capital of ~~₹5 Lakhs or such higher paid up share capital~~ as may be prescribed;
  ❖ Is a private company which is a subsidiary of a company which is not a private Company?

(ix) **Listed Company**: A listed company is a public company which has any of its securities listed in any recognized stock exchange.

(x) **Unlisted company**: An unlisted company is one whose securities are not listed on any recognized stock exchange.

MAINTENANCE OF BOOKS OF ACCOUNTS:

As per Section 128 of the companies act, 2013, Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statements for every financial year which give a true and fair view of state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to double entry system of accounting.

Provided further that the company may keep such books of account in electronic mode in such manner as may be prescribed.

PREPARATION OF FINANCIAL STATEMENTS:

- Under Section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of company and comply with the Accounting Standards and shall be in form as prescribed in Schedule III.

- Financial Statements as per Section 2(40) of the Companies Act, 2013, includes:
  a) A Balance Sheet;
  b) A Profit & loss Account or in case of company carrying out any activity not for profit, an income & Expenditure account;
  c) Cash Flow Statement;
  d) A Statement of changes in equity;
  e) An Explanatory Note required in above clauses.

- Balance sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III.

- As per Section 129 of Companies Act, 2013, it is mandatory to comply with Accounting Standards notified by Central Government.

- Schedule III of the Companies Act, 2013 deals with the preparation and presentation of profit and loss account and the balance sheet. It requires that final accounts of a company shall give a true and fair view of the state of affairs of the company. Schedule III prescribe the form in which profit and loss account& Balance Sheet should be prepared.

- A Vertical Format for Balance Sheet with classification of balance sheet items in Current &Non-Current Category. (*Horizontal i.e. T format not allowed under Companies Act, 2013)*

- It uses Equities & Liabilities and Assets as Headings.

- A Vertical Format for Profit & Loss Account with classification of expenses based on nature.

- Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet.

SHARE CAPITAL:

Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share. The fixed value of a share, printed on the share certificate, is called nominal/par/face value of a share. However, a company can issue shares at a price different from the face value of a share. The liability of holder of shares (called shareholders) is limited to the issue price of shares acquired by them.

As per SEBI guidelines, a company is free to price its issue, if it has a three years track record of consistent profitability and in case of new company, if it is promoted by a company with a five years track record of consistent profitability. As the total capital of the company is divided into shares, the capital of the company is called 'Share Capital'.

Share capital of a company is divided into following categories:

(i) **Authorized Share Capital**: A company estimates its maximum capital requirements. This amount of capital is mentioned in '**Capital Clause'** of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of capital, which a company is authorized to raise during its lifetime and is called 'Authorized Capital'. It is also referred to as **'Registered Capital' or 'Nominal Capital'**. It is shown in the balance sheet at face value.

(ii) **Issued Share Capital**: A company need not issue total authorized capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'. Issued capital means and includes the nominal value of shares issued by the company for: 1. Cash, and 2. Consideration other than cash to: (i) Promoters of a company; and (ii) Others. It is also shown in the balance sheet at nominal value. The remaining portion of the authorized capital which is not issued either in cash or consideration may be termed as 'Un-issued Capital'. *It is not shown in the balance sheet.*

(iii) **Subscribed Share Capital**: It is that part of the issued share capital, which is subscribed by the public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

(iv) **Called-up Share Capital**: Companies generally receive the issue price of shares in instalments. The portion of the issue price of shares which a company has demanded or called from shareholders is known as 'Called-up Capital' and the balance, which the company has decided to demand in future, may be referred to as Uncalled Capital.

(v) **Paid-up Share Capital**: It is the portion of called up capital which is paid by the shareholders. Whenever a particular amount is called by the company and the shareholder(s) fails to pay the amount fully or partially, it is known as '*unpaid calls*' or '*instalments (or Calls) in Arrears*'. Thus, instalments in arrears mean the amount not paid although it has been demanded by the company as payment towards the issue price of shares. *To calculate paid-up capital, the amount of instalments in arrears is deducted from called up capital.* In balance sheet, called-up and paid-up capitals are shown together.

(vi) **Reserve Share Capital**: As per Section 65 of Companies Act, 2013, a company may decide by passing a special resolution that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. Portion of the uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Liability/Reserve Capital. Reserve Capital is different from Capital reserve, Capital reserves are part of 'Reserves and Surplus' and refer to those reserves which are not available for declaration of dividend. These reserves may be used to write off capital losses such as discount on issue of shares.

These can also be used to issue bonus shares, subject of the condition, that reserve is realized in cash. Thus, reserve capital which is portion of the uncalled capital to be called up in the event of winding up of the company is entirely different in nature from capital reserve which is created out of profits only.

TYPES OF SHARES:

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

(i) **PREFERENCE SHARES**: According to section 55 of the Companies Act, 2013, persons holding preference shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company. They also carry a preferential right over other shareholders to be paid first in case of winding up of the company. Thus, they enjoy preferential rights in the matter of: (a) Payment of dividend, and (b) Repayment of capital. Generally, holders of these shares do not get voting rights. Dividend is generally cumulative in nature and need not be paid every year in case of deficiency of profits. The Companies Act, 2013, prohibits the issue of any preference share which is irredeemable. *Preference shares are cumulative and non-participating unless expressly stated otherwise*.

TYPES OF PREFERENCE SHARES:

Preference shares can be of various types, which are as follows:

(a) **Cumulative Preference Shares**: A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at a fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose.

This means that dividend on these shares accumulates unless it is paid in full and, therefore; the shares are called Cumulative Preference Shares. The arrears of dividend are then shown in the balance sheet as a contingent liability. In India, a preference share is always cumulative unless otherwise stated.

(b) **Non-cumulative Preference Shares**: A non-cumulative preference share carries with it the right to a fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires. It implies that holder of such a share is not entitled to arrears of dividend in future.

(c) **Participating Preference Shares**: Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate. Similarly, in the event of winding up of the company, this type of share carries the right to receive a pre-determined proportion of surplus as well once the equity shareholders have been paid off.

(d) **Non-participating Preference Shares**: A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.' Unless otherwise specified, the preference shares are generally non-participating.

(e) **Redeemable Preference Shares:** These are shares that a company may issue on the condition that the company will repay after the fixed period or even earlier at Company's discretion.

(f) **Non-redeemable Preference Shares**: The preference shares, which do not carry With them the arrangement regarding redemption, are called Non-redeemable Preference Shares. According to Section 55, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of **20 years** from the date of issue.

(g) **Convertible Preference Shares**: These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

(h)**Non-convertible Preference Shares**: When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference Shares. Preference shares are non-convertible unless otherwise stated.

(ii) **EQUITY SHARES**: Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment of capital. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders.

These shares carry voting rights. Companies Act, 2013 permits issue of Equity share capital with differential rights as to dividend, voting or otherwise.
The shares can be issued by a company either
(1) For cash or
(2) For consideration other than cash.

EQUITY SHARES WITH DIFFERENTIAL RIGHTS:
Section 43 of the Companies Act 2013 & Rule 4 of Companies (Share capital and Debentures) Rules, 2014

No Company Whether Unlisted or Listed public company shall issue equity shares with differential rights as to Dividend, Voting or Otherwise, unless it complies with the following conditions:

(a) **Authorization in the Articles of Association (AOA):** the AOA of the company authorizes the issue of shares with differential rights.

(b) **Shareholder's Approval**: the issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders.

(c) **Maximum Limit**: the voting power in respect of shares with differential rights of the company shall not exceed seventy four per cent. of total voting power including voting power in respect of equity shares with differential rights issued at any point of time;

(d) Omitted

(e) **No Default in Statutory Filing**: The Company has not defaulted in filing financial statements and annual returns for 3 financial years immediately preceding the financial year in which it is decided to issue such shares.

(f) **No Default in the payment of dividend, F or Debentures**: The Company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend.

(g) **No Penalty**: The Company has not been penalized by Court or NCLT during the last 3 years of any offence under the RBI Act, SEBI Act, SCRA, FEMA, or any other Special Act.

PROCEDURE FOR ISSUE OF SHARES

To issue shares, company has to follow a definite procedure with prescribed rules and regulations, which is controlled and regulated by the Companies Act, 2013 and Securities Exchange Board of India (SEBI).

When a public company desires to raise capital by issuing its shares to the public, it must invite them to subscribe for the shares. The person who intends to become a shareholder must thus subscribe to those shares by making an application for the desired number of shares to the company. Consequently, the company will allot shares to the applicant.

Allotment means allocating or apportioning a certain number of shares to an applicant in response to his application. The company cannot allot more than the number of shares offered to the public for subscription through the prospectus. Moreover, the company cannot make allotment unless the amount stated in the prospectus as the minimum subscription has been subscribed and the sum payable on application for the stated amount has been received by the company.

If the number of shares applied for is less than the number of shares offered the allotment can be only for the shares applied for, provided minimum subscription is raised. Shares can be issued either for cash or for consideration other than cash

In general, shares are issued for cash. The company may call the share money either in one instalment or in two or more instalments.

IMPORTANT PROVISIONS RELATING TO ISSUE OF SECURITIES UNDER COMPANY LAW:

- The Board of Directors or its committee authorized to allot the securities after receiving the minimum subscription.

- No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.

- The amount payable on application on every security shall ***not be less than 5% of the nominal amount*** of the security or such other percentage or amount, as may be specified by SEBI.

- If minimum amount has not been subscribed and the sum payable on application is not received within 30 days from the date of issue of the prospectus, the amount so received shall be returned within 15 days from the closure of the issue.

- If any such money is not so repaid within such period the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at 15% p.a.

IMPORTANT PROVISIONS RELATING TO ISSUE OF SECURITIES UNDER SEBI GUIDELINES:

- The minimum subscription to be received in the issue shall be ***at least 90% of the offer*** through the offer document;

- In the event of non-receipt of minimum subscription referred to in sub-regulation (1), all application monies received shall be refunded to the applicants forthwith, but not later than 15 days from the closure of the issue.

- The minimum sum payable on application per specified security shall be ***at least 25% of the issue price***;

- If the issuer proposes to receive subscription monies in calls, it shall ensure that the outstanding subscription money is called within twelve months from the date of allotment in the issue and if any applicant fails to pay the call money within the said twelve months, the equity shares on which there are calls in arrears along with the subscription money already paid on such shares shall be forfeited;

- The issuer shall not make an allotment pursuant to a public issue if the number of prospective allottees is less than one thousand.

- Where the specified securities are not allotted and/or application monies are not refunded within the period stipulated, the issuer shall undertake to pay interest at the rate of 15% per annum to the investors and within such time as disclosed in the offer document;

JOURNAL ENTRIES FOR ISSUE OF SHARES:

On receipt of Application money Bank A/c ....Dr To Share Application Money A/c (Being Amount received as Share Application Money)
On allotment of shares Share application money A/c ..,...Dr Share Allotment A/c ....Dr To Share Capital Account A/c (Being Shares Allotted and Share Allotment money due)
On Receipt of allotment money Bank A/c ....Dr To Share Allotment A/c (Being Share Allotment Money received)
On a call being Due Share Call Account A/c.....Dr To Share Capital A/c (Being Share Call Money Due)
On Receipt of call money Bank A/c ....Dr To Share Call a/c (Being Share Call Money Received)

SUBSCRIPTION OF SHARES

APPLICATION SUPPORTED BY BLOCKED AMOUNT:

ASBA means "Application Supported by Blocked Amount". ASBA is an application containing an authorization to block the application money in the bank account, for subscribing to an issue. If an investor is applying through ASBA, his application money shall be debited from the bank account only if the application is selected for allotment after the basis of allotment is finalized.

In other words, ASBA is a process for subscribing to a public issue. An investor authorises a Bank (SCSB) for blocking a specific amount in his account for the purpose of subscribing in a public Issue. The ASBA process is available in all public issues made through the book building route.

Self-Certified Syndicate Bank (SCSB): SCSB is a bank which is recognized by SEBI as a bank capable of providing ASBA services to its customers. SCSB offers the facility of applying through the ASBA process.

A bank desirous of offering ASBA facility shall submit a certificate to SEBI as per the prescribed format for inclusion of its name in SEBI's list of SCSBs. A SCSB shall also identify its Designated Branches (DBs) at which an ASBA investor shall submit ASBA application and shall also identify the Controlling Brach (CB) which shall act as a coordinating branch for the Registrar of the Issue, Stock Exchanges and Merchant Bankers.

The SCSB, its DBs and CB shall continue to act as such, for all issues to which ASBA process is applicable. The SCSB may identify new DBs for the purpose of ASBA process and intimate details of the same to SEBI, after which SEBI will add the DB to the list of SCSBs maintained by it. The SCSB shall communicate the following details to Stock Exchanges for making it available on their respective websites.

FULL SUBSCRIPTION:

Issue is said to be fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same. However, such a situation does on arise practically as issue is either under subscribed or oversubscribed.

UNDER SUBSCRIPTION:

Issue is said to be under subscribed if the number of shares offered for subscription are more than the number of shares actually subscribed by the public. The only difference is calculation of application, allotment and call money is based on the number of shares actually applied and allotted.

OVER SUBSCRIPTION:

If an issue is oversubscribed, some applications may be rejected and application money refunded and in respect of others, only a part of shares applied for may be allotted and excess amount received can be utilized towards allotment or call money which has fallen due or will soon fall due for payment.

Entry for Refund of application money to applicants:

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

When only a part of shares applied for are allowed:

Share Application A/c ....Dr
  To Share Allotment
  To Share Calls in Advance A/c

CALLS IN ARREARS:

Shareholders may fail to pay the amount due on allotment or calls. The total amount on one or more instalments is known as "Calls in Arrears" or "Unpaid Calls"

As such amount represents uncollected amount from shareholders, it is shown by way of ***deduction from the "Called up Capital"*** to arrive at the "Paid up Capital" to be shown in the balance sheet.

Journal Entry:
Calls in Arrears ……………Dr
To Share Allotment A/c
To Share Calls A/c

The articles of association of a company usually empower the directors to charge interest at a stipulated rate on calls in arrears. ***According to table F, interest maximum at the rate of 10% pa (maximum rate) is to be charged on unpaid calls for the period intervening between the due date and the date of actual payment.*** However, the directors have a power either to waive the interest to be charged or charge a higher rate of interest.

Shareholder's A/c……….Dr
To Interest on Calls in Arrears

Bank A/c……………………Dr
To Shareholder's A/c

CALLS IN ADVANCE:

Shareholders may the pay the amount, which is yet to be called up, such amount is called as "Calls in Advance". ***According to Table F, Interest maximum at the rate of 12%pa (maximum rate) is to be paid on such advance call money***.

The balance in Calls in Advance is shown as a ***separate item on the liabilities side*** of company's balance sheet under the Share Capital but is not added to the amount of "paid up capital".

Journal Entry:

Receipt of Calls in advance Bank A/c….Dr To Calls in Advance
Adjustment of Calls in Advance Calls in Advance A/c……..Dr To Particular Call (allotment/First/Final)
Interest due for payment on calls in advance Interest on Calls in Advance A/c…..Dr To Shareholder's A/c
Actual payment of interest due Shareholder's A/c……..Dr To Bank A/c

DIVIDEND OF SHARES:

- Dividend paid on shares is treated as an appropriation of profits.
- **It Is Paid On Paid Up Share Capital.**
- Rate of dividend on Equity Shares is not fixed; it depends on the dividend policy of the company.

ISSUE OF SHARES AT A DISCOUNT:

When a company issues its shares at a price less than the face value of shares is known as "Shares issued at a Discount". As per the provisions of Section 53, no company can issue shares at a Discount except issue of Sweat Equity Shares.

**Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949*
***Inserted by Companies Amendment Act, 2017**

ISSUE OF SHARES AT A PREMIUM:

When company issues its shares at a price higher than its face value, then it is said to be issued at a premium. It is very common now a days for blue chip companies to issue shares at a premium because they are financially strong, well-managed & have proven track record of profits.

When issue is at a premium, the amount of premium may technically be called at any stage of share capital transactions. But generally it is called with the amount due for share allotment, sometimes with the application money and rarely with the call money.

When shares are issued at a premium, the premium amount is credited to a separate account called "Securities Premium Account" because it is not a part of share capital. Rather, it represents a gain of a *capital nature* to the company. Being a credit balance, Securities premium Account is shown on the liabilities side of the company's Balance Sheet under the heading "**Reserves and Surplus**".

According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:
(a) In paying up un-issued securities of the company to be issued to members of the company as *fully paid bonus securities.*
(b) To write off preliminary expenses of the company.
(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.
(d) To pay premium on the redemption of preference securities or debentures of the company.
(e) buyback of equity shares.

Journal Entries:

When premium amount is called with Share Application: Bank A/c ....Dr   To Share Application A/c

Share Application A/c ....Dr
  To Share Capital A/c
  To Securities Premium A/c

When premium amount is called with Share Allotment:
Share Allotment A/c.........Dr
  To Share Capital A/c
  To Securities Premium A/c
 	
Bank A/c.................Dr
  To Share Allotment A/c

SWEAT EQUITY SHARES (Section 54)

Sweat Equity Shares means such Equity Shares as are issued by a company to its Directors or Employees at a Discount or for consideration, other than cash, for providing their Know How or making available rights in the nature of intellectual property rights or value additions, by whatever name called. [Section 2(88)]

Who shall be eligible for Sweat Equity Shares?

Employee means:

(a) **Permanent employees:** A permanent employee of the company who has been working in India or outside India; or

(b) **Directors:** A director of the company whether a Whole time director or not;

(c) **Employees of Holding or Subsidiary Companies:** An employee or a director of a subsidiary or holding company whether in India or outside India;

CONDITIONS FOR ISSUING SWEAT EQUITY SHARES:

(a) The issue of sweat equity shares must be authorized by a **Special resolution**.

(b) The SR carries the **details** like number of shares, current market price, consideration, and the class of directors or employees to whom sweat equity shares are to be issued;

(c) ~~The Sweat Equity Shares must be issued **at least 1 year after** the date of commencement of the business.~~ (Now, Deleted)

(d) In case of listed Company, the Sweat Equity shares are issued in accordance with the regulations made by **SEBI** and in case of unlisted company; the sweat equity shares are issued in accordance with **the companies act** and its rules.

(e) The holders of such shares **shall rank Pari Passu** with other equity shareholders.

CONDITIONS AS PER RULE 8 OF COMPANIES (SHARE CAPITAL AND DEBENTURE) RULES, 2014:

(a) **Special Resolution:** Issue of Sweat Equity shares to be authorized by Special Resolution at a General meeting.

Explanatory Statement to the Special resolution:

The Explanatory Statement to be annexed to the Notice of General meeting shall contain the following details:

a) Date of Board Meeting wherein Sweat Equity Shares proposal was approved.
b) Reasons/ Justification for the issue of Sweat Equity Shares.
c) Total numbers of shares to be issued as sweat equity including the class of shares are intended to be issued.
d) Class of directors or employees to whom such equity shares are to be issued.
e) Principal Terms and Conditions on which sweat equity shares are to be issued.
f) Time period of association of Directors or employees with the company;
g) The price at which Sweat equity shares are proposed to be issued;
h) The consideration including consideration other than cash.
i) Ceiling on Managerial remuneration, if any.
j) A statement to the effect that the company shall conform to the applicable Accounting Standards and diluted EPS pursuant to the issue of sweat equity shares calculated in accordance with the applicable accounting standards.

(b) **Validity:** The Special Resolution shall be valid only for ***12 months*** for allotment of sweat equity shares.

(c) **Maximum Limit:** A company cannot issue sweat equity shares not more than 15% of the existing paid up equity share capital in a year or shares of the issue value of 5 crores, whichever is higher and 25% of paid up share capital of the company at any time.

Provided further that a startup company, as defined in notification number G.S.R. 127(E), dated the 19th February, 2019 issued by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India, may issue sweat equity shares not exceeding fifty percent of its paid up capital upto ten years from the date of its incorporation or registration.

(d) **Valuation:** The sweat equity shares to be issued shall be valued at a price determined by a registered valuer, if the shares to be issued for intellectual property rights. A copy of the valuation report obtained in both the above cases shall be sent to the shareholders along with the notice of the general meeting.

(e) **Register of Sweat Equity Shares:** The Company shall maintain a register of sweat equity shares in form SH 3.

(f) **Lock in Period:** Sweat Equity Shares shall be non-transferable for 3 years from the date of allotment.

ADDITIONAL REQUIREMENTS FOR SWEAT EQUITY SHARES:

Part of Managerial Remuneration: The amount of Sweat Equity Shares issued shall be treated as part of managerial remuneration subject to the fulfilment of the following conditions:

(a) The Sweat Equity Shares are issued to the Director or Manager; and
(b) They are issued for consideration other than cash.

Disclosure in Director's Report: The Board of Directors shall disclose the following details in Director's Report with regard to sweat equity shares:

a) Class of director/ employee to whom Sweat Equity Shares were issued;
b) Class of Shares issued as Sweat Equity Shares;
c) The number of Sweat Equity Shares issued to directors, KMP or other employees showing separately the number of such shares issued to them, if any, for consideration other than cash and the individual names of allottees holding 1% or more of issued share capital;
d) The reasons/Justification for the issue;
e) Total number of shares arising as a result of issue of sweat equity shares;
f) Percentage of sweat equity shares of total post issued and paid up share capital;
g) Consideration including consideration other than cash received;
h) Diluted Earnings per share pursuant to issuance of Sweat Equity Shares;

EMPLOYEE STOCK OPTION SCHEME

ESOPs means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officer or employees, the benefit or right to purchase or to subscribe for, the shares of the company at a future date at a pre-determined rate.

Rule 12 of Companies (Share Capital and Debenture) Rules, 2014:

Every company other than listed company is required to comply with the following requirements:

The issue of ESOPs has been **approved by the Shareholders** of the company by passing a **Special Resolution**.

Who are eligible for an ESOP Scheme?

(a) A permanent employee of the company who has been working in India or Outside India; or

(b) A director of the company, whether a whole time director or not but excluding Independent Director; or

(c) An Employee of Subsidiary, in India or Outside India, or a Holding Company of the company or of an Associate Company;

Who are not eligible for an ESOP Scheme?

(a) Promoter Cum Employee: An Employee who is a Promoter or a person belonging to the Promoter Group;

(b) Director cum Employee: A director who either himself or through his relatives or through any body corporate, directly or indirectly, hold more than 10% of the outstanding equity shares of the company;

Disclosures in Explanatory Statement of Notice for passing Special Resolution:

(i) Total number of Stock options to be granted;
(ii) Identification of classes of employees entitled to participate in ESOP;
(iii) The Appraisal process for determining the eligibility of employees to ESOP;
(iv) The requirements of vesting and period of vesting;
(v) The maximum period within which the options shall be vested;
(vi) The exercise price or formula used for arriving at the price;
(vii) The exercise period and process of exercise;
(viii) The Lock in period, if any;
(ix) The maximum number of options to be granted per employee or in aggregate;
(x) The conditions under which option vested in employees may lapse e.g. termination of employment for misconduct;

Varying the Terms of ESOP requires Special Resolution:

The company may by special resolution, vary the terms of ESOP not yet exercised by the employees provided such variation is not prejudicial to the interest of option holders.

The notice of passing special resolution for variation of terms of ESOP shall disclose full of the variation, rationale therefore, and the details of the employees who are beneficiary of such variation;

Minimum One year Vesting Period:

There shall be a minimum period of 1 year gap between the grant of options and vesting of option. In a case where options are granted by a company under its ESOP scheme in lieu of options held by same period under ESOP in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required.

Company has freedom to specify the lock in period:

The Company shall have the freedom to specify the lock in period for the shares issued pursuant to exercise of option.

No Right of Dividend or Voting till exercise of option:

The employees shall not have right to receive any dividend or to vote in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

Forfeiture/Refund:
The amount, if any, payable by the employees, at the time of grant of option:
(a) May be forfeited by the company if the option is not exercised by the employees within the exercise period; or
(b) the amount may be refunded to the employees if option are not vested due to non-fulfilment of conditions relating to vesting of option as per the ESOP scheme.

Status of ESOP in case of Death/Permanent Disablement/ Resignation of Employees:
(a) in the event of death of employee while in employment, all the option granted to him till such date vest in the legal heirs or nominees of the deceased employee.

(b) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

(c) In the event of resignation or termination or employee, all options not vested in the employee as on that day shall expire.

Disclosure in the Board's Report:
The BOD shall disclose the details in the Director's report in a particular year of ESOP scheme i.e. option granted, options vested, option exercised, the total number of shares arising as a result of exercise of option, options lapsed, exercise price, variation in terms of option, money realized by exercise of options, total number of options in force, employee wise details of options granted.

ALTERATION OF SHARE CAPITAL:

A limited company having a share capital may, if so authorized by its articles, alter its memorandum in its general meeting to:
(a) Increase its authorized share capital by such amount as it thinks expedient;
(b) Consolidate all or any of its share capital into shares of a larger amount than its existing shares;
(c) Convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;
(d) Sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;
(e) Cancel Shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The cancellation of shares under sub-section (1) shall not be deemed to be a reduction of share capital.

FORFEITURE OF SHARES:

Forfeiture of share means taking away the shares for non-payment of call money. It is the action taken by the company for cancellation of shares. The articles of company usually authorize the board of directors to exercise the right of forfeiture of shares of defaulting shareholders on account of non-payment of call money or interest thereon after serving proper notice as may be prescribed by the Articles of Company.

When shares are forfeited, the title of shareholder is extinguished by the company and the amount already received by the company is also not refunded to the shareholder. The shareholder has no further claim on the shares.

Forfeited shares account will be added to the paid up share capital in the balance sheet.

IF SHARES ARE ISSUED AT PAR:

Share Capital A/c (called up value of shares)
  To Share Forfeiture A/c
  To Allotment Money A/c
  To Share Call A/c
  To Share Final Call A/c

If the due amount has been transferred to Call in Arrears A/c

Share Capital A/c (Called up Value)
  To Share Forfeiture A/c
  To Calls in Arrears A/c

IF SHARES WERE ISSUED AT A PREMIUM:

Share Capital account is debited with the called up value of shares forfeited. If premium on such shares has not been paid by the shareholder, the securities premium account will be debited to cancel the same.

Rule: If the premium is already received by the company, it cannot be cancelled by the company if the shares are forfeited by the company in future.

Share Capital A/c.............Dr (Called up value)
Securities Premium A/c ....Dr
  To Share Forfeiture A/c
  To Calls in Arrears A/c

REISSUE OF FORFEITED SHARES:

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

The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. *These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrears on those shares.*

In connection with re-issue, the following points are important:

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

ANALYSIS & EXAMPLES

Issue at Par, Reissue at Loss	**Issue at Par, Reissue at Premium**
Issue price: ₹ 10 Forfeited Amount: ₹ 5 Reissue Price: ₹ 7 Loss of Reissue = 10-7=3 Capital Reserve = Forfeited Amount – Loss = 5-3=2 Securities Premium = 0 as issued below nominal value	Issue price: ₹ 10 Forfeited Amount: ₹ 5 Reissue Price: ₹ 12 Loss of Reissue = 0 as issued above nominal value Capital Reserve = Forfeited Amount – Loss = 5-0=5 Securities Premium= 12-10=2 as reissued above nominal value
Issue at Premium, Reissue at Loss	**Issue at Premium, Reissue at Premium**
Issue price: ₹ 12 Forfeited Amount: ₹ 5 Reissue Price: ₹ 7 Loss of Reissue = 3 Capital Reserve = Forfeited Amount – Loss = 5-3 Securities Premium= 0 as issued below nominal value **If premium on issue of shares is received then it cannot be cancelled, it is transferred to securities premium but if it is not collected in cash, it can be cancelled on forfeiture of shares.**	Issue price: ₹ 12 Forfeited Amount: ₹ 5 Reissue Price: ₹ 12 Loss of Reissue = 0 as issued above nominal value Capital Reserve = Forfeited Amount – Loss = 5-0 Securities Premium= 12-10=2 as reissued above nominal value **If premium on issue of shares is received then it cannot be cancelled, it is transferred to securities premium but if it is not collected in cash, it can be cancelled on forfeiture of shares.**

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH:

Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. Shares may also be issued in payment for services rendered by promoters, lawyers in the formation of the company. In the Balance Sheet, these shares should be shown separately. Within one month of allotment, the company must produce before the Registrar a written contract of sale of service in respect of which shares have been allotted.

When Assets are purchased in exchange of shares:

Asset A/c...........Dr
To Share Capital A/c

When shares are issued to promoters:

Goodwill A/c......Dr
To Share Capital A/c

UNIT 3: REDEMPTION OF PREFERENCE SHARES

Compliance of Section 55

Preference shares can be redeemed only when Nominal value of capital is increased either out of free reserves or out of fresh issue of shares.

Free Reserves are to be transferred to Capital Redemption Reserve A/c. CRR is treated like a permanent reserve as it can be only used for issue of fully paid up bonus shares.

Wholly out of Fresh Issue

Number of shares to be issued =
Nominal value of shares to be redeemed ÷ Proceeds of one share.

Proceeds of one share is Par value if issue is at par or premium, but it means discounted value if issue is at discount.

Wholly out of free reserves

Free reserves includes General Reserves and Profit & Loss A/c however it does not include Capital reserve, securities premium, revaluation reserve, etc.

Partly out of Free reserves and partly out of fresh issue of shares

Firstly all free reserves available are deducted from the nominal value of preference shares redeemed.
Then for the balance, fresh issue of shares shall be made.

Number of shares to be issued =
Nominal value of shares to be redeemed ÷ Nominal value of one share

According to Section 55 of Companies Act, 2013; a company cannot issue any preference share, which is irredeemable or is redeemable after the expiry of a period of ***twenty years*** from the date of its issue.

A company if so authorized by its articles may issue preference shares which at the option of the company are liable to be redeemed. It should be noted that:

1. No shares can be redeemed **except** out of profits of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

2. No such shares shall be redeemed unless they are fully paid up;

3. The premium, if any, payable on redemption must be provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed.

4. Where any such shares are redeemed, *otherwise than out of the proceeds of fresh issue*, there shall, out of the profits, be transferred to a reserve account to be called as Capital Redemption Reserve Account, a sum ***equal to the nominal value*** of share redeemed.
5. The Premium, if any, payable on redemption shall be provided for out of the profits of the company or out of Securities Premium Account, **before** the shares are redeemed.

Section 55 speaks about only capital to be replaced; it does not deal with the cash required for redemption of preference shares. It can be arranged in any manner as company desires.

METHODS OF REDEMPTION:

Redemption of preference share requires either fresh issue of shares is made or distributable profits are retained and transferred to "Capital Redemption Reserve Account".

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsider is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholder's fund. In case of redemption is done out of proceeds of issue of shares, replacement of capital and tangible assets is obvious. But if redemption is done out of profits, replacement of capital is ensured in an indirect manner by retention of profits by transfer to CRR Account. The transfer of divisible profits to Capital Redemption Reserve makes them non-distributable profits. **As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.**

REDEMPTION OF PREFENCES SHARES OUT OF FRESH ISSUE OF SHARES:

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

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

ACCOUNTING ENTRIES:

Issue of new shares at par Bank A/c Dr To Share Capital A/c
Issue of new shares at Premium Bank A/c Dr To Share Capital A/c To Securities Premium A/c
Preference shares are redeemed at par Redeemable preference share capital A/c Dr To Preference Shareholders A/c
Preference shares are redeemed at Premium Redeemable preference share capital A/c Dr Premium on redemption of P S C A/c Dr To Preference shareholders A/c
Payment is made to preference shareholders Preference Shareholders A/c To Bank A/c

Adjustment of premium paid

Securities Premium Account Dr
To Premium on redemption of PSC A/c

CALCULATION OF MINIMUM FRESH ISSUE OF SHARES:

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of Section 55 of the Companies Act, 2013, are not violated. This is done in four steps as given below:

1. The maximum amount of Free Reserves available for redemption is ascertained taking into account the balances appearing in the balance sheet before redemption.

2. If the redemption is at premium, then Adjustment for premium on redemption payable out of profits is made first and then the balance available Free Reserves are utilized for transfer of Free Reserves to Capital Redemption Reserve.

3. The balance after transfer to CRR is the amount of capital to be brought by the issue of Equity Shares.

4. The number of shares to be issued is to be computed by dividing the balance Free Reserves Required as per Section 55 by the face value of shares issued. *(Share capital increases by nominal value of shares regardless whether issued at par, premium or discount)*

Minimum number of Shares = Nominal value of shares to be redeemed – Maximum Free Reserves available to be transferred to CRR

Minimum number of shares = Minimum proceeds required to comply with Section 55 divided by Proceeds of one share

Proceeds of one shares = Par value in case issue is at Par or Premium but if issue is at discount then it means the discounted value only.

UNIT 4: BUYBACK OF SECURITIES

Buy Back of shares means purchase of its own shares by the company. In short, buy back is a process when a company makes an offer to buy back its own issued shares.

Objectives of Buy Back:
(a) To return the surplus cash to shareholders.
(b) To increase the current Market price of the company.
(c) To discourage unwelcome takeover bids of the company.
(d) To increase promoter's Shareholding

Sections 67 & 68 of Companies Act & Rule 17 of Companies (Share Capital and Debentures) Rules, 2014:

A company limited by shares or guarantee having a share capital cannot buy its own shares and this restriction is applicable on all types of companies.

However, Section 68 allows a company to purchase its own shares or securities subject to certain conditions:

Methods for Buy Back: the buyback may be:

(a) From the existing shareholders;
(The offer should be opened for a period not less than 15 days and not more than 30 days from the date of dispatch of letter of offer to the security holders. Where all member of company agree, the offer for buy back may remain open for a period of less than 15 days.)

(b) From the Open Market;
(c) by purchasing the securities from employees which have been issued under ESOP or Sweat Equity.

AUTHORISATION & APPROVALS:
(a) **Authorization in AOA:** Buy Back must be authorized by the articles of association of the company. In Case, there is no such provision, the company has to first alter the articles of association to authorize buy back. Buy Back can be made with the approval of Board of Directors or Shareholders by passing SR in GM, depending on the quantum of buy back.

(b) **Approval by Board of Directors:** The Board of Directors can buy back upto 10% of total paid up Equity Share Capital and Free Reserves of the company by passing Board Resolution.

(c) **Approval of Shareholders:** The shareholders can buy back upto 25% of the total paid up Equity Share Capital and Free Reserves of the company by passing SR in GM.

SOURCES OF BUY BACK:
A company may purchase its own shares or other specified securities out of:
(a) its free reserves; or
(b) the securities premium account; or
(c) the proceeds of any shares of other specified securities

CONDITIONS FOR BUY BACK:
(a) **Power in AOA**: The buyback shall be **authorized by AOA**.

(b) **Approved**: The buyback either **approved** by BOD or Shareholders.

(c) **Debt Equity Ratio:** Debt Equity Ratio is **not more than twice** the capital and its free reserves after such buy back.
Debt to Capital and Free reserves Ratio shall be 6:1 for Government Companies which carries on Non-Banking Finance Institutions and Housing Finance Activities.

(d) No Shares or Securities can be bought back unless they are **fully paid up**.

(e) **Explanatory Statement:** The Notice of General Meeting shall be annexed with the Explanatory Statement and shall have the following details:
(i) A full and complete disclosure of all material facts;
(ii) The class of security intended to be purchased under the buy back;
(iii) The necessity of Buy Back
(iv) The amount to be invested under the buy back;
(v) The time limit for completion of buy back;

(f) **Completion of Buy Back:** The buyback should be completed within 1 year of the date of passing Board Resolution or Special Resolution as the case may be;

(g) **Declaration of Solvency**: When a company proposes to buy back its own securities, shall file with ROC and SEBI (if Listed) a declaration of Solvency signed by at least 2 directors, one of whom shall be MD, if any, in Form SH 9 before making buy back.

(h) **Extinguishment of Securities**: After completion of buy back the securities must be extinguished and physically destroyed within 7 days of the last date of completion of buy back.

(i) **No further Issue**: After the completion of buy back, the company shall not make a further issue of shares or other specified securities for a period of 6 months except by way of bonus shares or in discharge of subsisting obligations such as conversion of options, etc.

(j) **Buy Back Return**: A company shall file a return of buy back in form SH 15 within 30 days from the date of completion of buy back. Such form must be signed by two directors, one of whom shall be MD, if any, certifying that the buyback of securities has been made in compliance with the provisions of companies act, 2013 and its rules.

(k) **Register of Buy Back**: The company has to maintain a register of securities (SH 10) so bought, the consideration paid for the securities bought back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

PROHIBITION OF BUY BACK IN CERTAIN CASES:

A company cannot buy back shares or other specified securities, directly or indirectly;
(a) through any subsidiary company including its own subsidiary; or

(b) through investment or group of investment companies; or

(c) when the company has defaulted in the repayment of deposit or interest thereon, redemption of debentures or preference shares or payment of dividend or repayment of any term loan or interest thereon to any financial institution or bank;

(d) Company has defaulted in:
(i) Filing of Annual Return & financial statements;
(ii) Payment of dividend after declaration

Accounting Entries for Buy Back:

In case investments are sold for buying back own shares: Bank A/c To Investment A/c (the difference between the book value and the sale value will be either profit or loss which will debited or credited to Profit and Loss Account)
In case the proceeds of fresh issue are used for buy back purpose, then on fresh issue: Bank A/c To Debentures/other investment To securities premium
For buying back of shares: Equity shareholders A/c To bank A/c
For cancellation of shares bought back: Equity share capital A/c (Nominal Value) Securities premium/Free Reserves (Excess of amount paid over nominal value) To Equity Shareholders A/c (Total Amount Paid)

For transfer of nominal value of shares purchased out of free reserves to CRR A/c Free Reserves A/c Securities Premium A/c To CRR A/c (Nominal Value of Shares bought back)
For expenses incurred on buy back: Payment of Buy Back Expenses: Buy back expense A/c To Bank A/c Transfer of Expenses to P & L: Profit and Loss A/c To Buy Back expense A/c

UNIT 5: UNDERWRITING OF SHARES AND DEBENTURES

TYPES OF UNDERWRITING	**COMPLETE UNDERWRITING** If the whole of the issue of shares or debentures of a company is underwritten, it is said to be complete underwriting. In such a case, the whole of the issue of shares or debentures may be underwritten by – (a) one firm or institution, agreeing to take the entire risk; (b) a number of firms or institutions, each agreeing to take risk only to a limited extent. **PARTIAL UNDERWRITING** If only a part of the issue of shares or debentures of a company is underwritten, it is said to be partial underwriting. The part of the issue of shares or debentures may be underwritten by - (a) One person or institution; (b) A number of firms or institutions each agreeing to take risk only to a limited extent. In case of partial underwriting, the company is treated as "Underwriter" for the remaining part of the issue. **FIRM UNDERWRITING** It signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public. In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him that is to say, the underwriter is obliged to take up : (i) The number of shares he has applied for 'firm'; and (ii) The number of shares he is obliged to take up on the basis of the underwriting agreement.
UNDERWRITING COMMISSION	The consideration payable to the underwriters for underwriting the issue of shares or debentures of a company is called underwriting commission. Such a commission is paid at a specified rate on the issue price of the whole of the shares or debentures underwritten whether or not the underwriters are called upon to take up any shares or debentures. Thus, the underwriters are paid for the risk they bear in the placing of shares before the public. Underwriting commission may be in addition to brokerage. **Payment of Underwriting Commission** Section 40 (6) of the Companies Act 2013, provides that a company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions which are prescribed under Companies (Prospectus and Allotment of Securities) Rules, 2014: (a) the payment of such commission shall be authorized in the company's articles of association; (b) the commission may be paid out of proceeds of the issue or the

	profit of the company or both; (c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent (5%) of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed two and a half per cent (2.5 %) of the price at which the debentures are issued, or as specified in the company's articles, whichever is less; (d) the prospectus of the company shall disclose - • the name of the underwriters; • the rate and amount of the commission payable to the underwriter; and • the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally. (e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription; (f) a copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for registration. Thus, the Underwriting commission is limited to 5% of issue price in case of shares and 2.5% in case of debentures. **The rates of commission given above are maximum rates. The company is free to negotiate lower rates with underwriters**.
DETERMINATION OF LIABILITY IN RESPECT OF AN UNDERWRITING CONTRACT	If the whole of the issue has been underwritten by one person, he is responsible to subscribe for all the shares or debentures that have not been subscribed by the public. In such a case, it is not necessary to know the number of applications which had originated through the underwriter and those which had flowed directly to the company. In the case in which only part of an issue has been underwritten, or where there are a number of underwriters, a certain amount of difficulty may arise in determining the liability of each of the underwriters; such a difficulty may arise in deciding the basis on which the unmarked applications, i.e. the applications which have directly flowed to the company should be allocated among the different underwriters. This can be done in two ways. According to one method, the unmarked applications are allotted in the proportion of gross amount of capital underwritten. Alternatively these are allocated in proportion to the gross amount of capital underwritten as reduced by the marked applications.

<u>Accounting entries in relation to Underwriting:</u>

When the shares or debentures are allotted to the underwriters in respect of their liability: Underwriters A/c To share capital To Debentures

When commission becomes payable to the underwriters: Underwriter's commission A/c To Underwriter's A/c
When the net amount due from the underwriters on the shares taken up by them is received: Bank A/c To underwriter's A/c

In Firm Underwriting, following 2 scenarios emerge:

1. <u>Benefit of Firm underwriting is given to individual underwriters</u>: in such a case, Firm underwriting is deducted from gross liability as per the shares underwritten firm.

2. <u>Benefit of Firm Underwriting is not given to individual underwriters</u>: in such a case, Firm underwriting is treated as an Unmarked Application and divided among the individual underwriters in the ratio of gross liability.

UNIT 6: EMPLOYEES STOCK OPTION

"Employee stock option" means the option given to the whole-time directors, officers or employees of a company, which gives such directors, officers or employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a pre-determined price.

Accounting for employees stock option plan (ESOPs): Before proceeding on accounting treatment of ESOPs, certain words are necessary to be defined which will be covered later on in the context of accounting entries.

<u>Grant:</u> Grant of the option means giving an option to the employees to subscribe to the shares of the company.

<u>Vesting:</u> It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in pursuance of ESOS.

<u>Vesting Period:</u> It is the time period during which the vesting of the option granted to the employee on pursuance of employee stock option scheme (ESOS) takes place.

<u>Option:</u> Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.

<u>Accounting Policies of ESOS:</u>

a) In respect of options granted during any accounting period the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company.

b) The accounting value of options shall be equal to the aggregate, over all employee stock options granted during the accounting period, of the fair value of the option.

1. Fair value means the option discount, or, if the company so chooses, the value of the option using the Black Scholes formula or other similar valuation method.

2. Option discount means the excess of the market price of the share at the date of grant of the option under ESOS over the exercise price of the option (including up- front payment, if any).

(c) Where the accounting value is accounting for employee compensation in accordance with 'b', the amount shall be amortized on a straight-line basis over the vesting period.

(d) When an unvested option lapses by virtue of the employee not confirming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortized portion of accounting value of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortized portion.

(e) When a vested option lapses on expiry of the exercise period, after the fair value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense.

Employee Stock Options Outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity. Deferred Employee Compensation will appear in the Balance Sheet as a negative item as part of Net Worth or Shareholders' Equity.

Disclosure in the Directors' Report

The Board or Directors, shall, inter alia, disclose either in the Directors Report or in the annexure to the Director's Report, the following details of the ESOS :

(a) Options granted;
(b) The pricing formula;
(c) Options vested;
(d) Options exercised;
(e) The total number of shares arising as a result of exercise of option;
(f) Options lapsed;
(g) Variation of terms of options;
(h) Money realized by exercise of options;
(i) Employee wise details of options granted to;
(i) Senior managerial personnel;

(ii) Any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during that year;
(iii) Identified employees who were granted option, among any during the year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(j) Diluted Earnings Per Share (EPS) pursuant to issue of shares on exercise of option calculated in accordance with International Accounting Standard (IAS) 33.

UNIT 7: ISSUE OF BONUS SHARES

INTRODUCTION	Capitalization of profits refers to the process of converting profits or reserves into paid up capital. A company may capitalize its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members. A Bonus Share may be defined as a free share of stock given to the current shareholders in a company, based upon the number of shares that the shareholder already owns. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of shares increases, the ratio of number of shares held by each shareholder remains constant. Depending upon the MOA and AOA of the company, only certain classes of shares may be entitled to bonus shares or may be entitled to bonus shares in preference to other classes. No new funds are raised with a bonus issue. A bonus issue is a Stock Split in which a company issue new shares without charge in order to bring its issued capital in line with its employed capital. (reducing the gap between share capital and Net worth)
PROVISIONS OF COMPANIES ACT, 2013	Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to sub-section (1) of this section, a company may issue fully paid bonus shares to its members, in any manner whatsoever, out of: (i) Free Reserves (ii) Securities Premium Account or (iii) Capital Redemption Reserve Provided that no issue of bonus shares shall be made by capitalizing reserves created by revaluation of assets. **Conditions for Bonus Issue:** (i) It is authorized by its AOA. (ii) It has, on recommendation of board, has authorized in the general meeting of the company. (iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it; (iv) it has not defaulted in respect of payment of statutory dues of the employees, such as contribution to provident fund, gratuity and bonus; (v) the partly paid up shares, if any outstanding on the date of allotment, are made fully paid up; (vi) it shall not be issued in lieu of dividend. Two Ways to giving Bonus: (i) Issue of Fully paid bonus shares (ii) Converting partly paid up shares into fully paid up as bonus
JOURNAL ENTRIES	**(A) ISSUE OF FULLY PAID UP BONUS SHARES:** **Issue of Bonus Shares:** Bonus to Shareholders A/c...........Dr To Equity Share Capital A/c

	Capitalization of reserves: CRR A/c......................Dr Securities Premium......Dr Capital Reserves...........Dr (if realized in cash) General Reserve............Dr Profit and Loss ....Dr To Bonus to Shareholders A/c **(B) CONVERSION OF PARTLY PAID UP SHARES INTO FULLY PAID UP** Making Final Call: Share Final Call A/c............Dr To Equity Share Capital Adjustment of Final Call: Bonus to Shareholders A/c............Dr To Share Final Call Capitalization of Reserves: Capital Reserve............Dr (if realized in cash) General Reserves..........Dr Profit & Loss A/c...........Dr To Bonus to Shareholders *(Students should note that CRR & Securities Premium can be used only for issuing fully paid up bonus shares and cannot be used for converting partly paid up shares into fully paid up as Bonus)*

CHAPTER 4: ACCOUNTING FOR DEBENTURES

ISSUE OF DEBENTURES

MEANING:

"Debenture includes Debentures, Stocks, bonds and any other securities of a company whether constituting a charge on the assets of the company or not.

Provided that—
(a) the instruments referred to in Chapter III-D of the Reserve Bank of India Act, 1934; and
(b) such other instrument, as may be prescribed by the Central Government in consultation with the Reserve Bank of India, issued by a company, shall not be treated as debenture;

FEATURES OF DEBENTURES:

a. It is a document evidencing a loan made to a company.
b. It is a fixed interest bearing security where interest falls due on specific dates
c. Interest is payable at a predetermined rate regardless of the level of profits
d. The original sum is repaid at a specified future date.
e. It may or may not create a charge on the assets of a company as security.
f. Debentures can be issued for Cash, Consideration other than Cash, as Collateral Security.
g. Maximum Underwriting commission payable on issue of debenture is 2.5% of Issue price of debentures or at a rate authorized by articles whichever is lower.

DISTINCTION BETWEEN A SHARE AND A DEBENTURE:

DEBENTURE	SHARES
Debenture holders are the creditors of the company	Shareholders are the owners of the company
Debenture holders have no voting right	Shareholders have voting rights and hence control the total affairs of the company
Debenture interest is paid at a predetermined fixed rate. It is payable whether there is any profit or not.	Dividend on shares is payable at a variable rate which is mainly affected by the profitability of the company.
Interest on debentures is a charge on the profits of the company and hence deductible as an expense under income tax	Dividends is the appropriation of the profits of the company hence are not deductible as an expense under income tax
In balance sheet, debentures are shown under secured loans	In balance sheet, shares are shown under share capital
Debenture can be converted into shares as per the terms of issue.	Shares cannot be converted into debentures under any circumstances
Debentures cannot be forfeited for non-payment of calls money	Shares can be forfeited for non-payment of allotment and call money
At the time of liquidation, debenture holders are paid off before the shareholders	At the time of liquidation, shareholders are paid at the last after debenture holders, creditors, etc

Debenture can be issued at a discount, no such restriction in companies act, 2013	Shares cannot be issued at a discount as per companies act, 2013
Maximum Underwriting commission on Debentures can be 2.5% of Issue price as per companies Act, 2013 or As authorized by Articles whichever is less.	Maximum Underwriting commission on Shares can be 5% of Issue price as per Companies Act, 2013 or As authorized by Articles whichever is less.

TYPES OF DEBENTURES:

- **SECURITY**
  a. **Secured Debentures**: Secured by charge (Fixed or Floating) on some or all of the assets. Normally, Fixed Charge is created on Fixed Assets like Land & Building, Plant & Machinery, etc. Floating Charge is created on current assets like Stock & Debtors.

  b. **Unsecured debentures** : Not secured by any charge upon any assets

- **CONVERTIBILITY**
  1. **Convertible debentures**: that can be converted into Equity Shares after a certain period of time at the option of the holder. It can be Fully Convertible or Partly Convertible.

  2. **Non – convertible debentures**: There is no option to the holder for conversion into Equity Shares.

- **PERMANENCE:**

(i) **Redeemable debentures**: These types of debentures are redeemable after a specified period of time in lump sum or in instalments during the lifetime of the company.

(ii) **Irredeemable debentures (Perpetual debentures):** These types of debentures are not redeemable during the lifetime of company. These are redeemable at the time of liquidation of company.

- **NEGOTIABILITY: (TRANSFERABILITY)**

(i) **Registered debentures**: these are those which are payable to the person whose name appears in the Register of Debenture Holders. They can be transferred only by executing a transfer deed. Interest is paid to the registered holders.

(ii) **Non registered debentures (Bearer Debentures):** These are payable to the bearer thereof. These can be transferred by mere delivery. Interest is paid to the person who produces the interest coupon attached to such debentures.

- **PRIORITY**

(i) **First mortgage**: These have the first claim on the assets charged.
(ii) **Second mortgage**: These have the second claim on the assets charged.

ACCOUNTING ENTRIES: (different possible combinations)

Treatment of Discount or Loss on issue of debentures:

- Discount on issue of debentures is a **capital loss** of the company and it is required to be shown on the **assets side** of the Balance Sheet under the heading Other Current or other Non-Current Asset until written off.

- Although, there is no legal obligation on the part of the company to write off such a loss, sound business policy demands that it should be written off as quickly as possible.

Discount on issue of debentures can be treated in any of the following two ways:
1. Discount on issue of debentures being a capital loss, can be written off against capital profits.
2. Discount on issue of debentures can be treated as deferred revenue expenditure and written off against revenue over the period of life of the debentures.

In case there is no capital profit and it is decided to treat discount on issue of debentures as deferred revenue expenditure, it is desirable to write it off against revenue over the period of life of the debentures on an equitable basis. The following are the two methods which are generally adopted for this purpose.

1. *Fixed Instalment Method*: Under this method, the total amount of discount allowed on issue of debentures is spread over the life of the debentures equally and every year a fixed amount is written off against revenue.

2. *Fluctuating Instalment Method*: Where debentures are redeemed by annual drawings, the first method is not suitable for the simple reason that the burden of discount is equally spread over the period of life of the debentures. Under this method, the amount of discount to be written off every year should bear a proportion to the debentures outstanding at the beginning of each year. Thus, the amount of discount to be written off every year under this method cannot be fixed and will go on diminishing every year, i.e., the burden of discount will be in proportion to the benefits derived out of the debentures.

✓ If a company issues debentures at par or at a discount which are redeemable at a premium, the premium payable on redemption of the debentures should also be treated as capital loss and as such it should be dealt within the same manner as 'Discount on Issue of Debentures'.

✓ Redemption of debentures at a premium is a known loss at the time of issue of debentures as the terms of issue generally contain such provisions for redemption. As such, it would be prudent on the part of the company to write off such loss during the life time of the debentures.

✓ The loss to be incurred by a company for a particular issue of debentures is ascertained in the following manner:
(i) If the debentures are issued at par and redeemable at a premium, the loss will be equal to the amount of premium payable on redemption.

(ii) if the debentures are issued at a discount and redeemable at a premium, the loss will be equal to the total of the amount of discount on issue and the amount of premium on redemption.

Thus, **Total loss = Discount on issue of Debentures + Premium Payable on redemption of debentures.**

✓ In such a case, there is no need to debit Discount on Issue of Debenture Account. Instead, "Loss on Issue of Debentures Account" should be debited with total loss.

✓ When debentures are redeemable at a premium the liability for premium payable on redemption is recorded in the books at the time of issue of the debentures although the actual liability will arise only at the time of redemption.

- ✓ The main advantage derived by the company is that the loss on issue of debentures is completely written off before the debentures are due for redemption.

Debentures issued at discount and Redeemable at Premium:

Where debentures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on redemption.

DEBENTURE REDEMPTION PREMIUM ACCOUNT IS A PERSONAL ACCOUNT which represents a liability of the company in respect of premium payable on redemption.

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debentures. This total loss is to be accumulated over the life of debentures as per conservatism concept from profits of each year.

1) *at the time of issue of debentures*
Cash/ Bank…………………………………………….Dr
Discount on issue of debentures…………………..Dr
    To Debentures A/c

2) *Accumulation of Reserve for redemption of reserves every year:*
Loss on Issue of Debentures…………………Dr
    To Debenture Redemption Premium Reserve A/c

3) *At the time of redemption of debentures:*
Debentures A/c (Nominal Value)……………….Dr
Debenture Redemption premium reserve …..Dr
    To Debenture Holders A/c
    To Discount on issue of debentures A/c

Debenture issued at Par &Redeemable at Premium:

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debentures at the time of allotment of debentures.

1) *at the time of issue of debentures*
Cash/ Bank…………………………………………….Dr
    To Debentures A/c

2) *Accumulation of Reserve for redemption of reserves every year:*
Loss on Issue of Debentures…………………Dr
    To Debenture Redemption Premium Reserve A/c

3) *At the time of redemption of debentures:*
Debentures A/c (Nominal Value)……………….Dr
Debenture Redemption premium Reserve …..Dr
    To Debenture Holders A/c

Debentures issued at premium & Redeemable at premium:

In this situation the issue price is more than par value and also redemption value is more than par value. *The premium received at the time of issue of debentures is credited to*

Securities premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures.

This combination is same as the combination of issue at par and redeemable at premium.

Issue of debentures as collateral security

Collateral security means secondary or supporting security for a loan, which can be realized by the lender in the event of the original loan not being repaid on the due date.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder. *The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures*. *No interest is payable on Debentures issued as a collateral*.

Method 1: No entry is passed at the time of issue. In the balance sheet, the fact of debentures being issued and outstanding is shown by way of a note.

Method 2:
At the time of issue of debentures
Debenture Suspense A/c….Dr
To Debentures A/c

The "Debentures Suspense Account" will appear on the assets side of the Balance Sheet and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

Debentures issued for consideration other than cash

Only Assets taken over
Assets A/c……….Dr
To Debentures A/c

Interest on Debentures

INTEREST IS CALCULATED ON THE FACE VALUE OF DEBENTURES.
RATE OF INTEREST IS MENTIONED BEFORE THE NAME OF DEBENTURES.

Interest Due
Interest A/c………..Dr
To debenture holder's A/c

Making Payment net of TDS
Debenture Holder's A/c…….Dr
To Bank A/c
To TDS Payable A/c

Payment of TDS by company on due date
TDS Payable A/c…..Dr
To Bank A/c

Transfer of interest to P & L
P & L A/c ….Dr
To Interest A/c

Interest Accrued and Due (Outstanding):

Interest on debentures is usually paid every six months; interest really becomes due when the six months are over and not earlier; in other words no one can demand that the company pay interest before the due date.

Suppose a company has issued 13.5% Debentures for ₹10,00,000 interest is payable on 30th September and 31st March. The company will pay ₹67,500 in every six months. Suppose, the company closes its books on 31st March, the interest due on that date may be unpaid.

In that case, there will be a liability which will be recorded by the entry:
Debenture Interest A/c Dr. 67,500
To Debenture Interest Outstanding 67,500

The liability will be shown in the Balance Sheet along with debentures.

Interest Accrued but not Due:

On the closing date interest for the full period must be brought into books but, it is possible, that due date for payment of interest has not yet come.

Suppose, in the example given above, the company closes its books on 31st December. Interest upto 30th September must have been paid but that upto
31st March is not yet due. For proper accounting, however, interest from 1st October to 31st December (3 months) must be taken into account. Interest for such a period is termed as 'Interest accrued but not due'.

The entry for recording this interest is:
Debenture Interest A/c Dr. 33,750
To Debenture Interest Accrued but not Due 33,750

Debenture Interest Accrued but not Due is shown in the balance sheet under Other Current Liabilities.

REDEMPTION OF DEBENTURES

COMPANIES ACT, 2013 PROVISIONS	A company proposes for the Issue of Debentures, should take the approval from the **shareholders via special resolution**. A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. The issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a **special resolution passed at a general meeting**. **<u>COMPLIANCE FOR ISSUE OF SECURED DEBENTURES</u>** (a) **<u>Redemption period</u>**: Secured debentures can be issued subject to the maximum redemption period i.e. **not exceeding 10 years** from the date of issue. A company engaged in the setting up of **infrastructure projects, Infrastructure Finance & Companies Infrastructure Debt Fund Non-Banking Financial companies** may issue secured debentures for a period exceeding 10 years but not exceeding 30 years. (b) **<u>Creation of Charge</u>:** Such an issue of debentures shall be secured by the creation of a charge on the properties or assets of the company or its subsidiaries or its holding company or its associates companies, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon; (c) **<u>Appointment of Debenture Trustee</u>:** The Company shall appoint a debenture trustee before the issue of prospectus for subscription of its debentures and **not later than 60 days** after the allotment of the debentures, execute a **debenture trust deed** to protect the interest of the debenture holders. (d) **<u>Creation of Charge in favour of Debenture Trustee</u>** : the security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on:- (i) any specific movable property of the company or its holding company or subsidiaries or associate companies or otherwise. (ii) any specific immovable property wherever situate, or any interest therein. Provided that in case of a non-banking financial company, the charge or mortgage under sub-clause (i) may be created on any movable property. Provided further that in case of any issue of debentures by a Government company which is fully secured by the guarantee given by the Central Government or one or more State Government or by both, the requirement for creation of charge under this sub-rule shall not apply. Provided also that in case of any loan taken by a subsidiary company from any bank or financial institution the charge or mortgage under this sub-rule may also be created on the properties or assets of the holding company. **<u>CREATION OF DEBENTURE REDEMPTION RESERVE (DRR)</u>** When debentures are issued by a company, the company shall create a debenture redemption reserve account out of the profits of the

	company, shall not be utilized by the company except for the redemption of debentures. **<u>Conditions for creation of DRR</u>**: The company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year, in accordance with the conditions given below:- (a) Debenture Redemption Reserve shall be created out of profits of the company available for payment of dividend; (b) the limits with respect to adequacy of Debenture Redemption Reserve and investment or deposits, as the case may be, shall be as under;- (i) Debenture Redemption Reserve is not required for debentures issued by All India Financial Institutions regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures; (ii) For other Financial Institutions within the meaning of clause (72) of section 2 of the Companies Act, 2013, Debenture Redemption Reserve shall be as applicable to Non -Banking Finance Companies registered with Reserve Bank of India. (iii) For listed companies (other than All India Financial Institutions and Banking Companies as specified in sub-clause (i)), Debenture Redemption Reserve is not required in the following cases - (A) in case of public issue of debentures - A. for NBFCs registered with Reserve Bank of India under section 45-IA of the RBI Act, 1934 and for Housing Finance Companies registered with National Housing Bank; B. for other listed companies; (B) In case of privately placed debentures, for companies specified in sub items A and B. (iv) for unlisted companies, (other than All India Financial institutions and Banking Companies as specified in sub-clause (i)) - (A) for NBFCs registered with RBI under section 45-IA of the Reserve Bank of India Act, 1934 and for Housing Finance Companies registered with National Housing Bank, Debenture Redemption Reserve is not required in case of privately placed debentures. (B) for other unlisted companies, the adequacy of Debenture Redemption Reserve shall be ten percent. of the value of the outstanding debentures; (v) In case a company is covered in item (A) or item (B) of sub-clause (iii) of clause (b) or item (B) of sub-clause (iv) of clause (b), it shall on

	or before the 30th day of April in each year, in respect of debentures issued by a company covered in item (A) or item (B) of sub-clause (iii) of clause (b) or item (B) of sub-clause (iv) of clause (b), invest or deposit, as the case may be, a sum which shall not be less than fifteen per cent., of the amount of its debentures maturing during the year, ending on the 31st day of March of the next year in any one or more methods of investments or deposits as provided in sub-clause (vi): Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below 15% of the amount of the debentures maturing during the year ending on 31sr day of March of that year. (vi) for the purpose of sub-clause (v), the investments, as the case may be, are as follows: - (A) in deposits with any scheduled bank, free (B) in unencumbered securities of the Central methods of deposits or from any charge or lien; Government or any State Government; (C) in unencumbered securities mentioned in sub-clause (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882; (D) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882 : Provided that the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above. (c) In case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule. (d) The amount credited to Debenture Redemption Reserve shall not be utilized by the company except for the purpose of redemption of debentures. **[Substituted by The Companies (Share Capital and Debentures) Amendment Rules, 2019. Dated 16th August, 2019]** **<u>APPOINTMENT OF DEBENTURES TRUSTEES</u>** No company shall issue a prospectus or make an offer to its members exceeding 500 for the subscription of its debentures, unless the company has appointed debenture trustee. **<u>CONDITIONS FOR APPOINTMENT OF DEBENTURE TRUSTEES</u>** 1. The names of the debenture trustees must be stated in letter of offer for debentures. 2. A written consent must be obtained from the debenture trustee before his appointment as debenture trustee. 3. The following person shall not be appointed as a debenture trustee :

	(i) Beneficially holds shares in the company; (ii) Is a promoter, director or key managerial personnel or any other officer or an employee of the company or its holding, subsidiary or associate company; (iii) Is beneficially entitled to moneys which are to be paid by the company otherwise than as remuneration payable to the debenture trustee; (iv) Is indebted to the company, or its subsidiary or its holding or associate company or a subsidiary of such holding company; (v) Has furnished any guarantee in respect of the principal debts secured by the debentures or interest thereon; (vi) Has any pecuniary relationship with the company amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year; (vii) is a relative of any promoter or any person who is in the employment of the company as a director or key managerial personnel; **DUTIES OF DEBENTURES TRUSTEES** A debenture trustee shall take steps to protect the interests of the debenture holders and redress their grievances in accordance with such rules as may be prescribed. It shall be the duty of every debenture trustee to – (a) Satisfy himself that the letter of offer does not contain any matter which is inconsistent with the terms of the issue of debentures or with the trust deed; (b) Satisfy himself that the covenants in the trust deed are not prejudicial to the interest of the debenture holders; (c) Call for periodical status or performance reports from the company; (d) Communicate promptly to the debenture holders defaults with regard to payment of interest or redemption of debentures and action taken by the trustee; (e) Appoint a nominee director on the Board of the company in the event of – (i) Two consecutive defaults in payment of interest to the debenture holders; or (ii) Default in creation of security for debentures; or (iii) Default in redemption of debentures.
METHODS OF REDEMPTION	
METHOD OF REDEMPTION OF DEBENTURES	Following are the methods of redeeming the debentures: **(a) By annual drawings** • Under this method, a certain portion of the total debentures is redeemed every year over the life-time of the debentures and thus at the end of the life time of the debentures, the debentures are fully redeemed. • Which debenture should be paid in which year usually depends on the drawings. • The amount of debentures to be redeemed every year is generally calculated by dividing the total amount of the debentures by the number of years for which they have been issued. In such a case,

the amount of annual drawings will be equal. But the amount of annual drawings may also be unequal in some cases.

- When debentures are redeemed by annual drawings, the amount of annual drawings should be transferred to General Reserve Account out of the profits of the company and the same need not be invested in any other way.

(b) By payment in one lump sum at the expiry of a specified period

- Under this method the entire amount of the debenture debt is paid to the debenture holders in one lump sum at the expiry of a specified period, i.e., at maturity or at the option of the company at a date within such specified period according to the terms of issue.
- As the amount involved is large and the date of which debentures have to be redeemed is known to the company well in advance, it is possible for the company to make necessary arrangement to provide for the additional funds required for the debentures from the very beginning.
- In such a case, the best method is to set aside every year throughout the life of the debentures a part of the profits of the company which would otherwise be available for dividend and to invest the same in readily convertible securities together with compound interests at a fixed rate will amount to the sum required to pay off the debentures at the specified date.
- The investments, thus made, are sold when the debentures become due for payment. This method ensures the availability of sufficient cash for the redemption of debentures when they become due and is known as "Sinking Fund method".

(c) By purchase of debentures in the open market

- Under this method, a company may purchase its own debentures in the open market if it seems to be convenient and profitable to the company.
- When the market price of the debentures goes down below par or debentures are quoted at a discount on the stock exchange, the company usually takes the opportunity to buy the debentures in the open market and to cancel them.
- Own debentures may, also, be purchased by the company for its own investment when it is desired to keep the debentures alive with a view to issuing them in future.
- The law does not prohibit a company from purchasing its own debentures unless the terms of issue specify otherwise. In such a case, the purchase of debentures can be made out of the amount realized on sale of investments where sinking funds exists.
- Where there is no sinking fund, the debentures can be purchased out of the company's cash balance.

(d) By conversion into shares

- A company may issue convertible debentures giving option to the debenture holders to exchange their debentures for equity shares or preference shares in the company.
- The debenture holders are given the right on certain dates or before a specified date to exchange the debentures for the shares. A certain number of shares are offered for each debenture.
- When the debenture-holders exercise this option and the company issues the shares, it is referred as redemption by conversion.

PURCHASE OF DEBENTURES BEFORE THE SPECIFIED DATE OF PAYMENT OF INTEREST **[CUM-INTEREST AND EX-INTEREST QUOTATIONS]**	• Interest on debentures is generally paid half-yearly to the holders on certain specified dates, e.g., 30th September and 31st Mach every year. • If debentures are purchased exactly on these specified dates, it involves no problem. In such a case, interest is payable to the holders of debentures. • But, where debentures are purchased at a date before the specified date of payment of interest the question which naturally arises is whether the price paid for such debentures includes the interest for the expired period (i.e. from the previous date of payment of interest up to the date of purchase) or not. • For this purpose it is important to note whether the price paid for the debentures is quoted as "Cum-interest" or "Ex-interest". • If the purchase price for the debentures includes interest for the expired period, the quotation is said to be "Cum-interest". If, on the other hand, the purchase price for the debentures excludes the interest for the expired period, the quotation is said to be "Ex-interest". • In case of Ex-interest quotation, interest has to be paid to the holders for the expired period in addition to the price paid for the debentures. In any case, the company must pay interest for the expired period and while making entry in its books at the time of purchase of the debentures, the amount paid by way of interest should be treated separately from the price actually paid for the debentures.

FINANCIAL STATEMENTS	• Financial statements, as used in corporate business houses, refer to a set of reports and schedules which an accountant prepares at the end of a period of time for a business enterprise. • The financial statements are the means with the help of which the accounting system performs its main function of providing summarized information about the financial affairs of the business. • These statements comprise Balance Sheet or Position Statement and Statement of Profit & Loss or Income Statement. • Of course to give a full view of the financial affairs of an undertaking, in addition to the above, the business may also prepare a Statement of Retained Earnings and a Cash Flow Statement. In India, every company has to present its financial statements in the form and contents as prescribed under Section 2(2), 129 & 133 of the Companies Act 2013. The significance of these statements are given below: (i) **Balance Sheet or Position Statement**: Balance sheet is a statement showing the nature and amount of a company's assets on one side and liabilities and capital on the other. In other words, the balance sheet shows the financial position on a particular date usually at the end of one year period. Balance sheet shows how the money has been made available to the business of the company and how the money is employed in the business. (ii) **Statement of Profit & Loss or Income Statement**: Earning profit is the principal objective of all business enterprises and Statement of Profit & Loss or Income Statement is the document which indicates the extent of success achieved by a business in meeting this objective. Profits are of primary importance to the Board of directors in evaluating the management of a company, to shareholders or potential shareholders in making investment decisions and to banks and other creditors in judging the loan repayment capacities and abilities of the company. It is because of this that the profit and loss or income statement is regarded as the primary statement and commands a careful scrutiny by all interested parties. It is prepared for a particular period which is mentioned alongwith the title of these statements, which includes the name of the business firm also. (iii) **Cash Flow Statement**: This is a statement which summarises for the period, the cash available to finance the activities of an organization and the uses to which such cash have been put. A statement of cash flow reports cash receipts and payments classified according to the organization's major activities i.e., operating activities, investing activities and financing activities. This statement reports the net cash inflow or outflow for each activity and for the overall business.
DIFFERENT TYPES	**INTERIM STATEMENTS:**

OF FINANCIAL STATEMENTS	• Financial statements that are issued for the time periods *smaller than one year* are called interim statements, because they are used as *temporary statements* to judge a company's financial position, until the full annual statements are issued. • Interim financial statements are most commonly issued quarterly or semi-annually, but it is not uncommon for companies to issue monthly reports to creditors as part of their loan covenants. • Quarterly statements, as the name implies, are issued every quarter and only include financial data from that three-month span of time. Likewise, semi-annual statements include data from a six-month span of time. **ANNUAL STATEMENTS:** • The annual financial statement form is prepared once a year and covers a 12-month period of financial performance. • Generally, these statements are issued at the end of a company's fiscal year instead of a calendar year. • A company with a June year-end would issue annual statements in July or August; whereas, a company with a December year-end would issue statements in January or February.
USER OF FINANCIAL STATEMENTS	Financial statements are mainly prepared for *external users*. There users are people who are outside of the company or organization itself and need information about it to base their financial decisions on. These external users typically fall into four main categories: • Investors • Creditors • Competitors • Regulators like Income Tax Department, MCA, SEBI, RBI, etc Investors and creditors analyze these sets of statements to base their financial decisions on. They also look at extra financial reports like financial statement notes and the discussion done in management meetings. The Income Statement and Balance Sheet are compared with each other to see how efficiently a company is using its assets to generate profits. Company's debt and equity levels can also be examined to determine whether the companies are properly funding its operations and expansions. Most investors and creditors use *financial ratios* to analyze these comparisons. There is almost no limit to the amount of ratios that can be combined for analysis purposes. These ratios by themselves rarely give outside users and decision makers enough information to judge whether or not a company is fiscally sound. However, Investors and creditors generally compare different companies' ratios to develop an industry standard or a benchmark to judge a company's performance.
CURRENT / NON	Covered in Chapter 2

CURRENT DISTINCTION	
FINANCIAL STATEMENT TEMPLATE & FORM	Covered in Chapter 2
PRESENTATION OF FINANCIAL STATEMENT	Covered in Chapter 2
MANAGERIAL REMUNERATION OF KMP	The provisions relating of the Managerial Personnel in the Companies Act, 2013 are as under: (a) **Section 197:** Overall ceiling for Managerial Remuneration i. e. 11% of the Net Profit or Individual limit. (b) **Section 198:** Calculation of Net Profit as required under section 197. (c) **Schedule V:** Conditions for Appointments of KMPs and their remunerations in case of a Company having no profit or inadequate profits.
OVERALL LIMIT OF MANAGERIAL REMUNERATION (SECTION 197 OF THE COMPANIES ACT, 2013) (December 2015)	The maximum ceiling for payment of managerial remuneration by a public company to its MD, WTD and which ***shall not exceed 11%***of the net profit of the company in a particular financial year. This section only applies to public company or a private company which is a subsidiary of a public company. **Note:** The calculation of net profit for the purpose of Managerial Remuneration shall be made in accordance with section 198. ***A company may pay more than 11% of the Net Profit with authority of shareholders ~~& Central Government~~.*** (No CG Approval required now. Only Shareholders Approval is sufficient. Amendment is brought by Companies Amendment Act, 2017 w.e.f. 12th September 2018) **Individual limit of Managerial Remuneration to MD, WTD or Manager** The remuneration payable to any one MD or WTD or Manager shall not exceed 5% of the net profits and if there are more than one such directors and manager, remuneration shall not exceed 10% of the net profits. **Individual Limit to directors other than MD, WTD or Manager** The remuneration payable to Directors other than MD or WTD shall not exceed: (a) 1% of the net profits, if there is a MD, WTD or Manager; (b) 3% of the net profits in any other case. **Note:** The Company may increase the above limit of Managerial Remuneration subject to the approval of shareholders in general meeting by Special Resolution. (Words "Special Resolution" inserted by Companies Amendment Act, 2017 w.e.f 12th September 2018. Earlier it was not clear which resolution was required. Now it is clear that Special Resolution is required)

Provided also that, where the company has defaulted in payment of dues to any bank or public financial institution or non-convertible debenture holders or any other secured creditor, the prior approval of the bank or public financial institution concerned or the non-convertible debenture holders or other secured creditor, as the case may be, shall be obtained by the company before obtaining the approval in the general meeting. (Proviso inserted by Companies Amendment Act, 2017 w.e.f 12th September 2018)

Notwithstanding anything contained in sub-sections (1) and (2), but subject to the provisions of Schedule V, if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole time director or manager, by way of remuneration any sum exclusive of any fees payable to directors under sub-section (5) hereunder except in accordance with the provisions of Schedule V; (No Central Government Required)

In cases where Schedule V is applicable on grounds of no profits or inadequate profits, any provision relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof, whether the provision be contained in the company's memorandum or articles, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or its Board, shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule;

<u>Transitional Provision Added</u>: (Sub Section 17)
On and from the commencement of the Companies (Amendment) Act, 2017, any application made to the Central Government under the provisions of this section [as it stood before such commencement], which is pending with that Government shall abate, and the company shall, within one year of such commencement, obtain the approval in accordance with the provisions of this section, as so amended;

<u>Provisions relating to sitting fees</u>
The above mentioned limit of managerial remuneration shall be **exclusive of sitting fees** payable to directors for attending the board meetings/committees meetings.

The maximum sitting fees payable to the each director for attending the Board Meeting or any committee meeting **shall not exceed ` 1 lakh per meeting**.

Note: The Board may decide different sitting fee payable to independent and non – independent directors other than whole – time directors. Any director can take sitting fees including MD or WTD.

<u>Remuneration to Directors in other Capacity</u>: The remuneration payable to the directors including MD, WTD or Manager shall be inclusive of the remuneration payable for the services rendered by him in any other capacity except the services of a professional

	nature and in the opinion of the Nomination and Remuneration Committee or the Board, the director possesses the requisite qualification for the services of the professional nature. **<u>Other provisions relating to Monthly Remuneration to Director or Manager</u>** (a) Permissible forms of Remuneration: A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other. (b) Commission or remuneration from holding or subsidiary company: Any director who is in receipt of any commission from the company and who is a MD, WTD or Manager of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report. (c) ~~Independent directors are not entitled to stock options: An independent director shall not be entitled to any stock option and may receive remuneration by way of fees, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.~~ **(Deleted by Companies Amendment Ordinance 2018)** (d) Insurance Premium not part of Remuneration: Where any insurance is taken by a company on behalf of its MD, WTD, Manager, CEO, CFO or CS for indemnifying against any liability in respect of any negligence, default, or breach of trust for which they may be guilty in relating to the company, such insurance premium shall not be treated managerial remuneration. **Note:** If such KMP is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration.
CALCULATION OF PROFIT FOR PURPOSE TO PAY MANAGERIAL REMUNERATION UNDER SECTION 197	**SCHEDULE – V** **CONDITIONS FOR APPOINTMENTS OF KMPS AND THEIR REMUNERATIONS** **PART – I of the Schedule V** **PART – II of the Schedule V** **Section I: Remuneration by Companies having Profits** A company having profits in a financial year shall pay remuneration to its KMP in accordance with Section 197. **Section II: Remuneration by Companies having no profits or inadequate profits** Where in any financial year, if a company has no profits or inadequate profits, it may pay the remuneration to the managerial person not exceeding the limits as mentioned in Table A and Table B below: **TABLE – A (LOSS MAKING COMPANY)** **Effective Capital** | **Remuneration (Annually)**

Negative or less than ₹5 Crores	₹60 Lakhs
More than ₹5 Crores but less than ₹100 Crores	₹84 Lakhs
More than ₹100 Crores but less than ₹250 Crores	₹120 Lakhs
₹250 Crores and above	₹120 Lakhs plus 0.01% of the effective capital in excess of ₹250 Crores

Note: Provided that remuneration in excess of above limits may be paid if a special resolution is passed by the shareholders. It is clarified that for a period less than one year, the limits shall be pro – rated.

TABLE – B (A COMPANY HAVING INADEQUATE PROFIT)

In case of a managerial person who is functioning in a professional capacity, remuneration as per item (A) may be paid, if such managerial person is not having any interest in the capital of the company or its holding company or any of its subsidiaries directly or indirectly or through any other statutory structures and not having any, direct or indirect interest or related to the directors or promoters of the company or its holding company or any of its subsidiaries at any time during the last two years before or on or after the date of appointment and possesses graduate level qualification with expertise and specialised knowledge in the field in which the company operates:

Provided that any employee of a company holding shares of the company not exceeding 0.5% of its paid up share capital under any scheme formulated for allotment of shares to such employees including Employees Stock Option Plan or by way of qualification shall be deemed to be a person not having any interest in the capital of the company;

Provided further that the limits specified under items (A) and (B) of this section shall apply, if-
An unlisted company and subsidiary of a listed company may pay remuneration to its managerial person in the event of no profit or inadequate profit beyond ceiling prescribed in section II, part II of Schedule V subject to complying with the following conditions:

(a) Approval by the Board & Committee: Payment of remuneration is approved by a resolution passed by the Board & also approved by nomination and remuneration committee and while doing so record in writing clear reason and justification for payment of remuneration beyond the said limit;

(b) No default on repayments: The company has not made any default in repayment of any of its debts or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person;

(c) Approval from shareholders: Prior approval of shareholders by way of a special resolution at a general meeting of the company for payment of remuneration for a period not exceeding 3 years;

(d) Statement with Notice: Statement along with a notice calling the general meeting as referred above is given to the shareholders containing the following information, namely:-

CENTRAL GOVERNMENT OR COMPANY TO FIX LIMIT WITH REGARD TO REMUNERATION (SECTION 200)

Notwithstanding anything contained in this Chapter, ~~The CG~~ or the company may, while according its approval under section 196, to any appointment or to any remuneration under section 197 in respect of cases where the company has inadequate or no profits, fix the remuneration within the limits specified in this Act, at such amount or percentage of profits of the company, as it may deem fit and while fixing the remuneration~~, CG or~~ the company shall have regard to—

(a) the financial position of the company;

(b) the remuneration or commission drawn by the individual concerned in any other capacity;

(c) the remuneration or commission drawn by him from any other company;

(d) professional qualifications and experience of the individual concerned;

(e) such other matters as may be prescribed.

(Words "Central Government" Omitted by Companies Amendment Act, 2017 w.e.f 12th September 2018)

Parameters for Consideration of Remuneration:

The company shall have regard to the following matters, namely:-

(1) The Financial and operating performance of the company during the three preceding financial years.

(2) The relationship between remuneration and performance.

(3) The principle of proportionality of remuneration within the company, ideally by a rating methodology which compares the remuneration of directors to that of other directors on the board who receives remuneration and employees or executives of the company.

(4) Whether remuneration policy for directors differs from remuneration policy for other employees and if so, an explanation for the difference.

(5) The securities held by the director, including options and details of the shares pledged as at the end of the preceding financial year.

SECTION III: REMUNERATION IN SPECIAL CIRCUMSTANCES

Where the company is having no profit or inadequate profit can pay remuneration to its managerial personnel in excess of amount as mentioned in Section II above. The following companies are covered in this section:

(a) Foreign Company

(b) where the company—

(i) is a newly incorporated company, for a period of seven years from the date of its incorporation, or

(ii) is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction for a period of five years from the date of sanction of scheme of revival, or

(iii) is a company in relation to which a resolution plan has been approved by the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016 for a period of five years from the date of such approval, it may pay remuneration up to two times the amount permissible under section II

(c) Sick Company (as order passed by BIFR or NCLT for five years from date of sanction of scheme)

(d) ~~An unlisted company in a Special Economic Zone (Max. ₹2,40,00,000 per annum)~~
(Omitted w.e.f 12th September 2018)

SECTION IV: PERQUISITES NOT INCLUDED IN MANAGERIAL REMUNERATION

The following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III:

(a) **Contribution towards Statutory Requirements**: Contribution to provident fund, superannuation fund or annuity fund to the extend these either singly or put together are not taxable under the Income – tax Act, 1961;

(b) **Gratuity**: Gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and

(c) **Leave encashment**: Encashment of leave at the end of the tenure.

In addition to the above perquisites, an expatriate managerial person (including a non – resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III:

(i) **Children's education allowance**: In case of children studying in or outside India, an allowance limited to a maximum of ₹12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

(ii) **Holiday passage for children studying outside India or family staying abroad:** Return holiday passage once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad to India if they are not residing in India, with the managerial person.

(iii) **Leave travel concession**: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave to spent in home country instead of anywhere in India.

CALCULATION OF EFFECTIVE CAPITAL:

Paid – up share capital (Excluding Application money or advances against shares)	: XXXX
Add:	
(a) Credit of share premium account;	: XXXX
(b) Reserves and surplus (excluding revaluation reserve);	: XXXX
(c) Long – term loans and deposits repayable after one year (Excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short – term arrangements)	: XXXX
Less:	
(a) Aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities)	: XXXX
(b) Accumulated Losses	: XXXX
(c) Preliminary Expenses not written off	: XXXX
Effective Capital	**: XXXX**

Explanation II:
(a) Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital shall be calculated as on the date of such appointment;
(b) In any other case the effective capital shall be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.

Explanation III: For the purposes of this Schedule, "family" means the spouse, dependent children and dependent parents of the managerial person.

Explanation IV: The Nomination and Remuneration Committee while approving the remuneration under Section II or Section III, shall:
(a) Take into account, financial position of the company, trend in the industry, appointee's qualification, experience, past performance, past remuneration, etc.;
(b) Be in a position to bring about objectivity in determining the remuneration package while striking a balance between the interest of the company and the shareholders.

Explanation V: For the purposes of this Schedule, "negative effective capital" means the effective capital which is calculated in accordance with the provisions contained in Explanation I of this Part is less than zero.

Explanation VI: For the purposes of this Schedule"
(A) ~~"current relevant profit" means the profit as calculated under section 198 but without deducting the excess of expenditure over~~

	~~income referred to in section 4(1) thereof in respect of those years during which the managerial person was not an employee, director or shareholder of the company or its holding or subsidiary companies.~~ (Omitted w.e.f. 12th September 2018) **SECTION V: REMUNERATION PAYABLE TO A MANAGERIAL PERSON IN TWO COMPANIES** A managerial person shall draw remuneration from one or more companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person. **PART – III** **PROVISIONS APPLICABLE TO PARTS I AND II OF THIS SCHEDULE** 1. The appointment and remuneration referred to in Part I and Part II of this Schedule shall be subject to approval by a resolution of the shareholders in general meeting. 2. The auditor or the Secretary of the company or where the company is not required to be appointed a Secretary, a Secretary in whole – time practice shall certify that the requirement of this Schedule have been complied with and such certificate shall be incorporated in the return filed with the ROC. **PART – IV** The Central Government may, by notification, exempt any class or classes of companies from any of the requirements contained in this Schedule.
RECOVERY OF MANAGERIAL REMUNERATION (SECTION 197)	If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without approval required under this section, he shall refund such sums to the company, within two years or such lesser period as may be allowed by the company, and until such sum is refunded, hold it in trust for the company; (Substituted by Companies Amendment Act, 2017 w.e.f 12th September 2018) The company shall not waive the recovery of any sum refundable to it under sub-section (9) unless approved by the company by special resolution within two years from the date the sum becomes refundable; (No Central Government Approval required) Provided also that, where the company has defaulted in payment of dues to any bank or public financial institution or non-convertible debenture holders or any other secured creditor, the prior approval of the bank or public financial institution concerned or the non-convertible debenture holders or other secured creditor, as the case may be, shall be obtained by the company before obtaining the approval in the general meeting. (Proviso inserted by Companies Amendment Act, 2017 w.e.f 12th September 2018) The auditor of the company shall, in his report under section 143, make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of this section, whether remuneration paid to any director is in excess of

	the limit laid down under this section and give such other details as may be prescribed; (Inserted by Companies Amendment act, 2017 w.e.f 12th September 2018)
CONSEQUENCES OF DEFAULT WITH SECTION 197	If any person makes any default in complying with the provisions of this section, he shall be liable to a penalty of one lakh rupees and where any default has been made by a company, the company shall be liable to a penalty of five lakh rupees.
CORPORATE SOCIAL RESPONSIBITY COMMITTEE [Section 135 & The Companies (CSR Policy) Rules, 2014] **P: 5** **W: 500** **T: 1000**	As per section 135 of the Companies Act, 2013, certain class of companies must constitute a CSR Committee for formulation and implementation of CSR policy. **Constitution of CSR Committee**: Every company has to constitute a CSR Committee which is having: (a) Net worth of ₹ 500 Crores or more or (b) Turnover of ₹ 1000 Crores or more or (c) Net profit of ₹ 5 Crores or more **Note:** If a company crosses the above limits in respect of net worth or turnover or net profit during the immediately preceding financial year, such company has to constitute a CSR committee. **There is no bifurcation of Listed or Unlisted, Public or Private. All types of Companies can be covered.** **Members**: The CSR Committee shall consist of **3 or more** Directors, out of which at least one Director shall be an Independent Director. Provided that where a company is not required to appoint an independent director under Sub Section 4 of Section 149, it shall have in its CSR Committee; two or more directors; (Inserted by Companies Amendment Act, 2017 w.e.f. 19th September 2018) A private company having only two directors on its Board shall constitute its CSR Committee with two such directors; With respect to a foreign company covered under these rules, the CSR Committee shall comprise of at least two persons of which one person shall be as specified under clause (d) of sub-section (1) of section 380 of the Act and another person shall be nominated by the foreign company. **COMPOSITION OF CSR COMMITTEE** (a) **For Listed Company** : The CSR committee shall consist of 3 or more directors, out of which one director shall be an independent director. (b) **For Unlisted Public or Private Company** : In case of an unlisted public company or a private company which is not required to appoint an independent director shall have its CSR Committee without the independent director. Example: A private company having only two directors on its Board shall constitute its CSR Committee with two such directors.

Scope increased/relaxed by adding the words

	(c) For Foreign Company: With respect of foreign company, the CSR Committee shall comprise of at least two persons out of which one person resident in India and another person may be from foreign country duly nominated by the foreign company. **FUNCTIONS OF THE CSR COMMITTEE** The Committee formulate a CSR Policy and recommend to the Board which shall indicate the activities to be undertaken by the company in areas or subject specified in Schedule VII. The Committee shall recommend the amount of expenditure to be incurred on the activities. Further, the CSR Committee is under an obligation to monitor the implementation of the CSR policy from time to time. The CSR activities shall be completed by way of the following methods: (a) **By Charity** : A company can donate money to various charitable trusts, societies, NGOs etc. who work for social economic welfare of society. (b) **By Contract** : A company can make a contract with an NGO or any other agency for carrying out the CSR Activities for and on behalf of the company. (c) **By itself**: A company can take up any CSR activities on its own or create its own trust for CSR Activities. **SCHEDULE VII:** **Activities which may be included by companies in their Corporate Social Responsibility Policies Activities relating to:—** (i) Eradicating poverty and malnutrition, providing preventive health care and sanitation *including Contribution to Swatch Bharat Kosh set up by CG for promotion of Sanitation* and making available safe drinking water; (ii) Promoting education including special education and employment enhancing vocation skills especially among children, women and others; (iii) promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups; (iv) Ensuring environment sustainability, ecological balance, animal welfare, conservation of natural resources and maintaining quality of soil, air and water *including Contribution to Clean Ganga Fund set up by CG for rejuvenation of River Ganga;* (v) Protection of national heritage, art and culture including restoration of building and sites of historical important and works of art, setting up public libraries; promotion and development of traditional art and handicrafts; (vi) measures for the benefit of armed forces veterans, war widows and their dependents, *Central Armed Police Forces (CAPF) and*

	Central Para Military Forces (CPMF) veterans, and their dependents including widows; (vii) training to promote rural sports, nationally recognised sports, paralympic sports and olympic sports; (viii) Contribution to the Prime Minister's National Relief Fund or *Prime Minister's Citizen Assistance and Relief in Emergency Situations Fund (PM CARES Fund)* or any other fund set up by the Central Government or the State Governments for socio – economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women. (ix) (a) Contribution to incubators or research and development projects in the field of science, technology, engineering and medicine, funded by the Central Government or State Government or Public Sector Undertaking or any agency of the Central Government or State Government; and (b) Contributions to public funded Universities; Indian Institute of Technology (IITs); National Laboratories and autonomous bodies established under Department of Atomic Energy (DAE); Department of Biotechnology (DBT); Department of Science and Technology (DST); Department of Pharmaceuticals; Ministry of Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homoeopathy (AYUSH); Ministry of Electronics and Information Technology and other bodies, namely Defence Research and Development Organisation (DRDO); Indian Council of Agricultural Research (ICAR); Indian Council of Medical Research (ICMR) and Council of Scientific and Industrial Research (CSIR), engaged in conducting research in science, technology, engineering and medicine aimed at promoting Sustainable Development Goals (SDGs). **Clause (ix) Substituted w.e.f. 24th August 2020** (x) Rural Development Projects; (xi) Slum area development; (xii) Disaster Management, including, relief, rehabilitation and reconstruction activities. **ROLE OF THE BOARD OF DIRECTORS:** The Board of every company shall – (a) Ensure that the activities which formulate by CSR Committee are duly undertaken by the company. (b) Ensure that the company spends in every financial year, at least 2% of the average net profits of the company made during the 3 immediately preceding financial years, in pursuance of its CSR Policy. (c) Ensure that the company shall give preference to the local area and areas around it where it operates.

	Note: If the company fails to spend CSR amount (2%), the Board shall give reasons for not spending the amount in the Director's report. Explanation: For the purposes of this section "net profit" shall not include such sums as may be prescribed, and shall be calculated in accordance with the provisions of section 198. (Words inserted by Companies Amendment Act, 2017) **Penalty** For Company: If a Company fails to comply with the above provisions, it shall be punishable with fine which shall not be less than ₹50,000/- which may extend up to ₹ 25 lakh. For every officer: Every officer who is in default shall be punishable with imprisonment upto 3 years or with fine which shall not be less than ₹ 50 thousand which may extend up to ₹ 5 lakh or with both.
WHICH ACTIVITIES DO NOT QUALIFY FOR CSR	• The CSR projects or programs or activities that benefit only the employees of the company and their families. • One-off events such as marathons/awards/charitable contribution/advertisement/sponsorships of TV programmes etc. • Expenses incurred by companies for the fulfilment of any other Act/Statute of regulations (such as Labour Laws, Land Acquisition Act, 2013, Apprentice Act, 1961 etc.) • Contribution of any amount directly or indirectly to any political party. • Activities undertaken by the company in pursuance of its normal course of business. • The project or programmes or activities undertaken outside India.

CSR FAQs

1. **Whether the 'average net profit' criteria for section 135(5) is Net profit before tax or Net profit after tax?**

Computation of net profit for section 135 is as per section 198 of the Companies Act, 2013which is primarily PROFIT BEFORE TAX (BT).

2. **Can contribution of money to a trust/Society/Section 8 Companies by a company be treated as CSR expenditure of the company?**

General Circular No. 21/2014 Of MCA Dated June 18, 2014 Clarifies That
Contribution To Corpus Of A Trust/Society/Section 8 Companies Etc. Will Qualify As CSR Expenditure As Long As:

(a) The Trust/Society/Section 8 company etc. is created exclusively for undertaking CSR activities or

(b) where the corpus is created exclusively for a purpose directly relatable to a subject covered in Schedule VII of the Act.

3. **Whether CSR expenditure of a company can be claimed as a business expenditure?**

The amount spent by a company towards CSR cannot be claimed as a business expenditure. The Finance Act, 2014 provides that any expenditure incurred by an assessee on the activities relating to Corporate Social Responsibility referred to in section 135 of the Companies Act, 2013 shall not be deemed to be an expenditure incurred by the Assessee for the purposes of the business or profession.

4. Can the CSR expenditure be spent on the activities beyond Schedule VII?

General Circular No. 21/2014 dated June 18, 2014 of MCA has clarified that the statutory provision and provisions of CSR Rules, 2014, is to ensure that activities undertaken in pursuance of the CSR policy must be relatable to Schedule VII of the Companies Act, 2013.The entries in the said Schedule VII must be interpreted liberally so as to capture the essence of the subjects enumerated in the said Schedule. The items enlisted in the Schedule VII of the Act, are broad-based and are intended to cover a wide range of activities. The General Circular also provides an illustrative list of activities that can be covered under CSR. In a similar way many more can be covered. It is for the Board of the company to take a call on this.

5. What tax benefit can be availed under CSR?

No Specific Tax Exemptions Have Been Extended To CSR Expenditure Per Se. The Finance Act, 2014 Also Clarifies That Expenditure On CSR does not form part of business expenditure. While no specific tax exemption has been extended to expenditure incurred on CSR, spending on several activities like contributions to Prime Minister's Relief Fund, scientific research, rural development projects, skill development projects, agricultural extension projects, etc., which find place in Schedule VII, already enjoy exemptions under different sections of the Income Tax Act, 1961.

6. Whether it is mandatory for Foreign Company to give report on CSR activity?

In case of a foreign company, the balance sheet filed under sub-clause (b) of sub-section (1) of section 381 shall contain an Annexure regarding report on CSR.

7. If a company spends in excess of 2% of its average net profit of three preceding years on CSR in a particular year, can the excess amount spent be carried forward to the next year and be offset against the required 2% CSR expenditure of the next year?

Any excess amount spent (i.e., more than 2% as specified in Section 135) cannot be carried forward to the subsequent years and adjusted against that year's CSR expenditure.

8. Can the unspent amount from out of the minimum required CSR expenditure be carried forward to the next year?

The Board is free to decide whether any unspent amount from out of the minimum required CSR expenditure is to be carried forward to the next year. However, the carried forward amount should be over and above the next year's CSR allocation equivalent to at least 2% of the average net profit of the company of the immediately preceding three years.

9. Can CSR funds be utilized to fund Government Scheme?

The objective of this provision is indeed to involve the corporate in discharging their social responsibility with their innovative ideas and management skills and with greater efficiency and better outcomes. Therefore, CSR should not be interpreted as a source of financing the resource gaps in Government Scheme. Use of corporate innovations and management skills in the delivery of 'public goods' is at the core of CSR implementation by the companies. In principle, CSR fund of companies should not be used as a source of funding Government Schemes. CSR projects should have a larger multiplier effect than that under the Government schemes.

However, under CSR provision of the Act and rules made thereunder, the Board of the eligible company is competent to take decision on supplementing any Government Scheme provided the scheme permits corporate participation and all provisions of Section 135 of the Act and rules thereunder are complied by the company.

10. Who is the appropriate authority for approving and implementation of the CSR programmes/projects of a Company? What is Government's role in this regard?

Government has no role to play in this regard. Section 135 of the Act, Schedule VII and Companies CSR Policy Rules, 2014 read with General Circular dated 18.06.2014 issued by the
Ministry of Corporate Affairs, provide the broad contour with which eligible companies are required to formulate their CSR policies including activities to be undertaken and implement the same in the right earnest. Therefore, all CSR programmes/projects should be approved by the Boards on the recommendations of their CSR Committees.

COVID-19 related Frequently Asked Questions (FAQs) on Corporate Social Responsibility (CSR)

General Circular No. 15 /2020 dated 10.04.2020

Whether contribution made to 'PM CARES Fund' shall qualify as CSR expenditure?	Contribution made to 'PM CARES Fund' shall qualify as CSR expenditure under item no (viii) of Schedule VII of the Companies Act, 2013 and it has been further clarified vide Office memorandum F. No. CSR-05/1/2020-CSR-MCA dated 28th March, 2020
Whether contribution made to 'Chief Minister's Relief Funds' or 'State Relief Fund for COVID-19' shall qualify as CSR expenditure?	'Chief Minister's Relief Fund' or 'State Relief Fund for COVID-19' is not included in Schedule VII of the Companies Act, 2013 and therefore any contribution to such funds shall not qualify as admissible CSR expenditure.
Whether contribution made to State Disaster Management Authority shall qualify as CSR expenditure?	Contribution made to State Disaster Management Authority to combat COVID-19 shall qualify as CSR expenditure under item no (xii) of Schedule VII of the 2013 and clarified vide general circular No. 10/2020 dated 23rd March, 2020.
Whether spending of CSR funds for COVID-19 related activities shall qualify as CSR expenditure?	Ministry vide general circular No. 10/2020 dated 23rd March, 2020 has clarified that spending CSR funds for COVID-19 related activities shall qualify as CSR expenditure. It is further clarified that funds may be spent for various activities related to COVID-19 under items nos. (i) and (xii) of Schedule VII relating to promotion of health care including preventive health care and sanitation, and disaster management. Further, as per general circular No. 21/2014 dated 18.06.2014, items in Schedule VII are broad based and may be interpreted liberally for this purpose.
Whether payment of salary/wages to employees and workers, including	Payment of salary/ wages in normal circumstances is a contractual and statutory obligation of the company. Similarly, payment of salary/ wages to employees and

contract labour, during the lockdown period can be adjusted against the CSR expenditure of the companies?	workers even during the lockdown period is a moral obligation of the employers, as they have no alternative source of employment or livelihood during this period. Thus, payment of salary/ wages to employees and workers during the lockdown period (including imposition of other social distancing requirements) shall not qualify as admissible CSR expenditure.
Whether payment of wages made to casual /daily wage workers during the lockdown period can be adjusted against the CSR expenditure of the companies?	Payment of wages to temporary or casual or daily wage workers during the lockdown period is part of the moral/ humanitarian/ contractual obligations of the company and is applicable to all companies irrespective of whether they have any legal obligation for CSR contribution under section 135 of the Companies Act 2013. Hence, payment of wages to temporary or casual or daily wage workers during the lockdown period shall not count towards CSR expenditure.
Whether payment of exgratia to temporary /casual /daily wage workers shall qualify as CSR expenditure?	If any ex-gratia payment is made to temporary / casual workers/ daily wage workers over and above the disbursement of wages, specifically for the purpose of fighting COVID 19, the same shall be admissible towards CSR expenditure as a onetime exception provided there is an explicit declaration to that effect by the Board of the company, which is duly certified by the statutory auditor.

AUDIT QUERY	• An accounting audit is the process of examining a company's entire financial situation, with an emphasis on ensuring compliance with relevant reporting standards, and promoting adequate cash-handling policies and internal controls. • In most countries, regular audits by outside firms are required for publicly traded corporations. In contrast, small businesses are typically not subject to as rigorous a set of reporting standards and controls. Therefore, are often not subject to mandatory audits. • Learning how to perform a basic internal accounting audit on your own small business can provide you with a comprehensive understanding of your company's financial strengths and weaknesses. • Audit queries are questions asked by an auditor during an investigation. These may be used to gather information to come to a conclusion in the audit. The following parameters are looked during audit queries: 1. Any questions related to a company which is being audited either by an internal or external auditor. 2. The final touch of the accounts. 3. It is the matter being investigated while examining financial report of a company. 4. Audit queries are questions asked by an auditor during an investigation. These may be used to gather information to come to a conclusion in the audit.

	5. An audit query is a explanation that is required by the audit team on certain points that they may have identified during an audit. 6. When you get asked to justify an action by the auditors - e.g., invoice accrual prepayment, etc. 7. It is an inquiry from an auditor also known as findings. 8. Audit queries are questions asked by the auditor during an investigation. The response can be used to help the auditor come to a conclusion regarding an audit. 9. I assume an audit query is when a particular set of data is pulled to audit.

CONSOLIDATION PROCESS	In preparing the consolidated financial statements, firstly, the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, equity, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps are then taken: 1. the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated. In case cost of acquisition exceeds or is less than the acquirer's interest, goodwill or capital reserve is calculated retrospectively. 2. Intragroup transactions, including sales, expenses and dividends, are eliminated, in full; 3. Unrealized profits resulting from Intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full; 4. unrealized losses resulting from Intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered; 5. minority interest in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and 6. Minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.
TREATMENT OF DIFFERENTIAL i.e., COST OF CONTROL	• Any excess of the cost to the parent of its subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognized as an asset in the considered financial statements. • When the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements. • For the purpose of all these computations, where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.
MINORITY INTERESTS	• Minority interest represents that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries, by the holding (parent) company. • In short, minority interest represents the claims of the outside shareholders of a subsidiary. Minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the shareholders of the holding company. • Minority interest in the income of the group should be separately

	presented. The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. • The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to make good the losses. If the subsidiary subsequently reports profit, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered. • As per Para 13(e) of AS 21, minority interest in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interest in the net assets consist of : (i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and (ii) the minorities share of movements in equity since the date the parent-subsidiary relationship and into existence.
PROFIT OR LOSS OF SUBSIDIARY COMPANY	• For the purpose of consolidated balance sheet preparation all reserves and profits (or losses) of subsidiary company should be classified into pre and post-acquisition reserves and profits (or losses). • Profits (or losses) earned (or incurred) by subsidiary company upto the date of acquisition of the shares by the holding company are pre acquisition or capital profits (or loss). • Similarly, all reserves of subsidiary company upto the date of acquisition are capital reserves from the view point of holding company. • If the holding interest in subsidiary is acquired during the middle or some other period of the current year, pre-acquisition profit should be calculated accordingly. • In addition profit or loss on revaluation of fixed assets of subsidiary should also be treated as capital profit or loss. But if the fall in the value of the asset occurs after the date of acquisition, the loss should be treated as revenue loss. Adjustment for depreciation would be made in the profit and loss account of the subsidiary. • The minority interest in the reserves and profits (or losses) of subsidiary company should be transferred to minority interest account which will also include share capital of subsidiary company held by outsiders / minority shareholders. • The holding company's interest in the pre-acquisition reserves and profits (or losses) should be adjusted against cost of control to find out goodwill or capital reserve on consolidation. • The balance of reserves and profits (or loss) of subsidiary company, representing holding company's interest in post-acquisition or revenue reserves and profits (or losses), should be added to the balances of reserves and profits (or losses) of holding company.
DIVIDEND RECEIVED FROM SUBSIDIARY	• The holding company, when it receives a dividend from a subsidiary company, must distinguish between the part received out of capital profits and that out of revenue profits - the former

COMPANIES	is credited to Investment Account, it being a capital receipt, and the latter is adjusted as revenue income for being credited to the Profit & Loss Account. • It must be understood that the term 'capital profit', in this context, apart from the generic meaning of the term, connotes profit earned by the subsidiary company till the date of acquisition. • As a result, profits which may be of revenue nature for the subsidiary company, may be capital profits so far as the holding company is concerned. If the controlling interest was acquired during the course of a year, profit for that year must be apportioned into the pre-acquisition and post-acquisition portions, on the basis of time in the absence of information on the point.
PREPARATION OF CONSOLIDATED BALANCE SHEET	• While preparing the consolidated balance sheet, assets and outside liabilities of the subsidiary company are merged with those of the holding company. • Share capital and reserves and surplus of subsidiary company are apportioned between holding company and minority shareholders. These items, along with investments of holding company in shares of subsidiary company are not separately shown in consolidated balance sheet. • The net amounts resulting from various computations on these items, shown as (a) minority interest (b) cost of control (c) holding company's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the holding company) are entered in consolidated balance sheet. The method of calculation of these items with detailed treatment of other relevant issues has been dealt with in various paras separately. • As per para 15 of AS 21, if an enterprise makes two or more investments in another enterprise at different dates and eventually obtain control of the other enterprise the consolidated financial statements are presented only from the date on which holding- subsidiary relationship comes in existence. • If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment for the purposes of paragraph 13 of AS 21, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.
ELIMINATION OF INTRA-GROUP BALANCES AND INTRA-GROUP TRANSACTIONS	• Intragroup balances should be eliminated from both sides of the consolidated Balance Sheet. Similarly intragroup transactions (e.g. sales, expenses, dividends etc. are also to be eliminated in full in the consolidated profit and loss account. • Suppose A Ltd. is a holding company of B Ltd. Bills payable of B Ltd. include ₹ 4,000 issued to A Ltd. out of which A Ltd. had discounted ₹1,000 and that debtors of A Ltd. include ₹10,000 owings by B Ltd. • In this situation, Bills of ₹ 3,000 still held by A Ltd. would be eliminated both from Bills Receivable and Bills Payable in the consolidated balance sheet. Also both sundry debtors and creditors would get reduced by ₹ 10,000.

	• Consider another example if S Ltd. (a subsidiary of H Ltd.) has paid ₹ 12,000 as interest out of which ₹ 6,000 has been received by H Ltd., in the consolidated profit and loss account interest paid should be shown only at, ₹6,000, intragroup interest being eliminated in full.
UNREALIZED PROFIT ON INTER-COMPANY TRANSACTIONS	• It is natural for a company to sell goods to its subsidiary or subsidiaries and vice versa, usually goods are sold at normal selling price. • For the purpose of consolidation of financial statements, profit on goods received from the other company of the same group but sold away before the balance sheet date raises no problem. But in respect of such goods not yet sold, the unrealized profits are to be eliminated in full as per Para 16 of AS 21. • This may be done by creating a reserve in respect of total unrealized profit which has not yet been realised. • Suppose A Ltd. supplies goods of the invoice value of ₹ 20,000 to B Ltd. (a subsidiary of A Ltd.) of which goods valued at ₹ 8,000 were still in stock of B Ltd. and invoice value was cost plus 25%. The total unrealized profit in the unsold stock of ₹ 8,000 will be ₹ 1,600. Also, unrealized losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered. • Here, the point to be noted is that one has to see whether the intragroup transaction is "upstream" or "downstream". Upstream transaction is a transaction in which the subsidiary company sells goods to holding company. While in the downstream transaction holding company is the seller and subsidiary company is the buyer. In the case of upstream transaction, goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. • In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their shareholding besides deducting the same from unsold stock. • But in the case of downstream transaction the whole profit is earned by the holding company, therefore whole unrealized profit should be adjusted from unsold stock account and consolidated profit and loss account only.
PREPARATION OF CONSOLIDATED PROFIT AND LOSS ACCOUNT	Preparation of Consolidated Profit and Loss Account of holding company and its subsidiaries is not very difficult. All the revenue items are to be added on line by line basis and from the consolidated revenue items inter-company transactions should be eliminated. For example, a holding company may sell goods or services to its subsidiary, receives consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full. If there remains any unrealized profit in the stock of good, of any of the Group Company, such unrealized profit is to be eliminated from

	the value of stock to arrive at the consolidated profit. Also it is necessary to eliminate the share of holding company in the proposed dividend of the subsidiary.
BONUS SHARES	The issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as the minority shareholders. Issue of bonus shares may or may not affect the cost of control depending upon whether such shares are issued out of capital profits or revenue profits. (a) *Issue of bonus shares out of capital profit (Pre-acquisition profits):* In this case there will be no effect on accounting treatment because while calculating the cost of control the share of the holding company in pre-acquisition profit is reduced because of capitalisation of profit and the paid-up value of shares held in subsidiary company is increased. Hence there is no effect on cost of control when bonus shares are issued from pre-acquisition profit. (b) *Issue of bonus shares out of post-acquisition profit:* In this case, a part of the revenue profits will get capitalized resulting in decrease of cost of control or increase in capital reserve.
TREATMENT OF DIVIDEND	• Dividends may be received out of capital or revenue profits of the subsidiary company. Dividend received by the holding company from the capital profits of the subsidiary company are credited to investment in shares of the subsidiary account thereby reducing the cost of control or increasing capital reserve. • On the other hand, dividend received out of the revenue profits (i.e., post-acquisition profits) are treated as income and credited to profit & loss Account by the holding company. • If dividend declared partly out of capital profits (i.e., pre-acquisition profits) and partly out of revenue profits (i.e., post-acquisition profits), the dividend received is divided into two parts in proportion to its declaration out of capital profits and revenue profits. • The dividend pertaining to the first part (i.e., capital profits) is credited to Investment Account reducing the cost of control or increasing the capital reserve and dividend pertaining to the second part (i.e., revenue profits) is credited to profit and loss Account or surplus account. • It may be noted that in the absence of information whether dividend has been declared out of pre-acquisition or post-acquisition profits, it is assumed that dividend is out of profits for the year for which the dividend is declared.

STEPS FOR PREPARING CONSOLIDATED BALANCE SHEET:

Step 1: Date of Acquisition:

Ascertain the date of acquisition by Parent company in a Subsidiary Company.
This date is relevant for the purpose of analysing subsidiary profits as pre-acquisition and post-acquisition profits.

Step 2: Shareholding Pattern:

Determine the shareholding pattern of the Subsidiary Company as on date on which the Consolidated Balance Sheet is to be Prepared.
This pattern is essential for apportionment of Subsidiary Profits.

Particulars	No. of Shares	%
Parent	***	**
Minority Interest	***	**
Total	***	**

Step 3: Analysis of Subsidiary Reserves and Surplus:
Analysis of subsidiary reserves and profits as pre-acquisition and post acquisition profits based on the date of acquisition.

- The reserves to be analysed shall be reserves as appearing in the balance sheet of the subsidiary company as at the date of preparation of consolidated balance sheet subject to adjustments relating to proposed dividend/bonus/unaccounted items.
- In certain instances where assets are revalued, the surplus/deficit should also be considered.
- If the subsidiary has outstanding cumulative preference shares, on which dividend has not been provided for or dividend is in arrears, the same should be provided and residuary reserves analysed.
- If the investments are made during the financial year, either:
    - Separate Financial Statements should be drawn up to the date of acquisition to determine the pre-acquisition profits. OR
    - Profits apportioned where practicable on a reasonable basis, for example, on the basis of time with assumption that profits have accrued evenly during the year.

Step 4: Apportionment of Profits:

	Pre-Acquisition Profits	Post-Acquisition Profits	
		Profits	Reserves
Profit & Loss	***	***	***
General Reserve	***	***	***
Total			
Holding Company (%)	***	***	***
Minority Interest (%)	***	***	***

Step 5: Minority Interest:

(i) Share Capital
(ii) Share of Post Acquisition profits and reserves
(iii) Share of Pre Acquisition profits
(iv) Proposed Dividend

Step 6: Cost of Control

(i) Cost of Investment
Amount Invested
Less: Pre Acquisition Dividend

(ii) Share in the net assets:
Share Capital
Pre Acquisition Profits

(iii) Goodwill / Capital Reserve

Step 7: Reserves for Consolidated Balance Sheet

(i) Reserves of Holding Company

(ii) Profits of Holding Company

(iii) Post acquisition profits of subsidiary

(iv) Post Acquisition reserves of subsidiary

(v) Dividend receivable from subsidiary

(vi) <u>Less</u>: Unrealized profits in stock

(vii) <u>Less</u>: Proposed dividend by Holding Company

CONCEPT	• Accounting is a process to identify measure and communicate economic information to permit informed judgments and decisions by the user of the information. • Its function is to provide quantitative information, primarily financial in name, about economic entities, that is intended to be useful in making economic decisions and related choice among alternative course of action. • Financial reporting may be defined as communication of published financial statement and related information from a business enterprise to all users. • It is the reporting of accounting information of an entity to a user or group of users. It contains booth qualitative and quantitative information. The Financial report made to the management is generally known as internal reporting, while financial reporting made to the shareholders is known as external reporting. • The internal reporting is a part of management information system and the uses MIS reporting for the purpose of analysis and as an aid indecision making process. The management of a corporate is ultimately responsible for the generation of accounting information. The accountability of a company has two distinct aspects – legal and social. • Under legal requirements a company has to supply certain information to the various users through annual reports and under the social obligation, a company has to provide additional information to various user groups
OBJECTIVE OF CFR	1. Financial reporting should provide information that is useful to investors and creditors and other users in making rational investment, credit and similar decisions. The information should be useful to both, the present and potential investors. 2. Financial reporting should provide information about the economic resources of an enterprise the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners equity) and the effects of transactions event, and circumstances that change resources and claims to those resources. 3. Financial reporting should provide information about the enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. 4. Financial reporting should provide information about how management of an enterprise obtains and spends cash, its borrowing and repayment of borrowing, capital transactions including cash dividends and other distributions of enterprise resources to owners, and other factors that may affect an enterprise's liquidity or solvency. 5. Financial reporting should provide information about how management of an enterprise has discharged its stewardship

responsibilities to owners (shareholders) for the use of enterprise resource entrusted to it.

6. Financial reporting should provide information that is useful to management and directors in making decisions in the interest of owners.

VALUE ADDED STATEMENT (VAS)

1. Value added can be defined as the value created by the activities of a firm and its employees, that is, sales less the cost of bought in goods and services. The value added statement (VAS) reports on the calculation of value added and its allocation among the stakeholders in the company.
2. The value added by a firm, i.e. the value created by the activities of the firm and its employees, can be measured by the difference between the market value of the goods that have been turned out by the firm and the cost of those goods and materials purchased from other producers. This measure will exclude the contribution made by other producers to the total value of the firm's production, so that it is essentially equal to the market value created by this firm.
3. As per the concept of Value added statement, gross value added is distribute to employees in form of salaries and wages, to government in form of taxes and duties, to financer in form of interest, to shareholders in form of dividend and balance remained in business in form of retained earning including depreciation.

Advantages of Value Added Statement –

1. It is an alternative performance measure to profit and therefore helps in the comparison of the performance of the company. Value added is superior performance measure because it pays attention on inputs which are under the control of the management.
2. By employing various productivity measures like value added per rupee of capital employed, value added per rupee sales, value added per employee etc., it helps in judging the productivity of the company.
3. Resource allocation decisions are normally based on the concept of maximizing profit but value added statement provides a better alternative by focusing on other factors rather than just profit.
4. It also helps in devising the incentives schemes for the employees of the company in a better way.
5. It reflects a broader view of the company's objectives and responsibilities rather than just focusing only on the small aspects about the company

Limitation of Value added Statement

1. The treatment of depreciation resulting in gross and net value added;
2. The treatment of taxes like pay-as-you-earn, fringe benefits and other benefits in the employees' share of value added;
3. The timing of recognition of value added - production or sales;
4. The treatment of taxes such as VAT /GST and deferred tax; and
5. The treatment of non-operating items

FORMAT

A. Generation of Value Added:	
Sales/Turnover (including Excise duty and sales taxes	XXX

<table>
<tr><td></td><td>
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<tr><td>excluding trade discounts)</td><td></td></tr>
<tr><td>+/- Stock of WIP & FG</td><td>XXX</td></tr>
<tr><td>Production Value</td><td>XXX</td></tr>
<tr><td>(+) Income from Services</td><td>XXX</td></tr>
<tr><td>(-) Bought in goods and services purchased from outsiders</td><td>XXX</td></tr>
<tr><td>Gross Value Added (GVA)</td><td>XXX</td></tr>
<tr><td>(-) Depreciation and deferred revenue expenses</td><td>XXX</td></tr>
<tr><td>Net Value Added (NVA)</td><td>XXX</td></tr>
<tr><td></td><td></td></tr>
<tr><td>B. Application of Value Added:</td><td></td></tr>
<tr><td>Receipt by Employees</td><td></td></tr>
<tr><td>Receipt by Providers of Loan</td><td></td></tr>
<tr><td>Receipt by Government</td><td></td></tr>
<tr><td>Receipt by Owners</td><td></td></tr>
<tr><td>Net Value Added (NVA)</td><td></td></tr>
</table>
</td></tr>
<tr><td>ECONOMIC VALUE ADDED (EVA)</td><td>

Economic value added (EVA) is a financial measure of what economists sometimes refer to as economic profit or economic rent. The difference between economic profit and accounting profit is essentially the cost of equity capital – an accountant does not subtract a cost of equity capital in the computation of profit, so in fact an accountant’s measure of income or profit is in essence the residual return to that equity capital since all other costs have been deducted from the revenue stream.
In contrast, an economist charges for all resources in his computation of profit – including an opportunity cost for the equity capital invested in the business – so an economist’s definition and computation of the profit is net above the cost of all resources.
A positive EVA means the firm is generating a return to invested capital that exceeds the direct (i.e. interest) and opportunity cost of that invested capital; a negative EVA means that the firm did not generate a sufficient return to cover the cost of its debt and equity capital

<u>How to Compute EVA:</u>
Earnings Before Interest and Tax
Less: Interest
Earnings Before Tax
Less: Taxation
Profits after tax
Add: Interest (Net of Taxes)
Net Operating Profits after taxes (NOPAT)
Less: Cost of Equity Capital
Economic Value Added

<u>Advantages of EVA Analysis</u>
1. In various cases, company pay bonuses to the employees on the basis of EVA generated. Since a higher EVA implies higher bonuses to the employees, it promotes the employees for working hard for generating higher revenue.

2. Using EVA , company can evaluate the projects independently and hence decide on whether to execute the project or not

3. It helps the company in monitoring the problem areas and hence taking corrective action to resolve those problems.
</td></tr>
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	4. Unlike accounting profit, such as EBIT, Net Income and EPS, EVA is based on the idea that a business must cover both the operating costs as well as the capital costs and hence it presents a better and true picture of the company to the owners, creditors, employees, shareholders and all other interested parties. 5. It also helps the owners of the company to identify the best person to run the company effectively and efficiently.
MARKET VALUE ADDED	Market value added is the difference between the Company's market and book value of shares. According to Stern Stewart, if the total market value of a company is more than the amount of capital invested in it, the company has managed to create shareholder value. If the market value is less than capital invested, the company has destroyed shareholder value. Market Value Added = Company's total Market Value – Capital Invested With the simplifying assumption that market and book value of debt are equal, this is the same as Market ValueAdded = Market Value of equity – Book value of equity Market value added (MVATM) is identical in meaning with the market–to–book ratio. The difference is only that MVA is an absolute measure and market–to–book ratio is a relative measure. If MVA is positive, that means that market–to– book ratio is less than one.
SHAREHOLDERS VALUE ADDED	Shareholder Value Added (SVA) represents the economic profits generated by a business above and beyond the minimum return required by all providers of capital. "Value" is added when the overall net economic cash flow of the business exceeds the economic cost of all the capital employed to produce the operating profit. Therefore, SVA integrates financial statements of the business (profit and loss, balance sheet and cash flow)into one meaningful measure. The benefits of moving towards SVA include: 1. Overall, value-based performance measures will result in greater accountability for the investment of new capital, as well as for the use of existing investments. 2. Organization will have the opportunity to apply a meaningful private sector benchmark to evaluate performance. 3. Managers will be provided with an improved focus on maximizing shareholder value. **DRAWBACKS OF ADOPTING SVA: (JUNE 15)** 1. A limitation in the use of SVA as a performance measure is that, by nature, it is an aggregate measure. In order to analyse the underlying causes of any changes in calculated value between years, it is necessary to fully comprehend the value drivers and activities specific to a given firm. 2. There may be certain enterprises which are subject to any degree of price regulation then it may not be possible for management to adjust

	output prices to achieve a commercial return in response to upward movements in input prices. Such a situation may result in SVA being reduced even though there may have been no decrease in overall efficiency. 3. Similarly, a reduction in direct Government funding would result in a decrease in SVA. 4. Combined with the use of traditional accounting measures, a thorough knowledge of the value drivers of the business will assist in determining the underlying causes of fluctuations in the value added measure. 5. Again, the use of SVA is not a substitute for detailed analysis of business drivers, rather it is an additional measurement tool with an economic foundation

COMPANIES (AUDITORS REPORT) ORDER, 2020
DATED 25.02.2020 BUT APPLICABLE FROM FY 2021-22

SHORT TITLE, APPLICATION AND COMMENCEMENT	(1) This Order may be called the Companies (Auditor's Report) Order, 2020. (2) It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], except– (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949); (ii) an insurance company as defined under the Insurance Act,1938 (4 of 1938); (iii) a company licensed to operate under section 8 of the Companies Act; (iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements. (3) It shall come into force on the date of its publication in the Official Gazette.
AUDITORS REPORT TO CONTAIN MATTERS SPECIFIED IN PARAGRAPH 3 & 4	Every report made by the auditor under section 143 of the Companies Act on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after the 1st April, 2021, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable: Provided this Order shall not apply to the auditor's report on

consolidated financial statements except clause (xxi) of paragraph 3.

MATTERS TO BE INCLUDED IN AUDITOR'S REPORT

The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

(i) (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;
(B) whether the company is maintaining proper records showing full particulars of intangible assets;

(b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross Carrying value	Held in the name of	Whether promoter, director or their relative or employee	Period held – indicate range, where appropriate	Reason for not being held in the name of company Also indicate if in dispute

(d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

(e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;

(ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

(iii) whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,-
(a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-

(A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;

(B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;

(b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

(c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(d) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];

(f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;

(iv) in respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with, if not, provide the details thereof;

(v) in respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;

(vi) whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act and whether such accounts and records have been so made and maintained;

(vii) (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

(viii) whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;

(ix) (a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	**Name of lender**	**Amount not paid on due date**	**Whether principal or interest**	**No. of days of delay or unpaid**	**Remarks if any**
	Lender wise details to be				

	provided in case of defaults to banks, financial institutions and government				

(b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

(c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

(d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

(e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;

(f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

(x) (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;

(xi) (a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

(b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

(c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

(xii) (a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability;

(b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

(xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

(xiv) (a) whether the company has an internal audit system commensurate with the size and nature of its business;

(b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

(xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;

(xvi) (a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;

(b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

(c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

(d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;

(xvii) whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

(xviii) whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

(xix) on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities,

	other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date; **(xx)** (a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act; (b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of subsection (6) of section 135 of the said Act; **(xxi)** whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.
REASONS TO BE STATED FOR UNFAVOURABLE OR QUALIFIED ANSWERS	(1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be. (2) where the auditor is unable to express an opinion on any specified matter, his report shall indicate such fact together with reasons as to why it is not possible for him to give his opinion on the same.

CHAPTER 9: CASH FLOW STATEMENT

A cash flow statement is useful for **short-term planning**. A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts maturing in the near future, expenses of the business, etc. A historical analysis of the different sources and applications of cash will enable the management to make reliable cash flow projections for the immediate future. It may then plan out for investment of surplus or meeting the deficit, if any. Thus, a cash flow analysis is an important financial tool for the management. Its chief advantages are as follows:

- Helps in efficient cash management.
- Helps in internal financial management.
- Discloses the movements of cash.
- Discloses the success or failure of cash planning.

LIMITATIONS OF CASH FLOW STATEMENT:

- Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash flow does not necessarily mean net income of the business.
- The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.
- Cash flow statement cannot replace the Income Statement or the Funds Flow Statement. Each of them has a separate function to perform.

Cash: Cash Comprises of Cash in Hand & Demand Deposits with Banks.

Cash Equivalents: Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short term cash commitments rather than for investments or other purposes. Examples of cash equivalents are treasury bills, commercial paper etc.

Cash Flows: Cash Flows are Inflows & Outflows of Cash & Cash Equivalent. The difference between cash inflow & cash outflow is known as Net Cash Flow which can be either Net Cash Inflow or Net Cash Outflow.

REPORTING CASH FLOWS FROM OPERATING ACTIVITIES: (Related to Income & Expenses)

1. **Direct Method**: whereby major classes of major cash receipts and gross cash payments are disclosed; or

2. **Indirect Method**: Whereby net profit or loss is adjusted for the effect of:
   - Transactions of a non-cash nature,
   - any deferrals or accruals of past or future operating cash receipts or payments, and
   - Items of income or expense associated with investing or financing cash flows.

INVESTING ACTIVITIES: (Relating to Assets)

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

a. Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets;
b. cash receipts from disposal of fixed assets (including intangibles);
c. cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
d. cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
e. cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
f. cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
g. cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
h. Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

FINANCING ACTIVITIES: (Relating to Loans)

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

a. Cash proceeds from issuing shares or other similar instruments;
b. Cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
c. Cash repayments of amounts borrowed.

REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES:

An Enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraph 22 and 24 are reported on a net basis.

~~3.14.3~~ **Format of Cash Flow Statement:** AS 3 (Revised) has not provided any specific format for the preparation of cash flow statements, but a general idea can be had from the illustration given in the appendix to the Accounting Standard. There seems to be flexibility in the presentation of cash flow statements. However, a widely accepted format under direct method and indirect method is given below:

Option 1:- Cash Flow Statement (Direct Method)			₹
Cash Flow from Operating Activities			
Cash receipts from customers		xxx	
Cash paid to suppliers and employees		(xxx)	
Cash generated from operations		xxx	
Income tax paid		(xxx)	
Cash flow before extraordinary items		xxx	
Proceeds from earthquake disaster settlement etc		xxx	
Net cash from Operating Activities	(a)		xxx
Cash Flows from Investing Activities			
Net Proceeds / (purchase) of fixed assets		(xxx)	
Purchase of investments		(xxx)	
Interest received		xxx	
Dividend received		xxx	
Net cash from investing Activities	(b)		xxx
Cash Flows from Financing Activities			
Proceeds from issue of share capital		xxx	
Net Proceeds/ (Repayments) from long term borrowings		xxx	
Interest paid		(xxx)	
Dividend paid		(xxx)	
Net cash from Financing Activities	(c)		xxx
Net increase / (decrease) in Cash and Cash Equivalent	(a+b+c)		xxx
Cash and Cash Equivalents at beginning of period			xxx
Cash and Cash Equivalent at end of period			xxx

Illustration of Direct Method:

The following are the summary of cash transactions extracted from the books of Happy Ltd.:

	(₹ in '000)
Balance as on 1st April, 2013	140
Receipts from customers	11,132
Issue of shares	1,200
Sale of fixed assets	512
	12,984
Payments to suppliers	8,188
Payments for fixed assets	920
Payments for overheads	460
Wages and salaries	276
Taxation	972
Dividends	320
Repayment of bank loans	1,000
	12,136
Balance as on 31st March, 2014	848

You are required to prepare a cash flow statement of the company for the period ended 31st March, 2014 in accordance with the Accounting Standard- 3 (Revised).

Solution:

In the books of Happy Limited

Cash Flow Statement for the period ending 31st March, 2014

		(₹ in '000s)
A.	*Cash Flow from Operating Activities*	
	Receipts from customers	11,132
	Payment to suppliers	(8,188)
	Payment of Wages and Salaries	(276)
	Payment of Overheads	(460)
	Payment of Taxes	(972)
	Net Cash from Operating Activities(A)	1236
B	*Cash Flow from Investing Activities*	
	Proceeds on sale of fixed assets	512
	Acquisition of (payments) fixed assets	(920)
	Net Cash Used in Investing Activities (B)	(408)
C	*Cash Flow from Financing Activities*	
	Proceeds on issue of shares	1200
	Payments of dividends	(320)
	Repayments of bank loans	(1000)
	Net Cash Used in Investing Activities (C)	(120)
	Net increase in cash and cash equivalents (A)+(B)+(C)	708
	Cash and cash equivalents at the beginning of the period	140
	Cash and cash equivalents at the end of the period	848

Option 2:- Cash Flow Statement (Indirect Method)			(₹)
Cash Flow from Operating Activities			
Net profit before tax and extraordinary items		xxx	
Adjustments for:			
- Depreciation		xxx	
- Exchange Fluctuation loss/ (gain) – net		xxx	
- Loss on sale of fixed assets		xxx	
- Interest Income		(xxx)	
- Dividend Income		(xxx)	
- Interest Expense		xxx	
- Dividend Paid		xxx	
Operating profit before working capital changes		xxx	
Adjustments for:			
- Trade and other receivables (increase) / decrease		(xxx)	
- Inventories (increase) / decrease		(xxx)	
- Trade payable (decrease) / increase		xxx	
Cash generation from operations		xxx	
- Income Tax		(xxx)	
Cash flow before extraordinary items		xxx	
Proceeds from earthquake disaster settlement etc.		xxx	
Net cash from Operating Activities	(a)		xxx
Cash Flow from Investing Activities			
Net Proceeds / (purchase) of fixed assets		(xxx)	
Purchase of investments		(xxx)	
Interest received		xxx	
Dividend received		xxx	
Net cash from Investing Activities	(b)		Xxx
Cash Flow from Financing Activities			
Proceeds from issue of share capital		xxx	
Net Proceeds/ (Repayments) from long term borrowings		xxx	
Dividend Paid		(xxx)	
Interest Paid		(xxx)	
Net cash from Financing Activities	(c)		xxx
Net increase / (decrease) in Cash and Cash Equivalent	(a+b+c)		xxx
Cash and Cash Equivalents at the beginning of the year			xxx
Cash and Cash Equivalents at the end of the year			xxx

IMPORTANT FORMULA'S:

1. **Cash Collected from Debtors** = Opening Balance of Debtor + Credit Sale – Closing Balance of Debtors

2. **Cash Paid to Suppliers** = Opening Balance of Creditor + Credit Purchase – Closing Balance of Creditor

3. **Payment to Employees** = Opening Outstanding Salary + Salary of Current Year – Closing Outstanding Salary

4. **Interest Paid** = Opening Outstanding Interest + Interest of Current Year – Closing Outstanding Interest

5. **Insurance Paid** = Insurance Expense of Current Year + Closing Prepaid Insurance – Opening Prepaid Insurance

TREATMENT OF NON-CASH TRANSACTIONS

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these do not involve cash flows in the current period. Following are examples of noncash transactions:

(i) the acquisition of assets by assuming directly related liabilities.
(ii) the acquisition of an enterprise by means of issue of shares.
(iii) conversion of debt into equity.

OBJECTIVES OF ACCOUNTING STANDARDS	• Accounting Standards *standardize diverse accounting* policies with a view to eliminate, to the maximum possible extent, (i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and (ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements. • Since it is *not possible to prescribe a single set of policies* in any area to be appropriate for all enterprises for all time, it is not enough to comply with the standards and state that they have been followed; • In addition to improving credibility of accounting data, standardization of accounting procedures *improves comparability of financial statements*, both intra-enterprise and inter-enterprise. • A third advantage of standardization is *reduction of scope for creative accounting*. The creative accounting refers to twisting of accounting policies to produce financial statements favorable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. • In brief, the accounting standards aim at *improving the quality of financial reporting* by promoting comparability, consistency and transparency, in the interests of users of financial statements. • Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks.
BENEFITS OF ACCOUNTING STANDARDS	Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits: (i) **Standardization of Alternative Accounting Treatments:** Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements. (ii) **Requirement of Additional Disclosures:** There are certain areas where important information is not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law. (iii) **Comparability of Financial Statements:** The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and

	legal systems from one country to another give rise to differences in accounting standards adopted in different countries.
LIMITATION OF ACCOUNTING STANDARDS	However, there are some limitations of setting of accounting standards: (i) **<u>Difficulty in choosing Accounting policy:</u>** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult. (ii) **<u>Lack of Flexibility:</u>** There may be a trend towards rigidity and away from flexibility in applying the accounting standards. (iii)**<u>Scope Restricted:</u>** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.
ACCOUNTING STANDARDS SETTING PROCESS	The standard-setting procedure of ASB can be briefly outlined as follows: ✓ Identification of broad areas by ASB for formulation of AS. ✓ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements. ✓ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations. ✓ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments. ✓ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard. ✓ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments. ✓ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance. ✓ Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done. ✓ The accounting standard on the relevant subject is then issued by

	the ICAI.
ACCOUNTING STANDARDS BOARD	**FORMATION OF THE ACCOUNTING STANDARDS BOARD** ✓ The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, **1977**) to harmonise the diverse accounting policies and practices in use in India. ✓ ASB of the ICAI has been issuing accounting standards since then. It has issued 32 Accounting Standards and 29 Accounting Standards Interpretations so far. ✓ "AS 6, AS 8, AS 30, AS 31, AS 32 has been withdrawn, therefore there are **27 Accounting Standards in effect currently**. ✓ ASB takes into consideration the applicable laws, customs, usages and business environment prevailing in the country. ✓ It also gives due consideration to International Accounting Standards (IASs) and tries to integrate them, to the extent possible, in the light of conditions and practices prevailing in India. **COMPOSITION OF THE ACCOUNTING STANDARDS BOARD** The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, the following are represented on the ASB: (i) Nominee of the Central Government representing the Department of Company Affairs on the Council of the ICAI (ii) Nominee of the Central Government representing the Office of the Comptroller and Auditor General of India on the Council of the ICAI (iii) Nominee of the Central Government representing the Central Board of Direct Taxes on the Council of the ICAI (iv) Representative of the Institute of Cost and Works Accountants of India (v) Representative of the Institute of Company Secretaries of India (vi) Representatives of Industry Associations (1 from Associated Preface to the Statements of Accounting Standards 3 Chambers of Commerce and Industry (ASSOCHAM), 1 from Confederation of Indian Industry (CII) and 1 from Federation of Indian Chambers of Commerce and Industry (FICCI) (vii) Representative of Reserve Bank of India (viii) Representative of Securities and Exchange Board of India (ix) Representative of Controller General of Accounts (x) Representative of Central Board of Excise and Customs

	(xi) Representatives of Academic Institutions (1 from Universities and 1 from Indian Institutes of Management) (xii) Representative of Financial Institutions (xiii) Eminent professionals co-opted by the ICAI (they may be in practice or in industry, government, education, etc.) (xiv) Chairman of the Research Committee and the Chairman of the Expert Advisory Committee of the ICAI, if they are not otherwise members of the Accounting Standards Board (xv) Representative(s) of any other body, as considered appropriate by the ICAI **OBJECTIVES AND FUNCTIONS OF THE ACCOUNTING STANDARDS BOARD** The following are the objectives of the Accounting Standards Board: (i) To conceive of and suggest areas in which Accounting Standards need to be developed. (ii) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India. (iii) To examine how far the relevant International Accounting Standard/International Financial Reporting Standard can be adapted while formulating the Accounting Standard and to adapt the same. (iv) To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same. (v) To provide, from time to time, interpretations and guidance on Accounting Standards. (vi) To carry out such other functions relating to Accounting Standards. The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. While formulating the Accounting Standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India. The ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board's (IASB) pronouncements in the country with a view to facilitate global harmonization of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the

	conditions and practices prevailing in India.
SCOPE OF ACCOUNTING STANDARDS	(i) The Accounting Standards which are issued are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, ***the provisions of the said law will prevail*** and the financial statements should be prepared in conformity with such law. (ii) The Accounting Standards by their very nature cannot and ***do not override the local regulations*** which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements. (iii) The Accounting Standards are intended to ***apply only to items which are material***. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the ICAI. However, no standard will have retroactive application, unless otherwise stated. (iv) In formulation of Accounting Standards, the emphasis would be on laying down accounting principles and not detailed rules for application and implementation thereof.
APPLICABILITY OF ACCOUNTING STANDARDS	For the purpose of compliance with AS, ICAI has classified the entities into three levels. Level II & III are considered to be Small & Medium Entities (SME). However, Applicability of AS on Companies is as prescribed by CG under Section 133 of Companies Act, 2013 in consultation with **National Financial Reporting Authority (NFRA)**. AS notified by CG are mandatory for all the companies to follow. CG has issued "Criteria for classification of Entities & Applicability of AS" for Companies. There are two Levels. Small & Medium Sized Companies (SMC) and Companies other than SMC. Non SMC are required to comply with all AS notified by CG and SMC has been given certain exemptions/ relaxations. As there was difference in the classification prescribed by ICAI & CG for Companies, Accounting Standard Board (ASB) of ICAI has decided to apply the three level structures only to Non-Corporate entities. **NON CORPORATE ENTITIES:** **LEVEL I:** Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities: (i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside

	India. (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business. (iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income)exceeds rupees fifty crore in the immediately preceding accounting year. (iv) All commercial, industrial and business reporting entities having borrowings (including public deposits)in excess of rupees ten crore at any time during the immediately preceding accounting year. (v) Holding and subsidiary entities of any one of the above. Level II Entities (SMEs) **LEVEL II:** Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities: (i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees one crore but does not exceed rupees fifty crore in the immediately preceding accounting year. (ii) All commercial, industrial and business reporting entities having borrowings (including public deposits)in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year. (iii) Holding and subsidiary entities of any one of the above. Level III /Entities (SMEs) **LEVEL III:** Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities. **CORPORATE ENTITIES:** COMPANIES (AS) RULES, 2006 Clause 2(f): "Small and Medium Sized Company" (SMC) means, a company- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; (ii) which is not a bank, financial institution or an insurance company; (iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year; (iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

	Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.
ENTERPRISES TO WHICH AS APPLY	Accounting Standards apply in respect of ***any*** enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, ***whether or not profit oriented*** and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.
IMPLICATION OF MANDATORY STATUS	Where the statute governing the enterprise does not require compliance with the Accounting Standards, e.g. a partnership firm, the mandatory status of an Accounting Standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable Accounting Standards. In the event of any deviation from the Accounting Standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.
FINANCIAL ITEMS TO WHICH AS APPLY	The Accounting Standards are intended to apply only to items, which are ***materia***l. An item is considered material, if its omission or misstatement is ***likely to affect economic decision of the user***. Materiality is not necessarily a function of size; it is the information content i.e. the financial item which is important. A penalty of ₹ 50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crores of rupees in a year, yet is a material item because of the information it conveys. The materiality should therefore be judged on ***case-to-case basis***. If an item is material, it should be shown separately instead of clubbing it with other items. For example it is not appropriate to club the penalties paid with legal charges.
NEED FOR CONVERGENCE TOWARDS	The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain on going activities

GLOBAL STANDARDS	has necessitated raising of capital from all parts of the world, cutting across frontiers. Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the Accounting Standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations. International analysts and investors would like to compare financial statements based on similar Accounting Standards, and this has led to the growing support for an internationally accepted set of Accounting Standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks. Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of Accounting Standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements. The convergence of financial reporting and Accounting Standards is a valuable process that contributes to the ***free flow of global investment*** and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to ***compare investments on a global basis*** and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and ***eliminates some costly requirements*** say reinstatement of financial statements. It has the potential to create a new standard of accountability and ***greater transparency***, which are values of great significance to all market participants including regulators. It ***reduces operational challenges*** for accounting firms and focuses their value and expertise around an increasingly unified set of standards.

	It creates an unprecedented opportunity for standard setters and other stakeholders to ***improve the reporting model***. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.
NATIONAL & INTERNATIONAL ACCOUNTING AUTHORIES	**THE INSTITUTE OF COMPANIES SECRETARIES OF INDIA (ICSI)** • To develop and regulate the profession of Company Secretaries in India. • Set up under an act of Parliament, the Company Secretaries Act, 1980. • Functions under the jurisdiction of the Ministry of Corporate Affairs, Government of India. • At present, there are more than 50,000 members and about 4,00,000 students on the roll of ICSI. **THE INSTITUTE OF CHARTERED ACCOUNTANT OF INDIA** • Statutory body established by an Act of Parliament, viz., the Chartered Accountants Act, 1949 • For regulating the profession of Chartered Accountancy in the country • Functions under the administrative control of the Ministry of Corporate Affairs, Government of India. • **Second largest** professional body of Chartered Accountants in the world **THE INSTITUTE OF COST ACCOUNTINGS OF INDIA** • Was first established in **1944** as a **registered company** under the Companies Act with the object of promoting, regulating and developing the profession of Cost Accountancy. • The Institute of Cost Accountants of India is the only recognized statutory professional organization and licensing body in India specializing exclusively in Cost and Management Accountancy. **IFRS FOUNDATION / INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)** • not-for-profit international organization responsible for developing a single set of high-quality global accounting standards, known as IFRS Standards • IFRS Standards are now required in more than 125 jurisdictions • has a three-tier governance structure • Trustees are appointed for a renewable term of three years. **INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARD BOARD (IPSASB)** • The IPSASB develops accounting standards and guidance for use by public sector entities. • Since 1997, the IPSASB has developed and issued a suite of 38 accrual standards. • In October 2014 the IPSASB issued the first global conceptual framework for public sector entities. • In 2015 following the report of the IPSASB Governance Review Group, the Public Interest Committee (PIC) was established.

FINANCIAL REPORTING COUNCIL (FRC)

- The Financial Reporting Council (FRC) is the UK's regulator for the accounting, audit and actuarial professions and is also responsible for corporate governance in the UK.
- The FRC is a company limited by guarantee, partly funded by government and partly by the industry
- The Board is supported by three governance committees (Audit Committee, Nominations Committee and Remuneration Committee) and by two business committees (Codes & Standards Committee and Conduct Committee).

EUROPEAN FINANCIAL REPORTING ADVISORY GROUP (EFRAG)

- private association established in 2001

FINANICAL ACCOUNTING STANDARD BOARD (FASB)

- Private, non-profit organization, a standard setting body whose primary purpose is to establish and improve Generally Accepted Accounting Principles (GAAP) in the public's interest within the United States.
- The FASB replaced the American Institute of Certified Public Accountants' (AICPA) Accounting Principles Board (APB) on July 1, 1973.
- In 1984, the FASB formed the Emerging Issues Task Force (EITF).
- The FASB is subject to oversight by the Financial Accounting Foundation (FAF), which selects the members of the FASB and the Governmental Accounting Standards Board and funds both organizations

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

- Founded in 1887
- national professional organization of Certified Public Accountants (CPAs) in the United States, with more than 418,000 members in 143 countries
- In January 2012, the AICPA entered into a joint venture with the Chartered Institute of Management Accountants (CIMA), a partnership that produced the Chartered Global Management Accountant (CGMA) designation
- In 2014, the AICPA and the CIMA cocreated the Global Management Accounting Principles (GMAPs)

AUSTRALIAN ACCOUNTING STANDARD BOARD (AASB)

- develops and maintains financial reporting standards applicable to entities in the private and public sectors of the Australian economy
- The AASB's functions and its powers are set out in the Australian Securities and Investments Commission Act 2001
- consisting of two tiers of reporting requirements: Tier 1: Australian Accounting Standards; and Tier 2: Australian Accounting Standards – Reduced Disclosure Requirements
- AASB Board comprises 12 members including the Chair

CHARTERED ACCOUNTANTS AUSTRILIA & NEW ZEALAND

- It is a founding member of the Global Accounting Alliance (GAA).
- On December 31, 2014, The Institute of Chartered Accountants in Australia and the New Zealand Institute of Chartered Accountants

(NZICA) amalgamated to become one body—Chartered Accountants Australia and New Zealand (CA ANZ).

CANADIAN INSTUTE OF CHARTERED ACCOUNTANTS (CICA)
- The Canadian Institute of Chartered Accountants was incorporated by an Act of the Parliament of Canada in 1902, which later became known as the Canadian Institute of Chartered Accountants Act.
- In 2014, CICA merged with Canada's two other major accounting delegations to form the Chartered Professional Accountants of Canada.

ACCOUNTING STANDARDS BOARD OF JAPAN (ASBJ)
- private sector organization

EXTERNAL REPORTING BOARD (XRB), NEW ZEALAND
- The XRB came into existence on 1 July 2011
- The XRB was reconstituted from the Accounting Standards Review Board
- The Board is the governing body of the XRB and comprises nine members appointed by the Governor General on the recommendation of the responsible Minister

LIST OF ACCOUNTING STANDARDS

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies & Events occurring after balance sheet date
AS 5	Net Profit or Loss for the period, Prior Period Items and changes in Accounting Policies
AS 7	Construction Contracts
AS 9	Revenue Recognition
AS 10	Property, Plant & Equipment
AS 11	Effects of changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Employee Benefits
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interest in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities & Contingent Assets

List of IND AS

IND AS 101	First Time Adoption of IND AS
IND AS 102	Share Based Payments
IND AS 103	Business Combinations
IND AS 104	Insurance Contracts

	IND AS 105	Non-Current Assets held for Sale and Discontinuing Operations
	IND AS 106	Exploration for and Evaluation of Mineral Resources
	IND AS 107	Financial Instruments: Disclosures
	IND AS 108	Operating Segments
	IND AS 109	Financial Instruments
	IND AS 110	Consolidated Financial Statements
	IND AS 111	Joint Arrangements
	IND AS 112	Disclosure of Interest in Other Entities
	IND AS 113	Fair Value Measurement
	IND AS 114	Regulatory Deferral Accounts
	IND AS 115	Revenue from Contracts with Customers
	IND AS 1	Presentation of Financial Statements
	IND AS 2	Inventories Accounting
	IND AS 7	Statement of Cash Flows
	IND AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
	IND AS 10	Events after reporting period
	IND AS 12	Income Taxes
	IND AS 16	Property, Plant & Equipment
	IND AS 19	Employee Benefits
	IND AS 20	Accounting for Government Grants and Disclosure of Government Assistance
	IND AS 21	The effects of changes in Foreign Exchange Rates
	IND AS 23	Borrowing Cost
	IND AS 24	Related Party Disclosures
	IND AS 27	Separate Financial Statements
	IND AS 28	Investment in Associates & Joint Venture
	IND AS 29	Financial Reporting in Hyper Inflationary Economies
	IND AS 32	Financial Instruments: Presentation
	IND AS 33	Earnings Per Share
	IND AS 34	Interim Financial Reporting
	IND AS 36	Impairment of Assets
	IND AS 37	Provisions, Contingent Liabilities & Contingent Assets
	IND AS 38	Intangible Assets
	IND AS 40	Investment Property
	IND AS 41	Agriculture
LIST OF INTERNATIONAL ACCOUNTING STANDARDS (IAS)	IAS 1	Preparation of Financial Statements
	IAS 2	Inventories
	IAS 7	Statement of Cash Flows
	IAS 8	Accounting Policies, Changes in Accounting Estimates & Errors
	IAS 10	Events after Balance Sheet date
	IAS 11	Construction Contracts
	IAS 12	Income Taxes
	IAS 16	Property, Plant & Equipment
	IAS 17	Leases
	IAS 18	Revenue
	IAS 19	Employee Benefits
	IAS 20	Accounting for Government Grants & Disclosure of Government Assistance

	IAS 21	Effects of changes in Forex Rates
	IAS 23	Borrowing Costs
	IAS 24	Related party Disclosures
	IAS 26	Accounting & Reporting by Retirement benefits plan
	IAS 27	Consolidated & Separate Financial Statement
	IAS 28	Investment in Associates & Joint Ventures
	IAS 29	Financial Reporting in Hyper Inflationary Conditions
	IAS 32	Financial Instruments: presentation
	IAS 33	Earnings per share
	IAS 34	Interim Financial Reporting
	IAS 36	Impairment of Assets
	IAS 37	Provisions, Contingent Liabilities & Contingent Assets
	IAS 38	Intangible Assets
	IAS 39	Financial Instruments: Recognition & measurement
	IAS 40	Investment Property
	IAS 41	Agriculture

PHASES OF ADOPTION OF IND AS	MCA has notified a phase-wise convergence to Ind AS from current accounting standards. Ind AS shall be adopted by specific classes of companies based on their Net worth and listing status. **Phase I** Mandatory applicability of Ind AS to all companies from 1st April 2016, provided: • It is a listed or unlisted company • Its Net worth is greater than or equal to ₹ 500 crore* *Net worth shall be checked for the previous three Financial Years (2013-14, 2014-15, and 2015-16). **Phase II** Mandatory applicability of Ind AS to all companies from 1st April 2017, provided: • It is a listed company or is in the process of being listed (as on 31.03.2016) • Its Net worth is greater than or equal to ₹ 250 crore but less than ₹ 500 crore (for any of the below mentioned periods). Net worth shall be checked for the previous four Financial Years (2013-14, 2014-15, 2015-16, and 2016-17) **Phase III** Mandatory applicability of Ind AS to all Banks, NBFCs, and Insurance companies from 1st April 2018, whose: • Net worth is more than or equal to INR 500 crore with effect from 1st April 2018. IRDA (Insurance Regulatory and Development Authority) of India shall notify the separate set of Ind AS for Banks & Insurance Companies with effect from 1st April 2018. NBFCs include core investment companies, stock brokers, venture capitalists, etc. Net Worth shall be checked for the past 3 financial years (2015-16, 2016-17, and 2017-18) **Phase IV** All NBFCs whose Net worth is more than or equal to INR 250 crore but

	less than INR 500 crore shall have Ind AS mandatorily applicable to them with effect from 1st April 2019. Things to note: If Ind AS become applicable to any company, then Ind AS shall automatically be made applicable to all the subsidiaries, holding companies, associated companies, and joint ventures of that company, irrespective of Individual qualification of such companies. In case of foreign operations of an Indian Company, the preparation of stand-alone financial statements may continue with its jurisdictional requirements and need not be prepared as per the Ind AS. However, these entities will still have to report their Ind AS adjusted numbers for their Indian parent company to prepare consolidated Ind AS accounts.

CHAPTER 13: OVERVIEW OF COST

BACKGROUND:

Accounting information is important for every business which will serve the needs of variety of interested parties. To satisfy the needs of all interested parties a sound accounting system is very necessary. Accounting may be divided into three parts:

i. Financial Accounting
ii. Cost Accounting
iii. Management Accounting.

Financial accounting is mostly concerned to record the business transactions in books of accounts so that final accounts can be prepared.

*Cost accounting developed to help the **internal management** in decision making*. The information provided by cost accounting acts as a managerial tool so that business can utilize the available resources at optimum level.

Management accounting is an extension of management aspects of cost accounting. It provides the information to management so that planning, organizing, directing and controlling of business operations can be done in an orderly manner.

DEFINITION OF COSTING, COST ACCOUNTING AND COST ACCOUNTANCY:

COST	The Chartered Institute of Management Accountants, London defines **cost** as "the amount of expenditure (**actual or notional**) incurred on, or attributable to a specified thing or activity". For a consumer cost means price. For management cost means 'expenditure incurred' for producing a particular product or rendering a particular service. It is necessary to specify the exact meaning of "cost". When the term is used specifically, it is modified with such terms as prime cost, fixed cost, sunk cost, etc. Each description implies a certain characteristic which is helpful in analysing the cost. It helps cost accounting in achieving its three basic objectives namely-cost ascertainment, cost control and cost presentation.
COSTING	The process of ascertaining the cost is known as **costing.** Costing is the techniques and processes of ascertaining costs. These techniques consist of ***principles and rules*** which govern the procedure of ascertaining cost of products or services. The techniques to be followed for the analysis of expenses and the processes of different products or services differ from industry to industry. The main object of costing is the ***analysis*** of financial records, so as to subdivide expenditure and to allocate it carefully to selected cost centres, and hence to build up a total cost for the departments, processes or jobs or contracts of the undertaking.
COST ACCOUNTING	**Cost accounting** may be regarded as "a specialized branch of accounting which involves classification, accumulation, assignment and control of costs." The Costing terminology of **C.I.M.A.** London defines **Cost Accounting** as "The establishment of budgets, standard costs and actual costs of

	operations, processes, activities or products, and the analysis of variances, profitability or the social use of funds". **Wheldon** defines **Cost Accounting** as "classifying, recording and appropriate allocation of expenditure for determination of costs of products or services and for the presentation of suitably arranged data for purposes of control and guidance of management". It is thus, a formal mechanism by means of which costs of products or services are ascertained and controlled. Cost accounting is different from costing in the sense that the former provides only the basis and information for ascertainment of costs. Once the information is made available, costing can be carried out arithmetically by means of memorandum statements or by method of integral accounting.
COST ACCOUNTANCY	**Cost Accountancy** has been defined as "the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived there from for the purpose of managerial decision making."

OBJECTIVES OF COST ACCOUNTING:

The main objectives of Cost Accounting are as follows:

(1) To **analyse and classify** all expenditures with reference to the cost of products and operations.

(2) To **arrive at the cost** of production of every unit, job, operation, process, department or service and to develop cost standard.

(3) To indicate to the management any **inefficiencies** and the extent of various forms of waste, whether of materials, time, expenses or in the use of machinery, equipment and tools. Analysis of the causes of unsatisfactory results may indicate remedial measures.

(4) To **provide data** for periodical profit and loss accounts and balance sheets at such intervals, e.g., weekly, monthly or quarterly, as may be desired by the management during the financial year, not only for the whole business but also by departments or individual products. Also, to explain in detail the exact reasons for profit or loss revealed in total, in the profit and loss account.

(5) To **reveal** sources of economies in production having regard to methods, types of equipment, design, output and layout. Daily, weekly, monthly or quarterly information may be necessary to ensure prompt and constructive action.

(6) To **provide actual figures** of cost for comparison with estimates and to serve as a guide for future estimates or quotations and to assist the management in their price-fixing policy.

(7) To show, where standard costs are prepared, what the cost of production ought to be and with which the actual costs which are eventually recorded may be compared.

(8) To present **comparative cost data** for different periods and various volumes of output.

(9) To provide a perpetual inventory of stores and other materials so that interim profit and loss account and balance sheet can be prepared without stock taking and checks on stores and adjustments are made at frequent intervals. Also to provide the basis for production planning and for avoiding unnecessary wastages or losses of materials and stores.

(10) To **provide information** to enable management to make short-term decisions of various types, such as quotation of price to special customers or during a slump, make or buy decision, assigning priorities to various products, etc.

SCOPE OF COST ACCOUNTING

ASCERTAINMENT OF COST	There are two methods of ascertaining costs, viz., Post Costing and Continuous Costing. **Post Costing** means, analysis of actual information as recorded in financial books. It is accurate and is useful in the case of "Cost plus Contracts" where price is to be determined finally on the basis of actual cost. **Continuous Costing**, aims at collecting information about cost as and when the activity takes place so that as soon as a job is completed the cost of completion would be known. This involves careful estimates being prepared of overheads. In order to be of any use, costing must be a continuous process. Cost ascertained by the above two methods may be compared with the standard costs which are the target figures already compiled on the basis of experience and experiments.
DETERMINATION OF SELLING PRICE	Though the selling price of a product is influenced by market conditions, which are beyond the control of any business, it is still possible to determine the selling price within the market constraints. For this purpose, it is necessary to rely upon cost data supplied by Cost Accountants.
COST CONTROL	To exercise cost control, broadly speaking the following steps should be observed: (i) Determine clearly the objective, i.e., pre-determine the desired results; (ii) Measure the actual performance; (iii) Investigate into the causes of failure to perform according to plan; and (iv) Institute corrective action. The target cost and/or targets of performance should be laid down in respect of each department or operation and these targets should be related to individuals who, by their action, control the actual and bring them into line with the targets. Actual cost of performance should be measured in the same manner in which the targets are set up, i.e. if the targets are set up operation-wise, then the actual costs should also be collected operation-wise and not cost centre or department-wise as this would make comparison difficult.
COST REDUCTION	➢ May be defined "as the achievement of **real and permanent** reduction in the unit cost of goods manufactured or services rendered

	without impairing their suitability for the use intended or diminution in the quality of the product." ➢ Cost Reduction should not be confused with Cost control. Cost saving could be a temporary affair and may be at the cost of quality. Cost reduction implies the **retention of the essential characteristics and quality of the product** and thus it must be confined to permanent and genuine savings in the cost of manufacture, administration, distribution and selling, brought about by **elimination of wasteful and inessential elements from the design of the product** and from the techniques carried out in connection therewith. ➢ In other words, the essential characteristics and quality of the products are retained through improved methods and techniques and thereby a permanent reduction in unit cost is achieved. ➢ The definition of cost reduction does not, however, include reduction in expenditure arising from reduction in taxation or similar Government action or the effect of price agreements. ➢ The three-fold assumptions involved in the definition of cost reduction may be summarized as under : (a) There is a saving in unit cost. (b) Such saving is of permanent nature. (c) The utility and quality of the goods and services remain unaffected, if not improved.
ASCERTAINING THE PROFIT OF EACH ACTIVITY	The profit of any activity can be ascertained by matching cost with the revenue of that activity. The purpose under this step is to determine costing profit or loss of any activity on an objective basis.
ASSISTING MANAGEMENT IN DECISION MAKING	**Decision making** is defined as a process of selecting a course of action out of two or more alternative courses. For making a choice between different courses of action, it is necessary to make a comparison of the outcomes, which may be arrived under different alternatives. Such a comparison has only been made possible with the help of **Cost Accounting** information.

IMPORTANCE (ADVANTAGES) OF A COST ACCOUNTING SYSTEM:

Help to Management

1. **Identify Unprofitable Activities or Products**: A good Cost Accounting System helps in identifying unprofitable activities, losses or inefficiencies in any form.

2. **Reduces Cost**: The application of cost reduction techniques, operations research techniques and value analysis technique helps in achieving the objective of economy in concern's operations.

3. **Identification of Root Causes**: Cost Accounting is useful for identifying the exact causes for decrease or increase in the profit/loss of the business. It also helps in identifying unprofitable products or product lines so that these may be eliminated or alternative measures may be taken.

4. **Helps in Decision Making**: It provides information and data to the management to serve as guides in making decisions involving financial considerations. Guidance may also be given by the Cost Accountant on a host of problems such as, whether to purchase or manufacture a given component, whether to accept orders below cost, which machine to purchase when a number of choices are available.

5. **Helps in Price Fixation**: Cost Accounting is quite useful for price fixation. It serves as a guide to test the adequacy of selling prices. The price determined may be useful for preparing estimates or filling tenders.

6. **Cost Control**: The use of cost accounting technique viz., variance analysis, points out the deviations from the pre-determined level and thus demands suitable action to eliminate such deviations in future. Cost comparison helps in cost control. Such a comparison may be made from period to period by using the figures in respect of the same unit of firms or of several units in an industry by employing uniform costing and inter-firm comparison methods. Comparison may be made in respect of costs of jobs, processes or cost centres.

7. **Helps in Compliances**: A system of costing provides figures for the use of Government, Wage Tribunals and other bodies for dealing with a variety of problems. Some such problems include price fixation, price control, tariff protection, wage level fixation, etc.

8. **Identification of Idle Capacity Cost**: The cost of idle capacity can be easily worked out, when a concern is not working to full capacity.

9. **Helps in Inventory Control**: Cost accounting furnishes control which management requires in respect of stock of materials, work-in-progress and finished goods.

Help to Creditors:

Investors, banks and other money lending institutions have a stake in the success of the business concern and are, therefore, benefited immensely by the installation of an efficient system of costing. They can base their judgment about the profitability and future prospects of the enterprise on the costing records.

Help to Employees:

Employees have a vital interest in their employer's enterprise in which they are employed. They are benefited by a number of ways by the installation of an efficient system of costing. They are benefited, through continuous employment and higher remuneration by way of incentives, bonus plans, etc.

Help to National Economy:

An efficient system of costing brings prosperity to the business enterprise which in turn results in stepping up of the government revenue. The overall economic development of a country takes place as a consequence increase in efficiency of production. Control of costs, elimination of wastages and inefficiencies led to the progress of the industry and, in consequence of the nation as a whole.

LIMITATIONS OF COST ACCOUNTING:

The cost accounting is subject to the following limitations:

(1) It presents the base for taking the best decisions, but it does not give outright solution to the problem.

(2) Cost varies with purpose. Therefore, cost called for a certain purpose will not be suitable for other purposes.

(3) Cost accounting is not an exact science. It involves inherent elements of judgment.

(4) It lacks a uniform procedure

(5) A suitable system is to be devised for each individual concern and it would be time consuming and expensive.

(6) Existence of numerous methods for apportionment and absorption of overheads, segregation of fixed and variable costs, division of costs into controllable and non – controllable costs, classification of costs into normal and abnormal costs, valuation of stocks, provision for depreciation etc. may lead to cost differences and it is difficult to ascertain true cost of product or service.

(7) Most of cost accounting techniques are based on some presumed notions.

(8) Different views are held for inclusion of certain items of cost in ascertainment of total cost.

(9) Many formalities are to be observed to obtain benefit from costing system. Small and medium concerns may not be in a position to install a costing system.

(10) If the system if not revised as per the changing circumstances, it will become a matter of routine forms and statements.

FORMAT OF COST SHEET

Particulars	₹
Opening Stock of Raw Materials **Add:** Purchases (including Carriage Inwards, Transit Insurance etc.) **Less:** Closing Stock of Raw Materials	
Direct Materials Consumed/Raw Materials Consumed **Add:** Direct Labour **Add:** Direct Expenses	
PRIME COST **Add:** Factory Overheads **Add:** Opening Stock of Work-in-Progress **Less:** Closing Stock of Work-in-Progress	
FACTORY COST/WORKS COST **Add:** Quality Control Cost **Add:** R & D Cost **Add:** Administration Overheads (related to Factory) **Less:** Credit for Recoveries/Scrap/ By Product/ Misc Income **Add:** Packing Cost	
COST OF PRODUCTION **Add:** Opening Stock of Finished Goods **Less:** Closing Stock of Finished Goods	
COST OF GOODS SOLD **Add:** Administrative Overheads (General) **Add:** Marketing Overheads - Selling Overheads - Distribution Overheads	
COST OF SALES	

MATERIAL CONTROL

Materials constitute a very significant proportion of total cost of finished product in most of the manufacturing industries. A proper recording and control over the material costs is essential because of the following:

(a) The exact quality of specification of materials required should be determined according to the required quality of the finished product. If too superior quality of material is purchased, it would mean higher cost due to high prices; if the quality of materials purchased is too low, the product will be of inferior quality.

(b) The price paid should be the minimum possible otherwise the higher cost of the finished products would make the product uncompetitive in the market.

(c) There should be no interruption in the production process for want of materials and stores, including small inexpensive items like lubricating oil for a machine. Sometime their out of stock situation may lead to stoppage of machines.

(d) There should be no over stocking of materials because that would result in loss of interest charges, higher godown charges, deterioration in quality and losses due to obsolescence (either due to manufacture of certain articles being given up or the material previously required for the production not being required any longer due to a change in methods of production).

(e) Wastage and losses while the materials are in store should be avoided as far as possible; and

(f) Wastage during the process of manufacture should be the minimum possible. It may also be added that information about availability of materials and stores should be continuously available so that production may be planned properly and the required materials purchased in time.

IMPORTANCE OF MATERIAL CONTROL:

The publication of the Institute of Cost and Management Accountants on **Budgetary Control** defines it as "the function of ensuring that sufficient goods are retained in stock to meet all requirements without carrying unnecessarily large stocks". When the functions of indexing buying, receiving, inspection, storing and paying of the goods are separated it is essential that these should be properly co-ordinate so as to achieve the advantages of specialization.

Objectives of system of material control: The objectives of a system of material control are the following:

(I) Ensuring that no activity, particularly production, suffers from interruption for want of materials and stores-it should be noted that this requires constant availability of every item that may be needed howsoever small its cost may be. Lubricating oil may cost much less than the main raw material but, from the point of view of uninterrupted production, both have equal importance.

(ii) Seeing to it that all the materials and stores are acquired at the lowest possible price considering the quality that is required and considering other relevant factors like reliability in respect of delivery, etc.

(iii) Minimization of the total cost involved, both for acquiring stocks (apart from the price paid to the supplier) and for holding them.

(iv) Avoidance of unnecessary losses and wastages that may arise from deterioration in quality due to defective or long storage or from obsolescence. It may be noted that losses and wastages in the process of manufacture, concern the production department.

(v) Maintenance of proper records to ensure that reliable information is available for all items of materials and stores that not only helps in detecting losses and pilferages but also facilitates proper production planning.

REQUIREMENTS OF MATERIAL CONTROL:

1. Proper co-ordination of all departments involved viz., finance, purchasing, receiving, inspection, storage, accounting and payment.
2. Determining purchase procedure to see that purchases are made, after making suitable enquiries, at the most favourable terms to the firm.
3. Use of standard forms for placing the order, noting receipt of goods, authorizing issue of the materials etc.
4. Preparation of budgets concerning materials, supplies and equipment to ensure economy in purchasing and use of materials.
5. Operation of a system of internal check so that all transactions involving materials, supplies and equipment purchases are properly approved and automatically checked.
6. Storage of all materials and supplies in a well designated location with proper safeguards.
7. Operation of a system of perpetual inventory together with continuous stock checking so that it is possible to determine at any time the amount and value of each kind of material in stock.
8. Operation of a system of stores control and issue so that there will be delivery of materials upon requisition to departments in the right amount at the time they are needed.
9. Development of system of controlling accounts and subsidiary records which exhibit summary and detailed material costs at the stage of material receipt and consumption.
10. Regular reports of materials purchased, issue from stock, inventory balances, obsolete stock, goods returned to vendors, and spoiled or defective units.

LABOUR COST

MEANING & TYPES OF LABOUR COST

Labour Cost

Labour cost covers wages paid to the workers but it also represents the various payments made to a worker due to his employment. These cover the following:

(1) Monetary/Pecuniary Benefits:

- Basic wages
- Dearness allowance
- Production bonus

(2) Deferred Monetary Benefits:

- Employer's contribution to PF
- Employer's contribution to ESI
- Retirement gratuity
- Profit bonus

(3) Fringe Benefits/Non – Pecuniary Gains:

- Free or subsidized food

- Free or subsidized housing
- Free or subsidized education to children
- Medical & hospital facilities
- Expenses incurred on canteen, sports club, etc.

Expenses listed under (3) may be termed as "Welfare Expenses". Mostly these are treated as manufacturing overheads. Wages paid to workers should be such as to attract and retain the work force and minimum labour turnover.

The total labour cost can be classified as follows:
(a) Direct labour costs;
(b) Indirect labour costs.

Besides wages paid to indirect workers, those also include:
(i) Losses e. g. waiting time, Idle time etc.
(ii) Other payments, e. g., premium pay, holiday and vacation pay, etc.
In Costing, labour cost is divided into direct and indirect types only.

DIRECT LABOUR COST:

It refers to all labour expended in altering the construction, composition, conformation or condition of the product. The wages paid to skilled and unskilled workers for his labour can be allocated specifically to the particular product or the process as the case may be. In any manufacturing process or department, the workers employed may be of the following two categories:

(i) Those who are directly engaged on the production or in the carrying out of an operation or an process.
(ii) Those who are assisting in the process by the way of supervision, maintenance, transportation of materials, etc.

The workers coming under the first category constitute direct labour and the wages paid to them are called as direct wages. In a factory, where production of a number of products is undertaken or in a jobbing concern, workers are given job cards on which they note the time devoted to each job or product. These job cards are then analysed job wise so that the wages attributable to each job can be computed.
Direct labour cost is that portion of wages or salaries which can be identified with and charged to a single costing unit.

It can be easily identified with and charged to a single costing unit as there is a direct relationship with the product or process. Direct labour cost can be easily calculated and is quite significant in amount.

The distinction between the direct and indirect labour is a matter of convenience and expediency. Too much effort should not be spend on treating some labour as direct. For example, supervision labour can be so analysed as to make it direct but the effort to do so will be proportionately too big. It is convenient to treat supervisory wages as indirect.

INDIRECT LABOUR COST:

It refers to labour expended that does not alter the construction or condition of a product or process, but which contributes generally to such work and to the completion of the product and its progressive movement and handling up to the point of dispatch. In other words, labour employed for the purpose of carrying out tasks incidental to goods produced or service provided is regarded as indirect labour. Wages or salaries paid to foreman, supervisors, inspectors, clerks, storekeepers, managers, accountants, directors, etc. are examples of indirect labour.

These cost are not easily identifiable with particular units of cost. Indirect labour cost can be classified as that expended in production departments and that in service department. The classification should enable control over such costs and codification of indirect labour accounts.

It should be noted that the labour that may be indirect for the main product may be direct for a particular purpose or activity. For example, workers in the power house are indirect for the purpose of the ascertaining the cost of the main product but they are direct as far as the power house cost is concerned.

Need for **distinguishing** between direct and indirect labour cost:

(i) For calculating accurate labour cost and thus provide a basis for strict control,
(ii) For facilitating calculation of labour efficiency
(iii) For proper allocation of overhead
(iv) For introduction of incentive schemes
(v) For inter unit comparison and
(vi) For estimating total labour cost.

TIME RECORDING:

Recording of time has two purposes – time keeping and time booking. It is necessary for both type of workers: direct and indirect. It is necessary even if the workers are paid on piece basis.
Time keeping is necessary for the purpose of recording attendance and for calculating wages. Time booking means a record for utilization point of view; the purpose is cost analysis and cost apportionment. Record keeping is correct when time keeping and time booking tally.

TIME KEEPING:

The purpose of time keeping is to provide the basic data for:

i. Pay roll preparation
ii. Finding out the labour cost of a job/product/service.
iii. Attendance records to meet the statutory requirements.
iv. Determining the productivity and controlling labour cost
v. Calculating overhead cost of a job, product or service.
vi. To maintain discipline in attendance
vii. To distinguish between normal and overtime, late attendance and early leaving, and
viii. To provide the internal check against dummy workers

TIME BOOKING:

The objectives of time booking are:

i. To apportion overheads against jobs;
ii. To calculate the labour cost of jobs done;
iii. To ascertain idle time for the purpose of control;
iv. To find out that the time during which a worker is in the factory is properly utilized
v. To evaluate labour performance, to compare actual and budgeted time;
vi. To determine overhead rates of absorbing overhead expenses under the labour hour and machine hour methods;
vii. To calculate the wages and bonus provided the system of payment depends on the time taken.

JOB EVALUATION AND MERIT RATING:

JOB EVALUATION: it can be defined as the process of analysis and assessment of jobs to ascertain reliably their relative worth and to provide management with a reasonably sound basis for determining the basic internal wage and salary structure for the various job positions. In other words, job evaluation provides a rationale for different wages and salaries for different group of employees and ensures that these differentials are consistent and equitable.

METHODS OF JOB EVALUATION:
(1) Ranking method
(2) Grading method
(3) Point rating method
(4) Factor comparison method.

MERIT RATING: it is a systematic evaluation of the personality and performance of each employee by his supervisor or some other qualified person.
Thus the main points of distinction between job evaluation and merit rating are as follows:

1. Job evaluation is the assessment of the relative worth of jobs within a company and merit rating is the assessment of the relative worth of the man behind a job. In other words, job evaluation rates the job while merit rating rates employees on the job.
2. Job evaluation and its accomplishment are means to set up a rational wage and salary structure whereas merit rating provides scientific basis for determining fair wages for each worker based on his ability and performance.
3. Job evaluation simplifies wage administration by bringing uniformity in wage rates. On the other hand merit rating is used to determine fair rate of pay for different workers on the basis of their performance.

DIRECT EXPENSES & OVERHEADS

DIRECT EXPENSES:

MEANING	Direct Expenses are also termed as **'Chargeable expenses'.** These are the expenses which can be allocated directly to a cost object. Direct expenses are defined as 'costs other than material and wages which are incurred for a specific product or saleable services'. Examples of direct expenses are: (I) Hire charges of special machinery or plant for a particular production order or job. (ii) Payment of royalties. (iii) Cost of special moulds, designs and patterns. (iv) Travelling and conveyance expenses incurred in connection with a particular job. (v) Sub-contracting expenses or outside work costs if jobs are sent out for special processing.
CHARACTE RISTICS	(i) Direct expenses are those expenses, which are other than the direct materials and direct labour. (ii) These expenses are either allocated or charged completely to cost centres or work orders. (iii) These expenses are included in prime cost of a product.

INTRODUCTION & MEANING

Besides direct expenditure, i.e., expenditure which can be conveniently traced to or identified with any particular unit of production, e.g., direct materials, direct wages and direct expenses, every form of production involves expenses that cannot be conveniently traced to or identified with the articles produced or services provided. Such expenses are incurred for output generally and not for a particular work order e.g., wages paid to watch and ward staff, heating and lighting expenses of factory etc. Expenses of these nature are known as overhead or indirect expenses. Often in a manufacturing concern, overheads exceed direct wages or direct materials and at times even both put together. On this account, it would be a grave mistake to ignore overheads either for the purpose of arriving at the cost of a job or a product or for controlling total expenditure.

Overheads also represent expenses that have been incurred in providing certain ancillary facilities or services which facilitate or make possible the carrying out of the production process; by themselves these services are not of any use. For instance, a boiler house produces steam so that machines may run and, without the generation of steam, production would be seriously hampered. But if machines do not run or do not require steam, the boiler house would be useless and the expenses incurred would be a waste.

Apart from the overheads incurred in the factory, overheads also arise on account of administration, selling and distribution.

CLASSIFICATION OF OVERHEADS:

CIMA defines classification as, “the arrangement of items in logical groups having regard to their nature. Classification is a prerequisite for cost analysis and control system.

CLASSIFICATION OF OVERHEADS BY FUNCTION:

Overheads principally are of four types: (i) Factory or Manufacturing Overheads; (ii) Office and Administrative Overheads; (iii) Selling and Distribution Overheads; (iv) Research and Development.

Whether an expense belongs to one class or another depends entirely on the benefit derived from it. For instance, salaries of clerks will be (i) factory or manufacturing expenses, when the clerks concerned work in the factory office; (ii) office and administrative expense when the clerks work in the general office; and (iii) selling and distribution expense when the clerks work in the sales office.

Small concerns may not distinguish between office and selling expenses and still smaller concerns may treat all overhead, of whatever class, together. Big concerns may have even a more detailed classification to be able to exercise better control. A detailed classification of such expenses is given below:

(i) **Factory or Manufacturing Expenses**:

(a) Stores overheads (expenses connected with purchasing and handling of materials);

(b) Labour overheads (expenses connected with labour); and

(c) Factory administration overheads (expenses connected with administration of the factory).

(ii) **Office and Administration Expenses**:

(a) Administrative expenses (expenses incurred on managerial personnel - their salaries, costs of facilities provided to them and salaries of their personal staff); and

(b) Office expenses (expenses on the routine office work).

(iii) **Selling and Distribution Expenses**:

(a) Selling expenses (expenses incurred to persuade customers to purchase the firm's products and, or engage its services, that is to maintain and expand the market); and

(b) Distribution expenses are those which are incurred to execute orders. One should note that many people use the two terms "selling" and "distribution" as synonymous.

CHAPTER 14: COST ACCOUNTING RECORDS & COST AUDIT

COST AUDIT	Cost audit is an independent examination of cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon. Cost audit comprises of the followings: (a) Verification of the cost accounting records for the accuracy of the cost accounts, cost reports, cost statements and cost data and (b) Examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives. It, therefore, means that the cost auditors' approach should be to ensure that the cost accounting plan is in consonance with the objectives set by the organization and the system of accounting is geared towards the attainment of these objectives. The cost auditor should also establish the correctness or otherwise of the figures by the processes of vouching verification, reconciliation etc.
PROVISIONS CONTAINED IN COMPANIES ACT, 2013 RELATING TO COST RECORDS	Section 2(13) and section 128 of the Companies Act, 2013 deals with the books of accounts to be kept by a company. According to section 2(13) on the Companies Act, 2013 "books of account" includes records maintained in respect of- (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place; (ii) all sales and purchases of goods and services by the company; (iii) the assets and liabilities of the company; and (iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section; Section 128 on the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting. Further all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place. Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may

	be prescribed. In exercise of powers conferred by section 469(1) and (2) read with section 2(13)(iv), section 128 and section 148 of the Companies Act, 2013, the Central Government prescribes the Companies (Cost Records and Audit) Rules, 2014 for the maintenance of cost records relating to the utilization of materials, labour and other items of cost, in the manner as prescribed by specified class of companies, including foreign companies defined in section 2(42) of the Companies Act, 2013, engaged in the production of such goods or providing such services as may be prescribed.
PROVISIONS CONTAINED IN COMPANIES ACT, 2013 RELATING TO COST AUDIT	Section 148 of the Companies Act, 2013 deals with the audit of Cost Accounting records. The section provides as follows: (1) Notwithstanding anything contained in Chapter X of Companies Act 2013, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies: Provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act. (2) If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order. (3) The audit under sub-section (2) shall be conducted by a Cost Accountant who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed: Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records: Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards. Explanation.—for the purposes of this sub-section, the expression "cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government. (4) An audit conducted under this section shall be in addition to the audit conducted under section 143.

	(5) The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company: Provided that the report on the audit of cost records shall be submitted by the cost accountant to the Board of Directors of the company. (6) A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (2) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein. (7) If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (6), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government. (8) If any default is made in complying with the provisions of this section,— (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147; (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.
PURPOSE OF COST AUDIT	The primary purpose of Cost audit is to express an opinion on the cost accounts of the company whether these have been properly maintained and compiled according to the cost accounting system followed by the enterprise or not. However the purposes of cost audit may be segregated into general and social objectives. The general objectives can be described to include the following: (1) Verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise. (2) Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to. (3) Detection of errors and fraud. (4) Verification of the cost of each "cost unit" and "cost centre" to ensure that these have been properly ascertained. (5) Determination of inventory valuation. (6) Facilitating the fixation of prices of goods and services. (7) Periodical reconciliation between cost accounts and financial accounts. (8) Ensuring optimum utilization of human, physical and financial resources of the enterprise.

	(9) Detection and correction of abnormal loss. (10) Inculcation of cost consciousness. (11) Advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement. (12) Promoting corporate governance through various operational disclosures.
SOCIAL PURPOSE OF COST AUDIT	The following deserve special mention 1. Facilitate in fixation of reasonable prices of goods and services produced by the enterprise. 2. Improvement in productivity of human, physical and financial resources of the enterprise. 3. Channelize enterprise resources to most optimum, productive and profitable areas. 4. Availability of audited cost data as regards contracts containing escalation clauses. 5. Facilitate in settlement of bills in the case of cost-plus contracts entered into by the Government. 6. Pinpointing areas of inefficiency and mismanagement, if any for the benefit of shareholders, consumers, etc., such that necessary corrective action could be taken in time.
APPLICABILITY OF COST AUDIT	Every such class of company and with such threshold limit as may be prescribed in the Companies (Cost Records and Audit) Amendment Rules, 2014, shall be required to get such cost records audited by a cost auditor. **Cost Audit** Every company covered under Rule 3 of the Companies (Cost Records and Audit) Amendment Rules, 2014 and with such threshold limits as specified in the Rules shall *within one hundred and eighty days of the commencement of every financial year* appoint a cost auditor. The company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government *within a period of thirty days of the Board meeting* in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in form **CRA-2,** alongwith the fee as specified in Companies (Registration Offices and Fees) Rules, 2014. Further every cost auditor appointed as such shall continue in such capacity till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed. The cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in **form CRA-3.** The cost auditor shall forward his **report to the Board of Directors** of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates and the

	Board of directors shall consider and examine such report particularly any reservation or qualification contained therein. Every company covered above shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, **furnish the Central Government** with such report alongwith full information and explanation on every reservation or qualification contained therein, in **form CRA-4** alongwith fees specified in the Companies (Registration Offices and Fees) Rules, 2014. The provisions of section 143(12) of the Companies Act, 2013 and the relevant rules made thereunder shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Companies Act, 2013 and the Companies (Cost Records and Audit) Rules, 2014. **Exemptions** The requirement of Cost Audit is not applicable for the following categories of companies even if they are covered under applicable class of companies: • whose revenue from exports, in foreign exchange, exceeds 75 per cent of its total revenue or • which is operating from a special economic zone
ADVANTAGES OF COST AUDIT	Cost audit provides numerous benefits to the management, society, shareholders and the government. The advantages are as under: **Advantages to Management** (i) Management gets reliable data for its day-to-day operations like price fixing, control, decision making, etc. (ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management. (iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action. (iv) Management by exception becomes possible through allocation of responsibilities to individual managers. (v) The system of budgetary control and standard costing will be greatly facilitated. (vi) A reliable check on the valuation of closing stock and work-in-progress can be established. (vii) It helps in the detection of errors and fraud. **Advantages to Society** (i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the Audit Cost data and so the consumers are saved from exploitation. (ii) Since price increase by some industries is not allowed without proper justification like increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living. **Advantages to Shareholder** Cost audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing stocks and workin- progress

	is on a fair basis. Thus the shareholders are assured of a fair return on their investment. **Advantages to Government** (i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level. (ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked. (iii) Cost audit enables the government to focus its attention on inefficient units. (iv) Cost audit enables the government to decide in favour of giving protection to certain industries. (v) Cost audit facilitates settlement of trade disputes brought to the government. (vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.
APPOINTMENT & REMUNERATION OF COST AUDITOR	**(1) For Cost Auditor** If default is made by the cost auditor in complying with the provisions of section 139, section 143, section 144 or section 145 of the Companies Act, 2013 then he shall be punishable in the manner as provided in sub-section (2) to (4) of section 147 of the Companies Act, 2013. According to section 147 (2) of the Companies Act, 2013, the auditor shall be punishable with fine which shall **not be less than twenty-five thousand rupees but which may extend to five lakh rupees**: **or four times the remuneration of the auditor, whichever is less;** Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be **punishable with imprisonment for a term which may extend to one year with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees or eight times the remuneration of the auditor, whichever is less**; According to section 147 sub-section (3) of the Companies Act, 2013, where an auditor has been convicted under section 147 (2) above, he shall be liable to— (i) refund the remuneration received by him to the company; and (ii) pay for damages to the company, statutory bodies or authorities or or to members or creditors of the company for loss arising out of incorrect or misleading statements of particulars made in his audit report. According to section 147 sub-section (4) of the Companies Act, 2013, the Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

	The provision of section 143 of the Companies Act, 2013 applies mutatis-mutandis to Cost Accountants conducting Cost Audit under section 148 of the Companies Act, 2013. If any cost accountant fails to comply with the provisions of section 143(12) of the Companies Act, 2013, for reporting of an offence involving fraud, they will be punished with a fine of minimum ₹ 1 lakh and upto ₹ 25 lakhs. **<u>(2) For Company</u>** If a company contravenes any provisions of section 139 to 146 of the Companies Act, 2013, the company and every officer thereof who is in default shall be punishable in the manner as provided in sub-section (1) of section 147 of the Companies Act, 2013, wherein the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.
RIGHTS & RESPONSIBILITIES OF COST AUDITOR	Section 148 of the Companies Act, 2013 gives the cost auditor same powers as the financial auditor has under section 143 of the Companies Act, 2013, which requires that the company and every officer thereof, shall make available to the cost auditor, such information and explanation as he may consider necessary for the performance of his duties as cost auditor and submit his report within the prescribed time limit. **<u>Rights of Cost Auditor</u>** The powers of the cost auditor under sub-Section (1) of Section 143 are as under: - Right to access at all times the books of account and vouchers of the company, whether kept at the head office of the company or elsewhere. - Entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as an auditor.
PUNISHMENT FOR CONTRAVENTION	**<u>(1) For Cost Auditor</u>** If default is made by the cost auditor in complying with the provisions of section 139, section 143, section 144 or section 145 of the Companies Act, 2013 then he shall be punishable in the manner as provided in sub-section (2) to (4) of section 147 of the Companies Act, 2013. According to section 147 (2) of the Companies Act, 2013, the auditor shall be punishable with fine which shall **not be less than twenty-five thousand rupees but which may extend to five lakh rupees**: Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be **punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees**. According to section 147 sub-section (3) of the Companies Act, 2013, where an auditor has been convicted under section 147 (2) above, he

	shall be liable to— (i) refund the remuneration received by him to the company; and (ii) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report. According to section 147 sub-section (4) of the Companies Act, 2013, the Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification. The provision of section 143 of the Companies Act, 2013 applies mutatis-mutandis to Cost Accountants conducting Cost Audit under section 148 of the Companies Act, 2013. If any cost accountant fails to comply with the provisions of section 143(12) of the Companies Act, 2013, for reporting of an offence involving fraud, they will be punished with a fine of minimum ₹ 1 lakh and upto ₹ 25 lakhs. **(2) For Company** If a company contravenes any provisions of section 139 to 146 of the Companies Act, 2013, the company and every officer thereof who is in default shall be punishable in the manner as provided in sub-section (1) of section 147 of the Companies Act, 2013, wherein the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.
COST AUDIT TECHNIQUES	There are no specific techniques being used by cost auditor in carrying out the cost audit assignments. Techniques employed by a Cost auditor in effectively carrying out his audit are – **(i) Accounting or economic techniques** 1. Vouching. 2. Physical Verification. 3. Comparison of data with Peer. 4. Break-even analysis. 5. Budgetary control including flexible budget system. 6. Cost management techniques indicating how an organization's assets should be allocated over competing projects or to decide whether it is worth proceeding with the investment, keeping in view proportionate value of expenditure on such projects. 7. Discounted cash flow and net present value methods. 8. Cost benefit analysis. 9. Standard costing and marginal costing. 10. Activity based costing to test the relevance of cost to activities. 11. Quality analysis of company transactions. **(ii) Scientific Techniques**

	(a) *Computer Models:* There are many types of problems which can be solved on a computer e.g. decision on material mix, product mix, make or buy decisions etc. (b) *Network analysis:* To analyse strings of tasks to arrange them in sequential or parallel order so that the project is completed in a shortest possible time. (c) Mathematical Programme solving by heuristic (trial and error) techniques to determine the best material mix, best use of organization's transport fleet, the best mix of products to obtain or to maximize profits and optimum use of labour, finance, equipments, etc. **(Iii) Statistical Techniques** (a) Activity Sampling: It is one of the many ways in which the present workloads can be measured to obtain controls to be exercised by management. (b) Monte Carlo Simulation: In this a number of variables are drawn from large statistical population which have equal choice of being selected and obtain the best sample possible. (c) Exponential smoothing (d) Inter firm comparison **(iv) Personnel Techniques** (a) Attitude survey (b) Ergonomic (Man-machine relationship) (c) Training methods (d) Profitability and productivity measurement **(v) General techniques** (a) Statistical theory of management is an attempt to emphasize what should be the practical approach to a problem by – • Analysing the problem to establish the basic difficulties and factors involved. • Establish management by objectives. • Identifying the likely ways of tackling the problems in the light of objectives to develop a solution. • Determine the key factors affecting management decision-making. • Evaluating alternative courses of action. • Evaluating each alternative in terms of economy, efficiency and best fit. • Specifying the action required to exploit the situation to the best advantage of the organization. (b) Brain storming (c) Transfer pricing (d) Management by objectives (e) Management by exception (f) Corporate planning (g) Information theory

COST AUDIT PROGRAMME	Cost audit programme is an essential prerequisite for conducting an audit. It is a plan of action drawn in advance before taking up the audit, and to help the auditor to cover the entire area of his function thoroughly. The audit programme should include all the usual broad steps that a financial auditor include in his audit programme. However, the significant things that should not be missed are: proper vouching of expenses, capital and revenue character determination, allocation of expenses, apportionment of overheads, arithmetical accuracy, the statutory requirements, examination of contracts and agreements, review of the Board's and shareholders' minute books to trace important decisions having bearing on costs, verification of title deeds and documents relating to properties and assets, etc. Cost audit, in order to be effective, should be completed at one time as far as practicable. The exact content of cost audit largely depends on the size of the organization, range of products, production process, the existence of a well organised costing department and of a well designed costing system, and the existence of a capable internal auditing system. Other relevant considerations may be: **(A) Review of Cost Accounting Records** This will include: 1. Method of costing in use - batch, process or unit. 2. Method of accounting for raw materials; stores and spares, wastages, spoilage, defectives, etc. 3. System of recording wages, salaries, overtime and spares, wastages, etc. 4. Basis of allocation of overheads to cost centres and apportionment of service department's expenses. 5. Treatment of interest, recording of royalties, research and development expenses, etc. 6. Method of accounting of depreciation. 7. Method of stock-taking and its valuation including inventory policies. 8. System of budgetary control. 9. System of internal auditing. **(B) Verification of cost statements and other data** This will include the verification of: (i) Licensed, installed and utilised capacities. (ii) Financial ratios. (iii) Production data. (iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads, provision for depreciation etc. (v) Sales realisation. (vi) Abnormal, non-recurring and special costs. (vii) Reconciliation with financial books.
COST AUDIT REPORT	Cost audit report means the report duly audited and signed by the cost auditor including attachment, annexure, qualifications or observations etc. to cost audit report. Every cost auditor, who conducts an audit of the cost records of the

	company, shall *within 180 days from the close of the company's financial year* to which the report relates, submit the cost audit report along with his reservations or qualifications or observations or suggestions in the Form CRA-3 to the *Board of Directors* of the company.

CHAPTER 15: BUDGET, BUDGETING & BUDGETARY CONTROL

The Chartered Institute of Management Accountants, London defines **BUDGET** as "a plan expressed in money. It is prepared and approved prior to the budget period and may show income, expenditure and the capital to be employed. May be drawn up showing incremental effects on former budgeted or actual figures"

Thus the essential features of a budget are as under:
(i) it is a statement expressed in monetary and/or physical units prepared for the implementation of policy formulated by the management.
(ii) it is laid down prior to the budget period during which it is followed.
(iii) it is prepared for the definite future period
(iv) the policy to be followed to attain the given objective must be laid before the budget is prepared.

Budgetary control is connected with budgets. The Chartered Institute of Management Accountants, London defines **Budgetary Controls** as "the establishment of budgets, relating the responsibilities of executive to the requirements of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objectives of that policy or to provide a firm basis for its revision"

A budgetary control system secures control over performance and costs in the different parts of a business:
(i) by establishing budgets
(ii) by comparing actual attainments against the budgets and
(iii) by taking corrective action and remedial measures or revision of the budgets, if necessary

The **budget** is a blue print of the projected plan of action expressed in quantitative terms and for a specified period of time. The budgets put the plan in a concrete form and follow up action to see that plan is adhere to complete the system of control. In other words, while **budgeting** is the art of planning, **budgetary control** is the act of adhering to the plan. In fact, budgetary control involves continuous comparison of actual results with the budgets and taking appropriate remedial action promptly.

Forecast and Budget:

Forecast	Budget
Forecast is a mere estimate of what is likely to happen. It is a statement of probable events which are likely to happen under anticipated conditions during a specified period of time.	Budget shows that policy and programme to be followed in a future period under planned conditions.
Forecasts, being statements of future events, do not connote any sense of control.	A budget is a tool of control since it represents actions which can be shaped according to will so that it can be suited to the conditions which may or may not happen.
Forecasting is a preliminary step for budgeting. It ends with the forecast of likely	It begins when forecasting ends. Forecasts are converted into budgets.

events.	
Forecast have wider scope, since it can be made in those spheres also where budget cannot be interfere.	Budgets have limited scope. It can be made of phenomenon non capable of being expressed quantitatively.

ADVANTAGES OF BUDGETARY CONTROL:	(i) To reduces losses and wastage to the minimum. (ii) To bring out clearly where effort is needed to remedy the situations. (iii) To achieve maximum profitability by planning income and expenditure through optimum use of available resources. (iv) To facilitate centralized control with delegated authority and responsibility. (v) Various activities like production, sales, purchase of materials, etc. are co-ordinated with the help of budgetary control. (vi) the task of managerial co-ordination and control is facilitated through budgets. (vii) it cultivates in the management the habit of thinking ahead – making careful study of the problems in advance before taking decisions.
LIMITATIONS OF BUDGETARY CONTROL:	(i) Budgets are meant to deal with business conditions which are constantly changing. Therefore, budget estimates lose much of their usefulness under changing conditions because of their rigidity. It is necessary that budgetary control system should be kept adequately flexible. (ii) it has often been found that in practice the organization of budgetary control system become top heavy and therefore, costly specially from the point of view of small concern. (iii) Budgets are mere an estimates and are not dependable.
INSTALLATION OF BUDGETARY CONTROL SYSTEM	**1. Organization Chart:** An **organizational chart** is a statement defining functional representatives of executives responsible for accomplishment of organizational objectives. (i) Functional responsibility of a particular executive. (ii) Delegation of authority to various levels. (iii) Relative position of a functional head with heads of other functions. **2. Budget Committee:** the budget committee is a group of representatives of various functions in an organization. As all functions are inter related and as any change in one's target will have its impact on that of the other, it is necessary to discuss the targets so that a mutually agreed programme is determined. It is a powerful force in knitting together the various activities of the business and enforcing real control over operations. The **budget manual** should specify the responsibilities and duties of the budget committee, which should include the following: (i) Receive and review budget estimates from the respective divisions or departments and make recommendations. (ii) recommend decisions or budget matters where there may be conflicts between departments or divisions. (iii) recommend changes and approval of the revised budget. (iv) Receive, study and analyse periodic reports comparing the budget with actual performance. Consider policies with respect to follow up

	procedures. (v) consider and make recommendations for revision of the budget when conditions warrant. (vi) make recommendations for the budget manual. **3. Budget Reports:** performance evaluation and reporting variances is an integral part of all control systems. ***Establishing budgets in itself is of no use*** unless a comparison is made regularly between the actual expenditure and budgeted allowances, and the results reported to the management. For this purpose, budget reports showing comparison between the actual and budgeted expenditure should be presented periodically and promptly. A budget report to be effective must be: (i) regularly and promptly presented. (ii) designed to give only the essential information required and avoid unnecessary details; (iii) Free from personal bias of the person preparing it; and (iv) dated and signed by those who prepare and check it. **4. Budget manual:** A **budget manual** is a document which sets outstanding instructions governing the responsibilities of persons and procedures, forms and records relating to the preparation and use of budgets and it is a booklet containing standing instructions regarding the procedures to be followed and the time schedules to be observed. (i) The dates by which preliminary forecast and plans are to be submitted; (ii) the important factors that must be considered for each forecast or plan; (iii) the manner of scrutiny and the personnel to carry it out; (iv) the finalisation of functional budgets and their compilation into master budget. (v) the manner in which budgets, after acceptance and issuance, are to be revised or amended; (vi) the matters, included in budgets, on which action may be taken only with the approval of top management.
FUNCTIONAL BUDGETS:	**(i) Sales Budget:** the sales budget is forecast of total sales, expressed in terms of money and quantity. The first step in the preparation of the sales budget is to forecast as accurately as possible the sales anticipated during the budget period. Sales forecasts are influenced by a variety of factors, external as well as internal. External factors includes general business conditions, government policy, etc. Internal factors include sales prices, sales mix, new products, etc. The sales budget is regarded as the keystone of budgeting. **(ii) Production Budget:** The production budget is a forecast of the production for budget period. It is prepared in two parts viz Production value budget for the physical units of the products to be manufactured and the cost of manufacturing budget detailing the budgeted costs. The main steps involving in the preparation of a production budget are production planning, consideration of the capacity, integration with sales forecasts, inventories policies, management's overall policies. **(iii) Materials Budget:** Material requirement budget, commonly known as

	materials budget, assist the purchase department in suitably planning the purchases, fixing the maximum and minimum levels of materials, components, etc. the timing and amount of funds which will be needed to make purchases are also known with the help of the materials budget. **(iv) Direct Labour Budget:** The labour content of each item of production as per the production budget is determined in terms of grades and trades of the workers required and the labour time for each job, operation and process. The rates to pay, allowances, bonus, etc. of each category are then considered and labour cost to be set for each budget centre is calculated by multiplying the wage rate with the labour hours for the number of units of products budgeted. **(v) Manufacturing OH budget:** The following steps are required to be taken up to prepare the manufacturing OH budget: (a) Classification of expenditure into fixed and variable and semi variable and collection thereof in accordance with the schedule of standing order numbers; (b) Departmentalization of expenditure; (c) Determining the level of activity for setting the overhead rates and level of activity may be actual, budgeted level or normal capacity; (d) Establishing the variable overhead rate per unit of production or productive hour. **(vi) Administration Cost Budget:** the administrative expenses includes items of expenditure relating to higher management functions as well as expenses of the legal, financial, accounting and other service departments. Since most of the items of administration overhead are of a fixed nature, there is not much difficulty in establishing budgets for these items. The budgeted expenses are determined on the basis of amounts spent in previous years and the minimum requirements for the efficient operation of each department. **(vii) Selling Expenses Budget:** the selling expenses includes all items of expenditure on the promotion, maintenance and distribution of finished products. This budget which is closely related to sales budget is the forecast of the cost of selling and distribution, for the budgeted period. Selling and distribution expenses may be fixed or variable with regard to the volume of sales, separate budgets are usually established for fixed and variable selling expenses.
CASH BUDGET	A cash forecast is an estimate showing the amount of cash which would be available in a future period. This budget usually of two parts giving detailed estimates of (i) Cash Receipts and (ii) Cash disbursements. Estimates of cash receipts are prepared on a monthly basis and depend upon estimated cash sales, collections from debtors and anticipated receipts from other sources like sale of fixed assets, borrowings, etc. estimates of cash disbursements are based on estimated cash purchases, payment to creditors, employees remuneration, bonus, advances to suppliers, budgeted capital expenditures, etc A cash Budget can be prepared by any of the following methods: **(i) Receipts and payment method:** In this method, cash receipts from various sources and cash payments to various agencies are estimated.

	Delay in cash receipts and lag in payments are taken into account for making estimates. Since this method is based on the concept of cash accounting, accruals and adjustments obviously cannot find place in the preparation of cash budgets. This opening balance of cash of a period and estimated cash receipts are added and from this, the total estimated cash payment are deducted to find out the closing balance. **(ii) Adjusted Profit and Loss Account method:** In this method, opening balance is adjusted with the anticipated increases or decreases in current assets and liabilities, provision for depreciation, special receipts and the net profit for the year before taxation and appropriations. From the aggregate amount of these, the estimated tax and dividend, expenditure on fixed assets are deducted. The resulting balance is the estimated cash in hand at the end of the budgeted period. **(iii) Balance sheet method:** Under this method, a forecast balance sheet is prepared as at the end of the budgeted period with all items of assets and liabilities except ***cash balance which is arrived at as the balancing figure***. The magnitude of two sides of the balance sheet ***excluding*** cash balance would determine the bank balance would show a debit or credit balance i.e. cash at bank or bank overdraft.
MASTER BUDGET	❖ **Master budget** is a consolidated summary of the various functional budgets. ❖ A master budget is the summary budget incorporating its component functional budget and which is finally approved, adopted and employed. ❖ It is the culmination of the preparation of all other budgets like the sales budget, production budget, purchase budget, etc. **it consists in reality of the budgeted profit and loss account, the balance sheet and budgeted cash flow statement**. ❖ The master budget is prepared by the **budget committee** on the basis of co-ordinate functional budget and becomes the target of the company during the budget period when it is finally approved. ❖ This budget acts as the company's individualized key to successful financial planning and control. It provides the basis of computing the effect of any changes in any phase of operations, such as sales volume, product mix, Prices, labour costs, material cost or change in facilities. It segregates income, cost and profits by areas of responsibility. ❖ Master budget presents all this information to the depth appropriate for the top management action. ❖ In the master budget, cost are classified and summarized by types of expenses as well as by departments. This information extends the range of usefulness of master budget. It is considered as the best mode of understanding the company's micro economic position relating to the forthcoming budget period. ❖ **Master budget is not merely a compendium of theoretical calculations**.

	❖ The figures that it contains are the reflection of the actual intentions of the company relating to different areas for the forthcoming budget period.
FIXED BUDGETS	❖ A budget may be established either as fixed budget or a flexible budget. ❖ A **fixed budget** is a budget designed to remain unchanged irrespective of the level of activity actually attained. ❖ A fixed budget is one which is designed for a specific planned output level and is not adjusted to the level of activity attained at the time of comparison between the budgeted and actual costs. ❖ Obviously, fixed budgets can be established only for a **small period of time** when the actual output is not anticipated to differ much from the budgeted output. ❖ However, a fixed budget is liable to revision if due to business conditions undergoing a basic change or due to other reasons, actual operations differ widely from those planned in the fixed budget. ❖ These budgets are most suited for fixed expenses but they have only a limited application and is ineffective as a tool for cost control.
FLEXIBLE BUDGETS	❖ It is a budget prepared in a manner so as to give the budgeted cost **for any level of activity**. ❖ It is a budget which by recognizing the difference between fixed, semi fixed and variable cost is designed to change in relation to the activity attained. ❖ Flexible budgeting is desirable in the following cases: (i) Where the level of activity during the year varies from period to period, either due to seasonal nature of industry or to variation in demand. (ii) Where the business is a new one and is difficult to foresee the demand. (iii) Where the undertaking is suffering from shortage of a factor of production such as materials, labour, plant capacity, etc. ❖ The main characteristic of flexible budget is that it shows the expenditure appropriate to various level of output. ❖ If the volume changes the expenditure appropriate to it can be established form the flexible budget for comparison with actual expenditure as a means of control. ❖ It provides a **logical comparison** of budget allowances with actual cost. When flexible budget is prepared, actual cost at actual activity is compared with the budgeted cost at actual activity level i.e. two things with same base. ❖ For preparation of flexible budgets, item of cost have to be analysed individually to determine how different items of cost behave to

	change in volume. Therefore, In-depth cost analysis and cost identification is required for preparation of flexible budgets. ❖ Following are the striking features of the flexible budgets: (i) they are prepared for a range of activity instead of a single level. (ii) They provide a very dynamic basis for comparison because they are automatically geared to changes in volume. (iii) they provide a tailor made budget for a particular volume. (iv) These are based upon adequate knowledge of cost behavior pattern. ❖ Flexible budgets may be prepared in the following method: (i) Tabular method or multi activity method (ii) Formula method or ratio method (iii) Graphic method
ZERO BASE BUDGETING	❖ Zero base budgeting is a revolutionary concept of planning the future activities and there is a sharp contradiction from conventional budgeting. ❖ Zero base budgeting, may be better termed as **"De Nova Budgeting"** or budgeting from the beginning without any reference to any base past budgets and actual happening. ❖ **Zero base budgeting** may be defined as "a planning and budgeting process which requires each manager to justify his entire budget requested in detail from scratch (hence zero base) and shifts the burden of proof to each manager to justify why he should spend any money at all. ❖ The approach requires that all activities be analysed in decision packages which are evaluated by systematic analysis and ranked in order of importance." ❖ It is a technique which complements and links the existing planning, budgeting and review processes. It identifies alternative and efficient methods of utilizing limited resources in effective attainment of selected benefits. ❖ It is a flexible management approach which provides a credible rationale for reallocating resources by focusing on systematic review and justification of the funding and performance levels of current programs of activities. ❖ **The concept of ZBB was developed in USA**. ❖ Under ZBB, each program and each of its constituent part is challenged for its very inclusion in each year's budget. Program objectives are also re-examined with a view to start things afresh. It requires analysis and evaluation of each program in order to justify its inclusion or exclusion from the final budget. **Advantages of ZBB:** (i) ZBB is not based on incremental approach, so its promotes operational efficiency because it requires managers to review and justify their activities or the funds requested.

	(ii) Since this system requires participation of all managers, preparation of budgets, responsibilities of all levels at management in successful execution of budgetary system can be ensured. (iii) This technique is relatively elastic because budgets are prepared every year on a zero base. This system make it obligatory to develop financial planning and management information system. (iv) This system weeds out inefficiency and reduces the cost of production because every budget proposal is evaluated on the basis of cost benefit analysis. (v) It provides the organization with a systematic way to evaluate different operations and programs undertaken by the management. It enables management to allocate resources according to priority of the programs. (vi) it is helpful to the management in making optimum allocation of scarce resources because a unique aspect of zero base budgeting is the evaluation of both current and proposed expenditure and placing it some order of priority. **Criticism against ZBB:** (i) Defining the decision units and decision packages is rather difficult. (ii) ZBB requires a lot of training for managers. (iii) Cost of preparing the various packages may be very high in large firms involving large number of decision packages. (iv) it may lay more emphasis on short term benefits to the detriment of long term objectives of the organization. (v) It will lead to enormous increase in paper work created by the decision packages. The assumptions about cost and benefits in each package must be continually up dated and new packages developed as soon as new activities emerge. (vi) Where objectives are very difficult to quantify as in research and development, zero base budgeting does not offer any significant control advantage.
PERFORMANCE BUDGETING:	The concept of performance budgeting relates to greater management efficiency specially in government work. With a view to introducing a system's approach, the concept of performance budgeting was developed and as such there was a shift from financial classification to Cost or Objective Classification. Performance budgeting, is therefore, looked upon as a budget based on functions, activities and projects and is linked to the budgetary system based on objective classification of expenditure. The purpose of performance budgeting is to focus attention upon the work to be done, services to be rendered rather than things to be spend for or acquired. In performance budgeting, emphasis is shifted from control inputs to efficient and economic management of functions and

	objectives. Performance budgeting takes a system view of activities by trying to associate the inputs of the expenditure with the output of accomplishment in terms of services, benefits, etc. in performance budgeting, the objective of the budget makers and setting the task and sub task for accomplishment of the defined objectives are to be clearly decided well in advance before budgetary allocations of inputs are made. The main purpose of performance budgeting are: (i) TO review at every stage, and at every level of organization, so as to measure progress towards the short term and long term objectives. (ii) To inter relate physical and financial aspects of every programme, project or activity. (iii) TO facilitate more effective performance audit (iv) TO assess the effects of the decision making of supervisor to the middle and top managers. (v) To bring annual plans and budgets in line with the short and long term plan objectives. (vi) To present a comprehensive operational document showing the complete planning fabric of the programme and prospectus their objectives interwoven with the financial and physical aspects. However, Performance budgeting has certain limitations such as difficulty in classifying Programmes and activities, problems of evaluation of various schemes, relegation to the background of important Programmes. Moreover, the technique enables only quantitative evaluation scheme and sometimes the needed results cannot be measured.

- Ratio analysis is used to **evaluate relationships** among financial statement items.
- The ratios are used to **identify trends** over time for one organization or to compare two or more Organizations at one point in time.
- Ratio analysis focuses on **three key aspects** of a business: liquidity, profitability, and solvency. Ratio Analysis is a important tool for any business organization.
- The computation of ratios **facilitates the comparison** of firms which differ in size. Ratios can be used to compare a firm's financial performance with industry averages. In addition, ratios can be used in a form of **trend analysis** to identify areas where performance has improved or deteriorated over time.

ACCOUNTING RATIOS

An absolute figure often does not convey much meaning. Generally, it is only in the light of other information that significance of a figure is realised. A weighs 70 kg. Is he fat? One cannot answer this question unless one knows A’s age and height. Similarly, a company’s profitability cannot be known unless together with the amount of profit and the amount of capital employed. The relationship between the two figures expressed ***arithmetically*** is called a ratio.

Accounting ratios are relationships, expressed in arithmetical terms, between figures which have a cause and effect relationship or which are connected with each other in some other manner.

Accounting ratios are a very useful tool for ***grasping the true message*** of the financial statements and ***understanding them***. Ratios naturally should be worked out between figures that are significantly related to one another. Obviously no purpose will be served by working out ratios between two entirely unrelated figures, such as discount on debentures and sales. Ratios may be worked out on the basis of figures contained in the financial statements.

Ratios provide clues and symptoms of underlying conditions. They act as indicators of financial soundness, strength, position and status of an enterprise.

Interpretation of ratios form the core part of ratio analysis. The computation of ratio is simply a clerical work but the interpretation is a taste requiring art and skill. The usefulness of ratios dependent on the judicious interpretations.

USES OF RATIO ANALYSIS

- A comparative study of the relationship, between various items of financial statements, expressed as ratios reveals the profitability, liquidity, solvency as well as the overall financial position of the enterprises.

- Ratio analysis helps to analyse and understand the financial health and trend of a business, its past performance makes it possible to have forecast about future state of affairs of the business.

- Inter firm ***comparison*** and intra firm comparison becomes easier through the analysis.

- Past performance and ***future projections*** could be reviewed through the ratio analysis easily.

- Management uses the ratio analysis in ***exercising control*** in various areas viz. budgetary control, inventory control, financial control etc. and fixing the accountability and responsibility of different departmental heads for accelerated and planned performance.

- It is useful for all the constituents of the company as discussed under:

1. **Management**: Management is interested in ratios because they help in the formulation of policies, decision-making and evaluating the performances and trends of the business and its various segments.

2. **Shareholders**: With the application of ratio analysis to financial statements, shareholders can understand not only the working and operational efficiency of their company, but also the likely effect of such efficiency on the net worth and consequently the price of their shares in the Stock Exchange. With the help of such analysis, they can form opinion regarding the effectiveness or otherwise of the management functions.

3. **Investors**: Investors are interested in the operational efficiency, earning capacities and 'financial health' of the business. Ratios regarding profitability, debt-equity, fixed assets to net worth, assets turnover, etc., are some measures useful for the investors in making decisions regarding the type of security and industry in which they should invest.

4. **Creditors**: Creditors can reasonably assure themselves about the solvency and liquidity position of the business by using ratio-analysis. Such analysis helps to throw light on the repayment policy and capability of an enterprise.

5. **Government**: The Government is interested in the 'financial health' of the business. Carefully worked ratios will reflect the policy of the management and its consistency or otherwise with the overall regional and national economic policies. Such ratios help in better understanding of cost structures and may justify price controls by the Government to save the consumers.

6. **Analysts**: Ratio analysis is the most important technique available to the financial analysis to study the financial statements to compare the progress and position of various firms with each other and vis-a-vis the industry.

TYPES OF RATIOS

1. ACCORDING TO THE STATEMENT UPON WHICH THEY ARE BASED

Balance Sheet Ratios: They deal with relationship between two items appearing in the balance sheet, e.g., current assets to current liability or current ratio. These ratios are also known as financial position ratios since they reflect the financial position of the business.

Operating Ratios or Profit and Loss Ratios: These ratios express the relationship between two individual or group of items appearing in the income or profit and loss statement. Since they reflect the operating conditions of a business, they are also known as operating ratios, e.g., gross profit to sales, cost of goods sold to sales, etc.

Combined Ratios: These ratios express the relationship between two items, each appearing in different statements, i.e., one appearing in balance sheet while the other in income statement, e.g., return on investment (net profit to capital employed); Assets turnover (sales) ratio, etc. Since both the statements are involved in the calculation of each of these ratios, they are also known as inter-statement ratios.

2. ACCORDING TO IMPORTANCE:

Primary Ratio: Since profit is primary consideration in all business activities, the ratio of profit to capital employed is termed as 'Primary Ratio'. In business world this ratio is known as "Return on Investment". It is the ratio which reflects the validity or otherwise of the existence and continuation of the business unit. In case if this ratio is not satisfactory over long period, the business unit cannot justify its existence and hence, should be closed down. Because of its importance for the very existence of the business unit it is called 'Primary Ratio'.

Secondary Ratios: These are ratios which help to analyse the factors affecting "Primary Ratio". These may be sub-classified as under:

- **Supporting Ratios:** These are ratios which reflect the profit-earning capacities of the business and thus support the "Primary Ratio". For example sales to operating profit ratio reflects the capacity of contribution of sales to the profits of the business. Similarly, sales to assets employed reflects the effectiveness in the use of assets for making sales, and consequently profits.

- **Explanatory Ratios:** These are ratios which analyse and explain the factors responsible for the size of profit earned. Gross profit to sales, cost of goods sold to sales, stock-turnover, debtors turnover are some of the ratios which can explain the size of the profits earned. Where these ratios are calculated to highlight the effect of specific activity, they are termed as 'Specific Explanatory Ratios'. For example, the effect of credit and collection policy is reflected by debtors turnover ratio.

3. ACCORDING TO FUNCTIONAL CLASSICATION:

The classification of ratios according to the purpose of its computation is known as functional classification. On this basis ratios are categorized as follows:

Profitability Ratios: Profitability ratios gives some yardstick to measure the profit in relative terms with reference to sales, assets or capital employed. These ratios highlight the end result of business activities. The main objective is to judge the efficiency of the business.

Turnover Ratios or Activity Ratios: These ratios are used to measure the effectiveness of the use of capital/assets in the business. These ratios are usually calculated on the basis of sales or cost of goods sold and are expressed in integers rather than as percentages.

Financial Ratios or Solvency Ratios: These ratios are calculated to judge the financial position of the organization from short-term as well as long-term solvency point of view. Thus, it can be subdivided into: (a) Short-term Solvency Ratios (Liquidity Ratios) and (b) Long-term Solvency Ratios (Capital Structure Ratios).

Market Test Ratios: These are of course, some profitability ratios, having a bearing on the market value of the shares.

DIFFERENT TYPES OF RATIOS

BASED ON LIQUIDITY	
Current Ratio	**Current Ratio:** $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ **Where,** **<u>Current Assets</u> = Inventories + Sundry Debtors + Cash & Bank Balances + Loans & Advances + Disposable Investments** **<u>Current Liabilities</u> = Sundry Creditors + Short term loans + Bank Overdraft + Cash Credit + Outstanding Expenses + Proposed Dividends + Provision for Taxation + Unclaimed Dividend** The main question the ratio addresses is "does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible loss in current assets?" **Standard Current Ratio is 2:1 (The ideal Current Ratio preferred by Banks is 1.33: 1)** but whether or not a specific ratio is satisfactory depends upon the nature of business and characteristics of its current assets and liabilities.
Quick Ratio	**Quick Ratio=** $\frac{\text{Quick Assets}}{\text{Quick Liabilities}}$ **Quick Assets = Current Assets – Inventories** **Quick Liabilities = Current Liabilities – Bank Overdraft – Cash Credit** **The ideal liquid ratio is taken as 1:1** The Quick Ratio is a much more exacting measure than the Current Ratio. By excluding inventories, it concentrates on the really liquid assets, with value that is fairly certain. It helps answer the question: If all sales revenues should disappear, could my business meet its current obligations with the readily convertible "quick funds on hand?"
BASED ON LONG TERM SOLVENCY	
Debt Equity Ratio	**Debt Equity Ratio =** $\frac{\text{Long Term Debt}}{\text{Equity}}$ **Ideal Ratio is 2:1** A high ratio here means less protection for creditors. A low ratio, on the other hand, indicates a wider safety cushion (i.e., creditors feel the owner's funds can help absorb possible losses of income and capital). This ratio indicates the proportion of debt fund in relation to equity. This ratio is very often referred in capital structure decision as well as in the legislation dealing with the capital structure decisions (i.e. issue of shares and debentures). Lenders are also very keen to know this ratio since it shows relative weights of debt and equity.
Dividend Coverage Ratio	**DCR=** $\frac{\text{EAT}}{\text{Dividend}}$

Interest Coverage Ratio / Debt Service Ratio	**ICR = EBIT / Interest** An interest cover of 7:1 is considered reasonable by financial institution
Capital Gearing Ratio	**Formula = (Preference Share Capital + Debentures + Long term Loan) (Equity Share Capital + Reserves & Surplus – Losses)** In addition to debt-equity ratio, sometimes capital gearing ratio is also calculated to show the proportion of fixed interest (dividend) bearing capital to funds belonging to equity shareholders.
Proprietary Ratio	**Proprietary Ratio = Proprietary Funds Total Assets** **Proprietary Funds** = Equity share capital + Preference share capital + Reserves – Fictitious Assets **Total Assets** = Fixed Assets + Current Assets (Excluding Fictitious Assets)
TURNOVER RATIOS	
Inventory Turnover Ratio	**Inventory Turnover Ratio**: This ratio also known as stock turnover ratio establishes the relationship between the cost of goods sold during the year and average inventory held during the year. It is calculated as follows: **Formula = Cost of Goods Sold Average Inventory** ***Average Inventory = (Opening Stock + Closing Stock) 2** This ratio indicates that how fast inventory is used/sold. A high ratio is good from the view point of liquidity and vice versa. A low ratio would indicate that inventory is not used/ sold/ lost and stays in a shelf or in the warehouse for a long time.
Debtor Turnover Ratio	**Debtor's Turnover Ratio**: In case firm sells goods on credit, the realization of sales revenue is delayed and the receivables are created. The cash is realised from these receivables later on. The speed with which these receivables are collected affects the liquidity position of the firm. The debtors turnover ratio throws light on the collection and credit policies of the firm. **Formula = Credit Sales Average Account Receivables**
Creditor Turnover Ratio	**Creditor's Turnover Ratio**: This ratio is calculated on the same lines as receivable turnover ratio is calculated. This ratio shows the velocity of debt payment by the firm. **Formula = Credit Purchase Average Account Payables**

	A low creditor's turnover ratio reflects liberal credit terms granted by supplies. While a high ratio shows that accounts are settled rapidly.
Fixed Asset Turnover Ratio	**Fixed Asset Turnover Ratio =** $\frac{\text{Net Sales}}{\text{Fixed Asset}}$ This ratio is an indicator of the extent to which investment in fixed assets contributes to generate sales. The fixed assets are to be taken net of depreciation. The higher is the ratio the better is the performance.
Working Capital Turnover Ratio	**WCTR =** $\frac{\text{Net Sales}}{\text{Working Capital}}$ It indicates to what extent the working capital funds have been employed in the business towards sales.
BASED ON PROFITABILITY	
Gross Profit Ratio	**GP Ratio =** $\frac{\text{Gross Profit}}{\text{Net Sales}} * 100$ **Gross Profit = Sales – Cost of Goods Sold** **Cost of Goods Sold = Opening Stock + Purchase – Closing Stock** This ratio is important to determine general profitability since it is expected that the ratio would be quite high so as to cover not only the remaining costs but also to allow proper returns to owners. Any fluctuation in the gross profit ratio is the result of a change either in 'sales' or the 'cost of goods sold' or both. The rise or fall in the selling price may be an external factor over which the management may have little control, specially when prices are controlled. The management, however, must try to keep the other end of the margin (i.e., cost) at least steady, if not reduce it. If the gross profit ratio is lower than what it was previously, when the selling price has remained steady, it can be reasonably concluded that there is an increase in the manufacturing cost. Since manufacturing overheads include a fixed element as well, a fall in the volume of sales will also lower the rate of gross profit and vice-versa.
Net Profit Ratio	**Net Profit Ratio =** $\frac{\text{Operating Profit}}{\text{Net Sales}} * 100$ It indicates the net margin earned in a sale of ₹100. Net profit is arrived at from gross profit after deducting administration, selling and distribution expenses; non-operating incomes, such as dividends received and non-operating expenses are ignored, since they do not affect efficiency of operations.
Return on Equity (ROE)	**Return on Equity =** $\frac{\text{Profit after Tax}}{\text{Net worth}}$ Return on equity is one of the most important indicators of a firm's profitability and potential growth. Companies that boast a high return on equity with little or no debt are able to grow without large capital

	expenditures, allowing the owners of the business to withdraw cash and reinvest it elsewhere. Many investors fail to realize, however, that two companies can have the same return on equity, yet one can be a much better business.
Return on Investment (ROI)	**Return on Investment (ROI):** $\frac{\text{Return}}{\text{Capital Employed}} * 100$ Where, Return = Profit after Tax + Interest on long term debts + Provision for Tax - Interest/Dividend from non-trade investments Capital Employed = Equity Share Capital + Reserves and Surplus + Preference Share Capital + Debenture and long term loan - Miscellaneous Expenditure and Losses - Non Trade Investments OR **Capital Employed = Fixed Assets + Working Capital**
Return on Total Assets (ROA)	**Return on Total Assets =** $\frac{\text{Net Profit after Tax}}{\text{Total Assets}}$
Return on Shareholder's Fund or Return on Net Worth	**Return on Shareholders Fund =** $\frac{\text{Net Profit after Interest \& Tax}}{\text{Shareholders Fund}}$
BASED ON MARKET TEST	
Earnings Per Shares (EPS)	**Earnings Per Share (EPS):** $\frac{\text{Net profit available for equity shareholders}}{\text{Number of ordinary shares outstanding}}$ The profitability of a firm from the point of view of ordinary shareholders can be measured in terms of number of equity shares. This is known as Earnings per share.
Dividend Per Share (DPS)	**Dividend Per share:** $\frac{\text{Total Profits distributed to equity shareholders}}{\text{Number of Equity Shares}}$ Earnings per share as stated above reflects the profitability of a firm per share; it does not reflect how much profit is paid as dividend and how much is retained by the business. Dividend per share ratio indicates the amount of profit distributed to shareholders per share.
Price Earnings Ratio (P/E)	**P/E Ratio =** $\frac{\text{Market Price per share}}{\text{Earnings per Share}}$ This ratio establishes relationship between the market price of the shares of a company and it's earning per share. This ratio helps in predicting the future market value of the shares within reasonable limits. It also helps in ascertaining the extent of under and over-

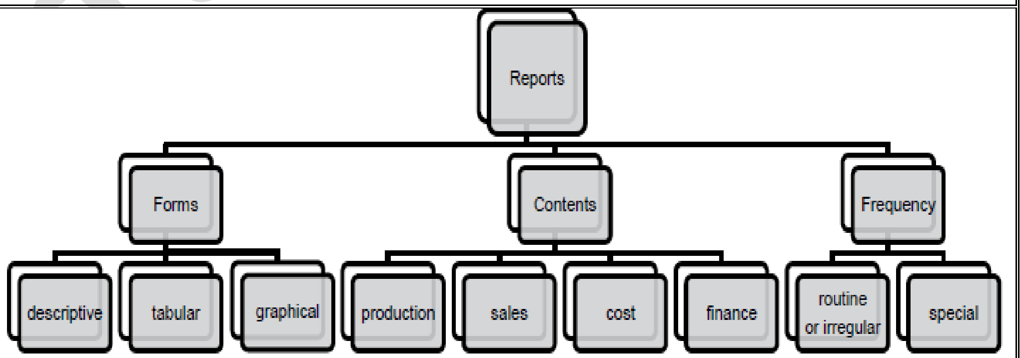
	valuation in the market price, thus pointing to the effect of factors generated by the company's financial position. P/E ratio is the barometer of the market sentiment.
Pay Out Ratio	**Payout Ratio = <u>Dividend Per Share</u>** **Earnings per Share** This ratio helps in predicting the future market value of the shares within reasonable limits. It also helps in ascertaining the extent of under and over-valuation in the market price, thus pointing to the effect of factors generated by the company's financial position.
Dividend Yield Ratio	**Dividend Yield Ratio = <u>Dividend Per Share</u>** **Market Price Per Share** This ratio establishes the relationship between the market price and the dividend paid per share. It is expressed as a percentage and gives the rate of return on the market value of the shares and helps in the decision of investors who are more concerned about returns on their investment rather than its capital appreciation. Since dividends are declared on paid-up value of shares, they do not reflect the actual rate of earning if the shares are purchased at market price, which is generally different from paid-up value. This ratio removes this ambiguity by relating the dividends to the market value of shares.

INTRODUCTION	Accounting is an information system and attempts to communicate information in the form of reports, statements, charts and graphs to help the management in taking appropriate decisions. Management needs information for arriving at decisions and for evaluating performance to run the business effectively. The required information can be made available to the management by means of reports. Reports can be defined as means of communication, usually in the written form, of facts which should be brought to the attention of the various levels of management who can use them to take suitable action for proper control. For proper control the reports have to be prepared and presented in proper manner. A systematic reporting system should be adopted for smooth flow of business.
IMPORTANCE OF REPORTING	1. <u>PROVIDES INFORMATION</u>: The very purpose of preparing a report is providing information to various levels of management. The term management includes Foreman, Chairman, Department Manager, General Manager and Special Officer. These people are getting information like trend of the business, cash flow and fund flow etc. 2. <u>HELPS IN SELECTION</u>: Out of the many information available, only relevant information is included in the report. A report brings many alternatives out of which a management has to choose one profitable alternative. 3. <u>ROLE IN CONTROL SYSTEM</u>: A target is fixed well in advance in an organization. The management has to see whether the employees are working according to the targets and standards. The reports are prepared in such a way as to measure the actual performance with the budgeted targets. If there are any unfavorable variances, the reasons are find out and remedial or corrective actions are taken by the management. In this way, a report is used as a control tool. A management can control with the help of this tool. 4. <u>HELPFUL IN PROFITABLE OPERATIONS</u>: A report highlights the direction of moving the business and the level of operation. On the basis of this type of report, a management can give clear cut instructions as how to increase the profitability to its employees. 5. <u>FOLLOW THE PRINCIPLE OF MANAGEMENT BY EXCEPTION</u>: A management has only a minimum time to exercise control. Hence, the activities, which are not carried out according to planning and budget, are highlighted before the management. This is the way of following the principle of management by exception. 6. <u>HELPFUL IN ACHIEVING OVERALL OBJECTIVES</u>: Report motivates the executives and employees to take necessary steps towards increasing the earnings of the organization significantly. In this way, the management is achieving the maximum profit with the help of reporting system.
LEVEL OF MANAGEMENT &	The fundamental principle of a system of reporting is that the information contained in the report should ***meet the requirements of***

REPORTING	***the recipient*** of the report. Reports are prepared for each executive from the bottom to the highest level of management keeping in view his status and responsibility in the organization so that he may be able to get timely information about the performance of persons working under him. In any organization, there are three distinct levels of managements First line managements, Middle management and Top management. The information to be presented and the method of reporting should meet the specific requirement of the selevels of managements. The three Guiding Principles to be followed are : 1) Lower the level of management, more detailed should be the report; higher the level of management, more summarized should be the report. 2) Lower the level of management, more frequent should be the period of reporting; higher the level of management, less frequent should be the period of reporting. Middle management requires more detailed reporting and a great frequency in reporting as compared to the top management because the former is concerned with day to day operations of the concerned requiring timely action for making improvements. 3) Lower the level of Management less should be number of reports; higher the level of management,l arge should be the number report. The Board of Directors will receive a large number of reports because the control every function in the organization. Person included in middle management and lower management will receive only those reports which relate to their departments.
MEANING OF MANAGEMENT REPORTING	A Management Reporting system is essentially a mechanism for monitoring the '***mission***' of an organization in terms of objectives set out in formal plan evolved by the organization. To the extent that the formal plan is imprecise or inadequate, failing to take into account the actuality of the real life situation, the de facto points of decision-making, and the personnel, the monitoring system becomes open ended and ineffective. Designers of the reporting system must, therefore, take into account the impact on it of such constraints. A good management reporting system will not make a company successful. It is the people in the organization, not the system, that make for corporate success. Yet, lacking a proper management reporting system, management at various levels will have no way of registering their accomplishments in relation to targets, or of taking remedial action.
NEED OF MANAGEMENT	Inefficient reporting processes that yield inaccurate and out dated

REPORTING	information normally cause more harm than good. Strong management reporting is a necessity to produce timely, reliable information, in order to make ***high quality business decisions*** about the future of your company. Insight gathered from reporting allows for ***deeper analysis*** to understand problems, provide ***accurate comparisons*** against competitors and ***implement controls*** to hold employees accountable for budgets. Effective processes ***uncover material financial misstatements*** prior to circulating information with investors and other stakeholders, and identify and address problem areas before they elevate to unmanageable levels. Without management reporting, employees may know there is a problem, but are unable to identify its origin. Reporting ***identifies the problem's source***, so you can begin working toward a solution. It also allows you to understand your current financial position compared to competitors, in order to focus or realign business strategies to improve specific operating activities. Often, businesses attempt to develop reporting processes, but miss the mark in achieving desired results. Common challenges include: • Selecting and correctly using the right system to develop and deliver reports. • Manipulating data in order to display the best metrics to make better business decisions and understand the company's current position. • Implementing an inefficient accounting close process that does not allow for timely report delivery to stakeholders. • Ensuring the integrity of the data. • Adopting management reporting processes at the incorrect stakeholder levels throughout the organization.
ESSENTIAL COMPONENTS TO MANAGEMENT REPORTING	A successful management reporting process contains several key elements. Your program should begin with ***accurate, healthy data and metrics*** to support core business strategies and initiatives to specific stakeholders. Data should support both the ***long- and short-term vision*** for the company, and should be ***trustworthy*** and from a ***reliable source***. For example, failing to remove data for a discontinued product will negatively skew the remaining pool of data and your ultimate reporting information. Developing a Successful Management Reporting Program As with any key process, executive buy-in and vision are required upfront, in order to effectively implement and change management reporting in an organization. After that has been attained, you can begin taking steps toward implementing an effective management

	reporting program. These include: DISCOVERY: Identify and involve stakeholders early on, and effectively communicate the vision across the organization and to the appropriate stakeholders. Identify and access the *data sources available* to meet your specific data needs. ANALYSIS: Understand the level of effort involved in creating each report. *Develop data definitions* to ensure everyone interprets the data the same way. Keep the data tight and prioritize your information, in order to keep from overwhelming the data recipient, and further encouraging quick decision-making abilities. REPORT CREATION AND DELIVERY: Create the reports and determine the *appropriate delivery method* of the data. Reports should be *concise and comprehensive*, but not overwhelming. Pay close attention to formatting and reporting, considering the specific needs of your users. IMPLEMENTATION: Develop each report separately, and establish a governance process and policies to ensure data health across the organization. *Define access control requirements*, detailing who should have rights to access information. Minimize work by leveraging implemented software to create repeatable processes and automate report jobs for predetermined times throughout the month. ACCESS POINT: Create a common place for users to access data, such as a Web portal or SharePoint site. FEEDBACK: Collect comments and suggestions from users to discover ways to continuously improve the data and process. IN-HOUSE IT CAPABILITIES: Ensure that in-house Information Technology (IT) personnel can manage necessary systems and issues if they arise.
GENERAL PRINCIPLES OF REPORT PRESENTATION	The basic principles to be kept in mind while preparing and submitting the report are as follows: 1) The report should have a ***proper title*** to describe the subject matter reported. The report should be in good form and should have subheadings and paragraph divisions. The name of recipient of the report should be written on the top of report. 2) The report should relate to ***certain period*** and the period of time should be indicated on the top of report. 3) The report should ***factual***. 4) The report should be ***brief and concise*** but clear. 5) The report should be ***prompt*** because information delayed is information denied. 6) A report should ***distinguish*** between controllable and non-controllable factors and should report them separately. It is because management can take suitable actions regarding controllable factors.

	7) Appropriate ***remarks*** should be given in the report. It saves valuable time of the management and ensures prompt attention. 8) A report should be ***periodically reviewed***. 9) The report must be ***correct*** within the permissible degree of inaccuracy. The margin of error allowed will depend upon the purpose for which the report is prepared. 10) The report should ***draw manager's attention*** immediately to ***exceptional matters*** so that management by exception may be carried out effectively. 11) ***Visual reporting*** through graphs, charts and diagrams should be preferred to descriptive reports because visual reporting attractive the eye more quickly and leaves the last impressions on the mind. 12) Whenever we are doing comparisons in the report, it should be ensured that there should be comparisons between the same matters. 13) ***Detailed analysis*** should be given for all the result so that there can be comparison between actual and budgeted. 14) The ***format*** of report should ***not be changed*** from period to period.
FORMS OF PRESENTATION OF INFORMATION	Information may be presented in the following forms: 1) **VERBAL (OR ORAL):** group meetings, seminars, conferences, or interviews may be organized where employees at various levels meet to discuss and exchange their ideas. 2) WRITTEN: this is the most usual form of reporting and the information takes the form of written report.
CLASSIFICATION OF REPORT	
FORMS OF REPORTING	1. DESCRIPTIVE REPORTING: These types of reports are written out in a descriptive style. These reports usually *do not take the help of tables and graphs*. They may include tables and graphs in order to lay emphasis on some of the points discussed. The language used is very important in such reports. The language should be simple and correct and may convey the idea of the reporter to the management. The report should have *suitable heading* and it should be *suitably paragraphed*. The main report should be summarized, so that the recipient of the report should be able to know the exceptional matters, and the recommendation of the reports without going into the details of the report.

	2. <u>TABULAR REPORTS</u>: Such reports are presented in the form of comparative statements. This form of reporting is applied in case of *<u>periodical reports covering production, costs, sales and finance</u>*. These reports should use same standard form of statements or tables from period to period so that proper comparison may be made between the present and past performance. 3. <u>GRAPHIC PRESENTATION</u>: It is very important method of presenting information to the management in a *<u>pictorial manner</u>* and attracts the eye of the recipient more quickly and forcibly. Recently graphs and diagram are becoming very popular because they make comparisons over fairly long periods within a short space. This method of presenting information can effectively depict production costs, fluctuations in input and output, position & movement of stocks, variances, components of cost of production.
FREQUENCY OF REPORTING – ROUTINE REPORTS	Routine reports are rendered at periodic intervals. The intervals at which routine reports are to be presented should be fixed for each report. Production reports should be rendered at shorter intervals because delayed reporting on production may lead to a continuing loss for a longer period. Thus, an effort should be made to take note of production losses as earlier as possible so that earlier corrective action may be taken to eliminate the losses.
SPECIAL REPORTS	Special reports are to be presented after making and investigation of the problem which requires to be investigated. The following matters may covered by special reports before presenting to the management: 1. The effect of idle capacity on cost of production of different products. 2. Make or buy decision. 3. Whether to replace labour by machinery or not. 4. Whether to explore the new market at a selling price which is below cost of production. 5. Whether to continue the selling of the product at a very low rate during depression. 6. Cost reduction schemes. 7. The most suitable method of raising funds. 8. The most suitable method of investing surplus cash. 9. Whether to purchase or hire fixed assets. 10. Research and development expenditure problems. 11. The effect of labour disputes on production and cost of production. 12. The effect of a high rate of labour turnover. 13. Price fixation problems. 14. The effect of providing a particular to facilities to workers. 15. Feasibility study for a project. 16. Report on new taxation policy and its effect on company's profits. 17. Report on important development in the industry. 18. Report on general economic forecast. 19. Report on whether to operate a casting system or not. 20. Report on company's financial position and profitability. 21. Report on effect on change in governments policy

CHAPTER 18: DECISION MAKING TOOLS

Marginal costing is not a distinct method of costing like job costing, process costing, operating costing, etc., but a special technique used for managerial decision making. Marginal costing is used to provide a basis for the interpretation of cost data to measure the profitability of different products, processes and cost centre in the course of decision making. It can, therefore, be used in conjunction with the different methods of costing such as job costing, process costing, etc., or even with other techniques such as standard costing or budgetary control.

In marginal costing, cost ascertainment is made on the basis of the nature of cost. It gives consideration to behaviour of costs. In other words, the technique has developed from a particular conception and expression of the nature and behaviour of costs and their effect upon the profitability of an undertaking.

THEORY OF MARGINAL COSTING

The theory of marginal costing is that in relation to a given volume of output, additional output can normally be obtained at less than proportionate cost because within limits the aggregate of certain items of cost will tend to remain fixed and only the aggregate of the remainder will tend to rise proportionately with increase in output. Conversely, a decrease in the volume of output will normally be accompanied by a less than proportionate fall in the aggregate cost.

MARGINAL COSTING	The ascertainment of marginal cost and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs.
MARGINAL COST	The amount at any given volume of output by which aggregate variable costs are changed if the volume of output is increased by one unit. In practice this is measured by the total variable cost attributable to one unit. **Marginal cost can precisely be the sum of prime cost and variable overhead.**
DIRECT COSTING	Direct costing is the practice of charging all direct cost to operations, processes or products, leaving all indirect costs to be written off against profits in the period in which they arise. Under direct costing the stocks are valued at direct costs, i.e., costs whether fixed or variable which can be directly attributable to the cost units.
CONTRIBUTION	**Contribution is the difference between sales value and the marginal cost.** It is obtained by subtracting marginal cost from sales revenue of a given activity. It can also be defined as excess of sales revenue over the variable cost. The difference between sales revenue and marginal/variable cost is considered to be the contribution towards fixed expenses and profit of the entire business. The contribution concept is based on the theory that the profit and fixed expenses of a business is a 'joint cost' which cannot be equitably apportioned to different segments of the business. In view of this difficulty the contribution serves as a measure of efficiency of operations of various segments of the business. ***Contribution = Sales – Variable Cost*** ***Sales = Contribution + Variable Cost***
DIFFERENTIAL COST	It may be defined as "the increase or decrease in total cost or the change in specific elements of cost that result from any variation in

	operations". It represents an increase or decrease in total cost resulting out of: (a) producing or distributing a few more or few less of the products; (b) a change in the method of production or of distribution; (c) an addition or deletion of a product or a territory; and (d) selection of an additional sales channel. Differential cost, thus includes fixed and semi-variable expenses. **It is the difference between the total costs of two alternatives.** It is an adhoc cost determined for the purpose of choosing between competing alternatives, each with its own combination of income and costs.
INCREMENTAL COST	It is defined as, "the additional costs of a change in the level or nature of activity". As such for all practical purposes there is no difference between incremental cost and differential cost. However, from a conceptual point of view, differential cost refers to both incremental as well as decremental cost. Incremental cost and differential cost calculated from the same data will be the same. In practice, therefore, generally no distinction is made between differential cost and incremental cost. One aspect which is worthy to note is that incremental cost is not the same at all levels. Incremental cost between 50% and 60% level of output may be different from that which is arrived at between 80% and 90% level of output. Differential cost or incremental cost analysis deals with both short-term and long-term problems. This analysis is more useful when various alternatives or various capacity levels are being considered.
KEY FACTOR	**Key factor or Limiting factor** is a factor which at a particular time or over a period limits the activities of an undertaking. It may be the level of demand for the products or services or it may be the shortage of one or more of the productive resources, e.g., Labour hours, available plant capacity, raw material's availability etc. Examples of Key Factors or Limiting Factors are: (a) Shortage of raw material. (b) Shortage of Labour. (c) Plant capacity available. (d) Sales capacity available. (e) Cash availability.

ABSORPTION COSTING	MARGINAL COSTING
Profit is the difference between sales and COGS	Profit in marginal costing is ascertained by establishing the total contribution and then deducting there from the total fixed expenses. Contribution is the excess of sales over variable cost.
Costs are seldom classified into variable and fixed. Although such a classification is possible, it fails to establish a cost volume profit relationship.	Cost volume profit relationship is an integral part of marginal costing studies. Cost have to be classified into fixed cost and variable costs.
Fixed production overheads are charged to the product to be subsequently released as a part of goods sold i.e. it is	Fixed production cost are regarded as period cost and are charged to revenue along with the selling and administration expenses i.e

included in cost per unit.	they are not included while computing cost per unit.

ASCERTAINMENT OF MARGINAL COST

Under marginal costing, fixed expenses are treated as period costs and are therefore, charged to profit and loss account. In order to ascertain the marginal cost, we classify the expenses as under:

1. **Variable expenses:** Apart from prime costs which are variable, the overhead expenses that change in proportion to the change in the level of activity are also variable expenses. Thus when expenses go up or come down in proportion to a change in the volume of output, such that, with every increase of 20% in output, expenses also go up by 20% or vice versa, these expenses are known as variable expenses. Variable expenses fluctuate in total with fluctuations in the level of output but tend to remain constant per unit of output. Examples of such expenses are raw material, power, commission paid to salesmen as a percentage of sales, etc.

2. **Fixed expenses:** Fixed expenses or constant expenses are those which do not vary in total with the change in volume of output for a given period of time. Fixed cost per unit of output will, however, fluctuate with changes in the level of production. Examples of such expenses are managerial remuneration, rent, taxes, etc. There may, however, be different levels of fixed costs at different levels of output, as for example, where after certain level of output extra expenditure may be needed. In the case of introduction of additional shift working, fixed expenses will be incurred, say, for the appointment of additional supervisors. **Fixed expenses are treated as period costs and are therefore charged to profit and loss account**.

3. **Semi-variable expenses:** These expenses (also known as semi-fixed expenses) do not change within the limits of a small range of activity but may change when the output reaches a new level in the same direction in which the output changes. Such increases or decreases in expenses are not in proportion to output. An example of such an expense is delivery van expense. Semi-variable expenses may remain constant at 50% to 60% level of activity and may increase in total from 60% to 70% level of activity. These expenses can be segregated into fixed and variable by using any one of the method, as given under next heading. Depreciation of plant and machinery depends partly on efflux of time and partly on wear and tear. The former is fixed and the latter is variable. The total cost is arrived at by merging these three type of expenses.

Behaviour of Cost:

1. **Total Fixed Cost remains Constant**
2. **Fixed Cost per unit decreases with increase in Output**
3. **Total Variable Cost varies in direct proportion with output**
4. **Variable Cost per unit remain Constant**

ADVANTAGES OF MARGINAL COSTING

1. The marginal cost remains constant per unit of output whereas the fixed cost remains constant in total. Since marginal cost per unit is constant from period to period within a short span of time, firm decisions on pricing policy can be taken. If fixed cost is included,

the unit cost will change from day to day depending upon the volume of output. This will make decision making task difficult.

2. Overheads are recovered in costing on the basis of pre-determined rates. If fixed overheads are included on the basis of pre-determined rates, there will be under- recovery of overheads if production is less or if overheads are more. There will be over- recovery of overheads if production is more than the budget or actual expenses are less than the estimate. This creates the problem of treatment of such under or over-recovery of overheads. Marginal costing avoids such under or over recovery of overheads.

3. Advocates of marginal costing argues that under the marginal costing technique, the stock of finished goods and work-in-progress are carried on marginal cost basis and the fixed expenses are written off to profit and loss account as period cost. This shows the true profit of the period.

4. Marginal costing helps in the preparation of break-even analysis which shows the effect of increasing or decreasing production activity on the profitability of the company.

5. Segregation of expenses as fixed and variable helps the management to exercise control over expenditure. The management can compare the actual variable expenses with the budgeted variable expenses and take corrective action through analysis of variances.

6. Marginal costing helps the management in taking a number of business decisions like make or buy, discontinuance of a particular product, replacement of machines, etc.

LIMITATIONS OF MARGINAL COSTING

1. It is difficult to classify exactly the expenses into fixed and variable category. Most of the expenses are neither totally variable nor wholly fixed. For example, various amenities provided to workers may have no relation either to volume of production or time factor.

2. Contribution of a product itself is not a guide for optimum profitability unless it is linked with the key factor.

3. Sales staff may mistake marginal cost for total cost and sell at a price; which will result in loss or low profits. Hence, sales staff should be cautioned while giving marginal cost.

4. Overheads of fixed nature cannot altogether be excluded particularly in large contracts, while valuing the work-in- progress. In order to show the correct position fixed overheads have to be included in work-in-progress.

5. Some of the assumptions regarding the behaviour of various costs are not necessarily true in a realistic situation. For example, the assumption that fixed cost will remain static throughout is not correct. Fixed cost may change from one period to another. For example salaries bill may go up because of annual increments or due to change in pay rate etc. The variable costs do not remain constant per unit of output. There may be changes in the prices of raw materials, wage rates etc. after a certain level of output has been reached due to shortage of material, shortage of skilled labour, concessions of bulk purchases etc.

6. Marginal costing ignores time factor and investment. For example, the marginal cost of two jobs may be the same but the time taken for their completion and the cost of machines used may differ. The true cost of a job which takes longer time and uses costlier machine would be higher. This fact is not disclosed by marginal costing.

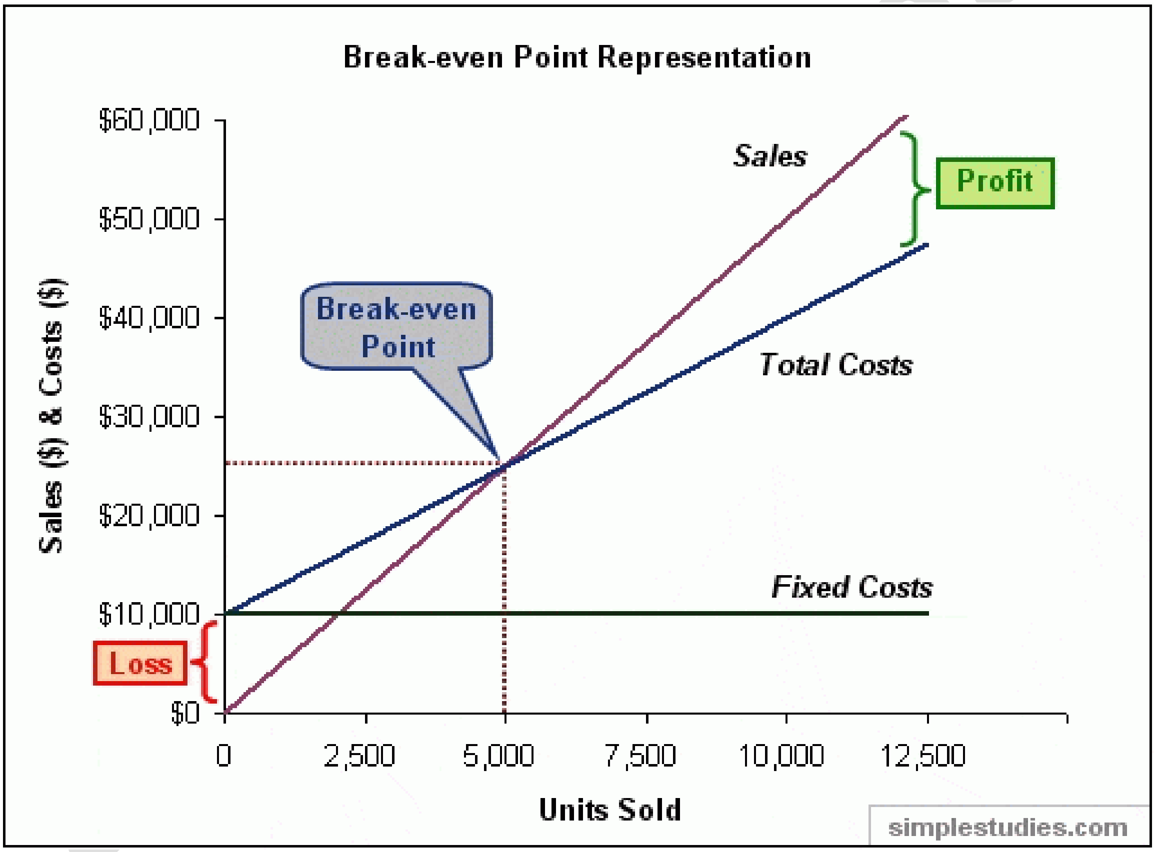
MARGINAL COST EQUATION

The contribution theory explains the relationship between the variable cost and selling price. It tells us that selling price minus variable cost of the units sold is the contribution towards fixed expenses and profit. If the contribution is equal to fixed expenses, there will be no profit or loss and if it is less than fixed expenses, loss is incurred. Since the variable cost varies in direct proportion to output, therefore if the firm does not produce any unit, the loss will be there to the extent of fixed expenses. These points can be described with the help of following marginal cost equation:

S × U – V × U = F + P

Where,
S = Selling price per unit
V = Variable cost per unit
U = Units
F = Fixed expenses
P = Profit

COST-VOLUME-PROFIT ANALYSIS



As the name suggests, cost volume profit (CVP) analysis is the analysis of three variables cost, volume and profit. Such an analysis explores the relationship between costs, revenue, activity levels and the resulting profit. It aims at measuring variations in cost and volume.

CVP analysis is based on the following assumptions:

1. Changes in the levels of revenues and costs arise only because of changes in the number of product (or service) units produced and old – for example, the number of television sets produced and sold by Sony Corporation or the number of packages delivered by Overnight Express. The number of output units is the only revenue driver

and the only cost driver. Just as a cost driver is any factor that affects costs, a revenue driver is a variable, such as volume, that causally affects revenues.

2. Total costs can be separated into two components; a fixed component that does not vary with output level and a variable component that changes with respect to output level. Furthermore, variable costs include both direct variable costs and indirect variable costs of a product. Similarly, fixed costs include both direct fixed costs and indirect fixed costs of a product

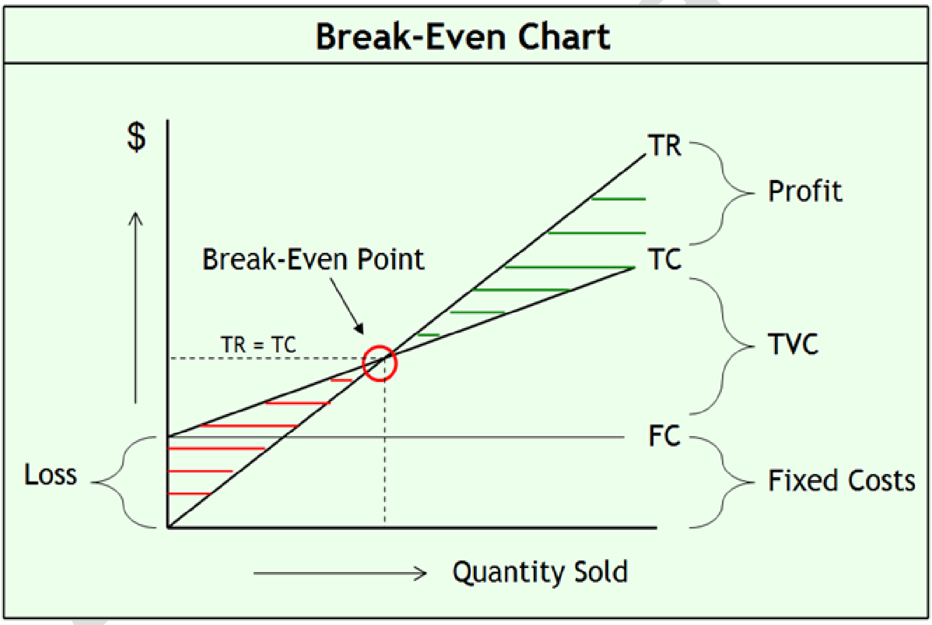
3. When represented graphically, the behaviours of total revenues and total costs are linear meaning they can be represented as a straight line) in relation to output level within a relevant range (and time period).

4. Selling price, variable cost per unit, and total fixed costs (within a relevant range and time period) are known and constant.

5. The analysis either covers a single product or assumes that the proportion of different products when multiple products are sold will remain constant as the level of total units sold changes

6. All revenues and costs can be added, subtracted, and compared without taking into account the time value of money. (Refer to the FM study material for a clear understanding of time value of money).

THE BREAKEVEN POINT:



The word contribution has been given its name because of the fact that it literally contributes towards the recovery of fixed costs and the making of profits. The contribution grows along with the sales revenue till the time it just covers the fixed cost. This point where neither profits nor losses have been made is known as a break-even point. This implies that in order to break even the amount of contribution generated should be exactly equal to the fixed costs incurred. Hence, if we know how much contribution is generated from each unit sold we shall have sufficient information for computing the number of units to be sold in order to break even.

MARGIN OF SAFETY

The margin of safety can be defined as the difference between the expected level of sale and the breakeven sales. The larger the margin of safety, the higher are the chances of making profits.

Margin of safety = Projected sales – Breakeven sales

The Margin of Safety can also be calculated by identifying the difference between the projected sales and breakeven sales in units multiplied by the contribution per unit. This is possible because, at the breakeven point all the fixed costs are recovered and any further contribution goes into the making of profits.

CONTRIBUTION TO SALES RATIO (PROFIT VOLUME RATIO)

A higher contribution to sales ratio implies that the rate of growth of contribution is faster than that of sales. This is because, once the breakeven point is reached, profits shall grow at a faster rate when compared to a product with a lesser contribution to sales ratio.

Breakeven point in sales=$\frac{Fixed\ Cost}{PV\ Ratio}$

THE LIMITATIONS OF BREAKEVEN ANALYSIS:

The limitations of the practical applicability of breakeven analysis and breakeven charts stem mostly from the assumptions underlying CVP which have been mentioned above. Assumptions like costs behaving in a linear fashion or sales revenue remain constant at different sales levels or the stocks shall remain constant period after period are unrealistic. Similarly, the assumption that the only factor which influences costs is the 'activity level achieved' is erroneous because other factors like inflation also have a bearing on costs.

COST SHEET UNDER MARGINAL COSTING

SALES	
Less: Variable Cost	
CONTRIBUTION	
Less: Fixed Cost	
PROFIT	

ACTIVITY BASED COSTING

Traditional Absorption Costing System:

The traditional absorption system for overheads involves the following procedure:

Step 1: Collection of overhead costs.

Step 2: Classification of overhead costs into fixed and variable for decision making purposes.

Step 3: Allocation of specific costs to particular cost centres.

Step 4: Apportionment of common costs to various cost centres on appropriate basis e. g. rent based on area.

Step 5: Re- apportionment of service cost centre expenses to production cost centres.

Step 6: Computation of overhead recovery rate based on labour hours or machine hours.

Disadvantages: The traditional system outlined above suffers from the following disadvantages:

(a) This method attributes costs to cost centres. However, costs are influenced by a particular factor called cost driver. They are not influenced by cost centres. Even within a cost centre, different heads of cost items can be influenced by different factors and behave in different ways.
(b) This method seeks to measure the cost per unit of time, instead of cost per unit of the product.
(c) This method uses a denominator that may be defective. These rates assume that products, which take longer time, involve more overheads.
(d) This method does not facilitate easy identification of idle capacity costs or abnormal overhead costs.
ABC or activity based costing system has been devised to overcome the above disadvantages.

ACTIVITY BASED COSTING

Activity based costing (ABC) is a technique which involves identification of cost with each cost driving activity and making it as the basis for apportionment/assignment of costs over different cost objects/jobs/products/customers/services.

Features of Activity Based Costing

- Activity – based costing (ABC) is a two – stage product costing method that first assigns costs to activities and then allocates them to products based on each product's consumption of activities.
- The cost pools in the two – stage approach now accumulate activity – related costs.
- An activity is any discrete task that an organization undertakes to make or deliver a product or service.
- Activity – based costing is based on the concept that products consume activities and activities consume resources.
- Activity – based costing can be used by any organization that wants a better understanding of the costs of the goods and services it provides, including manufacturing, service, and even non-profit organizations.

Classification of Activities

1. Unit Level: This type of activity must be done for each unit of production. The machine – related activity cost pool represents a unit – level activity since every product unit requires machine time.

2. Batch Level: These activities must be performed for each batch of products, rather than each unit. Batch – level activities include the set up, purchasing, material handling, quality assurance, and packing/shipping activity cost pools.

3. Product Sustaining Level: This category includes activities that are needed to support an entire product line but are not performed every time a new unit or batch of products is produced. Engineering design costs as a product – sustaining – level activity cost pool

4. Facility (or general operations) Level: Facility – level activities are required in order for the entire production process to occur: Examples of such activity costs include plant management salaries, plant depreciation, property taxes, plant maintenance, and insurance.

This classification of activities into unit – level, batch – level, product – sustaining – level, and facility – level activities is called a cost hierarchy.

Terminology of Activity Based Costing

(1) Cost Object: It is an item for which cost measurement is required e. g. Product, job or a customer.

(2) Cost Pool: Costs are grouped into pools according to the activities, which drive them. In this all costs associated with procurement i. e. ordering, inspection, storing etc. would be included in this cost pool and cost driver identified.

(3) Cost Driver: In an ABC system, the allocation bases that are used for applying costs to services or procedures are called cost drivers. It is a factor that causes a change in the cost of an activity.

(a) Resource Cost Driver: It is a measure of the quantity of resources consumed by an activity. It is used to assign the cost of a resource to an activity or cost pool.

(b) Activity Cost Driver: It is a measure of the frequency and intensity of demand placed on activities by cost objects. It is used to assign activity costs to cost objects.

Examples of cost drivers: (Very Important)

Function	Cost drivers
Research & development	No. of research projects Personnel hours on a project Technical complexities of projects
Customer service	No. of service calls No. of products received Hours spent on servicing products
Design of products, service & processes	No. of products in design No. of parts per product No. of engineering hours
Marketing	No. of advertisements/insertions No. of sales personnel Sales revenue
Distribution	No. of items distributed No. of customers Weight of items distributed

(4) Unit Level Cost: Traditionally, cost drivers were viewed only at the unit level. These drivers create unit – level costs meaning that they are caused by the production or acquisition of a single unit of product or the delivery of a single unit or service.

For any given product, unit – level costs change in a more – or – less linear fashion with the number of units produced. For example, fabric and thread are unit – level costs for an apparel manufacturer: if the company wants to double production, it will need twice as much fabric and thread.

(5) Batch Level Cost: Costs that are caused by a group of things being made, handled or processed at a single time are referred to as batch level costs.
These costs change in a more – or – less linear fashion with the number of batches run. Machine set up costs are often batch – level costs. The time required to prepare a machine to run one batch of product is usually independent of the number of units in the batch: the same time is required to prepare the machine to run a batch of 100 units as a batch of 50 units. Hence, batch – level costs do not necessarily vary in a linear fashion with the number of unit produced.

Other Examples: Tasks such as placing purchase orders, setting up equipment, and arranging for shipments to customers are batch – level activities.

(6) Product Level Cost: A cost caused by the development, production or acquisition of different items is called a product level or process level cost. These include engineering change orders, equipment maintenance, product development and scrap, if related to product design.

These costs are usually fixed and direct with respect to a given product. An example is the salary of a product manager with responsibility for only one product. The product manager's salary is a fixed cost to the company for a wide range of production volume levels. However, if the company drops the product entirely, the product manager is no longer needed.

Other Examples: designing a product, advertising a product, and maintaining a product manger and staff are all product – level activities.

(7) Facility Level Cost: Some costs cannot be related to a particular product line. These are instead related to providing a facility. For example cost of maintaining a building or plant security or advertisement promoting the organization. Facility level costs cannot be traced to individual products or services but support the organization as a whole.
These costs are usually fixed and direct with respect to the facility. An example is property taxes on the facility, or the salaries of front office personnel such as the receptionist and office manager.
Some of the examples of facility level costs are: Managing factory, heating factory, providing factory safety and security, maintaining general – purpose equipment, cleaning executive offices, arranging for loans, closing books each month, preparing annual reports to shareholders, providing a computer network, etc.

(8) Product Sustaining Costs: These are costs of activities undertaken to support individual products regardless of the number of units or batches in which the units are produced.

(9) Service Sustaining Costs: These are costs of activities undertaken to support individual services.

(10) Organizational Level Cost: Certain costs are incurred at organizational level for the single purpose of supporting continuing facility operations. These organizational level costs common to many different activities and products and services can be prorated among services and products on an arbitrary basis only. These costs are not product related, thus they should be subtracted from net product revenues instead of an arbitrary and illogical apportionment.

Steps involved in Activity Based Costing

The various steps involved in computation of ABC Absorption rates are:

Step 1: Identify the various activities within the organization.

Step 2: Relate the overheads to the activities using resource cost drivers.

Step 3: Apportion the costs of support activities over the primary activities on suitable basis.

Steps 4: Determine the activity cost drivers for each activity/cost pool. Activity cost driver rates are computed for each activity, just like overhead absorption rates.

Activity Cost Driver Rate = Total Cost of Activity / Activity Cost Driver

Step 5: The rates will be multiplied by the different amounts of each activity that each product/other cost object to ascertain its cost.

Cost = Resources Consumed * Activity Cost Driver Rate

Benefits of Activity Based Costing

The purposes and benefits of ABC are:

(1) To link the cost to its causal factor i. e. the cost driver.

(2) To identify costs of activities rather than cost Centres.

(3) To ascertain product costs with greater accuracy by relating overheads to activities.

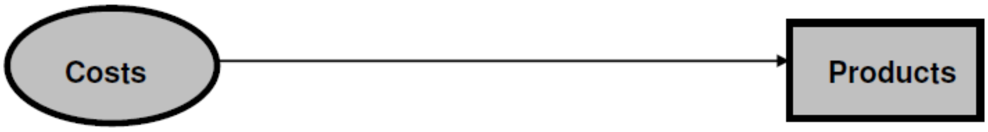
(4) To overcome the inherent limitations of traditional absorption costing and use of blanket overhead rates.

Distinction between: Traditional Absorption Costing & Activity Based Costing

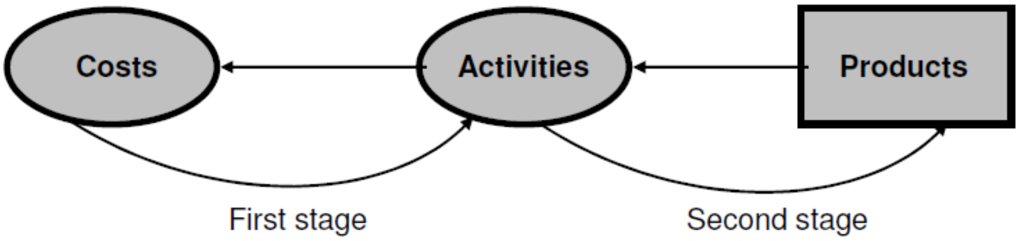
Points	Traditional absorption costing	Activity based costing
Meaning	Absorption costing can be defined as a managerial accounting cost method of expensing all costs related to manufacturing of a specific product, which involves the use of total direct costs and overhead costs related to the manufacturing of a product as the cost base.	Activity based costing (ABC) is a technique which involves identification of cost with each cost driving activity and making it as the basis for apportionment/assignment of costs over different cost objects/jobs/products/customers/services.
Relation of overheads	Overheads are first related to departments/cost centres production and service cost centres.	Overhead are first related to activities or grouped into cost pools.
Activities	Only two types of activities viz. unit level activities and facility level activities are identified.	All levels of activities in the manufacturing cost hierarchy viz. unit level, batch level, product level and facility level are identified.

Realistic	This method relates overheads to cost centres i. e. locations. It is not realistic of the behaviour of costs.	This method relates overheads to the casual factor i. e. cost driver. Thus, it is more realistic of cost behavior.
Used	Overhead rates can be used to ascertain cost of products only.	Activity cost driver rates can be used to ascertain cost of products and also cost of other cost objects such as customers/customer segments, distribution, channels etc.

- **Traditional allocation method**



- **Activity-based allocation method**



ABC in the Service Sector:

ABC is as important to companies in the merchandising and service sectors as to manufacturing companies. In fact, although the origination of ABC is generally ascribed to manufacturing companies in the 1980s, by then hospitals were already allocating overhead costs to departments and then to patient services using methods similar to ABC. Hospitals were required to implement relatively sophisticated allocation processes in order to comply with Medicare reimbursement rules. After its inception in the 1960s, Medicare established details rules regarding how overhead costs should be grouped into cost pools, and the choice of appropriate allocation bases for allocating overhead costs to departments and then to patients. Within these rules, hospitals were able to maximize revenues by shifting costs from areas such as paediatrics, labour and delivery, and maternity (which have low rates of Medicare utilization) to the intensive care unit, the critical care unit, and surgery (which have higher rates of Medicare utilization). Other non – manufacturing industries that have benefited from ABC include financial services firms and retailers.

Uses of Activity Based Costing

The areas in which activity based information is used for decision making are as under:

Activity Costs: ABC is designed to track the cost of activities, so we can use it to see if activity costs are in line with industry standards. If not, ABC is an excellent feedback tool for measuring the ongoing cost of specific services as management focuses on cost reduction.

Customer Profitability: Though most of the costs incurred for individual customers are simply product costs, there is also an overhead component, such as usually high customer service levels, product return handling, and cooperative marketing agreements. An ABC system can sort through these additional overhead costs and determine which customers are actually providing a reasonable profit. This analysis may result in some unprofitable customers being turned away, or more emphasis being placed on those customers who are contributing more in profits.

Distribution Cost: Organization uses a variety of distribution channels to sell its products, such as retail, internet, distributors, and mail order catalogues. Most of the structural cost of maintaining a distribution channel is overhead, so if we can make a reasonable determination of which distribution channels are using overhead, we can make decisions to alter how distribution channels are used, or even to drop unprofitable channels.

Make or Buy: ABC enables the manager to decide whether he should get the activity done within the firm or outsource the same. Outsourcing may be done if the firm is incurring higher overhead costs as compared to the outsourcer or vice – versa.
Margins: With proper overhead allocation from an ABC system, we can determine the margins of various products, product lines, and entire subsidiaries. This can be quite useful for determining where to position company resources to earn the largest margins.

Minimum Price: Product pricing is really based on the price that the market will bear, but the marketing manager should know what the cost of the product is, in order to avoid selling a product that will lose a company money on every sale. ABC is very good for determining which overhead costs should be included in this minimum cost, depending upon the circumstances under which products are being sold.

Production Facility Cost: It is usually quite easy to segregate overhead costs at the plant – wide level, so we can compare the costs of production between different facilities.

Limitations of Activity Based Costing

Activity based costing help managers in decision making. However activity based costing has certain limitations or disadvantages which are as under:

- Implementing an ABC system requires substantial resources, which is costly to maintain.
- Activity Based Costing is a complex system which need lot of record for calculations.
- In small organization managers are accustomed to use traditional costing systems to run their operations and traditional costing systems are often used in performance evaluations.
- Activity based costing data can be easily misinterpreted and must be used with care when used in decision making. Managers must identify which costs are really relevant for the decisions at hand.
- Reports generated by this system do not conform to generally accepted accounting principles (GAAP). Consequently, an organization involved in activity based costing should have two cost systems – one for internal use and one for preparing external reports.

<table>
<tr><td>NEED FOR VALUATION OF SHARES</td><td>
• Formulation of Schemes of Amalgamations, Absorption, Merger, Demerger, etc.
• Acquisition of dissenting shareholders under a scheme of reconstruction
• Advancing a Loan against securities of a company
• Assessments under Income Tax Act
• Conversion of Shares/Debentures/Bonds
• Compensating shareholders on the acquisition of their shares by the government under a scheme of rationalization.
• Purchase of shares by employees (ESOPs)

If the Shares are Listed, then the market price of the stock exchange is normally the acceptable value of the share. However, if the shares are unlisted, then valuation of share by a Valuer is necessary to settle the transactions:
When Valuation is Necessary:
✓ When Shares are unlisted.
✓ Shares relate to Private Limited Company
✓ Court directs valuation by an Expert
✓ Applicable Law requires Valuation Like Income Tax Act
</td></tr>
<tr><td>CONCEPT OF VALUATION</td><td>
Valuation means measurement of value in monetary term. The subjects of valuation are varied as stated below:
♦ Valuation of Tangible Fixed Assets
♦ Valuation of Intangibles including brand valuation and valuation of goodwill
♦ Valuation of Shares
♦ Valuation of Business
</td></tr>
<tr><td>APPROACHES OF VALUATION</td><td>
Three General Approaches to Valuation are as follows:
1) Cost Approach: e.g. Adjusted Book Value
2) Market Approach: e.g. Comparable
3) Income Approach: e.g. Discounted Cash Flow
</td></tr>
<tr><td>NEED FOR VALUATION OF GOODWILL</td><td>
In the case of partnership, the necessity of valuing goodwill arises in connection with the following:
1. When there is a change in the profit-sharing ratio among the partners;
2. When a new partner is admitted;
3. When a partner retires or dies; and
4. When the firm sells its business to a company or is amalgamated with another firm.
</td></tr>
<tr><td>FACTORS AFFECTING GOODWILL VALUATION</td><td>
(a) Nature of the industry, its history and the risks to which it is subject;
(b) Prospects of the industry in the future;
(c) The company's history - its past performance and its record of past profits and dividends;
(d) The basis of valuation of assets of the company and their value;
(e) The ratio of liabilities to capital;
(f) The nature of management and the chance for its continuation;
(g) Capital structure or gearing;
(h) Size, location and reputation of the company's products;
</td></tr>
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	(i) The incidence of taxation; (j) The number of shareholders; (k) Yield on shares of companies engaged in the same industry, which are listed in the stock-exchanges; (l) Composition of purchasers of the products of the company; and (m) Size of block of shares offered for sale since for large blocks very few buyers would be available and that has a depressing effect on the valuation. Question of control, however, may become important, when large blocks of shares are involved.
VALUATION OF GOODWILL	There are basically two accounting methods for goodwill valuation. **CAPITALISATION METHOD:** Under this method future maintainable profit is capitalized by applying normal rate of return to arrive at the normal capital employed. Goodwill is taken as the excess of normal capital employed over the actual capital employed. **Normal Capital employed = Future Maintainable Profits/Normal Rate of Return** **Goodwill = Normal Capital Employed – Actual Closing Capital Employed** Factors considered in this method are: (i) Future maintainable profit; (ii) Actual capital employed in the business enterprise for which goodwill is to be computed; (iii) Normal rate of return in the industry to which the business enterprise belongs. Naturally, if normal capital employed becomes less than actual capital employed there arises negative goodwill. **SUPER PROFIT METHOD:** Excess of future maintainable profit over normally expected profit is called super profit. Under this method goodwill is taken as the aggregate super profit future years for which such super profit is expected to be maintained. Factors considered in this method are: (i) Future maintainable profit; (ii) Actual capital employed; (iii) Normal rate of return; (iv) Period for which super profit is projected. **Super profit = Future maintainable profit minus (Actual Capital employed × Normal rate of return)** **Goodwill = Super profit × No. of years for which Super Profit can be maintained** **ANNUITY METHOD:** It is a refinement of the super profit method. Since super profit is expected to arise at different future time periods, it is not logical to simply multiply super profit into number of years for which that super profit is expected to be maintained. Further future values of super

	profits should be discounted using appropriate discount factor. The annuity method got the nomenclature because of suitability to use annuity table in the discounting process of the uniform super profit. In other words, when uniform annual super profit is expected, annuity factor can be used for discounting the future values for converting into the present value. Here in addition to the factors considered in super profit method, appropriate discount rate is to be chosen for discounting the cash flows.
FUTURE MAINTAINABLE PROFIT	We have seen earlier while discussing various methods of goodwill valuation that estimation of average maintainable profit is another important step in goodwill valuation. Future maintainable profit is ascertained taking either simple or weighted average of the past profits or by fitting trend line. Generally, profit of past three to five years are considered. (i) **Simple Average of Past Profits**: If the past profits do not have any definite trend, average is taken to arrive at the future maintainable profit. In this case no trend of past profit is available. So simple average is best suitable method to arrive at a figure which may be taken as future maintainable profit. (ii) **Weighted average of past profits**: If the past profits show increasing or decreasing trend, then more weights are given to the profit figures of the immediate past years and less weight to the profit figures of the furthest past.
ADJUSTMENTS NEEDED WITH PAST PROFITS	Since past profits are used to make an estimation about the future maintainable profit, it is necessary to make appropriate adjustments for better projection. The following adjustments generally become necessary: (i) Elimination of abnormal loss arising out of strikes, lock-out, fire, etc. Profit/loss figures which contain abnormal loss should either be ignored or eliminated. Similarly, if there is any abnormal gain included in past profits, that needs elimination. (ii) Interest/dividend or any other income from non-trading assets needs elimination because capital employed' used for valuation of goodwill comprises only of trading assets. (iii) If there is a change in rate of tax, tax charged at the old rate should be added back and tax should be charged at the new rate. (iv) Effect of change in accounting policies should be neutralized to have profit figures which are arrived at on the basis of uniform policies.
CAPITAL EMPLOYED	✓ The goodwill of a business depends on the amount of capital employed also. The term 'capital employed' for the valuation of goodwill should be calculated from the point of view of shareholders. ✓ Capital employed may be expressed as the aggregate of share capital and reserves less the amount of non-trading assets and fictitious assets. ✓ It can also be ascertained by adding up the present value of trading assets and deducting all liabilities.

	✓ For this purpose, the amount of debentures or loans should also be excluded from capital employed. ✓ Of course any profit or loss on revaluation of assets should be taken into account. ✓ It is considered desirable to use average capital employed in place of 'capital employed' because the capital employed must be such as may fairly represent the capital investment throughout the year. Average capital employed is the average of capital employed at the beginning and that employed at the end of the year. But if the current year's profit is not disturbed during the year itself the average capital employed is to be ascertained by deducting half the profit from capital employed at the end. ✓ This is appropriate for goodwill to be ascertained by reference to current year's profit and current year's capital employed.
NORMAL RATE OF RETURN	Apart from capital employed and future maintainable profit, the third important step in valuation of goodwill is determination of normal rate of return. It comprises of: (i) the risk-free rate, i.e., the pure interest rate prevailing in the concerned economy; (the rate of return on long term government securities or fixed deposit in bank may be taken as risk-free rate) (ii) the premium for business risks appropriate for the industry to which the firm/company belongs. If the industry is well established and yielding profits steadily the rate of return that will satisfy entrepreneurs will be rather low though higher than the risk- free rate. Higher the business risk, higher will be the normal rate of return.
Method 1: NET ASSET BASIS OR INTRINSIC VALUE METHOD	According to this method, value of equity share is determined as follows: =Net Assets available to Equity shareholders/No. of Equity Shares The following important aspects are to be considered while arriving at the net assets available to the equity shareholders: (i) **Value of tangible fixed assets**: Tangible fixed assets like plant, machinery, building, land, furniture, etc. should be taken at their current cost. Current cost implies current entry price, i.e., the price to be paid by the enterprise if it wants to acquire such assets at their present locations and conditions. (ii) **Value of intangibles**: Intangibles like goodwill, patents and know-how should also be taken at their current cost. Inherent goodwill is not shown in the books of accounts. For asset based valuation of share, valuation of goodwill is essential and valuation should be made following any of the methods (depending upon the circumstances) discussed in Unit 3. If purchased goodwill appears in the books of account it should be eliminated and new valuation should be taken into consideration. (iii) **Investments**: Shares and securities which are quoted in the stock exchange and traded on a regular basis, market price of them should be used as current value of investments. For other investments book value may be taken after adjustments for known loss or gain.

(iv) **Inventories**: The stock of finished goods may be taken at the market price. But other stocks like raw material, stores and work-in-progress should be taken at cost following conservative approach. Due allowance should be made for any obsolete, unusable or unmarketable stocks held by the company.

(v) **Sundry Debtors**: Appropriate allowance should be made for bad and doubtful debts.

(vi) **Miscellaneous expenditure and losses**: All fictitious assets appearing under this head should not be taken into consideration.
From the value of assets arrived at as per the criteria discussed above the liabilities are deducted to arrive at net assets.

These liabilities are:
- ♦ All short term and long term liabilities including outstanding and accrued interest;
- ♦ Tax provisions;
- ♦ All liabilities not provided for in the account;
- ♦ All prior period adjustments which would reduce profit of the earlier years net of items which would increase profit;
- ♦ Preference share capital including arrear of dividends and proposed preference dividend.

Method 2: YIELD BASIS

Yield based valuation may take the form of valuation based on rate of return. The rate of return may imply **rate of earning** or **rate of dividend**.

- ⇨ If a block of shares is sufficiently large, so as to warrant virtual control over the company the rate of earning should be the basis;
- ⇨ For small blocks the rate of dividend basis will be appropriate.

Valuation based on Rate of Dividend (DPS):

$$\text{Value of share} = \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}} \times \text{Paid up value per share}$$

OR

$$= \frac{\text{Dividend (in rupees) per share} \times 100}{\text{Normal rate of dividend}}$$

$$\text{Possible rate of dividend} = \frac{\text{Total profit available for dividend} \times 100}{\text{Total paid up equity capital}}$$

Valuation based on Rate of Earning (EPS):

$$\text{Value of share} = \frac{\text{Rate of earning} \times \text{Paid-up value per shar}}{\text{Normal rate of earning}}$$

$$\text{Rate of earning} = \frac{\text{Actual profit earned} \times 100}{\text{Capital employed}}$$

Valuation based on PE Ratio: Suitable in cases where the shares are quoted/listed on a Recognized Stock Exchange.

$$\text{Market value of share} = \text{Price earning ratio} \times \text{Earning per share}$$

$$\text{Earning per share} = \frac{\text{Profit available for equity shareholders}}{\text{Number of equity shares}}$$

$$\text{Price earning ratio} = \frac{\text{Market value per share}}{\text{Earning per share}}$$

Capitalization Factor:

$$\text{Capitalisation factor} = \frac{100}{\text{Normal rate of return}}$$

Stages for yield-based Valuation:
Broadly, the following steps are envisaged in a yield based valuation considering the rate of return:
(i) Determination of future maintainable profit;
(ii) Ascertaining the normal rate of return;
(iii) Finding out the Capitalisation factor or the multiplier;
(iv) Multiplying the future maintainable profit, by the multiplier; and
(v) Dividing the results obtained in (iv) by the number of shares.

Adjustment necessary for the determination of future maintainable profit:
Determination of future maintainable profits, based on past record, is a delicate and complicated task as it involves not only objective consideration of the available financial information but also subjective evaluation of many other factors, such as capabilities of the company's management, general economic conditions, future government policies, etc. Guiding principles can be laid down only in respect of the former and the valuer will have to give due consideration to the other matters according to his reading of the situation in each individual case.

The steps necessary to arrive at the future maintainable profits of a company are: (a) calculation of past average taxed earnings, (b) projection of the future maintainable taxed profits, and (c) adjustment of preferred rights

Calculation of past average earnings: In order to calculate the past average earnings, it is necessary to decide upon the number of years whose results should be taken for averaging: select the years and adjust their profits to make them acceptable for averaging.

The number of years to be selected must be large enough so as to cover generally the length of a business cycle, as an average for a shorter period might not be suitable. But it should not go too far back: results in the early 80's may have bearing on the results expected in the 90's. In inflationary conditions, that are present today, it is considered that a relatively short period may be more representative since it reveals more recent results. Similarly, for companies having steady growth, average of a rather short period, is more useful. In some unusual circumstances, average of a still shorter period, even only one year's profit may be more significant in estimating future earning, such as where a change in the business or a change in trading conditions forces the valuer to discard all earlier years and to rely upon the current year only or to select

	certain normal years and exclude others. In all these matters, a sound reasoning would alone aid the valuer. Whether a 3-yearly, 5- yearly or longer average would reflect the correct future earnings of a company depend upon the nature of concerned industry. **<u>Projection of future maintainable taxed profits</u>**: Projection is more a matter of intelligent guess work since it is essentially an estimation of what will happen in the risky and uncertain future. The average profit earned by a company in the past could be normally taken as the average profit that would be maintainable by it in the future, if the future is considered basically as a continuation of the past. If future performance of the company is viewed as departing significantly from the past, then appropriate adjustment will be called for before accepting the past average profit as the future maintainable profit of the company. The factors requiring consideration may be as stated below: (i) Discontinuance of a part of the business; (ii) Under-utilization of installed capacity; (iii) Expansion programmes; (iv) Major change in the policy of the company; and (v) Adjustment for rehabilitation and replacement. **<u>Mean between asset and yield based valuation</u>**: This is, in fact, no valuation, but a compromise formula for bringing the parties to an agreement. This presents averaging two results obtained on quite different basis. It is argued that average of book value and yield based value incorporates the advantages of both the methods. That is why such average is called the fair value of share.
Method 3: FAIR VALUE OF SHARES	The fair value of a share is the average of the value of shares obtained by the net assets method and the one obtained by yield method. Under net assets method, the value of an equity share is arrived at by valuing the assets of a company and deducting therefrom all the liabilities and claims of preference shareholders and dividing the resultant figure by the total number of equity shares with the same paid up value. Under yield method, the value of an equity share is arrived at by comparing the expected rate of return with the normal rate of return. If the expected rate of return is more than normal rate of return, the market value of the share is increased proportionately. The fair value of shares can be calculated by using the following formula: $\text{Fair value of share} = \dfrac{\text{Value by net asset method + Value by yield method}}{2}$ This method is also known as dual method of share valuation. This method attempts to minimize the demerits of both the methods. This is of course, no valuation but a compromised formula for bringing the parties to an agreement. However, it is recognised in Government circles for valuing shares of investment companies for wealth tax purposes.
SPECIAL FACTORS FOR VALUATION OF SHARES	***<u>Importance of Size of Block of Shares</u>***: Method of valuation depends on the size of block of shares involved in the transaction.

	Restricted Transferability: Shares of reputed companies normally enjoy the advantage of easy marketability which is of great significance to holder. At the time of need, they can easily convert the shares into cash. On the other hand, holders of unquoted shares do not enjoy this advantage, hence, theses shares how so ever good, are valued less due to lack of liquidity. **Dividends & Valuation:** Generally companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to the returns they expect to get and consequently they suffer in valuation. **Bonus & Rights Issue:** Share values have been noticed to go up when bonus or right issues are announced, since they indicate an immediate prospect of gain to the holder although, in the ultimate analysis, it is doubtful whether really these can alter the valuation. Bonus issues are made out of the accumulated reserves in the employment of the business, which in no way contribute to the increased earning capacity of the business and ultimately depress the dividend rate since the same quantum of profit would be distributed over a larger number of shares, which in turn also would depress the market value of the shares.
VALUATION OF INTANGIBLES	
INTERNALLY GENERATED ASSETS	**Goodwill:** i) Internally generated goodwill should not be recognised as an asset. ii) In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. **Research & Development Expenditure:** **Research Phase:** Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. No intangible asset arising from research or from the research phase should be recognized. Expenditure on research should be recognized as an expense when it is incurred. Examples of Research activities: a. Activities aimed at obtaining new knowledge. b. The search for, evaluation and final selection of, applications of research finding or other knowledge. c. The search of alternative for materials, devices, products, processes, systems, etc. d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, etc

	Development Phase: Development is the application of research finding or other knowledge to a plan for the production of new or substantially improved material, devices, products, etc. prior to the commencement of commercial production or use. An intangible asset arising from development should be recognized if, and only if, an enterprise can demonstrate all of the following: a. The technical feasibility of completing the intangible asset so that it will be available for use or sale. b. Its intention to complete the intangible asset and use or sell it. c. Its ability to use or sell the intangible assets. d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of market for the output of the intangible asset or if it is to be used internally, the usefulness of the intangible asset. e. The availability of adequate technical, financial or other resources to complete the development and to use or sell the intangible asset and f. its ability to measure the expenditure attributable to the intangible asset during its development reliably. Examples of development activities are: a. The design, construction and testing of pre-production or pre use models. b. The design of tools, jigs, moulds and dies involving new technology.
AMORTISATION OF GOODWILL/ INTANGIBLE AS PER AS 26	**Amortisation period:** Depreciable Amount of intangible assets should be allocated on a systematic basis over the best estimate of its useful life. Normally it is presumed that useful life will not exceed 10 years unless there is persuasive evidence that intangible asset has higher useful life. **Review of Amortisation period & Amortisation Method**: The Amortisation period and Amortisation method should be reviewed at least at each end of financial year. If the expected useful life of asset is significantly different from previous estimate, the amortization period should be changed accordingly. If there has been significant change in the expected pattern of economic benefits from the assets, the Amortisation method should be changed to reflect the changed pattern. **Retirement and Disposal**: An intangible asset should be derecognized on disposal or when no future economic benefits are expected from its use and subsequent disposal.
SEPARATE ACQUISITION	If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

	If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.
ACQUISITION BY WAY OF A GOVERNMENT GRANT	In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licenses to operate radio or television stations, import licenses or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also require that in case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.
EXCHANGES OF ASSETS	An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.
VALUATION OF BRANDS	
VALUATION OF BRANDS	**Introduction:** Assets held by an enterprise may be tangible or intangible. The value of an enterprise is determined by the value of both these type of assets. There are enterprises where the value of intangible assets is more than the value of tangible assets. In certain cases, the only major assets of an enterprise may be an intangible asset. **What is brand?** Brand means a name, term, sign, symbol or design or a combination of these intended to identify the goods or service of one seller or group of sellers and to differentiate them from those of competitors. E.g. Intel Inside is a popular brand used by Intel corporation for PCs containing Intel Chips. Other examples include Disney, Pepsi, Microsoft, etc. Brands can be acquired from outside or can be developed internally within the enterprise. **Branding and its objectives:** Branding refers to the act of creating, developing and maintaining a brand. In the modern business world, branding has become very important due to heavy competition. The objectives of branding are as follows: a. It helps in creating an identity for the enterprise and its product in the market and distinguishes them from rival enterprises and products in the market. b. strong brands combine with quality products results in customer loyalty, giving an edge over competition, and the customer can enjoy a

	brand premium in its pricing decisions. c. using a particular brand gives an advantage of status fulfillment to customers. d. brands are important tools to enterprises to achieve market segmentation and employ different efforts in different segments. **<u>Brand Accounting and its objectives:</u>** Brand accounting refers to identification, valuation and reporting of brands of enterprise in its financial statements. The main objectives of brand accounting is to enable a correct assessment of the real value of an enterprise and its correct profitability by both the management and the outsiders through recognition of brand assets. Consequential objectives are: a. recognition of brand assets increases share prices b. this keeps off unfavourable takeovers c. it enhances the enterprise borrowing ability d. improves quality of accounting e. facilitates correct managerial decision making. **<u>Difficulties in brand accounting:</u>** a. this is no standardized way of disclosure of brands. b. measuring returns from brand is difficult because of futuristic and uncertain nature. c. brands do not have an active market. So revaluation becomes difficult. d. amortization of brands is difficult because their useful lives cannot be estimated in advance. e. development of in-house brands involve both specific cost and joint cost. These joint costs are general in nature and related to day to day operation of business. it is difficult to identify and apportion these joint costs to the brand assets.

WHAT IS SHARE BASED PAYMENT TRANSACTION & ARRANGEMENT	SBP transaction is a transaction in which the entity : (a) receives goods or services from the supplier of those goods or services in a SBP arrangement, or (b) incurs an obligation to settle the transaction with the supplier in a SBP arrangement when another group entity receives those goods or services. SBP arrangement is an agreement between the entity (or another group entity or any shareholder of any group entity) and another party that entitles the other party to receive ; (a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments of the entity or another group entity, or (b) equity instruments of the entity or another group entity, provided the specified vesting conditions, if any, are met. **Example of Share-Based Payment Arrangements** *SBP arrangements between employers and employees* • Share Appreciation Rights (SAR) that entitle employees to cash payments calculated by reference to increases in the market price of an entity's shares. • Share ownership plans where employees receive an entity's shares in exchange for their services. *SBP arrangements that are not between employers and employees* • An external consultant (not an employee) may provide services in return for shares in the entity. • A supplier may provide goods in return for shares in the entity. • A shareholder (rather than an employer) may grant shares to an employee.
SCOPE	An entity shall apply this Standard in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including: 1. *Equity-Settled Share-Based Payment Transactions* in which the entity receives goods or services as consideration for equity instruments of the entity (e.g., the grant of shares or share options to employees). For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. 2. *Cash-Settled Share-Based Payment Transactions* in which the entity receives goods or services and incurs a liability based on the price (or value) of the entity's shares or other equity instruments of the entity as consideration (e.g., the grant of share appreciation

	rights to employees. Cash-Settled Share-Based Payment Transactions which entitle the employees to future cash payments based on the increase in the entity's share price. Cash-Settled Share-Based Payment Transactions in which the entity receives or acquires goods or services and the terms of the arrangement provided either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments,. In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case this Standard applies. **Determining the Fair Value of Equity Instruments Granted** • For transactions measured by reference to the fair value of the equity instruments granted, an entity shall measure the fair value of equity instruments granted at the measurement date, based on market prices if available, taking into account the terms and conditions upon which those equity instruments were granted. • If market prices are not available, the entity shall estimate the fair value of the equity instruments granted using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties. The valuation technique shall be consistent with generally accepted valuation methodologies for pricing financial instruments, and shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.