Index

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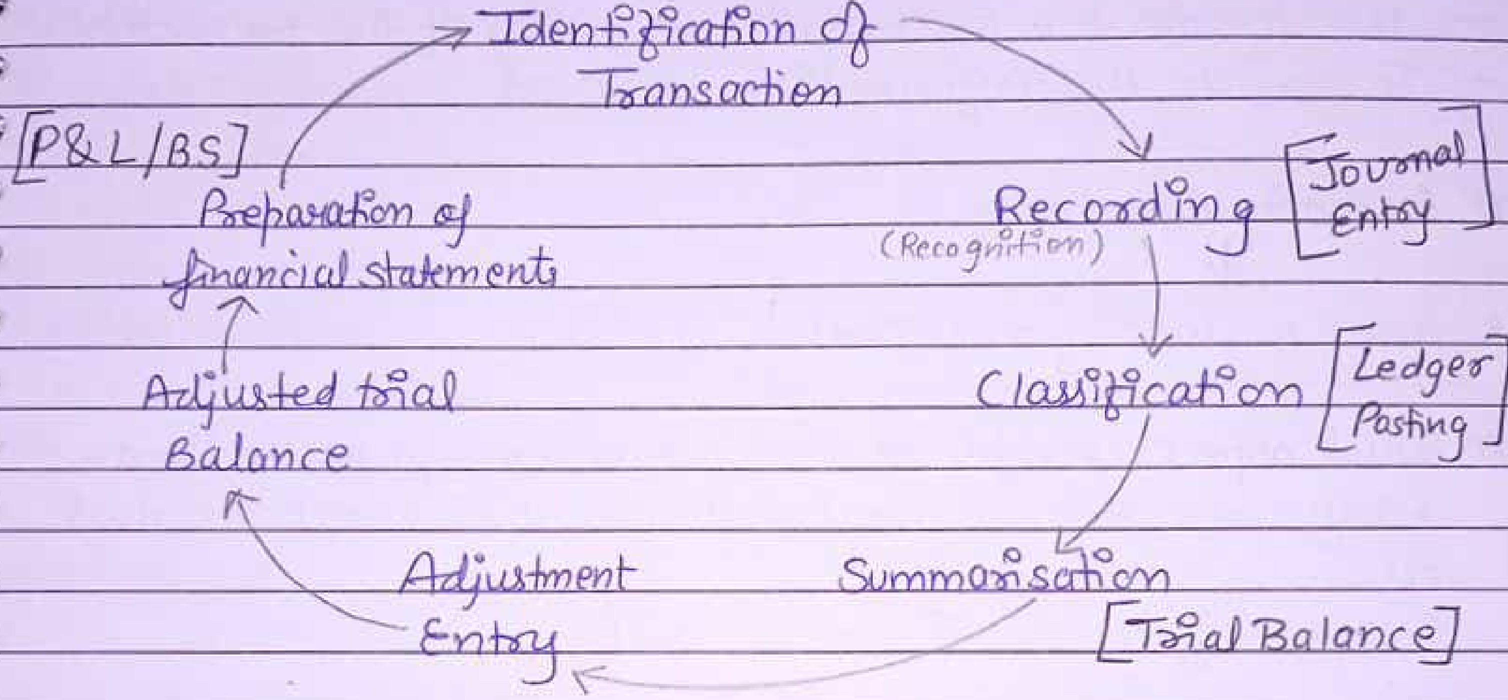
Lesson - 1
Introduction to Accounting

★ Accounting Cycle.



★ Accounting :-

Accounting is an art of identifying, recording, clasifying & summarisation of all transaction and event which are atleast of financial in nature and finding results thereof and interpretation and analysis and communication thereof.

→ According to American Institute of Certified Public Accountants (AICPA).

Good Write

☆ Objective of Accounts

- To Know the income position of the business entity.
- To Know the financial position of the business entity.
- To Know the solvency position of the business entity.
- To maintain the systematic recording of the transaction.
- To provide the information to users.

☆ Accounting Equation

↓

- $\boxed{\text{Asset = Liability + Capital.}}$

☆ **Dual aspect concept** → Dual aspect concept states that every transaction and event will have dual aspect or dual effect.

① Debt Effect ② Credit effect.

☆ **Asset** → It is also known as economic resources.

☆ **Capital** → Money (Cash transfer किया है) or Money's worth (Asset के Form में Invest किया है) invested into the business.

☆ **Liability** → It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties.

☆ **Accrual Basis** → According to accrual basis transaction and events will be recorded in the books as soon as they will occur irrespective of actual receipt of cash or actual payment of cash.

Good Write

☆ **Depreciation**

Reduction in value of assets

→ According to Co. Act, Allocation of depreciable amount of an asset over its useful life

<u>For Eg</u> → Machinery, Cash = 10,00,000, no. of years = 5

Scrap value ⟷ Residual Value = 1,00,000

The estimated value of a fixed asset at the end of its lease term or useful Life.

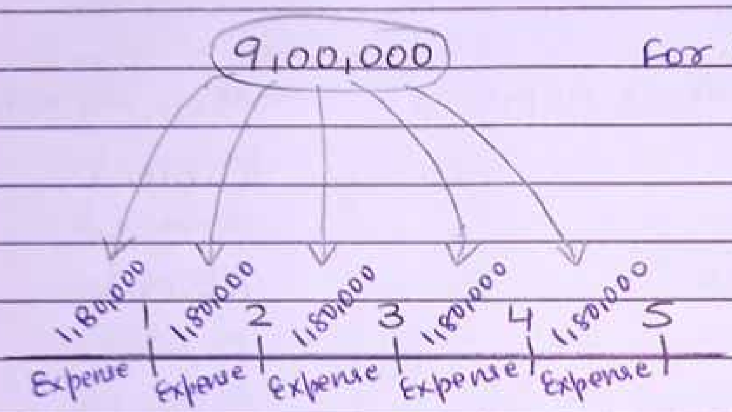
Depreciable Amount = Cost − R.V.

= 10,00,000 − 1,00,000

= 9,00,000

For 5 years = $\frac{9,00,000}{5}$

= 1,80,000



- Straight Line Method

$= \frac{\text{Cost} - \text{Scrap Value}}{n}$

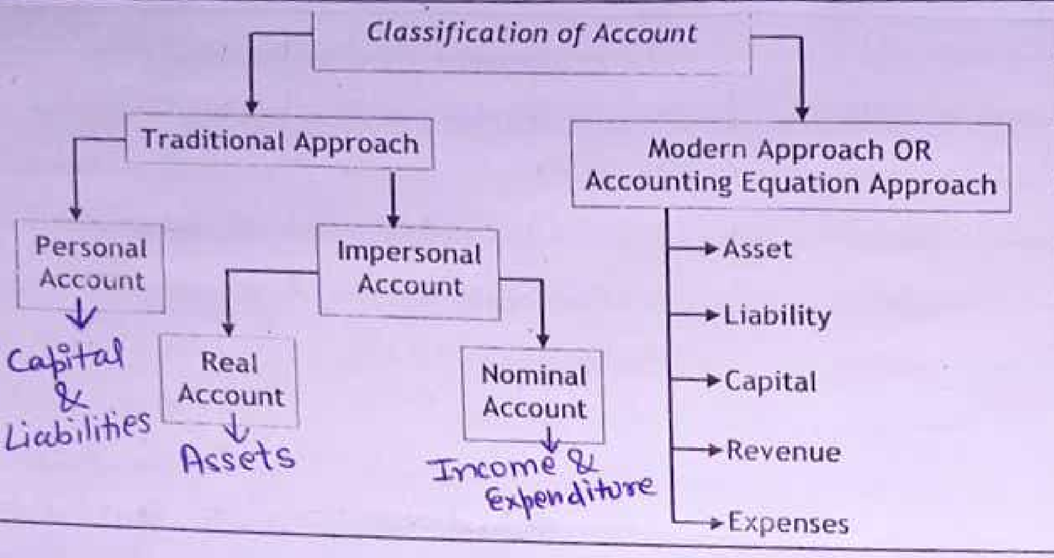
$= \frac{\text{Depreciable Amt}}{n}$

☆ **Expenses**

Due and Paid	Due but not yet paid	Paid but not yet due
↓	↓	↓
Cash Expense (Dr)	Outstanding Expense	Advance / Prepaid Expense
	↓	↓
	Liability (Cr)	Assets (Dr)

DUE − Benefits Received

★ Journal Entry.



	Item	Traditional Approach	Modern Approach
1	Capital	Personal Account	Capital
2	Purchases	Nominal Account	Expense
3	Sales	Nominal Account	Revenue
4	Advertisement	Nominal Account	Expense
5	Sundry Expenses	Nominal Account	Expense
6	Trade charges	Nominal Account	Expense
7	Miscellaneous Receipts	Nominal Account	Revenue
8	Office Expenses	Nominal Account	Expense
9	Charity	Nominal Account	Expense
10	Electric fittings	Real Account	Asset
11	Honorarium to Secretary	Nominal Account	Expense
12	Sundry Creditors	Personal Account	Liability
13	Sundry Debtors	Personal Account	Asset
14	Goodwill	Real Account	Asset
15	Software	Real Account	Asset
16	Websites	Real Account	Asset
17	Audit Fees	Nominal Account	Expense
18	Stationary	Nominal Account	Expense
19	Bad Debts Recovered	Nominal Account	Revenue

20	Bills Receivable	Personal Account	Asset
21	Dividend Received	Nominal Account	Revenue
22	Electricity Charges	Nominal Account	Expense
23	Commission allowed	Nominal Account	expense
24	Loan and Advances	Personal Account	Asset
25	Export Duty	Nominal Account	Expense
26	Loan from SBI	Personal Account	Liability
27	Wages	Nominal Account	Expense
28	Drawing	Personal Account	Capital
29	Rent	Nominal Account	Expense
30	Salaries	Nominal Account	Expense
31	Interest Received	Nominal Account	Revenue
32	Insurance	Nominal Account	Expense
33	Carriage Outwards	Nominal Account	Expense
34	Interest Paid	Nominal Account	Expense
35	Rent Received in Advance	Personal Account	Liability
36	Plant and Machinery	Real Account	Asset
37	Land and Building	Real Account	Asset
38	Furniture	Real Account	Asset
39	Fixtures and Fitting	Real Account	Asset
40	Bank Charges	Nominal Account	Expense
41	Knowhow	Real Account	Asset
42	Donation	Nominal Account	Expense
43	Stamp Charges	Nominal Account	Expense
44	Horse and Carts	Real Account	Asset
45	Accrued Income	Personal Account	Asset
46	Computer	Real Account	Asset
47	Postage and Telegrams	Nominal Account	Expense
48	Subscription Received	Nominal Account	Revenue
49	Depreciation	Nominal Account	Expense
50	Fixed Deposit	Real Account	Asset
51	Freight	Nominal Account	Expense

52	Royalty & Production	Nominal Account	Expense	
53	Carriage Inward	Nominal Account	Expense	
54	Discount Received	Nominal Account	Revenue	
55	Discount Allowed	Nominal Account	Expense	
56	Bad Debts	Nominal Account	Expense	
57	Gas and Fuel	Nominal Account	Expense	
58	Patent and Trade Marks	Real Account	Asset	Intangible
59	Repairs	Nominal Account	Expense	
60	Investment	Real Account	Asset	Tangible
61	Cash in Hand	Real Account	Asset	Tangible
62	Motor Cycle	Real Account	Asset	Tangible
63	Commission Received	Nominal Account	Revenue	
64	Equipment	Real Account	Asset	Tangible
65	Power	Nominal Account	Expense	
66	Fines & Penalties	Nominal Account	Expense	
67	General Expenses	Nominal Account	Expense	
68	Bank Overdraft	Personal Account	Liability	
69	Prepaid Insurance	Personal Account	Asset	
70	Bills Payable	Personal Account	Liability	
71	Tea for Customers	Nominal Account	Expense	
72	Outstanding Salaries	Personal Account	Liability	
73	Cash at Bank	Personal Account	Asset	
74	Subscription Paid	Nominal Account	Expense	
75	Salary	Nominal Account	Expense	

★ Insurance Policy

Asset but in some cases Expense.

① Life Insurance

② General Insurance → Flood, Marine, Transit, Theft, Fire

★ Debtors → Bad Debts → Bad Debts Recovered

- Debtors → Personal A/c
- Bad Debts → Nominal A/c
- Bad Debts Recovered → Nominal A/c

Debtors

Goods	Doubtful	Bad Debts
Debt that is likely to be repaid	Debt that is unlikely to be repaid.	Debt that is definitely not be repaid.

★ Rules for Debit and Credit.

Traditional Approach

Personal Account
Related to Person
- → Debit the Receiver (Person)
- → Credit the Giver (Person)

Impersonal Account
- → Real Account
  Related to Assets
  - → Debit what comes in
  - → Credit what Goes out
- → Nominal Account
  - → Debit all expenses / Losses
  - → Credit all incomes / Gains

Modern Approach

Asset	• Increase	Dr.	
	• Decrease	Cr.	
Liability	• Increase	Cr.	
	• Decrease	Dr.	
Capital	• Increase	Cr.	
	• Decrease	Dr.	
Revenue	• Increase	Cr.	
	• Decrease	Dr.	
Expense	• Increase	Dr.	
	• Decrease	Cr.	

☆ Journal - A Journal is a book in which transactions are recorded in the order in which they occur i.e. in Chronological Order.
- A Journal is called a book of Primary Entry (also called of Original Entry) because all business transactions are entered first in this book.
- On the basis of recording, Primary Book
- On the basis of Importance, Subsidiary Book.

☆ **Advantages of Journal**

The following are the advantages of a journal:

(a) **Chronological Record:** It records transactions as and when it happens. So it is possible to get detailed day-to- day information.

(b) **Minimizing the possibility of errors:** The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into both debit and credit aspects.

(c) **Narration:** It means explanation of the recorded transactions.

(d) **Helps to finalize the accounts:** Journal is the basis of ledger posting and the ultimate Trial Balance. The Trial Balance helps to prepare the final accounts.

☆ **Specimen of a Journal Book**

Journal Entries in the Books of xxx

Date	Particulars	Voucher Number	Ledger folio	Debit amount (Rs.)	Credit Amount (Rs.)
dd-mm-yy	Name of A/c. from which to be debited Name of A/c to be credited (narration describing the transaction)	----------	Reference of page number of the A/c in ledger	----------	----------

☆ (a) Date Column: This column contains the date of the transaction.
(b) Particulars: This column contains which account is to be debited and which account is to be credited. It is also supported by an explanation called narration.
(c) Voucher Number: This column contains the number written on the voucher of the respective transaction.
(d) Ledger Folio (L.F.): This column contains the folio (i.e., page no.) of the ledger, where the transaction is posted.
(e) Dr. Amount and Cr. Amount: This column shows the financial value of each transaction. The amount is recorded in both the columns, since for every debit there is a corresponding and equal credit.

★ Ledger and Trial Balance.

Practical Question

① Ans

Ledger Posting.

① Cash Account (Real A/C)

Date	Particulars	JF	₹	Date	Particulars	JF	₹
	To Capital A/c		2,00,000		By Purchase A/c		60,000
	To Sales A/c		20,000		By Ram A/c		20,000
	To Shyam A/c		40,000		By Rent A/c		4,000
					By Salary A/c		20,000
					By Machinery A/c		49,500
					By Machinery A/c		500
					By Balance c/d		1,06,000
			2,60,000				2,60,000

② Capital A/C (Personal A/C)

Date	Particulars	JF	₹	Date	Particulars	JF	₹
	To Balance c/d		2,00,000		By Cash		2,00,000
			2,00,000				2,00,000

③ Purchase A/C (Nominal A/C)

Date	Particulars	JF	₹	Date	Particulars	JF	₹
	To Cash A/c		60,000		By P&L A/c		1,00,000
	To Ram A/c		40,000				
			1,00,000				1,00,000

④ Shyam A/C (Personal A/C)

Date	Particulars	JF	₹	Date	Particulars	JF	₹
	To Sales		60,000		By Cash A/c		40,000
					By Sales Return A/c		10,000
					By Balance c/d		10,000
			60,000				60,000

⑤ Sales A/C (Nominal A/C)

Date	Particulars	JF	₹	Date	Particulars	JF	₹
	To P&L A/C		80,000		By Shyam A/c		60,000
					By Cash A/c		20,000
			80,000				80,000

Good Write

⑥ Ram A/c (Personal A/c)

To Cash A/c		20,000	By Purchase A/c		40,000
To Purchase Return A/c		5,000			
To Balance c/d		15,000			
		40,000			40,000

⑦ Rent A/c (Nominal A/c)

To Cash A/c		4,000	By P&L A/c		4000
		4,000			4,000

⑧ Salaries A/c (Nominal A/c)

To Cash A/c		20,000	By P & L A/c		20,000
		20,000			20,000

⑨ Sales Return A/c (Nominal A/c)

To Shyam A/c		10,000	By P & L A/c		10,000
		10,000			10,000

⑩ Purchase Return A/c (Nominal A/c)

To P&L A/c		5,000	By Ram A/c		5,000
		5,000			5,000

⑪ Machinery A/c (Real A/c)

To Cash A/c		49,500	By Balance c/d		50,000
To Cash A/c		500			
		50,000			50,000

Trial Balance (By Total Method)
(By Balance Method)

Particular	Dr. Balance	Cr. Balance	Dr. (₹)	Cr (₹)
Cash A/c	1,06,000	—	2,60,000	1,54,000
Capital A/c	—	2,00,000	Nil	2,00,000
Purchase A/c	1,00,000	—	1,00,000	Nil
Shyam A/c	10,000	—	60,000	50,000
Sales A/c	—	80,000	Nil	80,000
Ram A/c	—	15,000	25,000	40,000
Rent A/c	4,000	—	4000	Nil
Salary A/c	20,000	—	20,000	Nil
Sales Return A/c	10,000	—	10,000	Nil
Purchase Return A/c	—	5000	Nil	5000
Machinery A/C	50,000	—	50,000	Nil
	3,00,000	3,00,000	5,29,000	5,29,000

✯ Method of Preparing Trial Balance

- Total Method
  - Purpose
    - Checking Arithmatical Accuracy
- Balance Method
  - Purpose
    - Checking Arithmatical Accuracy
    - Facilitating Preparation of Financial Statement.
- Total & Balance Method.

☆ Nature of Balances

Asset (Dr) | Liability (Cr) | Capital (Cr) | Income (Cr) | Expenses (Dr)

② Ans

Debtors A/C (Asset A/C) ↑ Dr ↓ Cr

Particulars	₹	Particulars	₹
To balance b/d	1,25,000	By Discount allowed A/C	30,000
To Sales A/C	5,00,000	By Bad Debts A/C	20,000
		By Cash A/C (Cash collected from debtors)	4,45,000
		By Balance c/d	1,30,000
	6,25,000		6,25,000

☆ Balance

Opening Balance (at start of the year)
- Dr. Balance (Asset, Expenses) → Op. Bal
- Cr. Balance (Liability, Capital, Income) → OP. Bal

Closing Balance (at the end of the year)
- Dr. Balance (Asset, Expense) → Cl. Bal
- Cr. Balance (Liability, Capital, Income) → Cl. Bal

Op. Bal		OP. Bal	
	Cl. Bal		Cl. Bal

(3) Ans.

Creditors A/C (Liability) ↓ Dr ↑ Cr

Particulars	₹	Particulars	₹
To Cash A/c	3,00,000	By Balance b/d	50,000
To Discount Received A/c	15,000	By Purchase (Credit)	3,60,000
To allowances	25,000		
To Balance c/d	70,000		
	4,10,000		4,10,000

★ Interest

Received → Income → Outstanding (Accrued Interest)

Paid → Expense → Outstanding (Outstanding Interest)

★ Story of General Reserve.

	I Yr	II Yr
Income (Cr)	5,00,000	10,00,000
(−) Expense (Dr)	(2,00,000)	(3,00,000)
PBT (Cr)	3,00,000	7,00,000
(−) Tax @ 30% (Dr)	(90,000)	(2,10,000)
PAT / EAT (Cr)	2,10,000	4,90,000
Dividend (Dr)	1,00,000	2,00,000
General Reserve (Cr)	1,10,000	2,90,000
Balance of General Reserve	1,10,000	4,00,000

Appropriation of Profit

Good Write

★ Periodicity Concept

Generally
A/c Period
12 Months

Exception
A/c Period > 12 m
OR
A/c Period < 12 m

★ Income

Income due but Payment not received → Accrued or O/S income → Asset → Dr.

Income due and received → Income Or Revenue → Cr.

Income received but not yet due. → Advance income Or Unaccrued Income → Liability → Cr.

★ (Transportation Expense)
Carriage / Freight = Expense = Dr.

Inter City Transport Expense → Inward
Expense on Purchase

Intra City Transport Expense → Outward
Expense on Sales

★ Capital A/c → Permanent Capital → Cr.
Current A/c → Temporary Capital → Cr.

Basic of Final A/C

- Financial Statement includes - (General definition)

1) Balance Sheet A, L, C
2) Income statement (Profit / Loss) Y
3) Cash Flow Statement
4) Explanatory Notes

Asset
↓ → SLM → WDV
Method of Depreciation
↓
Rate of Depreciation
↓
Method of Recording Depreciation
↓
Accounting Policy.

Amount of Dep
Accounting Estimate

Types of Business

Trading Business

Buying → Selling

Gross Profit ⇒ Trading A/C ①
\+ Other Income
\- Other Expense
Net Profit ⇒ P&L A/C ②
Balance Sheet ③

Manufacturing Entities

Raw Material $\xrightarrow{\text{Convert}}$ Finished Goods → Sale

① Manufacturing A/C
(To ascertain Cost of Production)
Production Vs Sale
Gross Profit ⇒ Trading A/C ②
\+ Other income - Other Expense
Net Profit ⇒ P & L A/C
Balance Sheet

Good Write

☆ Not for Profit Organisation (NPO)

↓ Income and Expenditure A/C
- Surplus ↓ Income > Expense
- Deficit ↓ Income < Expense

↓ Financial Position ↓ Balance Sheet

$\underbrace{\text{Asset Liability Capital}}_{\text{Balance Sheet}}$

Income
- Direct Income — Sales, Services
- Indirect Income — other than Direct

Expenses
- Direct Expense — Purchase, other directly attributable Expenses
- Indirect — other than Direct Expense

(Trading A/C) → Gross Profit ← (Direct Income, Direct Expense)

→ Net Profit ← (Indirect Income, Indirect Expense)

→ (P & L A/C)

Delhi
|
Purchase

Wages
↑
Packing, Loading, Freight Charges

Excise Duty, Unload → Wages
|
Pune

Directly Attributable Expenses

☆ Subdivision of Journal and Ledger

★ Journal

- Cash Book
  - Types of Cash Book
    - → Single Column Cash Book (Cash)
    - → Double Column (Cash + Bank)
    - → Triple Column (Cash + Bank + Discount)
    - → Petty Cash Book (Petty Expenses)
- Sales Book
  - Credit Sales of Goods
- Purchase Book
  - Credit Purchase of Goods
- Sales Return Book
  - Credit Sales Return of Books
- Purchase return Book
  - Credit Purchase Return of Goods
- Bills Receivable Book
- Bills Payable Book

Format Simple (Single Column Cash Book)

Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F	Amount	Rs.

Dr. Cash Book (Double Column) Cr.

Date	Particulars	L.F.	Cash	Bank	Date	Particulars	L.F	Cash	Bank

Dr. Cash Book (Triple Column) Cr.

Date	Particulars	L.F.	Discount	Cash	Bank	Date	Particulars	L.F	Discount	Cash	Bank

- Petty Cash Book (Imprest Form of Cash Book)

Date	Receipt	Particulars	Payment	Stationary					

Checked by Head Accountant

Prepared by Junior Accountant

- Sales / Purchase / Sales Return / Purchase Return Book

Date	Particulars / Party Name	Voucher No.	L.F	Detail	₹
	Sales Book →	Invoice No.			
	Purchase Book →	Invoice No.			
	Sales Return Book →	Credit Note No.			
	Purchase Return Book →	Debit Note No.			

★ Ledger

① Personal A/C (Person)

- Ⓐ Debtors A/C
- Ⓑ Creditors A/C

② Impersonal A/C
Real A/C, Nominal A/C

- Ⓒ Nominal A/C (Income, Expense) ⇓ General Ledger
- Ⓓ Private Ledger

Lesson - 2

Introduction to Corporate Accounting.

A What is the definition of financial statements for the Joint stock Co. as per Companies Act, 2013?

- Section 2 (40) of the Companies Act 2013 states that the financial statement of a company includes:
  1) Balance Sheet
  2) Statement of Profit and Loss (Income and expenditure for not for profit corporate entities
  3) Cash flow Statement (Not mandatory for OPC, dormant Co., Small Co.)
  4) Notes to Account.

A Preparation and Presentation of financial statements.

Section 129 of the Companies Act, 2013

↓

True and fair view of the state of affairs of a Company

Comply with the accounting standards notified under Sec. 133

Form (Format) as may be provided Schedule III.

Shall not apply to

Insurance Co. | Banking Co. | Electricity Co.

Form of financial statements has been specified in under the act governing such company.

Insurance Co.	Banking Co.	Electricity Co.
Insurance Act, 1938 or IRDA Act, 1999	Banking Regulation Act, 1949	Electricity Act, 2003.

→ Accounting Principle

→ Measurement

Calculating the Monetary Value of any item whose MV is not available so that further accounting can be done. This is known as Measurement.

For Eg- SLM = $\frac{\text{Cost of asset} - RV}{n}$

→ Accounting

→ Disclosure

☆ Accounting Standards (AS) - ④ -

AS are written policy documents issued by expert accounting body or by the Govt or other regulatory body covering the aspects of recognition, measurement, presentation & disclosure of accounting transactions in financial statements.

↓

General Guidelines

↓ who is supposed to prepare these AS

ICAI

↓

IAS (International AS)

↓ carve out (−)
carve in (+)

AS

↓

NACAS (National Advisory Committee of AS)

↓

MCA

☆ AS-2 Valuation of Inventories

	Cost	Market Price	
A	60	100	Future Profit
B	50	50	No P & L
C	90	40	Future Loss

Stock → Cost / Market Value → Lower (Compare)

Inventory should be valued at cost or Market Price.

☆ Concept of Conservatism / Prudence

Future anticipated Profit should not be recorded until it gets realised but Future expected losses should be provided Immediately.

↳ Future
- Profit → Ignore
- Loss → Recorded Immediately.

Good Write

V.V. Imp

PART - I BALANCE SHEET ...

Particulars	Note No	Current period	Previous period
I. EQUITY AND LIABILITIES			
(1) Shareholders' funds			
(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 (Creditors + B/R)			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1) Non-current assets			
(a) Fixed assets			
(i) Property, Plant and Equipment and Intangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(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			
(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
TOTAL			

PART – II STATEMENT OF PROFIT AND LOSS ...

Particulars	Note No.	Current period	Previous period
I. Revenue from operations		xxx	xxx
II. Other income		xxx	xxx
III. Total Revenue (I + II)		xxx	xxx
IV. Expenses:			
a. Cost of materials consumed		xxx	xxx
b. Purchases of Stock-in-Trade		xxx	xxx
c. Changes in inventories of finished goods work-in-progress and Stock-in-Trade		xxx	xxx
d. Employee benefits expense		xxx	xxx
e. Finance costs		xxx	xxx
f. Depreciation and amortization expense		xxx	xxx
g. Other expenses		xxx	
Total expenses		xxx	xxx
V. Profit before exceptional and extraordinary items and tax (III - IV)		xxx	xxx
VI. Exceptional items		Xxx	xxx
VII. Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII. Extraordinary items		xxx	xxx
IX. Profit before tax (VII- VIII)		xxx	xxx
X. Tax expense:			
(1) Current tax		xxx	xxx
(2) Deferred tax		xxx	xxx
XI. Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	xxx
XII. Profit/(loss) from discontinuing operations		xxx	xxx
XIII. Tax expense of discontinuing operations		xxx	xxx
XIV. Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	xxx
XV. Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI. Earnings per equity share:			
(1) Basic		xxx	xxx
(2) Diluted		xxx	xxx

☆ Disclosure Requirement

- For 'Equity and Liabilities' items :

(a) Share Capital
- Authorized Capital
- Issued Capital
- Subscribed Capital
  - Fully paid up
  - Partly paid up
- Calls Unpaid
  - From Directors
  - From others
- Forfeited Shares

(Authorized, Issued and Subscribed Capital) → No. of Share, Face Value

→ Rights, preferences and restrictions attaching to shares
(Basically comparison between PSH & ESH)

→ Restrictions on the distribution of dividends & the repayment of capital

→ Shares held by
- Its holding company or > 50% sh. holding
- Its ultimate holding company 20% or more < 50% of sh. holding
- By subsidiaries or associates of the holding company or
- The ultimate holding company in aggregate.

→ List of shareholders holding more than 5% shares as on the B/S Date

→ Shares reserved for issue under options and contracts / commitments for the sale of shares / Disinvestment, including the terms and amounts.

Good Write

7(b). Reserve & Surplus

- **Capital Reserves**
  - Forfeited pesa
- **Securities Premium Reserve**
  - Eg = FV=10
  - IP=400
  - 390 (Profit)
  - S-52
  - IF U issue Financial security in Price above Face value then Transfer it to a separate A/c known as SPR
- **Revaluation Reserve**
  - comp Book value of Assets with Market value
  - When MV > BV
  - Write such Profit in Revaluation Reserve
  - (WCR we used to do in Partnership 12th)
- **Other Reserves**
  - Balance in Statement of P & L
    - Allocation and Appropriation
    - Dr. Balance (Loss)
- **Share Options Outstanding A/C**
  - To Compensate Loss which will be Procurred in Future
- **Capital Redemption Reserve**
  - Preference Share Redemption
    - S 55 — Redemption of Pre-Sh
    - Sec 68 — Buy Back of Equity Shares
      - Jab Co. Kepaas zyada Fund hojata hai & Usko Misuse hone Lagta hai tab BuyBack Karke Usko Sahi Karna
- **Debenture Redemption Reserve**
  - Payment of Liability i.e. repayment of debenture holder
  - Maintain till the date when it has to be paid back

Shares cannot be issued at discount
↳ Section 53

Except Sec 64
↳ Sweat Equity Shares.

1 (c). Money Received against Share Warrants

To be shown as a separate line item on the face of Balance Sheet.

2. Share Application Money Pending allotment

To be shown as a separate line item on the face of Balance Sheet.

Refundable → "Other Current Liability"

Calls in Advance → "Other Current Liability"

[Issued Capital > Authorised Capital & Approval of increase in authorized Capital is Pending] → Excess Application Money → "Other Current Liability"

3 (a) Long term Borrowings

- Bonds / Debentures
- Terms Loans -
  - ✓ From Banks
  - ✓ From other parties
- Deferred Payment Liabilities
- Deposits
- Loans & advances from related parties
- Long term maturities of finance lease obligations
- Other Loans and Advances

- Security-wise classification
  - Secured
  - Unsecured
- Guarantees
- Maturity Date Wise
  - Descending Order
- Installment Redemption
- Power to Reissue
- Terms of Repayment
- Default Period Amount

3 (b) Deferred Tax Liabilities (Net)

To be shown as a separate line item on the face of balance sheet.

3 (c) Other Long term Liabilities

- Trade Payables
  - Sundry Creditors
    - Goods
    - Services
  - Acceptance (B/P)
  - Disclosure Requirements under MSMED Act = Micro, Small & Medium enterprises Development.
- Others
  - Amounts due under contractual obligations
  - Example:
    - ✓ Payables in respect of statutory obligations
      - like contribution to provident fund
    - Purchase of fixed assets
    - Interest accrued on Trade payables etc.

Good Write

3 (d). Long term Provisions

(a) Provision for employee benefits

Others
Example: Provision for warranties etc.

4 (a) Short term Borrowings

Classification

- Loans repayable on demand
  - From Bank
  - From Other Parties
- Loans and advances from related parties
- Deposits
- Other Loans and advances

• Do not include Current Maturity of Long term Borrowings (Part of " Other Current Liabilities ")
• All existing as at the date of the B/S should be disclosed (item wise)

4 (b) Trade Payable

Only "Commercial Dues

Classification

- Total outstanding dues of MSME
  - Principal
  - Interest
    Accrued & remaining unpaid at the end of each accounting Year
- Others

Good Write

4 (c) Other Current Liabilities

Classification

- Current Maturities
  - Long term Debts
  - Finance Lease obligation
- Income received in advance
- Unpaid Dividends
- Application money received for allotment of securities & due for refund & interest accrued thereon.
- Unpaid Matured Deposits / Debentures
  - Principal
  - Accrued Interest
    - Due
    - Not Yet Due
- Other Payables

4 (d) Short term Provisions

Classification

- Provision for Employees Benefits
- Others

Good Write

- For "Assets" items :

(1) (a) (i) Property, Plant and Equipment

Classification	Re-evaluation	Reconciliation	
(a) Land	Show the reduced	W.D.V at the beginning of Year	X
(b) Buildings	or increased figures	+ Addition (Purchase)	X
(c) Plant & Equipment		+ Acquisitions through business combinations	X
(d) Furniture & Fixtures	Show the Revaluation		
(e) Vehicles	Profit / Loss for the		
(f) Office equipment	First 5 years	− Disposal (Sale / Discard)	(X)
(g) Others		− Disposals through Demergers	(X)
			X
		Opening Acc. depreciation	X
		+ Dep for the year	X
		Closing Acc. Dep	(X)
		W.D.V at the end of the Year	X

Assets Under Lease

Shall be separately specified under each class of Asset.

(1) (a) (ii) Intangible Assets

Classification

(a) Goodwill
(b) Brands / Trademarks
(c) Computer software
(d) Mastheads & Publishing titles
(e) Mining Rights
(f) Services & operating rights
(g) Receipes, Formula, Models, Designs & Prototypes
(h) Licenses & Franchise
(i) Others (specify nature)
(j) Copyrights & Patents & Other Intellectual property rights

(1) (a) (iii) Capital Work in Progress

To be shown as a separate line item on the face of Balance Sheet.

(1) (a) (iv) Intangible assets under Development

To be shown as a separate line item on the face of Balance Sheet.
Disclosed separately, If AS-26 criteria are met.

(1) (b). Non-Current Investments

Classification

- Trade Investments
- Others Investments

Trade Investments: Investment in another Co. → To ~~Promote~~ Trade or business of the First (Investor) Co.

- Property
- Equity Instrument
- Pr. Shares
- Govt. / Trust securities
- Deb/ or bonds
- Mutual Funds
- Partnership Firms
- Others

- Subsidiaries
- Associates
- Joint Ventures
- Controlled Special Purpose Entities
  Not defined in the Act / Sch. III / AS

Important Points :-

Basis of Valuation
- Cost
- Cost less Provision for other than temporary diminution
- Lower of Cost and fair Value

Investment in Partnership Firm
- Registered under Partnership Act, 1932
  - Names of the Firms
  - Names of all their Partners
  - Total Capital
  - Profit Shares of each Partner
- LLP
  "Other Investments"

(1)(c) Deferred Tax Assets

To be shown as a separate line item on the face of Balance Sheet.

(1)(d) Long term Loan & Advances

Classification
- Capital Advances
- Security Deposits
- Loans & Advances to related Parties
- Other Loans & Advances

- Security wise classification
  - Secured, Considered Good.
  - Unsecured, Considered Good.
  - Doubtful
- Bad / Doubtful
- Directors / Officers
  - Severally
  - Jointly

Good Write

(1) (e) Other Non Current Assets

Classification

- Long-term Trade Receivables
- Others

Security wise Classification

- Secured, Considered Good
- Unsecured, Considered Good
- Doubtful

Dues in respect of.

- ✓ Insurance Claims
- ✓ Sale of Fixed Assets
- ✓ Contractually Reimbursable Expenses
- ✓ Interest accrued on Trade Receivables.
- ✓ Etc.

2 (a) Current Investments

Same as Non-Current Investments Discussed in 1 (b)

2 (b) Inventories

Classification

(a) Raw materials
(b) Work in Progress
(c) Finished Goods
(d) Stock-in-Trade (in respect of Goods acquired for Trading)
(e) Stores & Spares
(f) Loose Tools
(g) Others (Specify nature)

Good Write

2 (c) Trade Receivables

Classification

- Outstanding for a period exceeding 6 months
- Others

(for both:)

- Security Wise Classification
  - Secured, Considered Good
  - Unsecured, Considered Good
  - Doubtful
- Bad / Doubtful
- Directors / Officers
  - Severally
  - Jointly

2 (d) Cash and Cash Equivalents

Classification

- Balances with Banks
  - Scheduled Bank
    - Term Deposit
    - Demand Deposit
  - Unscheduled Bank
    - Term Deposit
    - Demand Deposit
- Cheques, Drafts on Hand
- Cash on hand
- Other

Separate Disclosure

- Earmarked balances with banks (eg. for unpaid dividend)
- Balances with Banks as margin money.
- Repatriation Restrictions.

2(e) Short term Loan and Advances

Classification

- Loans & Advances to related parties
- Other loans and Advances
  - Security wise classification
    - Secured, Considered Good
    - Unsecured Considered Good
    - Doubtful
  - Bad / Doubtful
  - Directors / Officers
    - Severally
    - Jointly

2(f) Other Current Assets

This is an all-inclusive heading, which incorporates current Assets that do not fit into any other asset categories

Example :-

- ✓ Unbilled Revenue
- ✓ Unamortized Premium on Forward Contracts
- ✓ Etc.

Good Write

- For Profit & Loss Statement:

(1) Revenue from operations.

- For Company Other than a Finance Company
  - Sale of Products
  - Sale of Services
  - Other Operating Revenues.
  - Less: Excise Duty
- For Finance Company
  - Interest
  - Other financial services

(2) Other Income

- Interest Income
- Dividend Income
- Net Gain / Loss on Sale of Investments
- Other Non Operating Income

(3) Employee Benefits, Expense

- Salaries and Wages
- Contribution to PF & Other Funds
- Expense on ESOP and ESPP
- Staff Welfare Expenses

- **Additional Requirements Under Section 129.**

★ Companies shall mandatorily file their financial statements in XBRL Format.

Class → Notified by CG ← Format

eXtensible Business Reporting Language.

Language for the electronic communication of Business & Financial Data.

- Cost Saving
- Greater Efficiency
- Improved Accuracy
- Reliability

★ At every annual general meeting of a company, the board of directors of the company shall lay before all members financial statements for the financial year.

★ The Schedule III sets out minimum requirements for disclosure.
New line items or sub-items can be added or substituted
Relevant to an understanding of the company's financial position
To cater to industry / sector - specific disclosure requirements
Under the accounting standards.

★ Rounding off rule

Turnover	Rounding off
Less than one hundred crore rupees.	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
One hundred crore rupees or more.	To the nearest lakhs, millions or crores or decimals thereof.

Lesson – 4
Accounting For Share Capital.

★ **Share Capital**

Total Capital of the company is divided into a number of small indivisible units of a fixed amount & each such unit is called a Share and total capital of a company is called share capital

★ **Classification / Types of shares / Companies Act 2013 Section 43**

Types of Shares

(A) Equity Share Capital
Shares which are not preference shares

- (i) with voting Rights
- (ii) With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.

(B) Preference Share Capital
Companies Act, 2013
Sec-43 (b) Explanation (ii)

"Preference Share Capital" means that part of the issued share capital of the Co. which carries or would carry a preferential right with respect to

(a) Payment of Dividend
Either as a fixed amt or an amt calculated at a fixed rate, and

(b) Repayment
In the case of winding up or repayment of capital, there is a preferential right to the payment of any fixed Capital specified in the memorandum or articles of the Co.

Types of Preference Share Capital →

- On the basis of the accumulation of Dividend.
  - → Cumulative preference Share and
  - → Non-Cumulative preference Share
- On the basis of Participation in Surplus Profit
  - → Participating preference Share and
  - → Non-Participating preference Share
- On the basis of Conversion
  - → Convertible preference share and
  - → Non-Convertible preference share

☆ Classification of Share Capital According to disclosure in B/S.

Authorized Capital
1,00,000 equity shares of Rs.10 each = Rs. 10,00,000

- Issued Capital
  60,000 Equity shares of Rs.10 each = Rs. 6,00,000
  - Subscribed Capital
    60,000 equity shares of Rs.10 each = Rs. 6,00,000
    - Called up Capital
      60,000 ES of Rs.10 each Rs. 9 called up = 5,40,000
      - Paid up Capital
      - Calls in Arrear
        5,000 shares @ Rs. 2 per share = Rs. 10,000
    - Un-Called Capital
      - Reserved Capital
      - Un-Reserved Capital
  - Unsubscribed Capital
- Unissued Capital

★ Terms of Issue of Shares

- **Issued at PAR**
  - Issue Price = Face Value
- **Issued at PREMIUM**
  - Issue Price > Face Value
  - Sec. 52
  - Issue Price − Face Value = Security Premium
    - Capital Profit
      - Credited to Separate A/c "Security Premium Reserve A/c"
- **Issued at DISCOUNT**
  - Issue Price < Face Value
  - Sec. 53
  - (1) Except as provided in Section 54 a company shall not issue shares at a discount.
  - (2) Any share issued by a company at a discounted price shall be void

★ Purpose for Issue of Shares

- **For Cash Consideration**
  - Money Received in Lump Sum
  - Money Received in Installment
- **For Consideration other than cash**

1st Installment	Share Application
2nd Installment	Share Allotment
3rd Installment	1st Call Money
Last Installment	Final Call Money

Good Write

★ For Cash Consideration

Money Received in Lump Sum

Preliminary Expense	Share issue Expense (Invitation to offer)	IPO Open	IPO Close	BOD Meeting (Acceptance)
Preliminary Exp Dr. To Bank A/c	Share issue Exp Dr. To Bank A/c	offer		Share Allotment

Share Application Receive (IPO Open to IPO Close)

Bank A/c Dr.
To Eq. Share Application A/c
Or
To Eq. Share App & Allot A/c

★ Basic Journal Entry

Date	Particular		LF	Dr(₹)	Cr(₹)
—	Preliminary Expenses A/c	Dr.			
	To Bank A/c				
	(Being Preliminary Expenses incurred)				
—	Share Issue Expenses A/c	Dr.			
	To Bank A/c				
	(Being share issue expenses paid)				
—	Bank A/c	Dr.			
	To Equity Share Application A/c				
	(Being the App money received for XXX shares at Rs. XX per share)				
—	Equity Share Application A/c	Dr.			
	To Equity Share Capital A/c				
	(Being share allotment made for XXX shares at Rs. XX per share)				

Good Write

✱ Journal Entries for Installment

Ist installment — Application

→ Receive

Bank A/c Dr.
To Equity share Application A/c

→ Transfer

Equity share application A/c Dr.
To Equity Share ~~application~~ capital A/c

2nd installment — Allotment

→ Due

Equity share allotment A/c Dr.
To Equity share capital A/c

→ Receive

Bank A/c Dr.
To Equity share allotment A/c

3rd installment — First call

→ Due

Equity share first call A/c Dr.
To Equity share Capital A/c

→ Receive

Bank A/c Dr.
To Equity share first Call A/c

Last installment — Final call

→ Due

Equity share final call A/c Dr.
To Equity share capital A/c

→ Receive

Bank A/c Dr.
To Equity share final call A/c

Good Write

☆ Three different Situation of Subscription.

No. of Shares offered $=$ No. of Shares subscribed by the public → Full Subscription

No. of Shares offered $<$ No. of Shares subscribed by the public → Over Subscription

No. of Shares offered $>$ No. of Shares subscribed by the public. → Under Subscription

Good Write

☆ Over-Subscription

↓

Alternatives

① Reject Excess Applications & Money Returned
↓
Equity Sh Appl A/c Dr.
To Bank A/c

② Pro-Rata Allotment
↓
Subscription Ratio = $\frac{\text{Shares Allotted}}{\text{Shares Applied}}$
↓
Excess Application Money adjusted towards sum due on allotment.
↓
Eq. Sh. Appl. A/c Dr.
To Eq. Sh. Allotment A/c

③ ① + ② Partial Acceptance of Applications (Pro-Rata Acceptance)
↓
Eq. Sh. Appl. A/c Dr
To Eq. Sh. Allotment A/c
To Bank A/c.

No. of appl rcvd
−
No. of sh issue
=
Excess Appl.
× (₹)

Excess appl money
↳ allotment advance.

☆ Under-Subscription

SEBI Guideline – Must receive a minimum of 90% subscription against entire issue
↓
If not Received
↓
Entire Subs. shall be refunded to the applicant

Non-Underwriting Issue
Within 15 days

Underwriting Issue
Within 70 days

No. of days will be counted from date of closure of issue

☆ Forfeiture and Reissue of Shares

- On forfeiture of Shares

↓

If Security Premium Received
(Do not debit Security Premium)

↓

Equity Share Capital A/c Dr. (Called up Capital)
To Share forfeited A/c (Paid up Capital)
To Calls in Arrear A/c (Unpaid Calls)

- On Forfeiture of Shares

↓

If Security Premium NOT Received
(Debit Security Premium)

↓

Equity Share Capital A/c Dr. (Called up Capital)
Security Premium A/c Dr.
To Share forfeited A/c (Paid up Capital)
To Calls in Arrear A/c (Unpaid Calls)

- On Reissue of Shares

↓

Bank A/c Dr. (Cash Received)
Share Forfeited A/c Dr. (Loss on Reissue)
To Equity Share Capital A/c (Called up Capital)

- For Transfer of Remaining Profit to Capital Reserve

↓

Share Forfeited A/c Dr.
To Capital Reserve A/c

★ Shares Issued for Consideration Other than Cash

To Promotors

Goodwill A/c — Dr
Or
Incorporation expense — Dr
To Eq. Sh Capital
To Sec. Pre. A/c
To Bank A/c

For Purchase of Asset

① Asset — Dr
To Vendor A/c

② Vendor A/c — Dr
To Eq. sh Capital A/c
To Sec. Pre. A/c
To Bank A/c

For Purchase of Business

① Sundry Asset — Dr
Goodwill A/c (if any) — Dr
To Sundry Liabilities
To Vendor (PC)
To Cap. Reserve (If any)

any one

② Vendor A/c — Dr
To Eq. sh Capital
To Sec. Premium
To Bank A/c

PC = Purchase Consideration (कितने में खरीदा / सौदे की रकम)

For Payment Entry ⇒ $\text{No. of Share} = \dfrac{\text{Amount Payable}}{\text{Issue Price}}$

Note → No. of Shares हमेशा Complete Integer (eg – 1, 2, 100, 110) etc में होना चाहिए।
Fractional (Decimal) Part का Adjustment Cash / Bank से होगा।

★ Bonus Issue

- Company —Allotment of Share To→ Existing Equity Shareholder → Without any consideration (cash or Kind)

Capitalisation of Reserve
Section 63 of Companies Act, 2013

Accumulated Profit (Reserves) (Decrease) → Share Capital (Increase)

- Creation of Reserve.

	Yr I	Yr II	Yr III	Yr IV
Income (R)	5,00,000	10,00,000	15,00,000	20,00,000
(−) Expense (R)	(2,00,000)	(4,00,000)	(700000)	(1000000)
PBT (R)	3,00,000	6,00,000	8,00,000	10,00,000
(−) Tax 30%	(90000)	(180000)	(240000)	(300000)
PAT (R)	210000	420000	560000	700000

Appropriation of Profit

	(Assume)	(Assume)	(Assume)	(Assume)
Dividend	150000	220000	260000	300000
Revenue Reserve	60,000	200000	300000	400000
Bal. on Revenue Reserve	60,000	2,60,000	560000	960000

960000 ↓
- Accumulated Profit
- Retained Earnings
- Plouging bank of Profit.

Ploughing*

Authorised Capital
(i) 100000 Eq. Sh of ₹ 10 each 10,00,000

Issued, Subscribed & Called up
(ii) 50,000 Eq. Sh of ₹ 10 each
Fully paid up 5,00,000

1 Share
1 Bond

⇒ Bonus Issue 50,000
× Face value × 10
Profits / Fund 5,00,000

Appropriation of Profit

☆ Types of Reserves

Revenue Reserve
(Created out of Revenue Profit)

→ Free Reserve
1. P&L A/c
2. General Reserve
3. Dividend Equalisation Reserve
Etc.

→ Non-Free Reserve
Debenture Redemption Reserve.

Capital Reserve
1. Capital Redemption Reserve
Only for issue of fully paid up bonus share (Sec-69)
2. Security Premium Reserve
Only for issue of fully paid up bonus share (Sec 52)
(If realised in cash)
3. Capital Reserve
(If realised in cash)
4. Revaluation Reserve. Etc.

Statutory Reserve
1. Investment allowance Reserve.
2. Export Profit Reserve.
3. Foreign Project Reserve.
4. Development Rebate Reserve
Etc.

☆ Essential Conditions. (Section. 63)

No company shall capitalize its profits or reserves for the purpose of issuing fully paid up bonus shares under above, unless

(a) It is authorized by its articles
(b) It has, on the recommendation of the board, been authorized in the General Meeting of the Company.
(c) It has not defaulted in payment of Interest or Principal in respect of fixed deposits or debt securities issued by it.
(d) It has not defaulted in respect of the payment of statutory dues of the employees, such as contribution to provident fund, gratuity and bonus.
(e) The partly paid up shares, if any outstanding on the date of allotment, are made fully paid up.
(F) The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same. [Rule 14 of Companies (Share Capital and Debentures) Rules, 2014]

☆ Accounting Treatment of Bonus Issue

↓

Existing Equity Share

Fully Paid up
⇩
Issue fully paid up bonus share

Partly Paid up
⇩
Conversion of Partly-paid up shares into fully paid up by the way of BONUS.

Good Write

Existing Equity Share

↓

Fully Paid up

⇓

Issue fully paid up bonus share

Journal Entry

1. On Declaration of Bonus Issue.

Reserve A/c —— Dr

Capital Reserve

1st. Capital Redemption Reserve

2nd. Security Premium Reserve

3rd. Other Capital Reserve (Only realized in Cash)

Revenue Reserve

To Bonus to Shareholder A/c.

2. On allotment of Bonus Share

Bonus to Shareholder A/c —— Dr

To Equity Share Capital A/c.

Existing Equity Share
↓
Partly Paid up
⇩
Conversion of Partly paid-up shares into fully paid-up by the way of Bonus
(BONUS DIVIDEND)

Journal Entry

1. To make final call
Equity share final call A/c — Dr
To Equity share Capital A/c

2. On declaration of Bonus
Reserve A/c — Dr
Capital Reserve (Only realized in cash)
Revenue Reserve (any Order)
To Bonus to shareholder A/c

3. On making Share fully paid up by Bonus Issue.
Bonus to Shareholder A/c — Dr
To Equity share final call A/c.

★ Underwriting

It is the Process / Contract

where

Definite and unambiguous Assurance

given

By Underwriter(s)
(Individual, Partnership firm, Company)

To Secures Subscription of shares & debentures issued.

OR

To take up Unsubscribed no. of Shares / Debentures

Consideration = Underwriting Commission

- Types of Underwriting

Complete Underwriting
(WHOLE of the issue is underwritten)

- Sole Underwriting → Single Underwriter
- Joint Underwriting → More than One Underwriter

Partial Underwriting
(PART of the issue is underwritten)

- Sole Underwriting → Singer Underwriter
- Joint Underwriting → More than One Underwriter

- Consideration = Underwriting Commission

Sec 40(6) Allows payment of Underwriting Commission
↓
Subjected to conditions prescribed in
↓
Companies (Prospectus & allotment of securities) Rule, 2014

- Authorised by AOA
- Only on Public Issue.
- Max. Commission
  - Shares
    - 5% of Issue Price
    - Rate of AOA
    - Lower
  - Debentures
    - 2.5% of Issue Price
    - Rate of AOA
    - Lower
- Disclosure in Prospectus
  - Name of UW
  - Rate & Amount
  - No. of Securities
- Copy of Contract → Registrar

Formula for UW = No. of Securities underwritten × Issue Price × Rate of commission

- Classification of Application
  - Marked Application → Applications bearing stamps of respective Underwriter
  - Un-marked Application → Applications Do Not Bearing Stamps of respective underwriter / received directly by the Co.

- Firm Underwriting

Calculation of Underwriter's Liability

— Max. Liability = Gross Liability
(−) Marked Appl (Public)
(−) Marked Appl (firm U/R)
(−) Unmarked Appl
Balance
+ Firm U/R
Underwriter's liability

— Min. Liability = Firm U/R

— Min. Liability = 0
(without firm Underwriting)

★ Redemption of Preference Share

Redemption of → Repayment ⇓ $\boxed{\text{Sec. 55}}$ ⇓ Only fully paid up preference shares can be redeemed ⇓ Source of Fund for Red. of Preference Sh.

- 1. Fresh Issue
  - Eq. Sh
  - Other class Pre. Sh
- 2. Free Reserve → Utilise → Capital Redemption Reserve (CRR)
- 1+2

Preference Shares → Companies Act, 2013 Sec. 43 (b) Ex (ii) carries or would carry → Preferential Rights

- Payment of Dividend (Distribution of Profit)
- Payment of Capital (liquidation of company)

Only Fully Paid up

- ① When Fully Paid up → Start Red.
- ② Partly Paid up
  - Ⓐ Final call due
  - Ⓑ " " Receive
  - → Start Red. of PS
  - Call in Arrear → Forfeit
- Pre. share
  - Fully Paid up
  - Partly Paid up ✗

$$\boxed{\text{Face Value of Preference Share to be redeemed} = \text{Face value of Fresh Issue} + \text{Transfer to CRR}}$$

Can Security Premium Utilised for Redemption ?

Utilisation of Security Premium (Sec. 52)

1. Share issue expense w/off
2. Underwriting Commission w/off
3. Discount on issue of Security w/off
4. Preliminary Expenses w/off
5. Premium on Red. of Pre. Sh w/off
6. To issue fully paid up Bonus – Share.
7. To buy back of Eq. Share

NOTE

↓

Certain class of Companies whose Financial Statements comply with the Accounting Standards prescribed U/S. 133 can not apply Security Premium for Write off Preliminary Expenses and Write-off premium on Redemption of Preference Share.

ASSUMPTION

↓

If Nothing Specifies in the Question assume

Company can utilize security premium for writing off Premium on Redemption of Preference Share.

Companies Act, 2013
↓
Companies

- Division I — Sec 133
- ~~Division II~~ — ~~Ind AS~~
- ~~Division III~~ — Ind AS, IFRS

Not in the Syllabus

Good Write

Basic Journal Entries

OPTION A

Bank A/c —— Dr
    To Eq. sh Appl A/c
Eq. sh Appl A/c —— Dr
    To Eq. Sh Capital A/c

OPTION B

P & L A/c —— Dr
General Reserve A/c —— Dr
    To CRR A/c

Pre. sh Capital A/c —— Dr
Premium on Red. on Pre. Sh —— Dr
    To Pre. shareholder

Pre. Shareholder —— Dr
    To Bank A/c

Security Premium A/c —— Dr
Free Reserve A/c —— Dr
    To Premium on Red. on Pre. Sh

☆ Buy Back of Equity Shares

- Unless it is fully paid up
- Buy Back Price

Source of Fund.

- Fresh Issue ①
  - Eq. sh (Different Class)
  - Pre. sh
- Free Reserve ②
  - Capital Red Reserve (Sec-69)
- ① + ② ③

• Sec 68 "Security Premium is a Free Reserve"

$$\begin{bmatrix}\text{F.V. of Eq. sh} \\ \text{to BB}\end{bmatrix} = \begin{bmatrix}\text{Called up Capital of fresh issue} + \text{Amount t/f to CRR} \\ \text{Eq. Pre-Sh}\end{bmatrix}$$

• Bank A/c ——— Dr
  To Pre. Sh Appl A/c

Pre. Sh Appl A/c ——— Dr
  To Pre. Sh. Capital A/c
  To Sec. Premium

General Reserve A/c ——— Dr
P & L A/c ——— Dr
Dividend Eq. Res ——— Dr
  To Cap. Red. Reserve A/c

Eq. Sh Capital A/c — Dr
Premium on buy back — Dr
Any One
To Eq. Shareholder A/c
To Discount on Buy Back

Eq. Shareholder A/c — Dr
To Bank A/c

If Buy Back is on Premium	If Buy Back on Discount
Security Premium A/c — Dr	Discount on Buy Back A/c — Dr
P&L or Gen. Res. A/c — Dr	To Capital Reserve A/c
To Premium on Buy Back	

- Maximum Permissible Buy Back U/S 68.

Condition 1	Condition 2	Condition 3
O/S Share Test	Resources Test (Max Expenditure)	Debt Equity Test (Post Buy Back)
$\frac{\text{Max No}}{\text{of sh}} = 25\% \times \frac{\text{O/S No}}{\text{of Share}}$	$\frac{\text{Max}}{\text{(No.)}} = \frac{25\% \times \text{Eq. Base (₹)}}{\text{Buy Back Price}}$	★ Debts = Long term Liability + Current Liability
$\frac{\text{Max}}{\text{Sh}}$ (1)	$\frac{\text{Max}}{\text{Sh}}$ (2)	$\frac{\text{Debts}}{\text{Equity Base}} \leq 2$
		$\frac{\text{Max}}{\text{Sh}}$ (3)

Least of the Notice

Good Write

Equity Base

E-Sh Capital	₹	x
+ Pre-Sh capital	₹	x
+ Gen. Reserve	₹	x
+ P&L A/c	₹	x
+ SPR*	₹	x
(−) Exp or loss Not yet w/off	₹	(x)
Equity Base	₹	xx

☆ Employees Stock Option Plan (ESOP)

- **Employees Share Based Payment.**

Classification of Employees Share Based Payment

- Equity settled → Employees Receives Shares → ESOP
- Cash settled → Employees receives Cash Based on Price/Value of Share
- Share based Payment with Cash alternative → Enterprise / Employees has a choice to settle Payment in shares or cash.

- **Employees Stock Option Plan (ESOP)**
  - Employees → For Employees
  - Stock → Related to Shares
  - Option → Rights without Obligation
  - Plan → Scheme

As per Company Act 2013, the ESOP means:
option given to the Whole-time-director, 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 predetermined Price.

Objective of Issuing ESOPs

To Provide an Incentive to

Draw Retain Reward

Employees of the co.

To motivate employees to contribute to

Growth & Profitability of the Company.

Important Terms.

Grant : Issue of Option to Employees under ESOS / ESOP

Grant Date : Date at which the enterprise & its employee agree to the terms of an employee share-based payment plan.

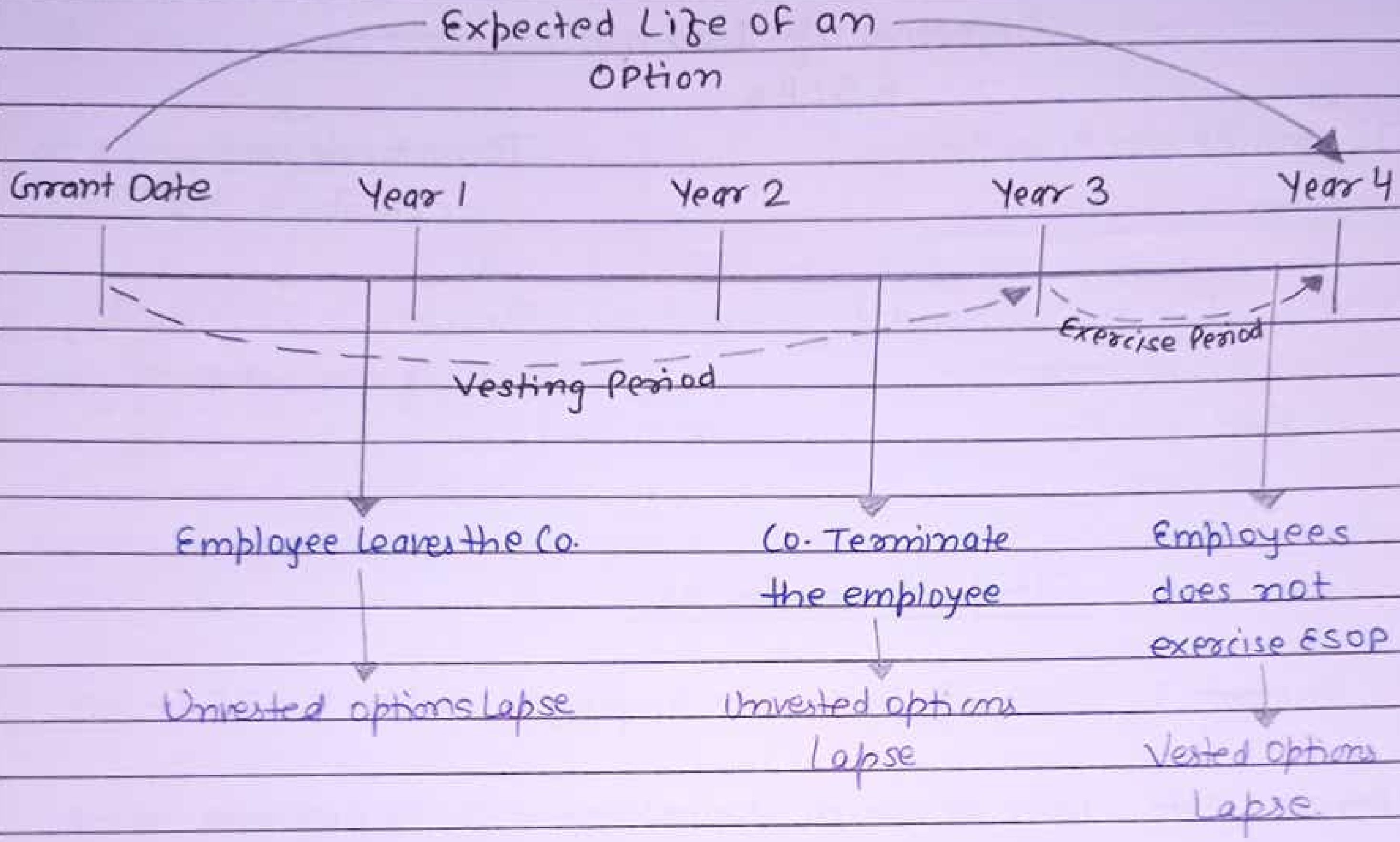
Vesting Condition : Conditions that must be satisfied for the employee to become entitled to receive cash or shares.

Vesting Period : Time period between grant date & the date on which all the specified vesting conditions is to be satisfied. (For Eg- 3Yrs)

Exercise Period : Time period after vesting within which the employee has to apply for shares against the option (For Eg- 1 Yr)

Expected Life of an Option : Period of time from Grant date to the date on which an option is expected to be exercised.

Exercise Price : It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS / ESOP.



Exercise Price.

Less: Fair Value of Share

Option Value
OR
Fair Value of Option
OR
Intrinsic Value of Option

Expense for the Co. (employees cost) → Benefit → Over the Vesting Period.

Written off Proportionately over vesting period.

Journal Entry

If Vesting Period ≤ 1 Year

If Vesting Period > 1 Year

If deferred Emp. Com. Exp. A/c is not maintained.

If deferred Emp. Com. Exp. A/c is maintained

If Vesting Period ≤ 1 Year.

1. On exercise of Option

Bank A/c —— Dr (Exercise Price)
Employees Compensation Exp. A/c —— Dr (Fair Value of Option)
To Eq. Sh Capital A/c (Face Value of Share)
To Security Premium A/c (Fair Value − Face Value)

2. To Transfer Employees cost

Profit & Loss A/c —— Dr
To Employees compensation Exp. A/c

If Vesting Period > 1 Year
If Deferred Employees Compensation Exp. A/c is NOT Maintained

1. To Record Employees Cost.	Employees Compensation Exp. A/c — Dr To Emp. Stock option O/S A/c.
2. To Transfer Employees Cost.	Profit & Loss A/c — Dr To Emp. Compensation Exp. A/c

Note - Above Entries will be recorded at the end of each year during the vesting period.

3. On Exercise of Option	Bank A/c — Dr (Exercise Price) Employees Stock Option Outstanding A/c — Dr (Fair Value of Option) To Eq-Sh Capital A/c (Face Value of Share) To Sec. Premium A/c (Fair Value - face Value)
4. For Vested Option Lapsed	Employees Stock Option O/S A/c — Dr To General Reserve A/c

Good Write

If Vesting Period > 1 Year
If deferred employees Compensation Exp. A/c is Maintained

1. To Record Fair Value of Option (On Grant Date)	Deferred Employees Compensation Exp. A/c — Dr To Employees Stock option O/s A/c
2. To Record Employees Cost (At Year End)	Employees Compensation Exp. A/c — Dr To deferred Emp. compensation Exp. A/c
3. To Transfer Employees Cost	Profit & Loss A/c — Dr To Employees Compensation Exp. A/c

Note – Above entries will be recorded at the end of each year over the vesting period.

4. On Exercise of Option	Bank A/c — Dr (Exercise Price) Employees Stock Option Outstanding A/c — Dr (Fair Value of Option) To Eq. Sh Capital A/c (Face Value of Share) To Sec. Premium A/c (Fair Value – Face Value)

Lesson - 5
Accounting For Debentures

☆ Meaning of Debentures :-

- General Sense

— Debentures are the source of obtaining long-term finance for a Company.
— A Debenture is a bond issued by a company under its seal, acknowledging a debts & containing provisions as regards repayment of the principal and interest.

- [Companies Act 2013 Sec. 2(30)]

— "Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

☆ Kinds of Debentures :-

(1) On the basis of Security
— Unsecured Debentures
— Secured Debentures — Fully Secured Debentures } Fixed Charge & Floating Charge
— Partly Secured Debentures

(2) On the basis of Permanence / Tenure of Redemption.
— Redeemable Debentures
— Irredeemable / Perpetual Debentures

(3) On the basis of convertibility
- Convertible Debentures (CD) — Fully Convertible Debentures
  — Partly Convertible Debentures

- Non-convertible Debentures (NCD)

(4) On the basis of negotiability
- Bearer Debentures
- Registered Debentures

(5) On the basis of Priority
- First Charge Debentures
- Second Charge Debentures

★ Distinction between a Share and a Debenture.

Basis	Share	Debenture
1. Nature	Share is a part of owned capital (owner's Fund).	Debenture constitutes a loan.
2. Reward for investment	Reward is the payment of Dividend.	Reward is the payment of Interest.
3. Fluctuation in the rate of interest and Dividend.	The rate of dividend may vary from year to year depending upon the profit decisions of directors and members.	The Rate of interest is fixed except in case of debentures carrying floating rate of interest.
4. Charge Vs. Appropriation.	Payment of Dividend is an appropriation out of profit & this cannot be made if there is not profit	Payment of interest is a charge against profits & is to be made even if there is no profit

5. Priority as to Payment of Interest/Dividend	Payment of Dividend gets no priority over the payment of Interest.	Payment of Interest gets priority over the payment of Dividend.
6. Priority as to repayment of principal during winding up.	Payment of Share Capital is made after the repayment of Debentures.	Payment of debentures is made before the payment of Share capital
7. Secured by Charge.	Shares are not secured by any charge.	Non- Convertible Debentures redeemable on or after 18 months are secured by a charge
8. Restriction on issue discount.	Section 53 prohibits the issue of Shares at discount.	No restriction is imposed on the issue of debentures at discount
9. Voting Rights.	Shareholders generally enjoy voting rights.	Debenture holders do not have any voting rights (except at their class - meetings)
10. Convertibility	Equity shares can never be convertible	Debentures can be convertible
11. Types	There are only two kinds of shares - Equity Shares & Preference Shares.	There are different kinds of deb. such as secured/unsecured; Redeemable-irredeemable; Registered/Bearer; Convertible/Non-convertible etc.
12. Disclosure in Balance Sheet.	In the Co's B/S, shares are shown under "Shareholders Fund detailed in Sh. Cap of Notes to Accounts.	In the Co's B/S, Deb. are shown under "Long term borrowings".

Good Write

★ Purpose for issue of Debentures

- For Cash Consideration
  - Money Received in Lump Sum
  - Money Received in Installment
- For Consideration other than Cash
  - For acquisition of Asset / Business
  - As Collateral Security

★ Issue of Debentures for cash under various cases of redemption.

ISSUE	REDEMPTION
PAR	PAR
PREMIUM	PREMIUM
DISCOUNT	DISCOUNT

Case I : Debentures issued at Par and redeemable at Par.
Case 2 : Debentures issued at Par and redeemable at Premium.
Case 3 : Debentures issued at Par and redeemable at Discount.
Case 4 : Debentures issued at Premium and redeemable at Par
Case 5 : Debentures issued at Premium and redeemable at Premium
Case 6 : Debentures issued at Premium and redeemable at Discount
Case 7 : Debentures issued at Discount and redeemable at Par
Case 8 : Debentures issued at Discount and redeemable at Premium
Case 9 : Debentures issued at Discount and redeemable at Discount.

Journal Entries

Case 1 :- Par → Par

Present		Future
Issue Price = FV	Face Value = FV	Redemption Value = FV
= 100	= 100	= 100

Bank A/C —— Dr	100	
To Debenture A/C		100

Good Write

Case 2 :- Par → Premium @10%

Present		Future
Issue Price = FV	Face Value = FV	Redemption Value > FV
= 100	= 100	= 110

Bank A/c —— Dr	100	
Loss on issue of Deb. A/c —— Dr	10	
To Debenture A/c		100
To Premium on redemption A/c		10

Case 3 :- Par → Discount @10%

Present		Future
Issue Price = FV	Face Value = FV	Redemption Value < FV
= 100	= 100	= 90

Bank A/c —— Dr	100	
To Debenture A/c		100

Case 4 :- Premium @15% → Par

Present		Future
Issue Price > FV	Face Value = FV	Redemption Value = FV
= 115	= 100	= 100

Bank A/c —— Dr	115	
To Debenture A/c		100
To Security Premium A/c		15

Case 5 :- Premium → Premium

15% → 10%

Present		Future
Issue Price > FV	Face Value = FV	Redemption Value > FV
= 115	= 100	= 110

	Dr	Cr
Bank A/c — Dr	115	
Loss on issue of Debenture A/c — Dr	10	
To Debenture A/c		100
To Security Premium A/c		15
To Premium on redemption A/c		10

Case 6 :- Premium → Discount

15% → 10%

Present		Future
Issue Price > FV	Face Value = FV	Redemption Value < FV
= 115	= 100	= 90

	Dr	Cr
Bank A/c — Dr	115	
To Debenture A/c		100
To Security Premium A/c		15

Case 7 :- Discount → Par

10%

Present		Future
Issue Price < FV	Face Value = FV	Redemption Value = FV
= 90	= 100	= 100

	Dr	Cr
Bank A/c — Dr	90	
Discount on issue of Debenture A/c — Dr	10	
To Debenture A/c		100

Case 8 :- Discount @10% ⟶ Premium @15%

Present		Future
Issue Price < FV	Face Value = FV	Redemption Value > FV
= 90	= 100	= 115

Bank A/c —— Dr	90	
Loss on issue of Debenture A/c —— Dr	25	
To Debenture A/c		100
To Premium on Redemption A/c		15

Case 9 :- Discount 10% ⟶ Discount 15%

Present		Future
Issue Price < FV	Face Value = FV	Redemption Value < FV
= 90	= 100	= 85

Bank A/c —— Dr	90	
Discount on issue of Debenture A/c —— Dr	10	
To Debenture A/c		100

Cases

1 2 3 — Same — 1
4 5 6 — Same — 2
7 8 9 — Same — 3

1 2 3 4 5 6

Good Write

★ Debenture Interest.

Debenture
(Loan Liability)

Company ⟷ Debenture - Holder

~~Interest~~
expense

Journal Entries

(A) For Interest Due.	Debenture Interest A/c —— Dr To Debenture Holder A/c To TDS Payable (Tax deducted at source) (Being interest on Debentures due)
(B) On Payment to Debenture-Holder	Debenture - Holder A/c —— Dr TDS Payable —— Dr To Bank A/c (Being Payment Made for debenture interest)
(C) To transfer interest to Profit & Loss A/c.	P & L A/c —— Dr To Debenture interest A/c (Being Debenture interest transferred to P & L A/c)

$$\text{Interest on Deb} = \text{No. of Debenture} \times \text{Face Value of Debenture} \times \text{Rate of interest} \times \frac{\text{No. of Months}}{12}$$

Good Write

☆ Purpose for issue of Debentures For Acquisition of Asset / Business

– For acquisition of Asset.

(i) On purchase of Asset
Assets A/c —— Dr
To Vendor A/c

(ii) On payment to Vendor
Vendor A/c —— Dr
Discount on issue of Deb. A/c —— Dr
(If Debentures are issued at discount)
To Bank A/c (if any)
To Debentures A/c
To Security Premium A/c
(If Debentures are issued at premium)

– For acquisition of Business.

(i) On Takeover of Business
Assets A/c —— Dr
Goodwill A/c —— Dr
To Liabilities A/c
To Vendor A/c
To Capital Reserve A/c

Asset = 20L
– Liability = 5L
Net Asset = 15L

PC = 18L
PC = 12L

PC > Net Asset ⇒ Capital
PC < Net Asset ⇒ Goodwill
Reserve

(ii) On Payment to Vendor
Vendor A/c —— Dr
Discount on issue of Deb A/c —— Dr
To Bank A/c
To Debentures A/c
To Security Premium A/c

PC = Purchase Consideration

✩ Collateral Security

Accounting Treatment

No Journal Entry (Recording)	With Journal Entry (Recording)
Only Disclosure in Balance Sheet	Debenture Suspense A/c — Dr To Debenture A/c.

Example :- To the banker as collateral security for a loan of Rs. 14,00,000 – Rs. 15,00,000 nominal value.

Option 1 : Without recording Debenture issued as Collateral Security

In the books of Y Company Ltd
Journal Entry

Date	Particular		LF	Dr (₹)	Cr (₹)
(ii)	Bank A/c	Dr		14,00,000	
	To Bank Loan A/c				14,00,000
	(Being a loan of Rs. 14,00,000 taken from bank by issuing deb. of Rs. 15,00,000 as Collateral security)				
(ii)	Debenture Suspense A/c	Dr		1500,000	
	To Debentures A/c				15,00,000

Option 2 : With recording Debenture issued as Collateral Security.
(then write both the entries)

☆ Redemption of Debentures.

Repayment — Loan

Cancellation of Debentures Liability

Forms of Redemption of Debentures

- In Cash
  - Direct Payment to Debenture-holders
    - Lump sum Payment
    - Installment Payment
      - Equal Installment
      - UN-Equal Installment
  - Open Market Operation
    - Purchase own Debentures & Cancel them
- By Conversion

☆ Redemption in Cash.

Debentures (Liability) ⇓ Decrease (Dr)

COMPANY

DEBENTURE HOLDERS

CASH payment

Bank Asset ⇓ Decrease (Cr.)

Good Write

Journal Entries
(Redemption by Cash)

(A) On making Redemption of Debenture due.	Debenture A/c —— Dr Premium on redemption of Debenture A/c —— Dr (If Debentures are redeemed at Premium) To Debenture Holder A/c To Capital Reserve A/c (If Redemption is at Discount) (Being Amount Payable on redemption of Debentures)
(B) On Payment to Debenture-Holder	Debenture Holder A/c —— Dr To Bank A/c (Being Debenture holder are paid by issue of ---- (Detail of Securities) ....)
(C) To Write off Premium on Redemption of Deb.	Security Premium A/c —— Dr Free Reserve A/c —— Dr To Premium on redemption of Debenture A/c

Journal Entries
(Redemption by Conversion)

(A) On making Redemption of Debenture Due.	Debenture A/c —— Dr Premium on redemption of Debenture A/c —— Dr (If Debentures are redeemed at Premium) To Debenture holder A/c To Capital Reserve A/c (Being amount payable on redemption of Debentures)
(B) On allotment of other Securities.	Debenture holder A/c —— Dr Discount on Issue of New Debenture A/C — Dr To Equity Share Capital A/c To Pre. Sh capital A/c To other Debentures A/c To Security Premium A/c (If Issued at Premium) (Being Debenture holder are paid by Issue of ------------)

Good Write

(c) To Write off Premium on redemption on Debenture.	Security Premium A/c — Dr P&L Free Reserve A/c — Dr To Premium on redemption of Debenture A/c

☆ Open Market Operation

Purchase of Own Debentures
(VVIMP)

For Immediate cancellation

These debentures will be cancelled on same day.

Debenture A/c — Dr (Face Value)
Int on Debenture A/c — Dr (Acc. Int)
Loss on redemption — Dr (Bal. Fig)
To Bank A/c (Cum. Int)
To Profit on Redemption (Bal. Fig)

If Profit then transfer :-
Profit on redemption A/c — Dr
To Capital reserve A/c

For Investment Purpose

These Debentures will be cancelled (Redemption) on Future Date.

On Purchase of Debenture
Own Debenture A/c — Dr (Ex. Int)
Int on Deb A/c — Dr (Accrued Int)
To Bank A/c (Cum. Int)

On Cancellation.
Debenture A/c — Dr (F.V.)
Loss on redemption A/c — Dr (Ex int - FV)
Any one
To own debenture A/c (Ex. Int)
To Profit on redemption A/c (FV - Ex. Int)

If Loss then transfer :-	
Security Premium A/c — Dr and/or	Profit on redemption — Dr
Capital Reserve A/c — Dr and/or	To Capital Reserve.
Free Reserve A/c — Dr	
To Loss on redemption.	Security Premium A/c — Dr
	Capital Reserve A/c — Dr
	Free Reserve A/c — Dr
	To Loss on redemption A/c

Important Notes :-

(i) Accrued Interest = $\frac{\text{No. of Deb Purchase}}{} \times \frac{\text{Face}}{\text{Value}} \times \frac{\text{Rate of}}{\text{Interest}} \times \frac{\text{No. of Months}^{*}}{12}$

* No. of Months will be calculated from date of last interest to date of Transaction.

(ii) Price of Debenture

Ex- Interest Rate (excluding interest) (Assume it nothing specified)

Cum interest Rate (including interest)

Ex. Interest Price = Cum interest Price − Accrued Interest.

☆ Sinking Fund Method:

Annual Installment → Given in Question

0	1	2	3	4	5	Redemption
Issue	① T/F to DRR	① T/F to DRR	① T/F to DRR	① T/F to DRR	① T/F to DRR	10,00,000
10,000 12% Deb ₹100	② Invest Purch.	Int Rcvd on inv.	② Int Rcvd	② Int Rcvd	② Int Rcvd	
		② Int T/F to DRR	③ Int t/F to DRR	③ Int t/F to DRR	③ Int t/F to DRR	
		② Inv. Purch	④ Inv. Purch.	④ Inv. Purch.	④ Sale of Inv.	
					⑤ Redemption of Debenture	

Important Notes :-

(i) Always transfer int. on DRR investment to DRR A/c or DRF A/C or S.F. (Do not transfer int on DRR inv. to P & L A/c)

(ii) Transfer profit / Loss on sale of investments to Deb. Red. Res. A/c (Do not t/F Profit / Loss on sale of DRR inv. to P & L A/c)

(iii) Deb. Red. Reserve (Accumulated Reserve) will always have CREDIT Balance.

(iv) DRR investment A/c (Asset) will always have DEBIT Balance.

(v) If nothing specifies in question.
Cr. Balance of Deb. Red. Res = Dr. Balance of DRR investment A/c

(vi) After redemption of debenture, sum equal to Nominal value of Debenture redeem or balance will be transferred from DRR A/c to General Reserve A/c.

Treatment of Sale of Investment (S.F / DRR / DRF Method)

Alter ①	Alter ②
Inv. A/c is to be credited by Cost of Investment Sold	Inv. A/c is to be credited by Sale Proceed of Investment Sold
+	⇓
P/L on Sale of Inv. will be calculated separately and directly t/F to "DRR" A/c.	Bal. fig of DRR Inv. A/c will be P/L on Sale and t/F to DRR A/c.

Good Write

Lesson - 7
Consolidation.

HOLDING COMPANY —Control→ SUBSIDIARY COMPANY

(i) Controls the composition of the board of Directors

OR

(ii) Exercises or Controls more than one-half of the TOTAL SHARE CAPITAL.

Sec 2(46) in relation to one or more other companies, means a Co. of which such companies are subsidiary companies.

Sec 2(87) Co. include a 'Body corporate'
Sec 2(11) Body corporate includes a 'Company incorporate out of India'.

⇒ Can Holding Co. hold shares of Subsidiary Co.? YES

⇒ Can Subsidiary Co. hold shares of Holding Co.?

- Generally — NO
- In Exceptional Cases — YES
  - Legal representative of deceased member of Holding Co.
  - As Trustee
  - Investment held before the Company became subsidiary can continue. (without any voting right)

- Section 129 (clause 3) of Companies Act, 2013 mandated to prepare Consolidated Financial Statements.
- How to Prepare? — As per AS 21 "Consolidated Financial Statements" issued by ICAI.

Good Write

RULE 1 – Consolidate Financial Statements on Line by Line Basis.

RULE 2 – All Liabilities (Except share capital of Subsidiary Co.) and All assets (Except Investments of Holding Co.) will be consolidated.

Note 1 – Controlling Ratio = $\frac{\text{No. of shares held by Holding Co.}}{\text{Total No. of shares of subsidiary Co.}} \times 100$

Note 2 – Cost of Control (CC)

Cost of Investment	XX
Less: Share Capital of Subsidiary Co.	(X)
Goodwill / Capital Reserve	XX

(For Understanding Purpose) ↓

Goodwill / Capital Reserve = Cost of Investment – Net asset acquired in Subs. Co.
(Cost of Control) (Presented by Shareholder's fund)

Cost of Investment > Net asset acquired → Goodwill ↑

Cost of Investment < Net asset acquired → Capital Reserve

RULE 3 – Treatment of Profits of Subsidiary Company.

⇓

Classification of Profit of Subsi. Co.
(Based on date of Acquisition)

- Pre-Acquisition Profit.
- Post-Acquisition Profit.

Good Write

Before Acquisition	Date of Acquisition	After Acquisition

Profit earned by Subsi. Co. ⇓ Pre-Acquisition Profit ↓ Capital Profit (Recovery of Cost) ↓ Less from Cost of Control

Profit earned by Subsi. Co. ⇓ Post-Acquisition Profit ↓ Revenue Profit ↓ Consolidate with Post Profit of Holding Company

- **Minority Interest :-** In any Co. The portion of share capital held by those investors other than holding are collectively called as Minority Interest.
  (A − L)
  Monetary Value of net assets OWNED by Minority (Outsider / 3rd Party) Shareholder controlled by Holding Company.

On Equity & Liability Side → Non Current Liability (Major Head) → Separate Line item. (Sub Head)

RULE 4 − Revaluation of Asset of Subsidiary Company.

Profit on Revaluation
① Add to cost of Asset of Subsi. Co.
② Add to Pre-Acq. Profit of Subsi. Co.

Loss on Revaluation
① Less from Cost of Asset of Subsi. Co.
② Less from Pre-Acq Profit of Subsi. Co.

Shortage of Depreciation
③ Less from Cost of Asset of Subsi. Co.
④ Less from Post-Acq Profit of Subsi. Co.

Excess Depreciation
③ Add to Cost of Asset of Subsi. Co.
④ Add to Post-Acq Profit of Subsi. Co.

1. Calculation of Revaluation Profit / Loss. (On DOR)

Revalued Amount (Market Value on DOR)		xx
(−) Book Value of Asset on the Date of Revaluation		
B. Value (Op. Bal)	xx	
Less: Depreciation (For Pre-Acq. Period)	(xx)	(xx)
Profit / Loss on Revaluation		xx

2. Calculation of Rate of Depreciation.

$$= \frac{\text{Op. Book Value of Asset } (-) \text{ CL. Book Value of Asset}}{\text{Opening Book Value of Asset}} \times 100$$

$$\text{Shortage of Depreciation} = \text{Revaluation Profit} \times \text{Rate (\%) of Depreciation} \times \frac{\text{No. of Months (Post Acq. Period)}}{12}$$

$$\text{Excess Depreciation} = \text{Revaluation Loss} \times \text{Rate (\%) of Depreciation} \times \frac{\text{No. of Months (Post Acq. Period)}}{12}$$

Op. Bal — Annual Dep — Cl. Bal

$$\% \text{ Dep} = \frac{\text{Dep}}{\text{Op. Bal}} \times 100$$

For Understanding Purpose ↓

- Market Value Vs Book Value

Market Value > Book Value → Revaluation Profit

Market Value < Book Value → Revaluation Loss

RULE 5 - Treatment of Stock Reserve

Unrealised Profit on Inter Co. Sale Purchase Transaction

Inter Co. Sale Purchase Transaction

Holding (Sale) → Downstream → Subsi. Co. (Purchase)

Holding (Purchase) ← Upstream ← Subsi. Co. (Sale)

①	②	①	②
Less from Profit of Holding Company (In CBS)	Less from Inventory of Subsi. Co. (In CBS)	Less from Profit of Subsi. Co. (In Analysis of P)	Less from Inventory of Holding Co.

Profit of Subsi. Co.:

- Trade occurred BEFORE Acq. → Pre-Acq. Pr.
- Trade Occurred AFTER Acq. → Post-Acq. Pr. Assume if DATE of Trade is not given in Ques.

Stock Reserve = Value of Stock x Profit % on Sales.

RULE 6 - Treatment of Inter - Company Debts.

Holding Co. → Debts → Subsidiary Co.

- Inter Co. Trade
- Bills of Exchange
- Cash Credit

Subsidiary Co. → Debts → Holding Co.

- Investment in Debts Security of other Co.

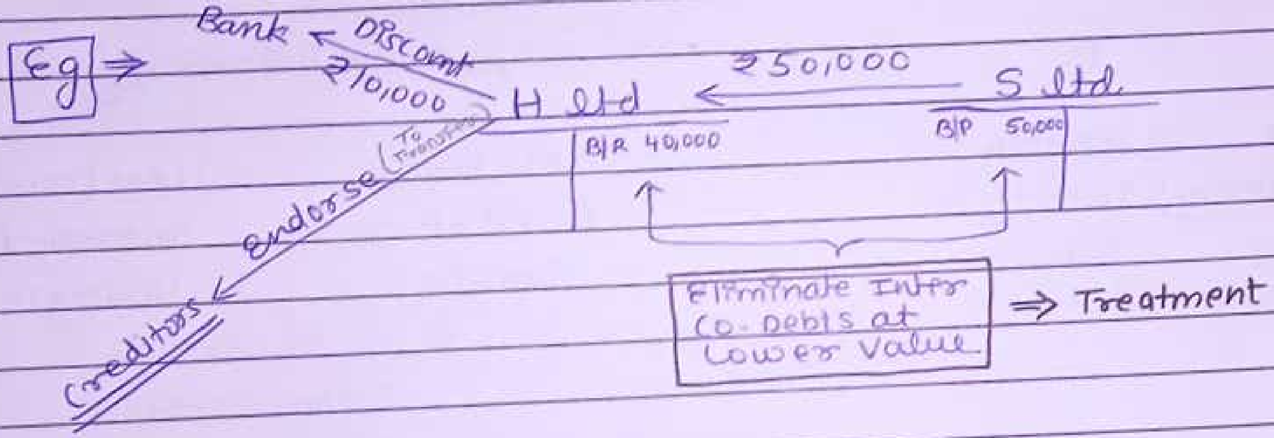
Inter Company Debts
Cancel / Elimination

① Less from Debtors / B.R. / Advance etc.

② Less from Creditors / B.P / Loan etc.

Note 1 – Treatment of Difference in amount of Bills receivable and Bills Payable (if any).

Eg ⇒



Note 2 – Treatment of Difference in amount of Debtors and Creditors.

Eg ⇒ Holding Co. Debtor (Subsi. Co) = 1,00,000 ← Cash in Transit = 20,000 ← Subsidiary Co. Creditor (Holding Co.) = ~~1,00,000~~ 80,000

Treatment ⇒ $\boxed{\text{Eliminate Inter Co. Debt with full value of Debtor and Creditor.}}$

Accidental Spot ✱ Cash in transit will appear additionally in Cash & Cash equivalent (Asset Side → Current Asset)

RULE-7 Dividend Distributed by Subsidiary Co.

Dividend = Distributed Profit

1. Less from Pre Acq-Profit of Subsi. Co. (100%)
2. Add to Post Acq-Profit of Subsi. Co. (100%)
3. Less from Profit of Holding Co. in Consolidated B/S (Holding share)
4. Less from Cost of Control (Holding Share)

RULE-8 Treatment of Bonus Issue (By Subsidiary Co.)

Reserve ↓ (Subsi. Co.) & Eq. Sh. Capital ↑ (Subsi. Co.)

Assume

- Already recorded or adjusted in the books of subsidiary Co.
  → No Treatment in Consolidated B/S.
- Not Adjusted in the books of Subsidiary Co.
  - Less from Profit of Subsi. Co.
    - Ist Preference = General Reserve
    - 2nd Preference = P & L A/c
  - Add to Eq. Sh Capital of Subsi. Co.

Lesson - 9
Cash Flow Statement.

↓
Report / Statement
↓
Prepared by Management
↓
Content

InFlows (Receipts) | OutFlows (Payments) | Net Changes

↓
Cash and Cash equivalents

Cash Balance (eg - ₹, US $) | Bank Balance | Marketable Security

Marketable Security → easily convertible into cash Max. Red. Period = 90 Days
→ should not have more than Ind. insignificant risq.

Investments
- Current Inv.
- Non current Inv.
  - Marketable Security
  - Non Marketable Security

★ Reasons for preparing Cash Flow Statement

↓ IND AS 1.

Presentation of Financial Statement.

A complete set of financial statement comprise of:
- → Balance sheet
- → Statement of Profit and Loss.
- → Statement of changes in equity
- → Statement of Cash Flows
  Not mandatory for:
  (i) OPC, small Co., Dormant Co.
  (ii) Entities falling in Level II & level III
- → Notes, comprising significant accounting policies.

↓ It provides important information that complimentory Statement of Profit and Loss and Balance Sheet.

☆ Classification of Cash Flow Statement

Cash Flows from Operating Activities
- Principal revenue producing activities and
- Other activities

Not investing or financing activities.

Cash Flows from Investing Activities

Acquisition & disposal of
- Long-term assets and
- other investments

Not included in Cash Equivalents.

Cash Flows from Financing Activities

Activities that result in changes in the size and composition of the
- Owner's Capital and
- Borrowings.

☆ Methods of Preparing Cash Flow Statement

Direct Method

Cash receipts from operating Revenue

Cash Payment for operating Expenses

Shown in the Cash Flow Statement.

Indirect Method

Net Profit (or Loss) as disclosed by P & L A/c	XX
± Adjustments	± XX
Cash Flow from operating activities	XX

☆ Effect of Changes in Working Capital

Current Assets
- Increase in Asset → Cash Outflow
- Decrease in Asset → Cash Inflow

Current Liabilities
- Increase in Liability → Cash Inflow
- Decrease in Liability → Cash Outflow

Cash Flow Statement
(For the Year ended ....)

		₹
(A) OPERATING ACTIVITY		
Closing Balance of Profit and Loss A/c	XX	
Less: Opening Balance of Profit and Loss A/c	(XX)	
Surplus during the Year	XX	
Add Back: Appropriation		
Dividend Paid	XX	
Transfer to Reserve	XX	
Profit after Tax	XX	
Add: Provision for Tax during the Year	XX	
Profit before Tax		XX
Add: Non Cash / Non-operating expenses		
Depreciation / Deferred expense. W/ off		XX
Amortization of intangible assets		XX
Loss on sale of fixed assets		XX
Interest Expenses		XX
Less: Non Cash / Non-Operating Income		
Gain on sale of fixed assets		(XX)
Dividend / Rent Received		(XX)
Operating profit before change in Working capital		XX
Adjustment for change in Working Capital		
Add: Increase in Current Liability → ↑ +	XX	
Add: Decrease in Current Assets → ↓ +	XX	
Less: Decrease in Current Liability → ↓ −	(XX)	
Less: Increase in Current Assets → ↑ −	(XX)	XX
Cash Operating Profit before Extraordinary item and Tax		XX
Add / Less: Extraordinary item Proceeds from Insurance settlement.		XX
Cash Operating Profit before Tax Paid		XX
Less: Tax Paid		(XX)
Cash Flow from Operating Activity		XX

Good Write

(B) INVESTING ACTIVITY
Purchase / Sale of fixed assets
Purchase / Sale of Investments
Interest / Dividend Received
Loans to subsidiaries

(C) FINANCING ACTIVITY
Proceeds from issue of share capital
Proceeds from long term borrowings
Repayment to finance lease liabilities
Dividend Paid

Net Cash Flow [A + B + C]

Add: Opening Balance of Cash and Cash equivalent
(Cash + Bank Balance + Marketable Securities)
Closing Balance of Cash and Cash equivalent
(Cash + Bank Balance + Marketable Securities)

- Treatment of Dividend in Cash Flow Statement
  - Dividend received ⇓ Inflow
    - Financial Institution ⇓ Operating Activity
    - Non-financial Institution ⇓ Investing Activity
  - Dividend Paid ⇓ Outflow ⇓ Financing Activity (All entities)

Good Write

- **Treatment of Proposed Dividend**

↓

ASSUMPTION

① Previous Year's proposed Dividend has been paid during Current Year
↓
OutFlow
[Financing Activity]

② Current Year's proposed Dividend will be appropriation of current Year.
↓
Add Back → Appropriation Section
[Under Operating Activity]

- **Treatment of Tax and Tax Provision**

Tax Paid
- Outflow
  ↓
  Operating Activity
  ↓
  "Separate Line Item".
- If Profit after Tax is given in Question
  ↓
  Add to PAT (optional)

"Only Provision for Tax given in Ques."
↓
ASSUMPTION
- Previous Year's Provision for Tax has been paid during the Year
  ↓
  OutFlow
  ↓
  Operating Activity
- Current Year's Provision for Tax will be added to PAT

⇒ If Provision for Tax and Tax Paid, Both given in Question.

Ist treatment ⇒ Tax Paid ⇒ OutFlow ⇒ Operating Activity

2nd treatment ⇒

Closing Provision for Tax	XX
+ Tax Paid during the Year	X
− Opening Provision for Tax	(X)
Provision made during the Year	XX

→ Add to PAT
↓
PBT

Good Write

Financial Statement Analysis 18

This chapter is 1st and Final Part of *"Lesson 8: Financial Statement Analysis"* of study material issued by ICSI for New Course

Question: What do you mean by Ratio Analysis and What are its uses?

Ratio analysis refers to the analysis of various pieces of financial information in the financial statements of a business. They are mainly used by external analysts to determine various aspects of a business, such as its profitability, liquidity, and solvency.

Analysts rely on current and past financial statements to obtain data to evaluate the financial performance of a company. They use the data to determine if a company's financial health is on an upward or downward trend and to draw comparisons to other competing firms.

Uses of Ratio Analysis

1. Comparisons: One of the uses of ratio analysis is to compare a company's financial performance to similar firms in the industry to understand the company's position in the market. Obtaining financial ratios, such as Price/ Earnings, from known competitors and comparing it to the company's ratios can help management identify market gaps and examine its competitive advantages, strengths, and weaknesses. The management can then use the information to formulate decisions that aim to improve the company's position in the market.

2. Trend line: Companies can also use ratios to see if there is a trend in financial performance. Established companies collect data from the financial statements over a large number of reporting periods. The trend obtained can be used to predict the direction of future financial performance, and also identify any expected financial turbulence that would not be possible to predict using ratios for a single reporting period.

3. Operational efficiency: The management of a company can also use financial ratio analysis to determine the degree of efficiency in the management of assets and liabilities. Inefficient use of assets such as motor vehicles, land, and building results in unnecessary expenses that ought to be eliminated. Financial ratios can also help to determine if the financial resources are over- or under-utilized.

Question: What are various types of ratios?

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A ratio is an arithmetical relationship between two figures. Financial ratio analysis is a study of ratios between various items or groups of items in financial statements. Financial ratios have been classified in several ways.

For our purposes, we divide them into four broad categories as follows:

- Liquidity Ratios
- Leverage / Solvency Ratios
- Turnover Ratios
- Profitability Ratios

4. What are liquidity ratios? Discuss the importance of current and liquid ratio.

Answer: Liquidity refers to the ability of a firm to meet its obligations in the short run, usually one year. Liquidity ratios are generally based on the relationship between current assets (the sources for meeting short-term obligations) and current liabilities.

The important liquidity ratios are:

Current Ratio **Acid-test Ratio** **Cash Ratio**

1. Current Ratio

= Current Assets / Current liabilities

Current assets include cash, current investments, debtors, inventories (stocks), loans and advances, and prepaid expenses.

Current liabilities represent liabilities that are expected to mature in the next twelve months.

These comprise (i) loans, secured or unsecured, that are due in the next twelve months and (ii) current liabilities and provisions.

Normally, a high current ratio is considered to be a sign of financial strength. Bankers in India have used a norm of 1.33. Internationally, the norm is 2.0.

2. Acid-test Ratio / Quick / Liquid Ratio:

= (Current Assets - Inventories) / Current liabilities

Quick assets are defined as current assets excluding inventories and other current assets such as prepaid expenses, advance tax, etc. This is a fairly stringent measure of liquidity as it excludes inventories, perhaps the least liquid of current assets, from the numerator.

3. Cash Ratio

= (Cash and bank balances + Current investments) / Current liabilities

This is a very stringent measure of liquidity. Indeed, lack of immediate cash may not matter if the firm can stretch its payments or borrow money at short notice.

Question: How would you study the Solvency position of the firm?

Answer: Financial leverage refers to the use of debt finance. While debt capital is a cheaper source of finance, it is also a riskier source of finance. Leverage ratios help in assessing the risk arising from the use of debt capital.

Two types of ratios are commonly used to analyse financial leverage: **structural ratios and coverage ratios.**

Structural ratios are based on the proportions of debt and equity in the financial structure of the firm. The important structural ratios are: **debt-equity ratio and debt-assets ratio.**

Coverage ratios show the relationship between debt servicing commitments and the sources for meeting these burdens. The important coverage ratios are: **interest coverage ratio, fixed charges coverage ratio, and debt service coverage ratio.**

1. Debt-equity Ratio

Debt-Equity Ratio = Long Term Debts / Shareholders' Funds

where:

Shareholders' Funds (Equity) = Share capital + Reserves and Surplus + Money received against share warrants + Share application money pending allotment

Share Capital = Equity share capital + Preference share capital

or

Shareholders' Funds (Equity) = Non-current Assets + *Working capital – Non-current liabilities

*Working Capital = Current Assets – Current Liabilities

Normally, it is considered to be safe if debt equity ratio is 2 : 1. However, it may vary from industry to industry.

Significance: This ratio measures the degree of indebtedness of an enterprise and gives an idea to the long-term lender regarding extent of security of the debt. As indicated earlier, **a low debt equity ratio reflects more security. A high ratio, on the other hand, is considered risky** as it may put the firm into difficulty in meeting its obligations to outsiders. However, from the perspective of the owners, greater use of debt (trading on equity) may help in ensuring higher returns for them if the rate of earnings on capital employed is higher than the rate of interest payable.

2. Debt to Capital Employed Ratio: The Debt to capital employed ratio refers to the ratio of long-term debt to the total of external and internal funds (capital employed or net assets). It is computed as follows:

Debt to Capital Employed Ratio = Long-term Debt/Capital Employed (or Net Assets)

Capital employed = the long-term debt + shareholders' funds.

Alternatively, it may be taken as net assets = total assets – current liabilities

Significance: Like debt-equity ratio, it shows proportion of long-term debts in capital employed. **Low ratio provides security to lenders** and **high ratio helps management in trading on equity.**

It may be noted that Debt to Capital Employed Ratio can also be computed in relation to total assets.

Debt to Capital Employed Ratio = Total Debts / Total Assets

3. Interest Coverage Ratio Also called the times interest earned, the interest coverage ratio is defined as:

= Profit before interest and taxes / Interest on Long term debts

A high interest coverage ratio means that the **firm can easily meet its interest burden** even if earnings before interest and taxes suffer a considerable decline.

A low interest coverage ratio may **result in financial embarrassment** when earnings before interest and taxes decline. This ratio is widely used by lenders to assess a firm's debt capacity. Further, it is a major determinant of bond rating.

Significance: It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts. Though widely used, this ratio is not a very appropriate measure of interest coverage because the source of interest payment is cash flow before interest and taxes, not earnings before interest and taxes. In view of this, we may use a modified interest coverage ratio:

(Profit before interest and taxes + Depreciation) / Debt interest

4. Fixed Charges Coverage Ratio: This ratio shows how many times the cash flow before interest and taxes covers all fixed financing charges. It is defined as:

(Profit before interest and taxes + Depreciation) / Repayment of loan Interest (1 – Tax rate)

This ratio **measures debt servicing ability** comprehensively because it considers both the interest and the principal repayment obligations. The ratio may be amplified to include other fixed charges like lease payment and preference dividends.

fixed charge coverage ratio of less 1 need not be viewed with much concern.

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5. Debt Service Coverage Ratio Used by financial institutions in India, the debt service coverage ratio is defined as:

= (Profit after tax +Depreciation +Other non-cash charges Interest on term loan + Lease rentals) / (Interest on term loan + Lease rentals + Repayment of term loan)

Significance: Financial institutions calculate the average debt service coverage ratio for the period during which the term loan for the project is repayable. Normally, financial institutions regard a debt service coverage ratio of 1.5 to 2.0 as satisfactory. The Debt Service Coverage Ratio can be a very helpful metric for assessing a company' s overall financial health, and specifically how capable it is of servicing its current debt.

6. What are various Turnover ratios? How are these worked out?

Answer: Turnover ratios, also referred to as activity ratios or asset management ratios, measure how efficiently the assets are employed by a firm. These ratios are based on the relationship between the level of activity, represented by sales or cost of goods sold, levels of various assets. The important turnover ratios are:

1. **Inventory Turnover**
2. **Receivables Turnover**
3. **Average Collection Period**
4. **Fixed Assets Turnover**
5. **Total Assets turnover.**

1. Inventory Turnover: The inventory turnover, or stock turnover, measures how fast the inventory is moving through the firm and generating sales. It is defined as:

= Cost of goods sold/ Average inventory

Significance: The inventory turnover reflects the efficiency of inventory management. **The higher the ratio, the more efficient the management** of inventories and vice versa. However, this may not always be true. A high inventory turnover may be caused by a low level of inventory which may result in frequent stock outs and loss of sales and customer goodwill.

2. Debtors' Turnover This ratio shows how many times sundry debtors (accounts receivable) turn over during the year. It is defined as:

= Net credit sales/ Average sundry debtors

If the figure for net credit sales is not available, one may have to make do with the net sales figure.

Obviously, the higher the debtors' turnover the greater the efficiency of credit management.

Average Collection Period

The average collection period represents the number of days' worth of credit sales that is locked in sundry debtors. It is defined as:

= Average sundry debtors / Average daily credit sales

Note that the average collection period and the debtors' turnover are related as follows:

Average collection period = 365 / Debtors' turnover

The average collection period may be compared with the firm's credit terms to judge the efficiency of credit management.

An average collection period which is shorter than the credit period allowed by the firm needs to be interpreted carefully. It may mean efficiency of credit management or excessive conservatism in credit granting that may result in the loss of some desirable sales.

3. **Fixed Assets Turnover:** This ratio measures sales per rupee of investment in fixed assets. It is defined as:

= Net sales / Average net fixed assets

This ratio is supposed to measure the efficiency with which fixed assets are employed - a **high ratio indicates a high degree of efficiency in asset utilisation** and a low ratio reflects inefficient use of assets.

However, in interpreting this ratio, one caution should be borne in mind. When the fixed assets of the firm are old and substantially depreciated, the fixed assets turnover ratio tends to be high because the denominator of the ratio is very low.

4. **Total Assets Turnover:** Akin to the output-capital ratio in economic analysis, the total assets turnover is defined as:

= Net sales / Average total assets

This ratio measures **how efficiently assets are employed, overall.**

6. What are various profitability ratios? How are these worked out?

Answer: Profitability reflects the final result of business operations. There are two types of profit ability ratios:

Profit Margin Ratios **Rate of Return Ratios.**

Profit margin ratios show the relationship between profit and sales. Since profit can be measured at different stages, there are several measures of profit margin. The most popular profit margin ratios are:

1. **Gross Profit Margin**
2. **Operating Profit Margin**
3. **Net Profit Margin.**

Rate of return ratios reflect the relationship between profit and investment. The important rate of return measures are:

1. **Return on Assets**
2. **Earning Power**
3. **Return on Capital Employed**
4. **Return on Equity.**

1. Gross Profit Margin

= Gross profit / Net sales or Revenue

Gross profit = Net sales (-) Cost of Goods Sold.

This ratio shows the margin left after meeting manufacturing costs. It measures the efficiency of production as well as pricing.

Significance: It indicates gross margin on products sold. It also indicates the margin available to cover operating expenses, non-operating expenses, etc.

Change in gross profit ratio may be due to change in selling price or cost of revenue from operations or a combination of both. **A low ratio may indicate unfavourable purchase and sales policy. Higher gross profit ratio is always a good sign.**

2. EBITDA Margin:

(Earnings before interest, taxes, depreciation, and amortization) / Net sales

This ratio shows the margin left after meeting manufacturing expenses, selling, general, and administration expenses (SG&A). **It reflects the operating efficiency** of the firm.

3. Net Profit Margin

= (Net profit / Net sales) x 100

This ratio shows the earnings left for shareholders (both equity and preference) as a percentage of net sales. It measures the overall efficiency of production, administration, selling, financing, pricing, and tax management.

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4. Return on Assets

ROA = Profit after tax / Average total assets

Though widely used, ROA is an odd measure because its numerator measures the return to shareholders (equity and preference) whereas its denominator represents the contribution of all investors (shareholders as well as lenders).

5. Earning Power

Earning power = Profit before interest and tax/ Average total assets

Earning power is a measure of business performance which is not affected by interest charges and tax burden.

It abstracts away the effect of capital structure and tax factor and focuses on operating performance. Hence it is eminently suited for inter-firm comparison. Further, it is internally consistent. The numerator represents a measure of pre-tax earnings belonging to all sources of finance and the denominator represents total financing.

6. Return on Capital Employed

ROCE = Profit before interest and tax (1 - Tax rate) / Average total assets

The numerator of this ratio viz., profit before interest and tax (1 - Tax rate) is also called net operating profit after tax (NOPAT).

It is internally consistent. Its merit is that it is defined in such a way that it can be compared directly with the post-tax weighted average cost of capital of the firm.

7. Return on Equity or return on net worth.

= Equity earnings / Average equity

Equity earnings = Profit After Tax (-) Preference Dividends.

Average equity = Paid-Up Capital + Reserves & Surplus

Because maximizing shareholder wealth is the dominant financial objective, ROE is the most important measure of performance in an accounting sense. It is influenced by several factors: earning power, debt-equity ratio, average cost of debt funds, and tax rate. Because ROA and ROE are commonly used measure, you must remember that they are accounting rates of return. Hence these measures may be properly referred to as **return on book assets and return on book equity.**

Question: How to read and analysize the Financial Statement?

Answer: The following point to be taken into consideration while analyse financial statements.

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1. Use ratios to get clues to ask the right questions: By themselves ratios rarely provide answers, but they definitely help to raise the right questions.

2. Be selective in the choice of ratios: Compute scores of different ratios and easily drown into confusion. For most purposes a small set of ratios-three to seven-would suffice. Few ratios, aptly chosen, would capture most of the information that can derive from financial statements.

3. Employ proper benchmarks: It is a common practice to compare the ratios (calculated from a set of financial statements) against some benchmarks. These bench marks may be the average ratios of the industry or the ratios of the industry leaders or the historic ratios of the firm itself.

4. Know the tricks used by accountants: Since firms tend to manipulate the reported income, should learn about the devices employed by them.

5. Read the footnotes: Footnotes sometimes contain valuable information. They may reveal things that management may try to hide. The more difficult it is to read a footnote, the more information-laden it may be.

6. Remember that financial statement analysis is an odd mixture of art and science: Financial statement analysis cannot be regarded as a simple, structured exercise. It is a process requiring care, thought, common sense, and business judgment-a process for which there are no mechanical substitutes.

Forecasting Financial Statement 19

This chapter is 1st and Final Part of ***"Lesson 10: Forecasting Financial Statement"*** of study material issued by ICSI for New Course

Question: What is Financial Forecasting? Explain its Importance.

Answer: Financial Forecasting is a process of estimating or predicting a company's financial future by examining historical performance of data like revenue, cash flow, expenses, or sales.

It basically includes the analysis of past business performance, current business trends, and other relevant factors. Moreover, a financial plan that estimates the projected income and projected expenses of a business, and a solid financial forecast contains both macroeconomic factors and conditions that are specific to the organization.

Importance of Financial Forecasting: Few important points have been pointed:

- It serves as the **basis for budgeting decisions.**
- It gives businesses **access to cohesive reports**, allowing finance departments to establish business goals that are both realistic and feasible.
- It **provides management valuable insights** into the way the business performed in the past and the way it will compare in the future.
- It provides a **barometer** for those making material financial decisions.
- It facilities to **build investor relations** by preparing well and structured plan and which is prepared for any unforeseen events impacting revenues and budgets.
- It **provides customizable approach** based on the core set of foundational components.
- **To make accurate budget** and facilitates to establish realistic business goals.
- With the help of accurate financial forecasting, **problem areas can easily be traced** out and company with remedial action plan can reduce the financial risk.
- Many times, accurate and authenticate financial forecast reflecting higher Return on Investment and that helps to build and enhance the investor's confidence.

Question: Difference between Financial Forecasting vs budgeting.

Answer: Financial forecasting should always precede the budgeting process to ensure spending is in line with factors that can impact overall financial performance. Those who create budgets without financial forecasts are at risk of overspending and not having enough available cash for unexpected costs or shortfalls in revenue.

Lacking a forecast may also keep the business from greenlighting a new capital investment or launching a product that may have ended up being a growth driver.

Basis	Forecast	Budget
Meaning	Mere estimate of what is likely to happen.	Shows that policy and program to be followed in future period under planned conditions
Nature of Event	Probable	Proposed
Tool of control	No	Yes
Base	It's a preliminary step or base for budgeting	Forecasts are converted into budget
Hierarchy	It ends with forecast of likely events	It begins when forecasting ends.
Scope	Wider	Limited

Question: Methods of Financial Forecasting? Explain with example.

Answer: Basically, there are two methods namely **Quantitative methods and Qualitative methods.**

Quantitative forecasting methods are used to make assumptions about the future based on historical data.

Qualitative forecasting relies on expert's knowledge and experience to predict performance rather than historical numerical data.

These forecasting methods are often called into question, as they are more subjective than quantitative methods and they can provide valuable insight into forecasts and account for factors that can't be predicted using historical data.

(1) Based on Revenue (% of Turnover)

As per this method, items like costs of goods sold (COGS), Stock and cash are calculated as a percentage of sales. Those percentages are then applied to future sales estimates to project each line item's future value.

(2) Moving Average Method

It is categorized into two parts namely, The average or Weighted average of previous periods to forecast the future. It is closely scrutinizing a business's high or low demands. Hence, it is more suitable for short term forecasting. For example, you can use it to forecast next month's sales by averaging the previous quarter. Using weighted averages to incorporate current periods can increase the accuracy of moving average forecasts.

(3) Constant Growth Rate

It assumes a company's historical growth rate will remain constant. Forecasting future revenue involves multiplying a company's previous year's revenue by its growth rate.
it excludes market fluctuations or supply chain issues.

(4) Regression Method

This method is based on a relationship between two variables: dependent and independent. The dependent variable represents the forecasted amount, while the independent variable is the factor that influences the dependent variable. E.g. Advertisement expense (Independent Variable) and Sales (Dependent). It means change in advertisement expense would lead to change in sales. It is based on equation:

$$Y = BX + A$$

Y= Dependent variable (Forecasted number)

B = Slope line

X = Independent variable

A = Y-intercept

(5) Delphi Method

The Delphi method i.e. Estimate-Talk-Estimate Technique (ETE) is a systematic and qualitative method of forecasting by collecting opinions from a group of financial experts through several rounds of questions.
The Delphi method relies on experts who are knowledgeable about a specific area so they can forecast the outcome of future scenarios, predict the likelihood of an event, or reach consensus about a particular topic. The financial experts then fill out another questionnaire that gives them the opportunity to provide updated opinions based on what they understand from the summary report. It is one of most important qualitative method.

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