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PAPER 3

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35	178	980
Chapters	Original questions	Recall prompts

How to use this book

Build the idea, work through the example, change the situation and explain the answer. Start with the situation: whose records are used, the period and the question asked. Read the meaning and assumptions before applying an entry, formula or legal provision, then work the steps and explain what the result means.

Answer the practice questions before reading their reasons, and use the recall prompts to test your explanation. The contents on the next page, the chapter learning tabs, the bookmarks and the alphabetical topic index are clickable.

Read dated clarifications alongside historical examples. Match the applicable accounting framework, entity, period and legal scope. This 2026 compiled study edition (1 November 2026) retains the review status of its chapters.

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MODULE A / CHAPTER 1

Definition, Scope and Accounting Standards including Ind AS

Understand the transaction. Explain the rule. Apply it to a new situation. Start with a small business, then connect its records to reporting frameworks and internal pricing decisions.

Learning route	What you should be able to explain
Accounting purpose and scope	Why records, profit, cash and financial position are different.
Indian accounting standards	Who develops standards, why compliance matters and how the AS titles fit together.
US GAAP and IFRS	How the frameworks developed and which older comparisons need correction.
Transfer pricing	How internal prices affect profit centres, choices and group reporting.
Practice and recall	Reason through examples and revise 28 essential facts.

1. Why does a business need accounting?

Meera starts a stationery shop. She receives her own capital, a bank loan and sales receipts. She pays for goods and rent. A full cash box cannot tell her how much profit she earned or how much she owes. Accounting is the business language that turns these financial events into organised, useful information.

RECORD Capture the event. → **CLASSIFY** Group similar items. → **SUMMARISE** Prepare totals. → **INTERPRET** Explain the result.

The process records transactions systematically, groups them by nature, summarises results and financial position, and interprets the information. Monetary measurement gives the records a common unit. Financial statements focus on financially measurable events; employee skill or reputation can matter without automatically becoming a recognised asset. Qualitative explanations can still be useful.

Output	Purpose and limitation
Trial balance	Summarises ledger balances and checks debit/credit agreement. Agreement alone does not prove that every entry is correct.
Profit and loss account	Explains income, expenses and the resulting profit or loss for a period.
Balance sheet	Shows assets, liabilities and equity at a particular date.

2. Objectives and branches of accounting

Objective	Practical meaning
Systematic records	Keep a traceable record instead of relying on memory.
Results of operations	Find profit or loss for the relevant period.
Financial position	Identify resources and claims against them.
Rational decisions	Help owners, lenders and managers interpret performance and choices.
Legal requirements	Maintain records and reports required by the relevant entity law and tax law.

Legal context varies: companies, societies and public trusts have different governing requirements, alongside income-tax and other applicable tax obligations. Older references to Sales Tax legislation describe their historical setting; they are not a complete statement of the present indirect-tax regime. GST and any continuing state taxes must be considered under their applicable laws.

Branch	Question it helps answer	Example
Financial accounting	What were the reported results and position?	Annual profit and balance sheet.
Cost accounting	What does a product/service cost?	Cost of processing a loan application.
Management accounting	Which decision should management take?	Whether to expand a service line.
Social responsibility accounting	What social effects/responsibilities arise?	Information about community impact.
Human resource accounting	What information about investment in people is useful?	Analysing training and workforce value; not automatic asset recognition.
Inflation accounting	How do price changes affect interpretation?	Comparing amounts from periods with different purchasing power.

Worked example: profit is not the cash balance

Given: owner capital Rs.50,000; loan Rs.20,000; goods bought for cash Rs.30,000; goods costing Rs.5,000 sold for Rs.8,000 cash; rent paid Rs.1,000. **Find:** profit, cash and closing position. Assume one period, no interest/tax/drawings/other transactions, and unsold goods held at purchase cost.

Movement	Reason	Cash after movement
Capital +50,000	Owner financing is not sales revenue.	50,000
Loan +20,000	A repayment liability arises.	70,000

Movement	Reason	Cash after movement
Goods -30,000	Cash becomes inventory.	40,000
Sale +8,000	Revenue 8,000; sold inventory cost 5,000.	48,000
Rent -1,000	Current-period expense.	47,000

Profit: 8,000 - 5,000 - 1,000 = **Rs.2,000**. Only the sold goods' cost is charged; Rs.25,000 remains inventory. **Cash:** 50,000 + 20,000 - 30,000 + 8,000 - 1,000 = **Rs.47,000**. **Check:** assets 47,000 + 25,000 = 72,000; loan 20,000 + equity (50,000 + 2,000) = 72,000.

CHANGE ONE ASSUMPTION

If the earned Rs.8,000 sale is on credit with no collection uncertainty, profit is still Rs.2,000 under accrual accounting. Cash is Rs.39,000 and receivables Rs.8,000; assets still total Rs.72,000. Later collection changes cash and receivables; it does not create a second sale.

3. From bookkeeping to useful financial information



Luca Pacioli and the written accounting tradition
Pacioli's *Summa* was published in Venice in 1494 and included an early printed treatment of bookkeeping. Double-entry practices existed before that publication. The important lesson is the discipline of explaining both sides of an event, rather than treating a cash movement as the entire story.

Portrait attributed to Jacopo de' Barbari; public-domain reproduction via Wikimedia Commons. History: Library of Congress.

A modern record can be digital rather than handwritten, but the questions remain: what happened, when, to which entity, at what amount and with what effect? A value-oriented view also asks what the numbers mean for performance, resources and decisions; it does not give permission to invent values for items that do not meet recognition requirements.

4. Indian standards: why and how they are made

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

ICAI - Institute of Chartered Accountants of India
ICAI constituted the Accounting Standards Board (ASB) on **21 April 1977** to harmonise diverse accounting policies and practices. ASB formulates standards through a consultative process.

Stage	What happens
1. Select priorities	Identify broad accounting areas needing standards and their priority.
2. Investigate	Study groups examine particular subjects and possible treatments.

Stage	What happens
3. Consult	Seek views of government, public/private industry and other organisations.
4. Expose draft	Issue a proposed standard for comments from members and the public.
5. Consider feedback	Review comments, revise the draft and submit it to ICAI Council.
6. Apply the legal framework	For companies, distinguish professional formulation from statutory prescription under section 133 and relevant rules.

A consultation is useful because the same transaction can look different to preparers, auditors, users and regulators. The objective is a coherent reporting treatment, not merely a preferred label. AS, Ind AS and IFRS are distinct frameworks. **Ind AS is substantially converged with IFRS, with Indian differences**; it is not identical to every IFRS requirement.

Official reference: ICAI Preface to Statements of Accounting Standards | checked 1 November 2026.

Official reference: ICAI Ind AS guidance and differences from IFRS | checked 1 November 2026.

5. Compliance: preparer, directors and auditor

An applicable mandatory standard is not optional. Older teaching often says every departure automatically requires a qualified audit report. The proper audit response depends on materiality, pervasiveness and the applicable auditing standards: a material misstatement can require a qualified or adverse opinion. Failure to discharge professional duties can lead to disciplinary consequences; a departure is not a licence to ignore it. Listed entities also operate within the relevant SEBI reporting framework.

Companies Act, 2013	Teaching point
Section 129(1)	Financial statements must give a true and fair view and comply with notified standards and applicable presentation requirements.
Section 133	Statutory prescription of accounting standards is distinct from professional standard formulation.
Section 134(5)(a)	Directors' Responsibility Statement addresses following applicable standards and proper explanation of material departures.
Section 129(5)	If statements do not comply, disclose: (1) deviation; (2) reasons; (3) financial effects, if any. Disclosure does not erase the compliance obligation.

EXPLAIN THE THREE DISCLOSURES

A policy departs from an applicable requirement. **What changed?** identifies the deviation. **Why?** gives the reason. **What did it do to the figures?** explains the financial effect, if any. A reader needs all three to interpret the result.

Official reference: Companies Act, 2013, sections 129, 133 and 134 | checked 1 November 2026.

6. AS number map: keep the topic and its status

Read this map by topic, not as a claim that every historical number is a current mandatory standard for every entity. Older teaching describes a sequence of “29 standards” and separately lists AS 30-32. Withdrawals, revisions and entity-specific applicability make that shorthand misleading.

Dated correction: the 2016 amendments omitted AS 6 and revised AS 10. AS 8 is a historical withdrawn standard. The old AS 10 title was *Accounting for Fixed Assets*; revised AS 10 is *Property, Plant and Equipment*. Older AS 15 wording referred to retirement benefits; its revised title is *Employee Benefits*.

AS 5 also addresses extraordinary items within the AS framework. That topic should not be confused with the current US GAAP prohibition on a separate extraordinary-item category; the applicable framework determines the treatment.

Code	Title / historical label	What to understand
AS 1	Disclosure of Accounting Policies	Explain significant accounting policies used.
AS 2	Valuation of Inventories	Determine the carrying amount of stock.
AS 3	Cash Flow Statements	Explain movements in cash and cash equivalents.
AS 4	Contingencies and Events Occurring after the Balance Sheet Date	Consider relevant events and conditions around the reporting date.
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Distinguish current results, prior-period items and policy changes.
AS 6	Depreciation Accounting	Historical standard: omitted in the 2016 amendments; depreciation is addressed in revised AS 10.
AS 7	Construction Contracts	Account for construction-contract revenue and costs under the AS framework.
AS 8	Accounting for Research and Development	Historical shorthand: withdrawn from 1 April 2003. More precisely, withdrawal followed AS 26 becoming mandatory for the concerned enterprise (phased 2003/2004 application).
AS 9	Revenue Recognition	Consider when revenue is recognised under the AS framework.
AS 10	Accounting for Fixed Assets -> Property, Plant and Equipment	Older title on the left; revised AS 10 uses the title on the right.
AS 11	The Effects of Changes in Foreign Exchange Rates	Translate foreign-currency transactions and balances.
AS 12	Accounting for Government Grants	Consider government assistance and its accounting treatment.

Code	Title / historical label	What to understand
AS 13	Accounting for Investments	Address investment classification and carrying amounts.
AS 14	Accounting for Amalgamations	Account for qualifying amalgamations.
AS 15	Retirement Benefits -> Employee Benefits	Older retirement-benefit wording is narrower than the revised title, Employee Benefits.
AS 16	Borrowing Costs	Consider which borrowing costs are capitalised or expensed.
AS 17	Segment Reporting	Show information about business/geographical segments under this framework.
AS 18	Related Party Disclosures	Identify relevant related-party relationships and transactions.
AS 19	Leases	Address accounting for lease arrangements under the AS framework.
AS 20	Earnings Per Share	Relate earnings to the relevant share count.
AS 21	Consolidated Financial Statements	Present the group as an economic entity.
AS 22	Accounting for Taxes on Income	Address current and deferred tax under the AS framework.
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements	Consider associates in group reporting.
AS 24	Discontinuing Operations	Identify and disclose qualifying discontinuing operations.
AS 25	Interim Financial Reporting	Deal with reports for periods shorter than a financial year.
AS 26	Intangible Assets	Consider assets without physical substance and relevant recognition requirements.
AS 27	Financial Reporting of Interests in Joint Ventures	Address joint-venture interests under the AS framework.
AS 28	Impairment of Assets	Consider whether an asset's carrying amount is recoverable.
AS 29	Provisions, Contingent Liabilities and Contingent Assets	Distinguish recognised provisions from contingencies.

AS 30-32: preserve the history, avoid a current-rule error

AS 30, AS 31 and AS 32 dealt with financial instruments. Older accounts call them “not mandatory”. ICAI records their withdrawal at the Council meeting of **7-9 November 2016**. Do not use them as a current optional substitute for an applicable notified standard or regulatory requirement.

Historical number/title	Distinction to retain
AS 30: Financial Instruments: Recognition and Measurement	Historical withdrawn standard; not a current optional substitute for notified requirements.
AS 31: Financial Instruments: Presentation	Historical withdrawn standard; distinguish it from Ind AS 32.
AS 32: Financial Instruments: Disclosures	Historical withdrawn standard; distinguish it from Ind AS 107.

A number can mean something different in another framework. AS 7 concerns construction contracts, while Ind AS 7 concerns cash flows. AS 32 historically concerned disclosures, while Ind AS 32 concerns presentation. Always read the **framework + number + title** together.

Official reference: ICAI September 2016 amendments | checked 1 November 2026.

Official reference: ICAI withdrawn-standards register | checked 1 November 2026.

7. US GAAP: the reporting framework and learning principles

GAAP means **generally accepted accounting principles**. US GAAP comprises detailed accounting requirements and practices for that jurisdiction. The **Financial Accounting Standards Board (FASB)** establishes standards; its Accounting Standards Codification (ASC) is the authoritative source for nongovernmental US GAAP, apart from relevant SEC requirements. Public and private entities can use US GAAP; not every entity that makes a report public is automatically subject to the same legal regime.

Standardised assumptions, terminology, definitions and methods help users compare reports and assess decisions. They improve transparency and consistency, but cannot guarantee that companies are economically comparable or that a report contains no error or judgement. Investors and managers must still analyse the underlying business.

Learning label	Meaning	Apply the reasoning
Regularity	Follow the requirements of the applicable accounting framework.	Choose the applicable rules before recording.
Consistency	Use consistent policies across periods unless a justified change is required/permitted.	A change should not hide poor performance.
Sincerity	Aim for accurate, impartial reporting.	Do not manipulate a number to please the reader.
Permanence of methods	Use stable procedures so comparisons remain meaningful.	Keep the method consistent; explain justified changes.
Non-compensation	Show relevant positive and negative aspects; do not conceal losses by arbitrary offsetting.	Offset only where the applicable requirements allow it.
Prudence	Exercise caution under uncertainty, without bias or unsupported speculation.	Caution does not authorise deliberately understated assets.
Continuity	Normally prepare on a going-concern basis, subject to the entity's circumstances.	Continued operation affects how assets are considered.

Learning label	Meaning	Apply the reasoning
Periodicity	Report activity for defined periods, such as quarters or years.	Put income and expenses in the relevant reporting period.
Materiality	Present/disclose information whose omission, misstatement or obscuring could influence decisions.	It does not mean disclosing every trivial detail.
Utmost good faith	Honesty is expected from participants in reporting.	Honesty supports reliable reporting but does not remove verification.

IMPORTANT DISTINCTION

These ten labels are popular introductory mnemonics. They are **not** an authoritative FASB list of ten rules that overrides the Codification. In particular, materiality does not mean “disclose everything”, and prudence does not mean deliberate pessimism.

Three explanatory building blocks

Building block	What it explains
Basic concepts and guidelines	Separate business/owner transactions; use monetary units and explicit reporting periods; apply cost, disclosure, going concern, matching, revenue recognition, professional judgement and cautious treatment of uncertainty within the applicable framework.
Standard-setting requirements	The FASB succeeded the Accounting Principles Board in 1973. The ASC reorganised authoritative nongovernmental US GAAP and became effective for periods ending after 15 September 2009; historic predecessor literature is not a separate competing current hierarchy.
Industry-specific requirements/practices	Banks and retailers face different transactions and risks. Industry-specific guidance can apply within the common reporting framework; it is not permission for each industry to invent unrelated GAAP.

US reporting institutions developed through a longer history, including securities regulation after the 1929 crash and the Great Depression. **Do not date FASB itself to 1929:** it was established in 1973. Historical origins and the present standard-setting body are different facts.

Official reference: FASB standards and Codification | checked 1 November 2026.

Official reference: FASB history and role | checked 1 November 2026.

8. IFRS, IASB and the reporting framework



The IFRS Foundation is the organisation; the **International Accounting Standards Board (IASB)** is its independent accounting standard-setting board. IASB began in **2001**, succeeding the International Accounting Standards Committee (IASC), and is based in London. IFRS Accounting Standards aim to provide a common

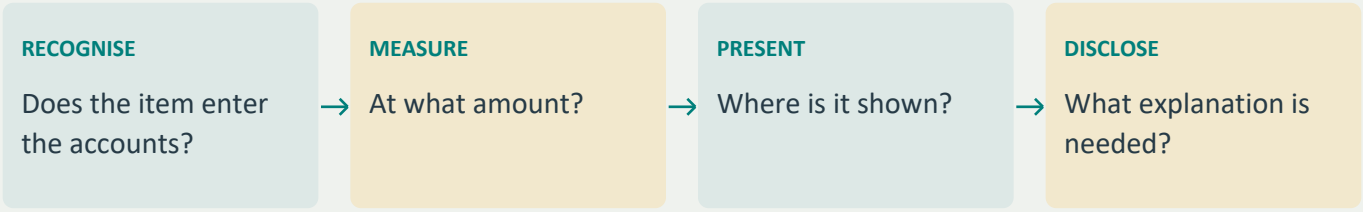
reporting language that helps users understand financial information across borders.

Foundation objective	Why it matters
Develop a high-quality common set	Standards should be understandable, enforceable and globally accepted.
Promote use and rigorous application	Common labels without faithful application do not produce useful comparisons.
Consider varied reporting needs	Emerging economies and small/medium-sized entities have relevant circumstances and needs.
Support adoption and convergence	Facilitate the relationship between national requirements, international standards and interpretations.

The Foundation now also has a sustainability standard-setting board, the ISSB. Keep its role distinct from the IASB's accounting role. Likewise, the IFRS Foundation's broad objectives do not make IFRS automatically mandatory for every Indian business.

The Conceptual Framework: understand the purpose before the rules

The IASB issued the Framework in **September 2010** and revised it in **March 2018**. It explains objectives, useful-information characteristics, reporting-entity boundaries, assets/liabilities/equity/income/expenses, recognition, measurement, presentation and disclosure. It supports consistent reasoning; it is **not an IFRS Standard and does not override a specific Standard**.



Official reference: IFRS Conceptual Framework and history | checked 1 November 2026.

9. IFRS and IAS: the complete chapter number map

IFRS-numbered and IAS-numbered standards form part of the same international reporting literature, subject to their status and scope. IAS numbers are not automatically obsolete simply because their prefix is older. Some have been replaced; others remain relevant. The maps retain every IFRS and IAS number introduced in this chapter.

Code	Title	Topic / status
IFRS 1	First-time Adoption of International Financial Reporting Standards	Transition to IFRS reporting.
IFRS 2	Share-based Payment	Transactions paid for with shares or share-based amounts.
IFRS 3	Business Combinations	Accounting when control of a business is obtained.

Code	Title	Topic / status
IFRS 4	Insurance Contracts	Historical interim standard replaced by IFRS 17 from 1 January 2023.
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	Held-for-sale classification and discontinued operations.
IFRS 6	Exploration for and Evaluation of Mineral Resources	Exploration/evaluation expenditure.
IFRS 7	Financial Instruments: Disclosures	Explain financial-instrument significance and risks.
IFRS 8	Operating Segments	Disclose operating-segment information.
IFRS 9	Financial Instruments	Classification, measurement, impairment and hedge accounting.
IFRS 10	Consolidated Financial Statements	Control and group consolidation.
IFRS 11	Joint Arrangements	Classify and account for joint arrangements.
IFRS 12	Disclosure of Interests in Other Entities	Explain interests and risks in other entities.
IFRS 13	Fair Value Measurement	A framework for measuring fair value when required/permitted.
IFRS 14	Regulatory Deferral Accounts	Rate-regulated deferral balances; future replacement by IFRS 20.
IFRS 15	Revenue from Contracts with Customers	Revenue from customer contracts; replaces IAS 11 and IAS 18 from 2018.
IFRS 16	Leases	Lease accounting; replaces IAS 17 from 2019.
IFRS 17	Insurance Contracts	Insurance accounting; effective for annual periods beginning on/after 1 January 2023.

Code	Title	Topic / status
IAS 1	Presentation of Financial Statements	Presentation framework; IFRS 18 replaces it from 2027, with early application permitted.
IAS 2	Inventories	Inventory costs and valuation.
IAS 7	Statement of Cash Flows	Cash flows classified by activity.
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	Policies, estimates and errors; renamed Basis of Preparation of Financial Statements when IFRS 18 is applied.
IAS 10	Events after the Reporting Period	Adjusting versus non-adjusting events.
IAS 11	Construction Contracts	Historical: replaced by IFRS 15 from 2018.
IAS 12	Income Taxes	Current and deferred income taxes.

Code	Title	Topic / status
IAS 16	Property, Plant and Equipment	Tangible operating assets.
IAS 17	Leases	Historical: replaced by IFRS 16 from 2019.
IAS 18	Revenue	Historical: replaced by IFRS 15 from 2018.
IAS 19	Employee Benefits	Benefits provided to employees.
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	Government grants and assistance.
IAS 21	The Effects of Changes in Foreign Exchange Rates	Foreign-currency transactions and translation.
IAS 23	Borrowing Costs	Borrowing costs, including qualifying-asset capitalisation.
IAS 24	Related Party Disclosures	Related parties and relevant transactions.
IAS 26	Accounting and Reporting by Retirement Benefit Plans	Retirement-plan reporting.
IAS 27	Separate Financial Statements	Investments in subsidiaries, joint ventures and associates in separate statements.
IAS 28	Investments in Associates and Joint Ventures	Equity-method accounting and related matters.
IAS 29	Financial Reporting in Hyperinflationary Economies	Financial statements when the functional currency is hyperinflationary.
IAS 32	Financial Instruments: Presentation	Liability/equity classification and presentation.
IAS 33	Earnings per Share	Basic and diluted earnings per share.
IAS 34	Interim Financial Reporting	Interim reports and their minimum content.
IAS 36	Impairment of Assets	Recoverability and impairment.
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	Obligations and uncertainty.
IAS 38	Intangible Assets	Recognition and measurement of intangible assets.
IAS 39	Financial Instruments: Recognition and Measurement	Largely superseded by IFRS 9; some hedge-accounting use remains.
IAS 40	Investment Property	Property held for rental income/capital appreciation.
IAS 41	Agriculture	Biological assets and agricultural produce within its scope.

Issued is not the same as effective: developments checked 1 November 2026

Development	Effective-date distinction
IFRS 15 / IAS 11 and IAS 18	IFRS 15 applies for annual periods beginning on/after 1 January 2018; it replaced the older construction-contract and revenue standards.
IFRS 16 / IAS 17	IFRS 16 applies for annual periods beginning on/after 1 January 2019.
IFRS 17 / IFRS 4	IFRS 17 applies for annual periods beginning on/after 1 January 2023.
IFRS 18: Presentation and Disclosure in Financial Statements	Applies from annual periods beginning on/after 1 January 2027; replaces IAS 1. Early application permitted.
IFRS 19: Subsidiaries without Public Accountability: Disclosures	Eligible subsidiaries may elect reduced disclosures from annual periods beginning on/after 1 January 2027; early application permitted.
IFRS 20: Regulatory Assets and Regulatory Liabilities	Issued May 2026; applies for annual periods beginning on/after 1 January 2029; early application permitted. Replaces IFRS 14 when applied.

Earlier application and local adoption conditions must be checked for a particular entity. In particular, the IFRS 18-related IAS 8 title change follows application of that new presentation framework; it should not be silently applied to every earlier report.

Official reference: IFRS Standards Navigator | checked 1 November 2026.

Official reference: IFRS 18 official overview | checked 1 November 2026.

Official reference: IFRS 19 effective-date information | checked 1 November 2026.

Official reference: IFRS 20 issue and effective date | checked 1 November 2026.

10. US GAAP versus IFRS: compare the right things

The following six issues are often compared in exam preparation. The historical column retains older teaching distinctions so that a learner can recognise them. The explanation column shows why several cannot be memorised as current rules. **Verified corrections are dated 1 November 2026.**

A **non-controlling interest** is the ownership interest in a subsidiary not attributable to the parent. It is often called minority interest; the accounting question concerns its classification and presentation, not simply whether the investor has a “significant” stake.

Financial-statement documents	Teaching and correction
Historical distinction	Older shorthand: IFRS lists balance sheet, income statement, changes in equity, cash flows and notes; US GAAP separately names comprehensive income.
Explanation / current distinction	Both systems report financial position, performance including comprehensive income, changes in equity, cash flows and notes. IFRS permits profit or loss/OCI in one or two statements. The older list is not proof that IFRS omits OCI.

Balance-sheet classification	Teaching and correction
Historical distinction	Older shorthand: IFRS requires a current/non-current split; US GAAP recommends it.
Explanation / current distinction	IFRS generally separates current/non-current items, but permits a liquidity presentation when more reliable and relevant. US presentation depends on entity and requirements; avoid a universal optional-versus-compulsory rule.

Deferred taxes	Teaching and correction
Historical distinction	Older shorthand: IFRS shows a distinct line; US GAAP places tax balances within assets/liabilities.
Explanation / current distinction	A deferred tax asset is an asset and a deferred tax liability is a liability under both frameworks. In a classified balance sheet, deferred taxes are non-current under IFRS and US GAAP; FASB ASU 2015-17 changed US classification. Relevant offset and presentation rules still apply.

Minority/non-controlling interests	Teaching and correction
Historical distinction	Historical US treatment: minority interests shown as liabilities; IFRS shown within equity.
Explanation / current distinction	For ordinary non-controlling ownership interests, both generally show a separate component of consolidated equity. FASB Statement 160 applied for fiscal years beginning on/after 15 December 2008. Redeemable instruments require separate analysis.

Extraordinary items	Teaching and correction
Historical distinction	Historical US treatment allowed an item that was both unusual and infrequent; IFRS prohibited the label.
Explanation / current distinction	IFRS does not permit an extraordinary-item category. FASB ASU 2015-01 eliminated that US category for fiscal years beginning after 15 December 2015. Unusual/infrequent events can still require separate presentation or disclosure.

Bank overdrafts	Teaching and correction
Historical distinction	Older shorthand: IFRS may include overdrafts in cash management; US GAAP treats them as financing.
Explanation / current distinction	IAS 7 permits an overdraft within cash/cash equivalents for cash-flow purposes only when repayable on demand and integral to cash management. Otherwise borrowing is financing. US GAAP generally treats overdraft borrowing as financing; this does not create a general balance-sheet offset right.

WHY THE CORRECTION MATTERS

"Unusual" describes an event; "extraordinary item" was a specific reporting category. An unusual event can still need explanation even though the former category has been removed. A classification label is not the event itself.

Official reference: IAS 1 complete financial-statement set | checked 1 November 2026.

Official reference: FASB ASU 2015-01: extraordinary items | checked 1 November 2026.

Official reference: FASB ASU 2015-17: deferred-tax classification | checked 1 November 2026.

Official reference: FASB Statement 160: non-controlling interests | checked 1 November 2026.

Official reference: IAS 7 overdraft conditions: March 2018 agenda decision | checked 1 November 2026.

11. Transfer pricing: one group, different profit centres

A transfer price is the amount used for a transaction between related units or entities. It can apply to products, services or other transactions; this chapter uses goods to explain the logic. A parent's subsidiaries may be measured as separate profit centres, so the price changes one unit's revenue and another's cost. It affects buying behaviour and can have income-tax implications.

UNIT A
Makes the component.

→

TRANSFER
Internal price = A revenue / B cost.

→

UNIT B
Finishes and sells outside.

Issue	Managerial implication
Revenue basis	A supplying unit's reported revenue and margin depend on the transfer price.
Preferred customers	A high external price may make the supplying unit prefer outside customers.
Preferred suppliers	A high internal price may make the buying unit prefer outside suppliers.

The managerial aim is a sensible decision for the group, alongside fair performance measurement. Tax transfer pricing has its own arm's-length rules and permitted methods. The management approaches below are **not a complete statutory tax-method list** and do not establish tax compliance by themselves.

12. Seven pricing approaches: method, example and limitation

1. Market rate	How to reason
Meaning	Use a comparable external market price.
Worked illustration	If the outside price is Rs.120, a comparable internal transfer can use Rs.120.
Condition / common mistake	The supplying unit can be indifferent between comparable internal and external sales, assuming the same costs/capacity. Market price is not a guarantee of maximum group profit.

2. Adjusted market rate	How to reason
Meaning	Start from a market price, then adjust for genuine differences.
Worked illustration	Rs.120 market price less Rs.5 external selling/credit cost avoided = Rs.115.
Condition / common mistake	A lower bad-debt risk may justify an adjustment only on the facts. Common ownership does not guarantee that payment risk disappears.

3. Negotiated price	How to reason
Meaning	The supplying and receiving units agree a price.
Worked illustration	A specialised component has no clear outside market; managers negotiate a transfer.
Condition / common mistake	The result depends on bargaining power, information and available alternatives; a tiny market or customised goods can make benchmarks difficult.

4. Contribution-margin approach	How to reason
Meaning	Consider variable cost and the contribution sacrificed by transferring internally.
Worked illustration	Variable cost Rs.70 + opportunity cost Rs.20 = Rs.90 minimum in the stated case.
Condition / common mistake	A useful management model, not a universal tax formula. With spare capacity and no displaced sale, opportunity cost may be zero.

5. Resale price	How to reason
Meaning	Work backwards from an independent customer's resale price using a suitable gross margin.
Worked illustration	Rs.200 resale price less 25% of sales (Rs.50) = Rs.150.
Condition / common mistake	Compare functions, risks and transaction conditions. A resale margin on sales is not the same as a markup on cost.

6. Cost-plus	How to reason
Meaning	Add an appropriate profit markup to the relevant cost base.
Worked illustration	Standard cost Rs.100 + 20% markup on cost (Rs.20) = Rs.120.
Condition / common mistake	Define the cost base and percentage base. Without a market price, cost-plus can be a management approach, but tax acceptance is not automatic.

7. Cost-based	How to reason
Meaning	Transfer at cost without an internal profit markup.
Worked illustration	A supplies at cost Rs.100; B adds Rs.30 and sells externally for Rs.200.
Condition / common mistake	A records no internal margin; B records the Rs.70 chain profit under these simplified assumptions. Each successive unit adds its cost; group profit still depends on external revenue and total group cost.

MARKUP IS NOT MARGIN

A 20% markup on cost Rs.100 gives price Rs.120 and a margin on sales of 20/120 = **16.67%**. A 20% margin on sales requires price 100/(1 - 0.20) = **Rs.125**. Always identify the denominator before calculating.

A price change moves unit profit; it does not manufacture group profit

All goods sold externally; no tax/other effects	Transfer at 120	Transfer at 150
A: cost 100; internal revenue	120	150
A: profit	20	50
B: external sales 200; own added cost 30	200 - 120 - 30	200 - 150 - 30
B: profit	50	20
Combined pre-tax profit	70	70

Check independently from the group's external transaction: external sales 200 - A's cost 100 - B's added cost 30 = **Rs.70**. Internal revenue and internal purchases are eliminated in consolidation. Actual changes in tax, capacity, sourcing or behaviour can change the economic result; the illustration holds those constant.

13. Apply your understanding: original questions

1. A fresh Rs.10,000 bank loan is received. Does profit immediately rise by Rs.10,000?

Answer and reason: No. Cash and a repayment liability rise together. The receipt is financing, not sales revenue.

2. Meera buys goods for Rs.30,000 but sells only goods costing Rs.5,000. Which amount enters the example's cost of goods sold?

Answer and reason: Rs.5,000. Unsold goods costing Rs.25,000 remain inventory under the stated assumptions. Charging all purchases would confuse stock with the cost consumed in earning the sales.

3. A manager needs the cost per service and a decision on which service to expand. Which branches help?

Answer and reason: Cost accounting helps determine service cost; management accounting uses relevant information to support the expansion decision. Financial accounting supplies broader reported results.

4. Should a learner memorise "AS 6 is a current separate depreciation standard" and "AS 30-32 are simply optional"?

Answer and reason: No. AS 6 was omitted in the 2016 amendments and depreciation is addressed in revised AS 10. AS 30-32 are historical withdrawn standards, not optional replacements for applicable requirements.

5. Are the ten mnemonic GAAP principles the authoritative US GAAP rulebook?

Answer and reason: No. They are introductory learning labels. The FASB Codification is the authoritative source for nongovernmental US GAAP, with SEC requirements relevant to SEC registrants.

6. Is "minority interest is always a US liability" a safe current distinction?

Answer and reason: No. Ordinary non-controlling interests are generally separately presented in consolidated equity under both systems. The older US treatment predates the change introduced by Statement 160; special redeemable instruments require separate analysis.

7. A reseller sells for Rs.200 and needs a 25% gross margin on sales. Is its transfer price Rs.160?

Answer and reason: No. Margin = 25% x 200 = Rs.50; transfer price = 200 - 50 = Rs.150. Rs.160 results from dividing 200 by 1.25, which assumes a 25% markup on cost instead.

8. A transfers at Rs.150 instead of Rs.120; external sale price and all group costs stay unchanged and all goods are sold outside. Does consolidated pre-tax profit rise?

Answer and reason: No, before other tax or economic effects. A's internal margin rises by Rs.30 and B's falls by Rs.30. Internal sales/purchases are eliminated in consolidation; external revenue and total group cost determine the simplified group profit.

Tempting shortcut	Reasoning to use instead
"Every cash receipt is income."	Identify whether the receipt is revenue, capital, borrowing or collection of an existing receivable.
"The older IFRS/US table must still be correct."	Read the issue, date and relevant change; ordinary NCI and extraordinary items illustrate why.
"Internal price rises, so group profit rises."	Check external revenue and total group cost after eliminating internal transactions.

14. Quick Revision: 28 essential recall facts

Use these as prompts to explain the topic, not as a substitute for the worked reasoning.

FOUNDATIONS / 01-14	FRAMEWORKS AND APPLICATION / 15-28
01. Accounting records, classifies, summarises and interprets financial information.	**15.** AS, Ind AS and IFRS are distinct frameworks; numbering alone misleads.
02. Performance concerns a period; financial position concerns a date.	**16.** Ind AS is substantially IFRS-converged, with Indian differences.
03. Monetary measurement does not capture every valuable business quality.	**17.** The FASB Codification is authoritative for nongovernmental US GAAP.
04. Trial balance, profit and loss account and balance sheet serve different purposes.	**18.** The ten GAAP mnemonic labels do not replace authoritative requirements.
05. Core objectives include records, results, position, decisions and legal compliance.	**19.** IASB began in 2001 and succeeded the IASC in standard setting.
06. Financial, cost and management accounting answer different questions.	**20.** The Framework was issued in 2010 and revised in March 2018.
07. Social, human-resource and inflation accounting broaden the information focus.	**21.** IFRS 15 replaced IAS 11/18; IFRS 16 replaced IAS 17.
08. Cash receipts are not automatically income; loans create liabilities.	**22.** IFRS 17 replaced IFRS 4; issued and effective are different concepts.
09. ICAI constituted its ASB on 21 April 1977.	**23.** IFRS 18/19: 2027; IFRS 20: 2029; early application permitted.
10. Standard setting includes research, consultation, exposure and consideration of comments.	**24.** Current US GAAP does not retain an extraordinary-item category.
11. Section 129(5): disclose deviation, reasons and financial effects, if any.	**25.** Ordinary non-controlling interests generally sit within consolidated equity.
12. AS 6 is historical; revised AS 10 addresses depreciation of PPE.	**26.** Internal prices change unit incentives and can have tax implications.
13. AS 8 is historical; intangible-asset issues are addressed under AS 26.	**27.** Resale margin on sales differs from a markup on cost.
14. AS 30-32 are withdrawn historical standards, not current optional substitutes.	**28.** Internal price changes alone do not create consolidated pre-tax profit.

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MODULE A / A02

Basic Accountancy Procedures

A business pays rent today, receives an advance for next month and sells goods on credit. The cash dates alone cannot tell us this month's profit. Accounting concepts explain what belongs to the business, when income or expense belongs to a period and how the two sides of a transaction stay equal.

Identify the entity → Recognise the event → Apply dual effect → Explain the period

Understand it through a worked situation

The owner contributes Rs.50,000: business cash and equity each increase by Rs.50,000. The business then pays next month's rent of Rs.6,000: cash falls and a prepaid asset arises, assuming the future benefit meets recognition requirements. At the next month-end, the prepaid amount becomes rent expense. If rent instead remains unpaid after being incurred, recognise expense and a payable. Payment timing and expense timing answer different questions.

COMMON MISTAKE - CHECK THE REASON

Equity is not an ordinary outside liability, and a loss is not an asset. Profit normally increases equity; loss reduces it. Prudence means evidence-based caution, not choosing the largest conceivable loss. Historical cost is one measurement basis, not a universal prohibition on remeasurement.

Concepts, procedures and worked records

Introduction

As with language, accounting has many dialects. There are differences in terminology. In dealing with the framework of accounting theory, one is confronted with a serious problem arising from the differences in terminology. A number of words and terms have been used by different writers to express and explain the same idea or notion.

Accounting concepts: recording and reporting

At the recording stage	At the reporting stage
Cost concept	Going concern concept
Money measurement concept	Matching concept
Business entity concept	Accounting period concept
Realisation concept	Conservatism
Dual aspect concept	Full disclosure
Historical records concept	Materiality
No additional recording-stage item in this row	Consistency

The various terms used for describing the basic ideas of accounting are: concepts, postulates, propositions, basic assumptions, underlying principles, fundamentals, conventions, doctrines, rules, etc.

Concepts of Accountancy

Accounting of often called the language of business through which a business house normally communicates with the outside world. In order to make this language

intelligible and commonly understand by all, it is necessary that it is based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Concepts

Concept / item	Meaning, condition or application
There following are the main accounting concepts	There following are the main accounting concepts

Cost Concepts: Every business transactions is recorded in the books of accounts at cost price, e.g, the machinery is recorded in the books by that amount which is paid to the supplier plus the expenses of bringing and installing the machinery which are necessary to put it in working order.

Applications

Historical formulation: Fixed assets are kept at the cost of purchase and not their market value.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Historical-cost shorthand is not a universal measurement rule. Apply the relevant framework: initial cost, later depreciation/impairment, permitted revaluation or fair-value requirements can differ. “Present value” is a particular discounted measurement, not a synonym for every current transaction amount.

Concept / item	Meaning, condition or application
Every transaction is recorded with the present...	Every transaction is recorded with the present value and not any future value.

Historical formulation: Unrealised gains are ignored.

Historical formulation: An item, that has no cost, is not taken in books

Money measurement concept: Every transaction that is recorded in books of accounts must be measured in terms of money. All the transactions are converted into a common form, which is money. Example, quarterly production, sales, wages, etc, all are converted in terms of money.

Applications

Concept / item	Meaning, condition or application
Health of a proprietor or manager is...	Health of a proprietor or manager is not taken into the books although it may have a great impact on the overall business.
We do not include any inflation or...	We do not include any inflation or deflation or deflation in the value of any asset.

Historical formulation: Business entity Concept: This concept separates the entity of the proprietor from the business transactions. The capital contributed by the owner is a liability for the business because business, which is an artificial person, is different from owner.

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Use the accounting equation precisely: capital is equity, distinct from outside liabilities. Profit increases equity and loss reduces it; a loss is not itself a resource meeting the asset definition.

Applications

Concept / item	Meaning, condition or application
Any money withdrawn by the proprietor is...	Any money withdrawn by the proprietor is treated separately as drawings.

Historical formulation: Profit is a liability while loss is an asset.

Historical formulation: Realisation concept: This concept tells us when is the revenue treated as realized or earned. It is treated as realized or earned on that date when the property in the goods pass to the buyer and he becomes legally liable to pay.

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This is older revenue-recognition shorthand. Identify the applicable AS/Ind AS requirements and the actual transfer/performance conditions. Cash receipt, a legal invoice or a hoped-for future sale alone is not sufficient.

Applications

Concept / item	Meaning, condition or application
No future income is considered.	No future income is considered.
Goods sold on approval will not be...	Goods sold on approval will not be included in sales but taken at cost only.

Historical formulation: The rules of revenue recognition determines that the earning process should be either complete or near completion.

Historical records Concept: In accounts, The historical cost principle states that businesses must record and account for most assets and liabilities at their purchase or acquisition price. In other words, businesses have to record an asset on their balance sheet for the amount paid for the asset.

Going concern concept: This concept indicates that the business is a going concern and the transactions are recorded accordingly. If an expense is incurred and its utility is consumed during the year, then it is treated as an expense, otherwise it is recorded as an asset.

Applications

Concept / item	Meaning, condition or application
The fixed assets are valued at cost and not at market value.	The fixed assets are valued at cost and not at market value.

Historical formulation: Current assets are valued at cost or the market value whichever is less.

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Do not generalise this to every current asset or every future possibility. Inventory uses the applicable lower-of-cost/NRV rule; a provision requires the applicable present-obligation, likelihood and measurement conditions. A reserve is not the same thing as a provision.

Concept / item	Meaning, condition or application
Depreciation is provided based on the total...	Depreciation is provided based on the total number of years of life of asset. Balances of one year are carried forward to the next year.

Historical formulation: Reserves and provisions are created for any future liability.

Matching concept: This concept explains that we have to match the income of a certain period with expenses of that period only. The term matching refers to the close relationship that exists between certain expired cost and revenues realized as a result of incurring those costs. The justification of the matching concept arises from accounting period concept.

Applications

Concept / item	Meaning, condition or application
All adjustments regarding prepaid expenses, outstanding expenses...	All adjustments regarding prepaid expenses, outstanding expenses are made in the final accounts.

Historical formulation: Deferred revenue expenditure concept arises due to this.

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Matching alone does not justify carrying an expenditure forward as an asset. First establish that an asset meets the applicable recognition requirements.

Accounting period concept: An accounting period is the span of time covered by a set of financial statements. This period defines the time range over which business transactions are accumulated into financial statements, and is needed by investors so that they can compare the results of successive time periods.

Main Conventions of Accounting

Accounting of full disclosure: Entries are made in such a way, that they provide honestly all information relating to the activities of the business. The records should not conceal anything from outsider. Secret reserves should not be maintained as per this convention.

Convention of materially: All material information, must be recorded. What is material depends upon the value of the item involved and circumstances of individual case of business. Exp: Paisa is not recorded.

Historical formulation: Convention of conservatism: While recording transactions, all possible losses must be taken into consideration, while all anticipated profits should be ignored. This is also called the principle of prudence.

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Prudence is cautious, neutral, evidence-based judgement under uncertainty. Do not create every possible loss or choose a pessimistic percentage automatically. Apply the relevant recognition/measurement requirements and use supportable estimates; the 2%/5% illustration needs evidence of changed credit conditions.

Convention of consistency: If a method is selected for recording purposes, it must be regularly followed in the future also. Whenever it is necessary to change, the impact of such change must be given separately.

Going Concern Entity

Concept / item	Meaning, condition or application
The going concern concept of accounting implies...	The going concern concept of accounting implies that the business entity will

continue its operations in the future and will not liquidate or be forced to discontinue operations due to any reason. A company is a going concern if no evidence is available to believe that it will or will have to cease its operations in foreseeable future.

An example of the application of going concern concept of accounting is the computation of depreciation on the basis of expected economic life of fixed assets rather than their current market value. Companies assume that their business will continue for an indefinite period of time and the assets will be used in the business until fully depreciated. Another example of the going concern assumption is the prepayment and accrual of expenses. Companies prepay and accrue expenses because they believe that they will continue operations in future.

Double Entry System

Concept / item	Meaning, condition or application
There are two systems of keeping records, i.e.	There are two systems of keeping records, i.e.

Single entry system and

Double entry system

Single entry system

Concept / item	Meaning, condition or application
The single entry system appears to be...	The single entry system appears to be time saving and economical but it is unscientific as under this system some transactions are not recorded at all, whereas some other transactions are recorded only partially. Under the double entry system of bookkeeping, both aspects of each and every transaction are recorded. This is known as the dual aspect analysis. Under the single entry system, only one aspect of the transaction, i.e. personal is recorded and the other aspect is ignored.
For example, in case goods are sold...	For example, in case goods are sold on credit to a customer, only the customer’s account is opened and debited but the goods account is not opened. Under this system, only the accounts which are absolutely necessary are maintained. Other accounts, i.e. nominal and real accounts are not opened except cash. The accounts maintained under this system are incomplete and unsystematic and, therefore, the system is not reliable. The system is followed by small business firms.

Double Entry System

Concept / item	Meaning, condition or application
The double entry system is based on...	The double entry system is based on scientific principles and is, therefore, used by most of the business houses. The system recognises the fact, that every transaction has two aspects and records both the aspects of each and every transaction.
Under this system, in every transaction, an...	Under this system, in every transaction, an account is debited and some other account is credited. The crux of accountancy lies in finding out which of the two accounts are affected by a particular transaction and out of these two accounts, which account is to be debited and which account is to be credited.

Account format: debit and credit sides

Field	Debit side (Dr.)	Credit side (Cr.)
Account name	Same account name spans both sides	Same account name spans both sides
Date	Date of debit	Date of credit
Particulars	Description/corresponding account	Description/corresponding account
J.F.	Journal folio reference	Journal folio reference
Amount (Rs.)	Debit amount	Credit amount

Principles of Double Entry System The following are the main principles of double

Concept / item	Meaning, condition or application
entry system	entry system:

Historical formulation: For every transaction, two parties must be interested.

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Two accounting aspects are required, not necessarily two outside people. A cash-to-bank transfer and depreciation each illustrate effects within the same reporting entity.

Concept / item	Meaning, condition or application
Every business transaction has two aspects, one...	Every business transaction has two aspects, one of receiving the benefit and the other of giving it. In simple words, ‘double entry’ system means ‘every debit has a corresponding credit’.
Both the aspects, are recorded in the books of account.	Both the aspects, are recorded in the books of account.

Concept / item	Meaning, condition or application
The two-fold effect of a business transaction...	The two-fold effect of a business transaction is recorded by debiting one account and crediting the other account at the same time.

Merits of Double Entry System

Concept / item	Meaning, condition or application
It keeps a complete record of business...	It keeps a complete record of business transactions. Both, the personal accounts and impersonal accounts are kept. The entire information regarding the value of assets and profits earned during the year can be easily obtained.
It provides a check on the arithmetical...	It provides a check on the arithmetical accuracy of both the accounts, since every debit has corresponding credit to it and vice versa.
The detailed profit and loss account can...	The detailed profit and loss account can be prepared to show the profits earned or the loss suffered during any given period.
The system makes possible the comparison of...	The system makes possible the comparison of purchases as well as sales, expenditure, income, etc., of a current year, with those of the previous years, thus enabling a businessman to control his business activities.
The balance sheet can be prepared at...	The balance sheet can be prepared at any specified point of time or any date showing the actual amount of assets, liabilities and capital.

Historical formulation: The system being a scientific one, prevents commission of fraud and, if a fraud is committed, it can be easily detected.

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Double entry helps arithmetic checking but does not guarantee fraud prevention or detection. Balanced false entries, collusion and complete omissions can escape it.

Concept / item	Meaning, condition or application
The accurate details, with regard to any...	The accurate details, with regard to any account, can be easily obtained.

System of Keeping Recording

Historical formulation: Single entry system: A single entry system records each accounting transaction with a single entry to the accounting records, rather than the vastly more widespread double entry system. The single entry system is centered on the results of a business that are reported in the income statement.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

“Single entry” describes incomplete-record systems in practice; do not assume every real-world transaction is uniformly recorded exactly once.

Double entry system: The double-entry system of accounting or bookkeeping means that for every business transaction, amounts must be recorded in a minimum of two accounts. The double-entry system also requires that for all transactions, the amounts entered as debits must be equal to the amounts entered as credits.

Principles of Double Entry system

Concept / item	Meaning, condition or application
The following are main principles of double entry system	The following are main principles of double entry system:

Historical formulation: For every transaction, two parties must be interested

Concept / item	Meaning, condition or application
Every business transaction has two aspects, one...	Every business transaction has two aspects, one of receiving the benefit and the other of giving it. In simple words, “Double entry” system means “every debit has a corresponding credit”.
Both the aspects, are recorded in the books of account.	Both the aspects, are recorded in the books of account.
The two-fold effect of a business transaction...	The two-fold effect of a business transaction is recorded by debiting one account and crediting the other account at the same time.

Principle of Conservatism

Historical formulation: The conservatism principle is the general concept of recognizing expenses and liabilities as soon as possible when there is uncertainty about the outcome, but to only recognize revenues and assets when they are assured of being received. Thus, when given a choice between several outcomes where the probabilities of occurrence are equally likely, you should recognize that transaction resulting in the lower amount of profit, or at least the deferral of a profit. Similarly, if a choice of outcomes with similar probabilities of occurrence will impact the value of an asset, recognize the transaction resulting in a lower recorded asset valuation.

Under the conservatism principle, if there is uncertainty about incurring a loss, you should tend toward recording the loss. Conversely, if there is uncertainty about recording a gain, you should not record the gain.

Historical formulation: The conservatism principle can also be applied to recognizing estimates. For example, if the collections staff believes that a cluster of receivables will have a 2% bad debt percentage because of historical trend lines, but the sales staff is leaning towards a higher 5% figure because of a sudden drop in industry sales, use the 5% figure when creating an allowance for doubtful accounts, unless there is strong evidence to the contrary.

Accrual Concept

The accrual concept makes a distinction the receipt of cash and right to receive, it and the payment of cash and the legal obligation to pay it. In actual business operations, the

obligation to pay and the actual movement of cash may not coincide. The accrual recognises this distinction. In connection with the sale of goods, revenue may be received.

Concept / item	Meaning, condition or application
Before the right to receive arise, or	Before the right to receive arise, or
After the right to receive has been created.	After the right to receive has been created.

Quick Revision

Connect the idea	Explain it
Accounting concepts support consistent meaning.	Accounting concepts support consistent meaning.
Terminology includes assumptions, principles, conventions and postulates....	Terminology includes assumptions, principles, conventions and postulates.
The business is accounted for separately from its owner.	The business is accounted for separately from its owner.
Owner withdrawals are drawings, not ordinary business expenses.	Owner withdrawals are drawings, not ordinary business expenses.

Original practice: explain your answer

Same event	Accrual view	Cash view
Rent paid Rs.6,000 for next period	Prepaid asset now; expense in covered period	Payment recorded when paid
Salary earned but unpaid	Expense and liability recognised	No cash payment yet
Credit service completed	Recognise earned revenue and receivable	No receipt yet

1. Capital of Rs.20,000 is introduced. Is it sales income?

Answer and reason: No. It increases business cash and the owner's equity. The business-entity perspective separates owner financing from trading results.

2. Rs.12,000 insurance covers twelve months; only one month has elapsed. What is the simple monthly charge?

Answer and reason: Rs.1,000 expense and Rs.11,000 prepayment, assuming an even benefit pattern and no other facts. Payment of the full amount does not make it all a one-month expense.

3. Does a balanced entry have to involve two outside people?

Answer and reason: No. A transfer from cash to the business bank account affects two accounts of the same entity. Dual accounting effects do not require two outside counterparties.

Entry	Why totals agree
Cash to bank Rs.1,000	Bank Dr 1,000 / Cash Cr 1,000; total assets unchanged.
Salary accrued Rs.1,000	Salary expense Dr 1,000 / Salary payable Cr 1,000; equity falls and liability rises.

4. Which bad-debt estimate is correct: 2% or 5%?

Answer and reason: Use the best supportable estimate under the applicable requirements. A worsening industry may justify 5%, but conservatism alone does not justify ignoring evidence or deliberately biasing the estimate.

5. Does double entry guarantee that fraud will be detected?

Answer and reason: No. Equal debits and credits provide an arithmetic control. Fictitious but balanced entries, collusion and omissions can remain undetected without effective controls and review.

Official reference: ICAI accounting framework | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Accounting concepts support consistent meaning.	**15.** Goods on approval need analysis of whether a sale exists.
02. Terminology includes assumptions, principles, conventions and postulates.	**16.** Going concern assumes continued operation unless circumstances require otherwise.
03. The business is accounted for separately from its owner.	**17.** Going concern is not a guarantee of indefinite survival.
04. Owner withdrawals are drawings, not ordinary business expenses.	**18.** Asset useful life and residual value affect depreciation.
05. Profit increases equity; losses reduce equity.	**19.** Inventory valuation is not a rule for every current asset.
06. Assets equal liabilities plus equity.	**20.** Matching relates relevant expenses to the reporting period.
07. Every debit requires an equal total credit.	**21.** Prepayments represent benefits not yet consumed.
08. A transaction can affect more than two accounts.	**22.** Outstanding expenses can create liabilities before payment.
09. Two accounting aspects do not require two outside persons.	**23.** The accounting period defines the interval being reported.
10. Historical cost includes relevant acquisition and installation costs.	**24.** Materiality depends on nature, magnitude and circumstances.
11. Historical cost is not a universal measurement rule.	**25.** Full disclosure does not require meaningless detail.
12. Money measurement gives records a common unit.	**26.** Prudence requires caution without deliberate bias.
13. Important non-monetary qualities may not be recognised assets.	**27.** Consistency permits justified, properly explained policy changes.
14. Revenue recognition depends on applicable requirements.	**28.** Accrual accounting distinguishes entitlement/obligation from cash movement.

MODULE A / A03

Maintenance of Cash/Subsidiary Books and Ledger

A business has hundreds of transactions but a customer asks for one account balance. A chronological journal tells the story in date order; a ledger collects the entries for that particular account. Cash books and subsidiary books make repeated transactions easier to record without losing the double-entry relationship.



Understand it through a worked situation

ABC owes Rs.5,000 and settles by paying Rs.4,800 with Rs.200 discount allowed. Debit Cash Rs.4,800 and Discount Allowed Rs.200; credit ABC Rs.5,000. Later the business settles a Rs.2,500 supplier balance with Rs.2,400 cash and Rs.100 discount received: debit supplier Rs.2,500; credit Cash Rs.2,400 and Discount Received Rs.100. The cash-book example therefore closes at 15,000 + 4,800 - 1,500 - 2,400 = Rs.15,900.

COMMON MISTAKE - CHECK THE REASON

The discount columns are totalled and posted to the relevant nominal accounts; they are not cash balances carried forward. A sale for cash debits Cash because cash comes in. Posting a cheque later does not automatically make every cheque-in-hand treatment a contra entry: follow the initial recording and the accounts used.

Concepts, procedures and worked records

Subsidiary Books and Ledger

Record Keeping Basics

Journal

The form of a journal contains a column Ledger folio. Journal records each transaction. However, if anyone wants to find out transactions affecting a personal account or an expense account, he will have to turn over pages of journal, add all debits and credits and then find out the balance of a particular account.

Cash Book

The Book that keeps records of all cash transactions, i.e. cash receipts and cash payments is called a cash book. Its ruling is like a ledge account and is divided into two sides, viz, debit and credit. All receipts are recorded on the debit side whereas all payment are recorded on the credit side. Since it serves the function of cash account, there is no need for opening cash account in the ledger.

Concept / item	Meaning, condition or application
Accounting cycle includes the following	Accounting cycle includes the following:
Recording	Recording: In the first instance, all transactions should be recorded in the journal or the subsidiary books as and when they take place.

Classifying: All entries in the journal or subsidiary books are posted to the appropriate ledger account to find out at a glance the total effect of all such transactions in a particular account.

Summarising: The last stage is to prepare the trial balance and final accounts with view to ascertain the profit or loss made during a particular period and the financial position of the business on a particular date.

Ledger

Concept / item	Meaning, condition or application
The Ledger is the principal book of...	The Ledger is the principal book of accounts where similar transactions relating

to a particular person or property or revenue or expense are recorded. In other words, it is a set of accounts. It contains all accounts of the business enterprise whether real, nominal or personal. The main function of a ledger is to classify or sort out all the items appearing in the journal or the other subsidiary books under their appropriate

accounts, so that at the end of the accounting period each account will contain the entire information of all the transactions relating to it in a summarized or condensed form.

Relationship Between ‘Journal’ and ‘Ledger’

Worked comparison / accounting record

BASIS FOR COMPARISON	JOURNAL	LEDGER
Meaning	The book in which all the transactions are recorded, as and when they arise is known as Journal.	The book which enables to transfer all the transactions into separate accounts is known as Ledger.
What is it?	It is a subsidiary book.	It is a principal book.
Also known as	Book of original entry.	Book of second entry.
Record	Chronological record	Analytical record
Process	The process of recording transactions into Journal is known as Journalizing.	The process of transferring entries from the journal to ledger is known as Posting.
How transactions are recorded?	Sequentially	Account-wise

BASIS FOR COMPARISON	JOURNAL	LEDGER
Debit and Credit	Columns	Sides
Narration	Must	Not necessary.
Balancing	Need not to be balanced.	Must be balanced.

Concept / item	Meaning, condition or application
Journalise the following transactions and post them...	Journalise the following transactions and post them in their respective
ledger accounts.	ledger accounts.

Worked comparison / accounting record

2016 Rs.	Field 2	Field 3
May 2	Paid interest to Loan	4,000
May 3	Ramesh who owed Rs.3,000 has become insolvent. He pays 50 paise in rupee in full settlement.	
May 4	A cheque received from Ranjan deposited into bank was returned dishonored.	6,300
May 5	Wood used for making office furniture.	5,000
May 21	Due from Rama are bad debts.	600
May 25	Purchased building and issued cheque.	4,300

Journal Entry

Journal entries: six transactions in May 2016

Date	Debit (Rs.)	Credit (Rs.) / explanation
2 May	Interest on Loan 4,000	Cash 4,000: interest payment.
3 May	Cash 1,500; Bad Debts 1,500	Ramesh 3,000: 50 paise per rupee received in full settlement.
4 May	Ranjan 6,300	Bank 6,300: deposited cheque dishonoured.
5 May	Furniture 5,000	Purchases 5,000: wood diverted to office furniture under the stated periodic system.
21 May	Bad Debts 600	Rama 600: amount written off.
25 May	Building 4,300	Bank 4,300: building acquired by cheque; the older narration says “goods”, but the asset is a building.

Account Categories

Classification of Accounts: Accounts are broadly classified into two classes:

Concept / item	Meaning, condition or application
Personal Accounts and	Personal Accounts and

Impersonal Accounts

Concept / item	Meaning, condition or application
The latter is further sub-divided into	The latter is further sub-divided into:

Real Accounts

Nominal Accounts

Personal Accounts

Concept / item	Meaning, condition or application
These accounts show the transactions with customers,...	These accounts show the transactions with customers, suppliers, moneylenders, banks and the owner.
Personal accounts can take the following forms	Personal accounts can take the following forms:
Natural Personal accounts	Natural Personal accounts: The term natural person means persons who are the creation of God. For example, proprietor's account, supplier's account, receiver's account (Abhinav a/c, Alpa A/c).
Artificial personal accounts	Artificial personal accounts: These accounts include the accounts of corporate bodies or institutions that are recongnised as persons in business dealings. Example: firm's a/c , club a/c.
Representative personal account	Representative personal account: These are accounts that represent a certain person or group of person. Example: Salary outstanding, Rent prepaid etc.
There following list indicates, some more of...	There following list indicates, some more of the usual accounts coming under each

Concept / item	Meaning, condition or application
category	category: (Personal accounts)
Bank (an artificial Person)	Bank (an artificial Person)
Tata Iron & Steel Co. (a Company)	Tata Iron & Steel Co. (a Company)
Alpa (an Individual)	Alpa (an Individual)
Capital (Abhinav –owner)	Capital (Abhinav –owner)
Bank loan (an artificial person)	Bank loan (an artificial person)

Concept / item	Meaning, condition or application
Rent outstanding (representative personal account)	Rent outstanding (representative personal account)

Impersonal Accounts

Real Accounts

Concept / item	Meaning, condition or application
Real accounts may be of the following types	Real accounts may be of the following types:

Tangible real accounts: These are accounts of such things that are tangible, i.e, which can be seen, touched, physically. Example: Land, building, cash etc.

Concept / item	Meaning, condition or application
Intangible real accounts	Intangible real accounts: These account represent such things that cannot be touched. Example: Trademarks, Patent right etc.
There following list indicates, some more of...	There following list indicates, some more of the usual accounts coming under each
category	category: (Real accounts)
Plant and machinery	Plant and machinery
Investment	Investment
Land and building	Land and building

Concept / item	Meaning, condition or application
Stock in hand	Stock in hand
Bill receivable	Bill receivable
Trademarks	Trademarks
Cash	Cash

Nominal Accounts

Nominal accounts are opened in the books to explain the nature of the transactions. Example: Salary is paid to the employees, rent is paid to the property owner etc.

Concept / item	Meaning, condition or application
There following list indicates, some more of...	There following list indicates, some more of the usual accounts coming under each
category	category: (Nominal accounts)
Interest	Interest
Salaries	Salaries
Rent	Rent
Carriage	Carriage

Concept / item	Meaning, condition or application
Commission received	Commission received
Insurance	Insurance
Discount received	Discount received
Wages	Wages

Credit and Debit Concept

Accounting and columnar accounting mechanics

Cash book may be defined as the record of transactions concerning cash receipts and cash payments. In other words, in cash book, all transactions (i.e receipts and payment of cash) are recorded as soon as they take place. Cash book is in the form of an account and actually it serves the purpose of a 'Cash Account'.

Concept / item	Meaning, condition or application
Cash book thus serves the purpose of...	Cash book thus serves the purpose of a book of original entry as well as that of a
ledger account. A cash book has the following features	ledger account. A cash book has the following features:
Only cash transactions are recorded in the cash book.	Only cash transactions are recorded in the cash book.
It performs the functions of both, the...	It performs the functions of both, the journal and the ledger, at the same time.
All cash receipts are recorded in the...	All cash receipts are recorded in the debit side and all cash payments are recorded in the credit side.

Historical formulation: It records only one aspect of transaction i.e, cash.

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The cash book records the cash/bank aspect in that book, but the complete double-entry system still records the corresponding effect. It does not authorise one-sided accounting.

Concept / item	Meaning, condition or application
All cash transactions are recorded chronologically in...	All cash transactions are recorded chronologically in the cash book.

Types of Cash book

Simple (Single column) cash book: This cash book will only record cash transactions. The cash coming in (receipts) will be on the left and the cash payments will be on the right. And since we will record all cash transactions here there is no need for a cash ledger account.

Single-column cash-book form

Receipts: debit-side fields	Payments: credit-side fields
Date | Particulars | L.F. | Receipt No. | Amount	Date | Particulars | L.F. | Voucher No. | Amount

Concept / item	Meaning, condition or application
Date	Date: The date on which cash is received or paid is entered in this column.
Particulars	Particulars: The name of the account in respect of which the amount is received or paid is shown.
LF (Ledger folio)	LF (Ledger folio): The column shows page number of the ledger where the entry has been posted.

Two Column Cash Books

Here instead of one column, we have an additional column for discounts. So along with the cash transactions, we will also record the discounts in the same cash book. So both discounts received and the discount that is given is recorded here. If any organization is in a general practice of giving or receiving discounts this is the preferable option.

Historical formulation: Discount is a nominal account – so the discount is given (loss) is on the debit side and discount received (profit) is on the credit side. At the end of the period, we balance both columns and transfer the closing balances.

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Total discount columns and post the respective discount nominal accounts. Cash is balanced and carried forward; discount allowed/received columns are not cash balances carried into the next period.

Concept / item	Meaning, condition or application
Prepare a two column cash book from the following entries	Prepare a two column cash book from the following entries
Cash in Hand – 15000	Cash in Hand – 15000
Received from ABC – 4800	Received from ABC – 4800; Discount – 200
Goods bought for cash 1500	Goods bought for cash 1500
Cash paid to LMN – 2400	Cash paid to LMN – 2400; Discount – 100

Cash Book

Cash and discount: original inconsistent grid and corrected treatment

Record / issue	Figures and interpretation
Opening cash / receipt	Balance b/d 15,000; ABC cash 4,800; discount allowed 200; receipts cash total 19,800.
Stated payments in the question	Goods 1,500; LMN cash 2,400; discount received 100.
Inconsistent printed continuation	LMN appears as 24,000; discount 1,000; cash payments total 25,500; balance c/d and next b/d 5,700. These do not reconcile with the stated question.
Corrected cash calculation	15,000 + 4,800 - 1,500 - 2,400 = 15,900. Payment side: 1,500 + 2,400 + balance c/d 15,900 = 19,800.
Corrected discount columns	Debit-side discount allowed total 200; credit-side discount received total 100. Total and post these nominal columns; do not carry them as cash balances.
Record fields retained	Both sides use serial number, particulars, cash and discount; the stray repeated serial-number column adds no separate monetary item.

Three Column Cash Books

This cash book has the cash, the discount and additionally the bank columns in it. Since the development of banking most firms, these days prefer to deal in cheques or other such bills of exchange. And so having a bank column in your cash book makes things concise and simpler to understand.

Historical formulation: So when you receive a cheque and you deposit it in the bank the same day you make the entry in the bank column (the debit side in this case). But say you send the cheque later (not the same day) then this will be a contra entry. A contra entry is transactions that happen between a cash account and a bank account. Ultimately your Cash & Bank balance remains the same, the money just moves around.

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A genuine cash-bank transfer is contra and does not change their combined total. A cheque received earlier needs treatment consistent with its original cheque-in-hand/cash recording; later deposit is not automatically the same entry under every accounting system.

Petty Cash Book

In a firm, there are usually cash transactions happening in all the departments. These we will record in one of the above formats of cash books. But there are many cash transactions happening for very small amounts. Sometimes there are dozens of such transactions that occur in just one day. These are known as petty transactions. Examples are expenses for postage, stationery, traveling, food bills, etc.

So since the number of such transactions tends to be very high we maintain a separate cash book for them – the petty cash book. Such a cash book is maintained by the petty cashier (who in most cases also handles the

petty cash).

Concept / item	Meaning, condition or application
Two types of petty cash book	Two types of petty cash book:
Simple petty cash Book	Simple petty cash Book
Columnar Petty cash Book	Columnar Petty cash Book

Journalising

Journalising refers to recording business transactions systematically and in a summarised form in the journal. It means a process of entering the twofold effects of transactions in the form of debit and credit in the journal.

Worked comparison / accounting record

Date	Particulars	L.F	Debit Amount	Credit Amount
(i)	(ii)	(iii)	(iv)	(v)

Date: In the first column the date of the transaction is entered, the year is most probably written on the top of the column than to repeat it every day.

Particulars: Here the accounting entry is written in a summarised form of debit and credit. The names of the accounts involved in the transaction are written in the journal entry.

Concept / item	Meaning, condition or application
On the first line, the account is...	On the first line, the account is debited, the word “Dr.” is written at the right end of the same line of account debited.
On the second line, the account credited...	On the second line, the account credited is written with a prefix “To” after leaving a little space towards the start.
Immediately below the entry, a small explanation...	Immediately below the entry, a small explanation of the transaction called ‘narration’ is written. The narration begins with the word “Being”.

Ledger Folio No. (L.F.): In this column, the page number of the Ledger in which the journal entry is posted, is recorded. This also helps is easy cross verification and reference in the future.

Concept / item	Meaning, condition or application
Debit Amount	Debit Amount: The amounts to be debited to the accounts concerned or involved are written.
Credit Amount	Credit Amount: The amounts to be credited to the accounts concerned or involved are written.

Rules for Journalising Transactions: (Golden rules of Accountancy)

Concept / item	Meaning, condition or application
Personal Account	Personal Account: It relates to persons(natural or legal) with whom a business keeps dealings.
Rule	Rule: Debit the receiver and Credit the giver.
E.g. Goods worth Rs. 5000/- sold to...	E.g. Goods worth Rs. 5000/- sold to Alpa. Here, because Alpa is the receiver of goods so it is to be debited.
Real Account	Real Account: It relates to property or goods which may come or go from the business.
Rule	Rule: Debit what comes in and Credit what goes out.

Historical formulation: E.g. Goods worth Rs. 7000/- sold on cash. Here, cash a/c is to be debited because cash flows out.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Correct the direction: for a cash sale, Cash is debited because cash COMES IN. Credit Sales; recognise inventory cost under the applicable system.

Concept / item	Meaning, condition or application
Nominal Account	Nominal Account: It relates to business expenses, losses, incomes, and gains.
Rule	Rule: Debit all the expenses or losses and Credit all the incomes, gains or profits.
E.g. Paid Rs. 2000/- as commission to...	E.g. Paid Rs. 2000/- as commission to the agent. Here, commission a/c is debited because it is a business expense.

Solved Example for You

Concept / item	Meaning, condition or application
Question	Question: Journalise the following transactions in the Journal of Mr. Abhinav for the
year 2018	year 2018
January 1 – Paid rent Rs. 4000/-	January 1 – Paid rent Rs. 4000/-
January 2 – Sold goods to Harsh for Rs. 10,000/-	January 2 – Sold goods to Harsh for Rs. 10,000/-
Answer	Answer:
In the Journal of Mr. Abhinav	In the Journal of Mr. Abhinav

Worked comparison / accounting record

Date	Particulars	Debit Amount	Credit Amount
2018 01/01	Rent A/c ..... Dr. To Cash A/c (Being rent paid)	4000	4000
02/01	Harsh A/c ..... Dr. To Goods A/c (Being goods sold to Harsh on credit)	10,000	10,000
Total		14,000	14,000

Posting the May transactions: ledger movements

Account	Debit movements	Credit movements
Cash	1,500	4,000
Bank	-	6,300 + 4,300 = 10,600
Interest on loan	4,000	-
Bad debts	1,500 + 600 = 2,100	-
Ramesh	-	3,000
Ranjan	6,300	-
Furniture	5,000	-
Purchases	-	5,000
Rama	-	600
Building	4,300	-
Total movements	23,200	23,200

These are movements from the listed transactions, not invented closing balances. Add actual opening balances where applicable before balancing each ledger account.

Quick Revision

Connect the idea	Explain it
A journal records transactions chronologically.	A journal records transactions chronologically.
A ledger organises transactions account by account.	A ledger organises transactions account by account.
Journalising records the twofold effect.	Journalising records the twofold effect.
Posting transfers entries into ledger accounts.	Posting transfers entries into ledger accounts.

Original practice: explain your answer

1. A debtor settles Rs.3,000 by paying 50 paise per rupee. What are the two debits?

Answer and reason: Cash Rs.1,500 and Bad Debts Rs.1,500; credit the debtor Rs.3,000. The total settlement extinguishes the original receivable.

2. An earlier deposited customer cheque for Rs.6,300 is dishonoured. What reverses?

Answer and reason: Debit the customer Rs.6,300 and credit Bank Rs.6,300, assuming the earlier entry credited the customer and debited Bank.

Dishonoured cheque	Account effect
Customer account	Debit Rs.6,300: the receivable is restored.
Bank account	Credit Rs.6,300: reverse the failed collection.

3. Timber bought for resale is used to make office furniture. Why is furniture debited?

Answer and reason: The value is now used to create a business asset. Under a periodic purchases system, credit Purchases; under a perpetual inventory system, credit Inventory. Use the stated system consistently.

4. Is a separate cash ledger account necessary when the cash book performs that role?

Answer and reason: Normally no. The cash book is both an original-entry record and the cash account. Other affected accounts still need their proper postings.

5. Why is ledger folio useful?

Answer and reason: It connects the original entry to its ledger destination. The cross-reference supports checking, correction and tracing an individual transaction.

Official reference: ICAI accounting framework | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. A journal records transactions chronologically.	**15.** Real accounts include tangible and intangible assets.
02. A ledger organises transactions account by account.	**16.** Land, buildings and cash illustrate tangible real accounts.
03. Journalising records the twofold effect.	**17.** Patents and trademarks illustrate intangible real accounts.
04. Posting transfers entries into ledger accounts.	**18.** Nominal accounts record expenses, losses, income and gains.
05. Ledger folio provides a cross-reference.	**19.** Traditional personal rule: debit receiver, credit giver.
06. Narration explains the transaction.	**20.** Traditional real rule: debit what comes in, credit what goes out.
07. Cash book can serve as original-entry book and cash account.	**21.** Traditional nominal rule: debit expenses/losses, credit income/gains.
08. Cash receipts enter the cash-book debit side.	**22.** Modern account-type reasoning should confirm the traditional rule.
09. Cash payments enter its credit side.	**23.** A single-column cash book records cash amounts.
10. Physical cash normally cannot have a credit balance.	**24.** A cash-and-discount book adds discount columns.
11. Personal accounts include natural persons.	**25.** A three-column form adds cash, bank and discount columns.
12. Artificial personal accounts include recognised organisations.	**26.** Petty cash separately records frequent small payments.
13. Representative personal accounts represent persons or groups.	**27.** Discount allowed and received are different nominal accounts.
14. Outstanding salary can be a representative personal account.	**28.** Closing cash in the corrected illustration is Rs.15,900.

MODULE A / A04

Bank Reconciliation Statement

A cheque can be entered in the business cash book today but paid by the bank next week. Both records can be correct at their own stage. Bank reconciliation separates timing differences from omitted entries and errors, then proves that the two views describe the same account at the chosen date.

Fix the date → Correct cash book → Identify timing items → Reconcile balances

Understand it through a worked situation

Start with the bank-statement balance Rs.15,534. Issued cheques total Rs.11,514, but only Rs.7,815 cleared: unpresented cheques = Rs.3,699. Adjusted statement = 15,534 - 3,699 = Rs.11,835. Independently correct cash book Rs.8,364: +150 +3,052 +350 -100 -131 +250 -100 = Rs.11,835. The Rs.3,052 correction is twice Rs.1,526 because an asset balance was carried forward on the opposite side.

COMMON MISTAKE - CHECK THE REASON

A debit in the customer cash book usually corresponds to a credit in the bank statement. Do not apply an add/subtract list without fixing the starting balance and perspective. Different-month extracts do not justify a universal rule that only common entries matter; opening balances, the reconciliation date and intervening transactions must be traced.

Concepts, procedures and worked records

Concept / item	Meaning, condition or application
Recording Transactions in cash Book	Recording Transactions in cash Book
Record the following transactions in a bank...	Record the following transactions in a bank column cash book for December
2019	2019:

December 2019: original transactions

Date	Transaction	Rs.
1 Dec	Started business with cash	80,000
4 Dec	Deposited cash into bank	50,000
10 Dec	Received cash from Abhinav	1,000
15 Dec	Bought goods for cash	8,000
22 Dec	Bought goods by cheque	10,000
25 Dec	Paid Alpa in cash	20,000
30 Dec	Drew from bank for office cash	2,000
31 Dec	Rent paid by cheque	1,000

December 2019 cash book: both columns and sides

Date / particulars	Cash Dr	Bank Dr	Cash Cr	Bank Cr
1: Capital	80,000	-	-	-
4: Bank (contra)	-	-	50,000	-
4: Cash (contra)	-	50,000	-	-
10: Abhinav	1,000	-	-	-
15: Purchases	-	-	8,000	-
22: Purchases	-	-	-	10,000
25: Alpa	-	-	20,000	-
30: Bank (contra)	2,000	-	-	-
30: Cash (contra)	-	-	-	2,000
31: Rent	-	-	-	1,000
31: Balance c/d	-	-	5,000	37,000
Column totals	83,000	50,000	83,000	50,000

Concept / item	Meaning, condition or application
Cash Book and Passbook	Cash Book and Passbook

Worked comparison / accounting record

BASIS FOR COMPARISON	CASH BOOK	PASSBOOK
Meaning	A book that keeps a record of cash transactions is known as cash book.	A book issued by the bank to the account holder that records the deposits and withdrawals is known as passbook.
Prepared by	Firms	Bank
Side affected	Receipts will be shown in the debit side while payments are entered in credit side.	Deposits will be shown in credit side while withdrawals are shown in debit side.
Preparation	Discretionary	Compulsory
Recording of cheque deposited for collection	Date of deposit	Date on which the amount is actually collected from the debtor's bank
Recording of cheque issued to the creditor	Date of issue.	When the amount is paid by the bank to the creditor.
What do the balances reflect?	Debit balance shows cash at bank while the credit balance shows overdraft.	Debit balance shows overdraft while the credit balance shows cash at bank.

READ THE TRADITIONAL COMPARISON IN CONTEXT

The grid describes traditional books. Bank records/statements may be electronic; a physical passbook is not universally compulsory for every account. A statement entry appears when the bank actually processes it, including digital or provisional arrangements; trace the real entry rather than assuming every cheque clears on presentation.

Concept / item	Meaning, condition or application
Understanding Reconciliation	Understanding Reconciliation

The Bank statement is received periodically, say every month. We check it for clerical and if any errors are found, we obtain a revised statement containing no errors. The

Concept / item	Meaning, condition or application
balance is this statement gives us a...	balance is this statement gives us a firm starting point to proceed for:
Finding out entries which do not requires...	Finding out entries which do not requires change in cashbook (these entries are present in the cashbook but not in the bank statement). These entries give us the ‘Adjusted bank balance’.

Concept / item	Meaning, condition or application
Finding out clerical mistake in our cashbook...	Finding out clerical mistake in our cashbook and rectifying them.
Finding out entries which require change in...	Finding out entries which require change in our cashbook (these entries are present in the statement but not in the cashbook).
Preparing Reconciliation Statement	Preparing Reconciliation Statement

Historical formulation: Based on these 3 steps, we can prepare a statement called “Bank Reconciliation”. It is pertinent to note that step 1 gives the adjusted bank balance which is a national figure and not the actual balance in the account with in bank while step 2 and 3 result in actually changing the balance in the cashbook by correction of errors and posting of missing entries. This cash book balance should be equal to the adjusted bank balance as arrived in step 1. This is balance which goes to the trial balance and balance sheet.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Read “notional adjusted figure”: it is the reconciliation calculation, not a new actual bank posting.

Bank Reconciliation Statement as in_____

Bank-statement route: blank reconciliation template

Item	Treatment / amount placeholder
Closing bank-statement balance	Rs.__
Deposited cheques not yet credited	Add Rs.__, under this starting perspective.
Issued cheques not yet presented	Subtract Rs.__.
Adjusted bank-statement balance	A = Rs.__

Cash-book route: correction template

Item	Treatment / amount placeholder
Book bank balance	Rs.__
Clerical errors	Add/subtract according to the specific error.
Statement credits missing from books	Add Rs.__ after verification.
Statement debits missing from books	Subtract Rs.__ after verification.
Corrected cash-book balance	B = Rs.__; reconcile A and B.

Concept / item	Meaning, condition or application
Need for Preparing a Bank Reconciliation Statement	Need for Preparing a Bank Reconciliation Statement
Accuracy	Accuracy
Check on the Entries	Check on the Entries
Rectifying Incorrect Entries	Rectifying Incorrect Entries
Updated Cash Book	Updated Cash Book
Detection of Delays	Detection of Delays

Historical formulation: Check on the Dishonest Behavior of Employees

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Reconciliation can reveal suspicious differences and support detection. It does not guarantee that fraud will be found or prevented.

Concept / item	Meaning, condition or application
Example	Example:

The cash book of Mr Abhinav shows Rs 8364 as the balance at the bank as on 31 December 2018, but you find this does not agree with the balance as per the bank pass book, which shows a balance of Rs 15534.

Concept / item	Meaning, condition or application
On scrutiny, you find the following discrepancies	On scrutiny, you find the following discrepancies:
On 1st December, the payment side of...	On 1st December, the payment side of the cash book was undercast by Rs100
A cheque of Rs 131 issued on...	A cheque of Rs 131 issued on 25th December, was not taken in the bank column.

Concept / item	Meaning, condition or application
One deposit of Rs 150 was recorded...	One deposit of Rs 150 was recorded in the cash book as if there is no bank column therein.
On 18th December, the debit balance of...	On 18th December, the debit balance of Rs 1526 as on the previous day, was brought forward as credit balance.
Of the total cheque, amounting to Rs...	Of the total cheque, amounting to Rs 11,514 drawn in the last week of December, cheques aggregating to Rs 7815 were encashed in December.

Concept / item	Meaning, condition or application
Dividend of Rs 250, collected by bank...	Dividend of Rs 250, collected by bank and, subscription of Rs 100, paid by it, were not recorded in the cash book
One out-going cheque of Rs 350 was...	One out-going cheque of Rs 350 was recorded twice in the cash book.
Rough working	Rough working: Correction of cash book for errors

Worked comparison / accounting record

Item	Debit	Credit
Deposit entry (shown in cash column)	150	
Wrong carry forward of balance	3052	
Outgoing cheque recorded twice	350	
Undercasting payment side		100
Cheuqe issued		131
Total	3552	231

Concept / item	Meaning, condition or application
The bank reconciliation statement will be as under	The bank reconciliation statement will be as under:

Worked reconciliation: bank-statement route

Item	Rs.
Statement closing balance	15,534
Deposits awaiting credit	None specified in this exercise.
Issued but unpresented cheques: 11,514 - 7,815	Subtract 3,699
Adjusted balance A	11,835

Worked reconciliation: corrected cash-book route

Item	Rs.
Cash-book opening figure	8,364
Net clerical corrections	Add 3,321
Bank-collected dividend	Add 250
Bank-paid subscription	Subtract 100
Corrected balance B	11,835

Concept / item	Meaning, condition or application
How to prepare a Bank Reconciliation statement...	How to prepare a Bank Reconciliation statement when extracts of cash Book and Pass Book are given
When the cash book and pass book...	When the cash book and pass book abstracts are given, the following points should
be noted.	be noted.
Find out the period for which both the abstracts are given	Find out the period for which both the abstracts are given
Compare the cash book debit side with...	Compare the cash book debit side with the pass book credit side and the cash book credit side with the pass book debit side.

Historical formulation: When the period for which both the abstracts are given is common, i.e. the cash book abstract relates to January and the pass book abstract is also given for January, take into account only uncommon entries.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Do not use a mechanical same-month/different-month rule. Establish the reconciliation date, opening balances and all intervening transactions; match evidence and identify timing differences relevant to that date.

Historical formulation: When the period for which both the abstracts are given is uncommon, i.e, the cash book relates to January but the pass book relates to February, take into account only common entries.

Historical formulation: Where the period is same, uncommon entries will appear in the reconciliation statement.

Historical formulation: When the period is different, common entries will appear in the reconciliation statement.

Concept / item	Meaning, condition or application
Adjusting The Cash Book Balance	Adjusting The Cash Book Balance

We have learnt that certain entries appear in the pass book first and then by comparing the pass book with the cashbook, these missing entries are incorporated in the cash book. The trader must know the correct bank balance at any time so that he can issue cheques only to the extent of the available bank balance. Therefore, preparing a bank reconciliation statement, the accountant makes the necessary corrections in the cash book and adjusts the cash book balance.

Concept / item	Meaning, condition or application
The items, which can usually be adjusted in the cash book are	The items, which can usually be adjusted in the cash book are:
Payment made by bank as per standing instructions.	Payment made by bank as per standing instructions.
Bank charges, interest on bank overdraft debited by the bank.	Bank charges, interest on bank overdraft debited by the bank.
Collection of interest in securities and dividend...	Collection of interest in securities and dividend on shares by bank.
Debits for the dishonor of cheques in the pass book.	Debits for the dishonor of cheques in the pass book.
Direct deposits made by customers of the trader.	Direct deposits made by customers of the trader.

Concept / item	Meaning, condition or application
Errors committed in the cash book.	Errors committed in the cash book.

Advantages of Bank Reconciliation Statement

Concept / item	Meaning, condition or application
Following are the advantage of preparing the...	Following are the advantage of preparing the bank reconciliation statement:
It helps the management to check the...	It helps the management to check the accuracy of the entries made in the cash book.
It helps to detect errors and to...	It helps to detect errors and to take timely action for the correction of balances.
It is a very important control technique for the management.	It is a very important control technique for the management.
It shows the correct bank balance at any particular time	It shows the correct bank balance at any particular time

Historical formulation: It reveals frauds committed by the staff handling cash and cheques and thus, helps the management to have effective control.

Quick Revision

Connect the idea	Explain it
Reconciliation explains differences at a chosen date.	Reconciliation explains differences at a chosen date.
The cash book reflects the customer's perspective.	The cash book reflects the customer's perspective.
The passbook reflects the bank's perspective.	The passbook reflects the bank's perspective.
Customer deposits usually credit the bank's deposit liability.	Customer deposits usually credit the bank's deposit liability.

Original practice: explain your answer

1. Why add a deposit in transit when starting from the bank statement?

Answer and reason: The business has recorded the receipt but the bank has not yet credited it. Adding it moves the statement balance towards the book position, assuming that stated perspective.

2. Does an unpresented cheque require a second cash-book payment?

Answer and reason: No. The payment is already recorded there. It is a timing item until the bank pays it; recording it twice would create an error.

3. Payment side is undercast by Rs.100. What happens to the book bank balance?

Answer and reason: Subtract Rs.100 from the book balance. Payments were understated, so the earlier asset balance was Rs.100 too high.

Starting perspective	Timing adjustment
Bank-statement credit balance	Add deposit in transit; subtract unpresented cheque.
Cash-book bank debit balance	To derive statement: subtract deposit in transit; add unpresented cheque.

4. A debit balance Rs.1,526 was carried as credit. Why add Rs.3,052?

Answer and reason: Add Rs.1,526 to cancel the wrong credit and another Rs.1,526 to restore the required debit. Both steps are necessary.

5. The bank debits charges not yet in the books. What should be done?

Answer and reason: After checking the charge, record the expense/debit in the cash book and reduce the bank balance. It is a book adjustment rather than a permanent timing-only item.

Official reference: ICAI accounting framework | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Reconciliation explains differences at a chosen date.	**15.** Dishonoured cheques may need reversal.
02. The cash book reflects the customer's perspective.	**16.** Cash-book errors must be corrected in the cash book.
03. The passbook reflects the bank's perspective.	**17.** Bank errors should be raised with the bank.
04. Customer deposits usually credit the bank's deposit liability.	**18.** Corrected balances should reconcile after timing adjustments.
05. Customer withdrawals usually debit that liability.	**19.** A BRS is not itself a replacement ledger entry.
06. Cash-book debit bank balance normally means an asset.	**20.** Perspective determines addition and subtraction signs.
07. Cash-book credit bank balance can mean overdraft.	**21.** Overdrafts need the same signed-balance reasoning.
08. Statement credit commonly represents money owed to the customer.	**22.** The illustration has Rs.3,699 unpresented cheques.
09. Issued but unpresented cheques are timing differences.	**23.** Wrong-side carry-forward Rs.1,526 requires Rs.3,052 correction.
10. Deposited but uncleared cheques are timing differences.	**24.** Illustration net clerical correction is Rs.3,321.
11. Bank charges can require cash-book adjustment.	**25.** Dividend adds Rs.250; subscription subtracts Rs.100.
12. Standing instructions can create unrecorded book payments.	**26.** Both corrected routes reach Rs.11,835.
13. Bank-collected dividend can require book income/receipt entries.	**27.** Different-period extracts require a dated transaction bridge.
14. Direct customer deposits may appear first in the statement.	**28.** Reconciliation supports control but does not guarantee fraud detection.

MODULE A / A05

Trial Balance, Rectification of Errors and Adjusting & Closing Entries

A trial balance agrees, yet a machine installation cost has been charged to repairs. Equal totals have not made the classification correct. Learn to distinguish arithmetic disagreement, wrong classification and missing transactions, then work from the wrong entry to the required entry.

Identify error → Compare correct entry → Reverse wrong effect → Clear suspense if used

Understand it through a worked situation

A purchases-book total Rs.50,000 was not posted to Purchases. Debit Purchases Rs.50,000 and credit Suspense Rs.50,000. Depreciation Rs.500 was omitted only from Furniture: debit Suspense Rs.500 and credit Furniture Rs.500. The suspense needs an opening debit Rs.49,500, because 49,500 + 500 = 50,000. Installation Rs.10,000 wrongly charged to repairs is corrected by Machinery Dr / Repairs Cr; it does not use suspense.

COMMON MISTAKE - CHECK THE REASON

An agreeing trial balance does not detect complete omissions, many wrong-account postings, principles errors or compensating errors. Errors of commission do not always affect agreement. A suspense account is a temporary unresolved difference, not evidence that the underlying accounts are correct.

Concepts, procedures and worked records

Errors and Adjusting & Closing Entries

Trial Balance

Multiple entries in various accounts will make a Ledger. Taking all the ledger balances and presenting them in a single worksheet as on a particular date is Trial Balance.

Concept / item	Meaning, condition or application
To understand a trial balance, we must...	To understand a trial balance, we must first understand the following:
Double entry system – Recording two entries...	Double entry system – Recording two entries for a single transaction that is equal and opposite in nature
Journal – All transactions recorded in double...	Journal – All transactions recorded in double entry system of bookkeeping
Ledger – Summary of all journals of a similar nature.	Ledger – Summary of all journals of a similar nature.

Features and Purpose of a Trial Balance

Concept / item	Meaning, condition or application
It is a list of debit and credit balance drawn from ledger.	It is a list of debit and credit balance drawn from ledger.
It includes cash and Bank balance.	It includes cash and Bank balance.
Its main purpose is to establish arithmetical...	Its main purpose is to establish arithmetical accuracy of transactions recorded in the books of account.
It is usually prepared at the end...	It is usually prepared at the end of the year but it can also be prepared any time, as and when required, e.g, monthly, quarterly or half yearly.
It enables the trader to know amounts...	It enables the trader to know amounts receivable from customers and amounts payable to suppliers.
It facilities preparation of final accounts.	It facilities preparation of final accounts.

Types of Trial Balance and Preparation of Trial Balance

Concept / item	Meaning, condition or application
There are two types of Trial balance	There are two types of Trial balance:
Gross Trial Balance	Gross Trial Balance
Net Trial Balance	Net Trial Balance
Gross Trial Balance	Gross Trial Balance
It is Prepared in the following stages	It is Prepared in the following stages:
Take totals of debit and credit columns of each ledger account.	Take totals of debit and credit columns of each ledger account.

Concept / item	Meaning, condition or application
Take totals of receipts and payments of...	Take totals of receipts and payments of cashbook showing separately cash, bank and discount columns.
Write names of all accounts as per...	Write names of all accounts as per the ledger and cash, bank and discount accounts as per cash book onto a statement.
Enter the debit and credit totals against each item.	Enter the debit and credit totals against each item.

Concept / item	Meaning, condition or application
Finally take total of debit and credit columns.	Finally take total of debit and credit columns.
Example	Example:

On 31st March 2014, the totals of debit and credit sides of various ledger accounts and receipts and payments sides of cash and bank columns of cash book of Mr. Abhinav are as under:

Worked comparison / accounting record

Total of debit side (Rs.)	Name of the account	Total of credit side (Rs.)
10, 000	Abhinav Capital	1,35,000
25,000	Drawings	-
15,000	Stock on 31st March, 1996	-
1,90,000	Purchases	4,000
-	Purchases Returns	18,000
6,000	Sales	2,45,000

Worked comparison / accounting record

13,000	Sales Returns	--
12,000	Expenses	-
3,05,000	Customers	2,50,000
2,00,000	Suppliers	2,35,000
1,00,000	Car	-
2,81,000	Dena Bank	2,75,000
43,000	Cash	38,000

Concept / item	Meaning, condition or application
Solution	Solution
Gross Trial Balance as on 31st March 2014	Gross Trial Balance as on 31st March 2014

Worked comparison / accounting record

Name of the Account	L.F	Debit (Rs.)	Credit (Rs.)
Abhinav Capital		10000	1,35,000
Drawings		25000	--
Stock on 31st March, 2013		15000	--
Purchases		190000	4000
Purchases Returns		--	18000
Sales		6000	2,45,000
Sales Returns		13000	--
Expenses		12000	--
Customers		3,05,000	2,50,000
Suppliers		2,00,000	2,35,000
Car		1,00,000	--
Dena Bank		2,81,000	2,75,000
Cash		43,000	38,000
Total		12,00,000	12,00,000

Concept / item	Meaning, condition or application
Net Trial Balance	Net Trial Balance

Under this trial Balance, net balance of each amount are drawn and shown in trial balance. If debit total of an account is more, it will show debit balance and of credit total of an account is more, it will show a credit balance.

Concept / item	Meaning, condition or application
Net Trial Balance as on 31st march 2014	Net Trial Balance as on 31st march 2014

Worked comparison / accounting record

Name of the Account	L.F	Debit (Rs.)	Credit (Rs.)
Abhinav Capital			1,25,000
Drawings		25000	--
Stock on 31st March, 2013		15000	--
Purchases		186000	
Purchases Returns		--	18000
Sales			2,39,000
Sales Returns		13000	--
Expenses		12000	--
Customers		55000	--
Suppliers			35,000
Car		1,00,000	--
Dena Bank		6000	
Cash		5000	
Total		4,17,000	4,17,000

Concept / item	Meaning, condition or application
Disagreement of a Trial Balance	Disagreement of a Trial Balance

Disagreement of a trial balance may be caused by the wrong totaling or balancing of ledger accounts. While totaling the figure of subsidiary books there may arise some errors that will cause disagreement of trial balance. Omission to post a ledger balance also causes the disagreement of a trial balance.

Concept / item	Meaning, condition or application
Classification of Errors	Classification of Errors
Errors can be broadly divided into two type	Errors can be broadly divided into two type:
Clerical Errors	Clerical Errors
Principle Errors	Principle Errors
Clerical Errors	Clerical Errors

Errors of Omission,

Errors of Commission, and

Concept / item	Meaning, condition or application
Compensating errors.	Compensating errors.

Errors of Omission

The Errors of Omission will occur when a transaction is not recorded in the books of accounts or omitted by mistake. The Errors of Omission two types.

Concept / item	Meaning, condition or application
Partial	Partial
Complete	Complete

The partial errors may happen in relation to any subsidiary books. This is the result of when a transaction is entered in the subsidiary book but not posted to the ledger. For example, cash paid to the suppliers has been entered in the payment side of the cash book but it will not be entered in the debit side of the suppliers account.

The complete omission may happen the transaction is completely omitted from the books of accounts. For example, an accountant fails to enter a specific invoice from the sales day book.

Errors of Commission

When a transaction is entered in the books of accounts in wrongly, this may be entered as partially or incorrectly. This kind of errors are known as Errors of Commission. The Errors of Commission may happens because of ignorance or negligence of the accountant. This may be of different types, the main reasons are Errors relating to subsidiary books and Errors relating to ledger. Following are some of the examples:

Concept / item	Meaning, condition or application
Posting of correct amount but on the wrong side	Posting of correct amount but on the wrong side
Posting of a wrong amount but on the correct side	Posting of a wrong amount but on the correct side
Posting of a wrong amount amount on wrong side of an account	Posting of a wrong amount amount on wrong side of an account
Compensating Errors	Compensating Errors

Historical formulation: Compensating Errors are those errors which compensates themselves in the net results of the business. This means, if there are over debit in one account which will be compensated by the over credit in some account in the same extent of the business. Like that, if there is a wrong debit in one account which will be neutralized by some wrong credit in the same extent of the business.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Compensating errors offset their effect on the trial-balance difference; they do not necessarily cancel misstatements of profit, individual accounts or disclosures.

Errors of Principles

This kind of errors are occurs when the entries are made against the principle of accounting. These Errors are made because of the following reasons:-

Concept / item	Meaning, condition or application
Errors happens due to the inability to...	Errors happens due to the inability to make a distinction between the revenue and capital items.
Errors happens due to the inability to...	Errors happens due to the inability to make a difference between the business expenses and personal expenses.
Errors happens because of the inability to...	Errors happens because of the inability to make a distinction between the productive expense and nonproductive expenses.

Error classification and trial-balance effects

Category / relationship	Effect and qualification
Errors -> errors of principle	Normally no disagreement if equal amounts are wrongly classified.
Errors -> clerical errors -> omission -> complete	Normally no disagreement when both sides are omitted.
Clerical errors -> omission -> partial	Can affect agreement when only one posting is omitted.
Clerical errors -> commission	The older diagram labels this “affect trial balance”; actual effect depends on whether the mistake is one-sided or balanced.
Clerical errors -> compensating errors	Can leave agreement unchanged while errors remain.

Rectification of Errors

Concept / item	Meaning, condition or application
One- sided Errors	One- sided Errors
These errors affect only one account. Thus,...	These errors affect only one account. Thus, these are one-sided errors. We can rectify these errors by giving an explanatory note in the account or by passing a journal entry with the help of Suspense A/c. When we detect an error before posting to the ledger, we can correct it by simply crossing the wrong amount, writing the correct amount above it and initialling it. Similarly, we can also correct an error in the ledger account.
Errors of casting, errors of carrying forward...	Errors of casting, errors of carrying forward the balances, errors of balancing the accounts, errors of posting the wrong amount in the correct account, error of posting in the correct account on the wrong side, omitting to show an account in the trial balance, posting in wrong side with wrong amount are the examples of errors affecting the Trial Balance.
Two-sided Errors	Two-sided Errors
These errors affect two or more accounts...	These errors affect two or more accounts simultaneously. Thus, these are two- sided errors. We can rectify these by passing a journal entry giving the correct debit and credit to the accounts. In order to rectify an error, we need to cancel the effect of wrong debit or credit by reversing it and restore the effect of correct debit or credit.
When there is short debit or excess...	When there is short debit or excess credit in an account we need to debit the concerned account. Whereas, when there is short credit or excess debit in an account we need to credit the concerned account.

Concept / item	Meaning, condition or application
Complete omission to record an entry in...	Complete omission to record an entry in the journal or the subsidiary books, incorrect recording of transactions in the books, complete omission of posting and errors of principle are the examples of these errors.
Suspense Account	Suspense Account

When the trial balance does not tally due to the one-sided errors in the books, an accountant puts the difference between the debit and credit side of the trial balance on the shorter side as the Suspense A/c. As and when we locate and rectify the errors, the balance in the Suspense A/c reduces and consequently becomes zero. Thus, we cannot

Concept / item	Meaning, condition or application
categorize the Suspense A/c. It is a...	categorize the Suspense A/c. It is a temporary account and can have debit or credit balance depending upon the situation.
While using the Suspense A/c to rectify...	While using the Suspense A/c to rectify the one-sided errors, the accountant needs

Concept / item	Meaning, condition or application
to follow the following steps	to follow the following steps:
Identification of the account with the error.	Identification of the account with the error.
Ascertainment of the excess debit or credit...	Ascertainment of the excess debit or credit or short debit or credit in the above account.
In case of short debit or excess...	In case of short debit or excess credit in an account, we need to debit the concerned account. Whereas, in case of short credit or excess debit in an account we need to credit the concerned account.

Concept / item	Meaning, condition or application
Pass the necessary journal entry by debiting...	Pass the necessary journal entry by debiting or crediting the Suspense A/c
Example	Example

Q: Trial Balance of M/s Srivastav Enterprises did not agree. It puts the difference to the Suspense A/c. Rectify the following errors and prepare the Suspense A/c to ascertain the original difference in the trial balance.

Concept / item	Meaning, condition or application
Amount paid for the installation of the...	Amount paid for the installation of the machinery Rs.10000 was posted to the Repairs and maintenance A/c.
Total of Purchases book Rs.50000 was not posted to the ledger.	Total of Purchases book Rs.50000 was not posted to the ledger.
Goods returned to John Rs.3000 were recorded in Sales Book.	Goods returned to John Rs.3000 were recorded in Sales Book.
Salary paid to Ram Rs.6000 was debited to his personal account.	Salary paid to Ram Rs.6000 was debited to his personal account.
Depreciation written-off on furniture Rs.500 was not...	Depreciation written-off on furniture Rs.500 was not posted to the furniture account.
Ans	Ans: In the books of M/s Srivastav Enterprises

Rectifying entries: all five errors

Error	Debit (Rs.)	Credit (Rs.)
Installation charged to repairs	Machinery 10,000	Repairs and Maintenance 10,000
Purchases total not posted	Purchases 50,000	Suspense 50,000
Purchase return recorded as sale	Sales 3,000	Purchases Return 3,000
Salary charged to Ram personally	Salary 6,000	Ram 6,000
Depreciation omitted from Furniture credit	Suspense 500	Furniture 500

Concept / item	Meaning, condition or application
Suspense A/c	Suspense A/c

Suspense account: complete debit and credit reconciliation

Debit side	Rs.	Credit side	Rs.
Difference per trial balance	49,500	Purchases rectification	50,000
Furniture rectification	500	-	-
Total	50,000	Total	50,000

Concept / item	Meaning, condition or application
Entries Adjusting and Closing	Entries Adjusting and Closing
Adjusting Entries	Adjusting Entries
Final Account are the accounts which are...	Final Account are the accounts which are prepared at the end of the trading year. These accounts show the final results of the business carried out. Final accounts are prepared to find out profit earned or loss sustained by a concern.
At the end of the accounting year,...	At the end of the accounting year, all ledger accounts are balanced and then trial balance is prepared. Form the trial balance, final accounts, i.e. trading, profit and loss account and balance sheet are drawn. While preparing trading and profit and loss account, all expenses and incomes for the full period are to be taken into consideration. If expenses have been incurred but not paid or income is due but not received, necessary entries are required to be passed to show the correct picture of the business. These entries are called “Adjusting Entries’.

Concept / item	Meaning, condition or application
Closing Entries	Closing Entries

At the end of cash year, all accounts of expenses and incomes must be closed. The balance of these accounts are transferred to trading account and profit and loss account. The entries passed to transfer these balances are called “Closing entries”.

DATE LABELS IN THE TRIAL-BALANCE EXAMPLE

The reporting date is 31 March 2014. The initial grid labels stock as 31 March 1996, while the worked solution labels it 31 March 2013. Preserve the Rs.15,000 stock amount in the computation and recognise the historical date-label inconsistency rather than treating both dates as the same opening period.

Quick Revision

Connect the idea	Explain it
A trial balance lists ledger totals or balances.	A trial balance lists ledger totals or balances.
It includes relevant cash and bank balances.	It includes relevant cash and bank balances.
It can be prepared monthly, quarterly or otherwise.	It can be prepared monthly, quarterly or otherwise.
Its agreement is an arithmetic check, not full proof.	Its agreement is an arithmetic check, not full proof.

Original practice: explain your answer

1. A machine cost is debited to Repairs and credited correctly to Bank. Will totals disagree?

Answer and reason: No. The entry is balanced but the classification is wrong. Correct by debiting Machinery and crediting Repairs, with the amount and applicable recognition facts checked.

2. Sales of Rs.2,000 are completely omitted. Can the trial balance still agree?

Answer and reason: Yes. Both debit and credit were omitted. Record the full correct transaction rather than creating an arbitrary suspense balance.

3. An account has an excess debit Rs.700. Which side corrects it?

Answer and reason: Credit that account Rs.700. The other side depends on the original error and whether a suspense balance already exists.

4. Why do the gross and net trial-balance totals differ?

Answer and reason: Gross uses account debit/credit totals; net uses each account's balance. Offsetting within each account reduces both column totals without changing equality.

5. Does a closed suspense account prove no errors remain?

Answer and reason: No. It shows that the differences routed through it have been resolved. Errors that never affected the trial-balance difference may remain.

Official reference: ICAI accounting framework | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. A trial balance lists ledger totals or balances.	**15.** Commission includes wrong amount, side or account.
02. It includes relevant cash and bank balances.	**16.** Not every commission error affects agreement.
03. It can be prepared monthly, quarterly or otherwise.	**17.** Compensating errors can conceal differences.
04. Its agreement is an arithmetic check, not full proof.	**18.** Capital/revenue misclassification is an error of principle.
05. Gross trial balance uses account debit and credit totals.	**19.** Business/personal confusion can misstate accounts.
06. Net trial balance uses each account's net balance.	**20.** Short debit requires an additional debit.
07. Debit excess creates a debit balance.	**21.** Excess debit requires a credit.
08. Credit excess creates a credit balance.	**22.** Short credit requires an additional credit.
09. The example gross totals are Rs.12,00,000 each.	**23.** Excess credit requires a debit.
10. Its net totals are Rs.4,17,000 each.	**24.** Two-sided rectification cancels wrong effects and restores correct effects.
11. Errors can be clerical or errors of principle.	**25.** Suspense can have a debit or credit balance.
12. Omission can be complete or partial.	**26.** Illustration suspense opening debit is Rs.49,500.
13. A complete omission can leave totals equal.	**27.** Adjusting entries recognise period-end matters not yet recorded.
14. A one-sided omission can cause disagreement.	**28.** Closing entries transfer temporary income/expense balances.

MODULE A / A06

Depreciation & its Accounting

A machine is paid for once but helps produce goods for several years. Charging its entire cost to the first year would distort performance. Depreciation allocates the depreciable amount over useful life using a pattern that reflects consumption; it is not simply a yearly estimate of resale-price decline.

Determine depreciable amount → Choose benefit pattern → Allocate by period/use → Review disposal and estimates

Understand it through a worked situation

A machine costs Rs.4,00,000, residual value Rs.40,000 and useful life three years. Annual straight-line depreciation = (4,00,000 - 40,000)/3 = Rs.1,20,000. Acquired 1 April 2015 with December reporting, the first nine months are Rs.90,000. The next two full years are Rs.1,20,000 each and the final three months Rs.30,000. Total Rs.3,60,000 leaves residual Rs.40,000; selling at that amount creates no disposal gain/loss.

COMMON MISTAKE - CHECK THE REASON

Depreciation does not by itself set aside cash for replacement. A sudden accident or loss of recoverability can require separate impairment/disposal analysis. Book depreciation and tax allowances have different rules. A reduced-balance method need not mechanically continue below the residual-value constraint.

Concepts, procedures and worked records

Concept / item	Meaning, condition or application
Depreciation	Depreciation

Historical formulation: Depreciation is a charge to profit and loss account for the fall in value of an asset

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Depreciation is systematic allocation of depreciable amount, not a direct measure of annual market-value decline. It is an operating-cost allocation, not an extra component of opening cost. Impairment, accident damage, disposal and revaluation require their own analysis.

Concept / item	Meaning, condition or application
during each year of its use.	during each year of its use.

Historical formulation: Depreciation is a part of the opening cost.

Concept / item	Meaning, condition or application
It is a reduction in the value of the asset.	It is a reduction in the value of the asset.

Concept / item	Meaning, condition or application
The decrease in the value of an...	The decrease in the value of an asset is due to its use, caused by wear and tear, or by other reasons.

Historical formulation: The decrease in the value of an asset is gradual and continuous.

Causes of Depreciation

Concept / item	Meaning, condition or application
Wear and tear due to actual use	Wear and tear due to actual use
Obsolescence	Obsolescence
Accidents	Accidents

Historical formulation: Fall in market price

Concept / item	Meaning, condition or application
Efflux of time	Efflux of time
Need for Depreciation	Need for Depreciation
To know the correct profit	To know the correct profit
To show correct financial position	To show correct financial position

Historical formulation: To make provision for replacement of asset

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Depreciation is a non-cash expense and does not itself reserve money. A replacement/sinking fund is a separate cash investment and financing decision; future replacement cost can differ from original cost.

Concept / item	Meaning, condition or application
Factors of Depreciation	Factors of Depreciation
For calculating depreciation, the basic factors are	For calculating depreciation, the basic factors are:
The cost of the asset	The cost of the asset;
The estimated residual or scrap value at the end of its life	The estimated residual or scrap value at the end of its life;
The estimated number of year of its commercial life.	The estimated number of year of its commercial life.

Methods of Depreciation

Concept / item	Meaning, condition or application
The following are the various methods for providing depreciation	The following are the various methods for providing depreciation:
Fixed percentage on original cost or fixed...	Fixed percentage on original cost or fixed instalment or straight line method.
Fixed percentage on diminishing balance or reducing...	Fixed percentage on diminishing balance or reducing instalment methods or written down value method.
Units of production method	Units of production method
Sum of years digits method	Sum of years digits method
Straight line Method	Straight line Method

Concept / item	Meaning, condition or application
Straight line method, the cost of the...	Straight line method, the cost of the asset is written off equally during its useful life.
Therefore, an equal amount of depreciation is...	Therefore, an equal amount of depreciation is charged every year throughout the useful life of an asset.
After the useful life of the asset,...	After the useful life of the asset, its value becomes nil or equal to its residual value.
Thus, this method is also called Fixed...	Thus, this method is also called Fixed Instalment Method or Fixed percentage on original cost method.

Historical formulation: If an asset is used only for 3 months in a year then depreciation will be charged only for 3 months. However, for the Income Tax purposes, if an asset is used for more than 180 days full years' depreciation will be charged.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Book allocation and tax depreciation are different. The older 1961 Act rule concerns eligible assets acquired and put to use, with the less-than-180-day restriction subject to its conditions; "more than 180" misses the exactly-180-day boundary. The Income-tax Act, 2025 applies from 1 April 2026, with transitional treatment for earlier years. Do not apply this line as a universal current book-depreciation rule.

Advantages

Concept / item	Meaning, condition or application
It is the simplest method of calculating depreciation.	It is the simplest method of calculating depreciation.
It is easy to understand, as there...	It is easy to understand, as there is no variation in the amount of depreciation charged from year to year.

Disadvantages

Concept / item	Meaning, condition or application
The depreciation is equal for all the...	The depreciation is equal for all the year, however, the expenditure on repairs and renewal goes on increasing as the asset gets older, resulting in higher amount charged to profit and loss account on account of depreciation and repairs in the subsequent years.
Formula	Formula:
Amount of Depreciation = (Cost of Asset...	Amount of Depreciation = (Cost of Asset – Net Residual Value) / Useful Life
The rate of Depreciation = (Annual Depreciation...	The rate of Depreciation = (Annual Depreciation x 100) / Cost of Asset
Journal Entries for Straight Line Method of Depreciation	Journal Entries for Straight Line Method of Depreciation

Straight-line journal-entry mechanics

Stage	Debit	Credit / narration
Purchase asset	Asset A/c: xx	Cash / Bank / Creditor A/c: xx. Being asset purchased.
Charge depreciation	Depreciation on Asset A/c: xx	Asset A/c: xx (direct-write-off presentation). Being depreciation charged on asset.
Transfer expense	Profit and Loss A/c: xx	Depreciation on Asset A/c: xx. Being depreciation expense transferred to P&L.

Concept / item	Meaning, condition or application
Example	Example

Q. Abhinav purchased a machine on 1 Apr 2015 for Rs.400000. The useful life of the machine is 3 years and its estimated residual value is Rs.40000. At the end of its useful life, the machine is sold for 40000. Prepare the

necessary ledger accounts in the books of Abhinav for the year ending 31st December every year. Use SLM.

Concept / item	Meaning, condition or application
Ans	Ans: In the books of Abhinav
Working Notes	Working Notes:
Calculation of amount of depreciation	Calculation of amount of depreciation
Depreciation = (Cost of Asset – Net Residual Value)/Useful life	Depreciation = (Cost of Asset – Net Residual Value)/Useful life
= (400000 – 40000)/3 = 120000 p.a.	= (400000 – 40000)/3 = 120000 p.a.
Machinery A/c	Machinery A/c

Straight-line machinery ledger: all dated movements

Date / opening debit	Credits / closing balance	Check (Rs.)
1 Apr 2015: Cash 4,00,000	31 Dec: depreciation 90,000; balance c/d 3,10,000	4,00,000 each side
1 Jan 2016: balance b/d 3,10,000	31 Dec: depreciation 1,20,000; balance c/d 1,90,000	3,10,000 each side
1 Jan 2017: balance b/d 1,90,000	31 Dec: depreciation 1,20,000; balance c/d 70,000	1,90,000 each side
1 Jan 2018: balance b/d 70,000	31 Mar: depreciation 30,000; Cash 40,000	70,000 each side

Depreciation ledger: charge and transfer

Date	Debit: Machinery A/c (Rs.)	Credit: Profit and Loss A/c (Rs.)
31 Dec 2015	90,000	90,000
31 Dec 2016	1,20,000	1,20,000
31 Dec 2017	1,20,000	1,20,000
31 Mar 2018	30,000	30,000

Concept / item	Meaning, condition or application
Depreciation A/c	Depreciation A/c
Diminishing Balance Method or Written-down Value Method	Diminishing Balance Method or Written-down Value Method

Concept / item	Meaning, condition or application
According to the Diminishing Balance Method, depreciation...	According to the Diminishing Balance Method, depreciation is charged at a fixed percentage on the book value of the asset.
As the book value reduces every year,...	As the book value reduces every year, it is also known as the Reducing Balance Method or Written-down Value Method.
Since the book value reduces every year,...	Since the book value reduces every year, hence the amount of depreciation also reduces every year.

Historical formulation: Under this method, the value of the asset never reduces to zero.

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That describes a mathematical fixed-percentage pattern. Book allocation must still consider residual value, useful life, disposal and applicable review requirements; do not indefinitely depreciate without those constraints.

Concept / item	Meaning, condition or application
Amount of depreciation=Book Value× Rate of Depreciation/100	Amount of depreciation=Book Value× Rate of Depreciation/100
Advantage	Advantage
This method is recognised under the Income-Tax...	This method is recognised under the Income-Tax Act and the Companies Act.

Historical formulation: The total expenditure on repairs and renewal and depreciation on asset are equal in all year, as in the initial years the depreciation will be more and less and in later years the expenditure on repairs will be high and depreciation less, through both may not exactly compensate the decrease/increase in the other.

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Declining depreciation may partly offset rising repairs, but equal total expense is not guaranteed. Use the method that reflects the pattern of benefit consumption.

Concept / item	Meaning, condition or application
Disadvantage	Disadvantage

Historical formulation: The asset can never be reduced to zero value on the books

Concept / item	Meaning, condition or application
Difficult to understand, as there is variation...	Difficult to understand, as there is variation in the depreciation charged from year to year.

Concept / item	Meaning, condition or application
Journal entry for Diminishing Balance Method of Depreciation	Journal entry for Diminishing Balance Method of Depreciation

Written-down-value journal-entry mechanics

Stage	Debit	Credit / narration
Purchase asset	Asset A/c: xx	Cash / Bank / Creditor A/c: xx. Being asset purchased.
Charge depreciation	Depreciation on Asset A/c: xx	Asset A/c: xx. Being depreciation charged on book value.
Transfer expense	Profit and Loss A/c: xx	Depreciation on Asset A/c: xx. Being depreciation expense transferred to P&L.

Concept / item	Meaning, condition or application
Example on Diminishing Balance method	Example on Diminishing Balance method

Q. M/s. Srivastav and sons purchased a machine on 1 Apr 2015 for Rs.400000 from ABC & Co. and paid Rs.100000 on its installation. The useful life of the machine is 3

Concept / item	Meaning, condition or application
years and its estimated residual value is...	years and its estimated residual value is Rs.40000. On 31st March 2018, M/s.
Srivastav and sons sell the machinery for 250000.	Srivastav and sons sell the machinery for 250000.
Charge depreciation as per the W.D.V. method...	Charge depreciation as per the W.D.V. method @10 % p. a. Prepare the
necessary ledger accounts in the books of...	necessary ledger accounts in the books of Anil for the year ending 31st December
every year.	every year.
Ans	Ans: In the books of M/s. Srivastav and sons

Concept / item	Meaning, condition or application
Machinery A/c	Machinery A/c

Written-down-value machinery ledger: chronological reconstruction

Debit movement / opening balance	Credits / balance carried down	Balanced total (Rs.)
1 Apr 2015: ABC & Co. 4,00,000; Cash installation 1,00,000	31 Dec 2015: depreciation 37,500; balance c/d 4,62,500	5,00,000
1 Jan 2016: balance b/d 4,62,500	31 Dec: depreciation 46,250; balance c/d 4,16,250	4,62,500
1 Jan 2017: balance b/d 4,16,250	31 Dec: depreciation 41,625; balance c/d 3,74,625	4,16,250
1 Jan 2018: balance b/d 3,74,625	31 Mar: depreciation 9,366; Cash 2,50,000; P&L disposal loss 1,15,259	3,74,625 (corrected total)
Historical final-row total printed as 4,01,625	That total conflicts with the displayed movements. The corrected final debit/credit total is 3,74,625.	Do not reproduce the inconsistent total as correct.

Concept / item	Meaning, condition or application
Working Notes	Working Notes:
Calculation of amount of depreciation	Calculation of amount of depreciation
Amount of depreciation=Book Value × Rate of Depreciation/100	Amount of depreciation=Book Value × Rate of Depreciation/100
2015	2015: Depreciation = 500000 x 10/100 x 9/12 = 37500
2016	2016: Depreciation = 462500 x 10/100 = 46250
2017	2017: Depreciation = 416250 x 10/100 = 41625

Concept / item	Meaning, condition or application
2018	2018: Depreciation = 374625 x 10/100 x 3/12 = 9366
Calculation of loss on sale of machinery	Calculation of loss on sale of machinery
Loss = Book Value on 1 Jan...	Loss = Book Value on 1 Jan 2018 – depreciation for 3 months – cash received
= 374625 – 9366- 250000 = 115259	= 374625 – 9366- 250000 = 115259

Concept / item	Meaning, condition or application
Units Of Production Method	Units Of Production Method
Accounting Standards in India (AS-10 and Ind...	Accounting Standards in India (AS-10 and Ind AS-16) recognise 3 methods of calculating depreciation.

Concept / item	Meaning, condition or application
These are Straight line method, Diminishing Balance...	These are Straight line method, Diminishing Balance method and the Units of Production method.
This method is a usage based method.	This method is a usage based method.
The depreciation amount is not based on...	The depreciation amount is not based on passage of time but actual use of the asset.
This method is suited to those assets...	This method is suited to those assets which depreciate in proportion to their use rather than having a useful life measured in number of years.
In this method, the useful life is...	In this method, the useful life is measured in term of production output or number of units which an asset is capable of producing during its lifetime. This method gives very accurate measure of the depreciation but suffers from the drawback of the need to maintain elaborate records.
FORMULA	FORMULA:

Depreciation amount during a period = (Actual production or usage during the period / of Total Expected Production or Usage during the asset life of the asset)× Total depreciable amount

Concept / item	Meaning, condition or application
Example	Example;
Company ABC Ltd. Purchases a pen production...	Company ABC Ltd. Purchases a pen production machine. This machine can manufacture 1,000,000 pens after which it will have to be scrapped. The purchase price of the machine is Rs. 100,000 and the scrap value is estimated at Rs. 10,000. During the first year of production, the machine produced 200,000 pens.
The depreciation amount in the first year will be	The depreciation amount in the first year will be; = (200,000/1,000,000) × (100,000 – 10,000) = 0.2 × 90,000 = 18,000
Sum Of the Years Digits Method	Sum Of the Years Digits Method

Historical formulation: According to SOYD method, to calculate the depreciated value we have to take the expected life of an asset (in years0 count back to one and add the figures together. This is a method of calculating depreciation of an asset that assumes a higher depreciation charge and a greater tax benefit in the early years of an asset’s life.

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SOYD is an allocation illustration. A tax deduction depends on tax law, not on assuming that every accelerated book method earns the same tax treatment.

Concept / item	Meaning, condition or application
Example	Example
A new machine was purchased for Rs....	A new machine was purchased for Rs. 3 lac with 5 years economic life. What is
WDV at the end of 3rd year as per SOYD method?	WDV at the end of 3rd year as per SOYD method?
Sum of Years Digit total = 5+4+3+2+1=15	Sum of Years Digit total = 5+4+3+2+1=15
Depreciation for 3 years = 12/15*300000=240000	Depreciation for 3 years = 12/15*300000=240000
WDV at the end of 3rd year = 300000-240000=60000	WDV at the end of 3rd year = 300000-240000=60000

Concept / item	Meaning, condition or application
Example	Example;
Company ABC Ltd. Purchases a pen production...	Company ABC Ltd. Purchases a pen production machine. This machine can

manufacture 1,000,000 pens after which it will have to be scrapped. The purchase price of the machine is Rs. 100,000 and the scrap value is estimated at Rs. 10,000.

Concept / item	Meaning, condition or application
During the first year of production, the...	During the first year of production, the machine produced 200,000 pens.
The depreciation amount in the first year will be	The depreciation amount in the first year will be; = (200,000/1,000,000) × (100,000 – 10,000) = 0.2 × 90,000 = ` 18,000
Replacement Of A Fixed Asset And Creation Of Sinking Fund	Replacement Of A Fixed Asset And Creation Of Sinking Fund
Since depreciation expense is a non-cash expense...	Since depreciation expense is a non-cash expense (i.e. cash is usually paid out in the year the asset is acquired, but the expense is distributed over several years),
it is important to plan for the...	it is important to plan for the replacement of fixed assets as they wear out or become obsolete.

Historical formulation: For example, some organisations set aside an amount of cash equal to the amount of their yearly depreciation expense so that money will be available to purchase a new asset once the current one is fully depreciated.

Concept / item	Meaning, condition or application
Under this method, a 'Depreciation Fund' or...	Under this method, a 'Depreciation Fund' or 'Sinking Fund' is created and the amount is invested in readily saleable securities.
At the end of the life of...	At the end of the life of the asset, the securities are sold and the sale proceeds of the old assets are used for replacement of the asset.
Amortisation Of Intangible Assets	Amortisation Of Intangible Assets

Historical formulation: Many of the intangible assets (e.g. patents, licences, trademarks, etc.) also have a limited useful life.

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For finite-life intangibles, amortise over useful life under the relevant framework. Under Ind AS 38, indefinite-life intangibles are not amortised but are subject to impairment testing/review. Recognition is not automatic merely because an item appears in an examples list.

Concept / item	Meaning, condition or application
Therefore, it is logical to reduce their...	Therefore, it is logical to reduce their value in every accounting year before carrying them to the new accounting year. This is called amortisation.

Historical formulation: Our discussion about depreciation, in this chapter, is equally applicable to amortization.

Historical formulation: Indian Accounting Standard (Ind AS) 38, which deals with intangible assets, describes amortisation as under; "Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life."

Concept / item	Meaning, condition or application
This Standard defines an intangible asset as,...	This Standard defines an intangible asset as, "an identifiable non-monetary asset without physical substance".
Some other examples of intangible assets are	Some other examples of intangible assets are; Scientific or technical knowledge, design and implementation of new process or systems, intellectual property,
copyrights, computer software, motion picture films, marketing...	copyrights, computer software, motion picture films, marketing rights, fishing licences etc.

Quick Revision

Connect the idea	Explain it
Depreciation systematically allocates depreciable amount.	Depreciation systematically allocates depreciable amount.
Depreciable amount is cost less residual value.	Depreciable amount is cost less residual value.
Useful life can be time-based or usage-based.	Useful life can be time-based or usage-based.
Wear, time and obsolescence affect benefit consumption.	Wear, time and obsolescence affect benefit consumption.

Original practice: explain your answer

1. Cost Rs.1,00,000, scrap Rs.10,000, capacity ten lakh units; output two lakh. Depreciation?

Answer and reason: (2,00,000/10,00,000) x (1,00,000 - 10,000) = Rs.18,000. The usage fraction is 20% of the depreciable amount.

2. Cost Rs.3,00,000, five-year life, no residual; SOYD carrying amount after year three?

Answer and reason: Denominator 5+4+3+2+1=15. Depreciation uses (5+4+3)/15=12/15, or Rs.2,40,000. Carrying amount is Rs.60,000.

3. Why include Rs.1,00,000 installation in the Rs.4,00,000 WDV machine cost?

Answer and reason: It is a directly attributable cost of bringing the asset to working condition in this illustration, giving a Rs.5,00,000 initial cost.

4. Does equal depreciation mean equal total annual maintenance cost?

Answer and reason: No. Repairs may rise with age. Straight-line allocation is constant; total expense can vary, and declining depreciation does not guarantee exact compensation for rising repairs.

5. Does every intangible asset get amortised under Ind AS 38?

Answer and reason: No. Finite-life intangibles are amortised over useful life; indefinite-life intangibles are not amortised but are subject to the relevant impairment and review requirements.

Official reference: ICAI revised AS 10 and AS 6 amendment | checked 1 November 2026.

Official reference: Income-tax Act transition | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Depreciation systematically allocates depreciable amount.	**15.** Residual value still matters in book accounting.
02. Depreciable amount is cost less residual value.	**16.** Repairs and depreciation need not exactly offset.
03. Useful life can be time-based or usage-based.	**17.** Units-of-production uses actual output over expected output.
04. Wear, time and obsolescence affect benefit consumption.	**18.** Usage records are necessary for output-based allocation.
05. A market-price fall is not automatically depreciation.	**19.** Illustration output depreciation is Rs.18,000.
06. Accidents can require separate impairment/disposal analysis.	**20.** SOYD denominator is the sum of life-year digits.
07. Depreciation helps measure period profit and carrying amount.	**21.** Five-year SOYD denominator is 15.
08. It does not automatically accumulate replacement cash.	**22.** Illustration SOYD carrying amount after year three is Rs.60,000.
09. Straight-line gives equal annual allocation under fixed assumptions.	**23.** Sinking funds involve a separate funding/investment arrangement.
10. SLM annual amount equals depreciable amount divided by life.	**24.** Disposal compares net carrying amount with net proceeds.
11. SLM rate may be expressed against original cost.	**25.** The WDV example starts with Rs.5,00,000 cost.
12. Partial periods require the stated time basis.	**26.** Its rounded final disposal loss is Rs.1,15,259.
13. WDV applies a rate to the carrying amount.	**27.** Finite-life intangible allocation is amortisation.
14. WDV expense normally declines over time.	**28.** Tax depreciation must not be confused with book depreciation.

MODULE A / A07

Capital and Revenue Expenditure

A branch pays for a new server, routine servicing and staff training. All three involve spending, but the size of the bill alone does not decide whether an asset exists. Ask what resource is created or replaced, whether recognition requirements are met and which benefits have already been consumed.

Identify benefit/resource → Apply recognition criteria → Separate asset from expense → Explain receipt versus income

Understand it through a worked situation

Equipment purchase Rs.1,00,000, delivery Rs.5,000 and necessary installation Rs.10,000 produce a simple initial asset cost Rs.1,15,000. Routine maintenance Rs.3,000 is an expense when incurred under these assumptions. If the supplier bill is unpaid, the classification remains the same: an asset/expense can arise before cash payment.

COMMON MISTAKE - CHECK THE REASON

Capital does not mean expensive and revenue does not mean cheap. Research is not automatically capitalised, and development must meet the applicable criteria. A grant, asset-sale receipt, customer advance or share issue needs its own analysis; not every cash receipt is immediate income.

Concepts, procedures and worked records

Concept / item	Meaning, condition or application
Expenditure	Expenditure
Expenditure	Expenditure

Expenditure means spending on something. This can be a payment is cash or can also be the exchange of some valuable item in exchange for goods or services. It is the process of causing a liability by a commodity. Receipts and invoices keep the records of expenditures. An expense is a word very similar to expenditure but expense shows the deduction in the value of the asset while expenditure simply denotes the obtaining of assets. Two types of expenditures are present on the basis of time durations, That is

Concept / item	Meaning, condition or application
Capital expenditures	Capital expenditures
Revenue expenditures	Revenue expenditures
Capital Expenditures	Capital Expenditures

Historical formulation: These are expenditures for high-value items that holds longer duration

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Amount, frequency and the label “long-term” are clues, not decisive recognition tests. Apply the asset/expense criteria. A large repair can be an expense and a modest qualifying asset can be capitalised.

requirements. Capital expenditures are long-term expenditures. In other words, when the expenses are made for a particular asset but they do not get completely consumed in the specific time. Due to this the earning capacity increases, and in the meanwhile, the price of the assets decreases. Example: Cash money spent on business purposes, Purchasing of Plants and machinery items Etc.

Concept / item	Meaning, condition or application
Costs which are classified as Capital Expenditure	Costs which are classified as Capital Expenditure
Initial costs	Initial costs: These include purchase price including duties and non-refundable taxes, costs directly attributable to bringing the asset to the location and condition necessary for it to be operational. This is also applicable to acquisition of intangible assets.
Subsequent costs	Subsequent costs: These include costs of parts of some items of the assets requiring replacement at regular intervals. These also include the costs of major inspections for potential faults in the assets.
Some of the examples of the above costs are	Some of the examples of the above costs are:
Costs of employee benefits arising directly from...	Costs of employee benefits arising directly from the construction or acquisition of the asset
Costs of site preparation	Costs of site preparation

Concept / item	Meaning, condition or application
Initial delivery and handling costs	Initial delivery and handling costs
Installation and assembly costs	Installation and assembly costs
Costs of testing	Costs of testing
Professional fees	Professional fees

Historical formulation: Research of development expenditure

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Do not capitalise all research/development expenditure. Research is generally expensed; development must satisfy the specified recognition criteria. Direct attribution is necessary in some cases but is not a substitute for recognition.

Historical formulation: All directly attributable costs necessary to create, produce and operate an internally generated intangible asset

Concept / item	Meaning, condition or application
Revenue Expenditures	Revenue Expenditures

In contrast to the capital expenditure, revenue expenditures are not the high- value items, instead, they are the routine expenditures that takes place in the normal business. In other words, this kind of expenditure maintains fixed assets.

Concept / item	Meaning, condition or application
Unlike capital expenditure, earnings do not increase...	Unlike capital expenditure, earnings do not increase but stay maintained in revenue
expenditure. The assets get consumed in an...	expenditure. The assets get consumed in an accounting year and no future benefits
are available.	are available.
Capital VS Expenditure	Capital VS Expenditure

Worked comparison / accounting record

Capital Expenditure	Revenue Expenditure
Amount spent of usually large.	Amount spent is relatively small.
The purpose is to improve or enhance business or productive or earning capacity	The Benefit is short duration
The benefit of long duration	The benefit is short duration
It is non-recurring	It is recurring
It is shown in balance sheet	It is shown in profit and loss account.
Not matched with capital receipts	Matched with revenue receipts

SIZE IS A CLUE, NOT THE TEST

The large/small and recurring/non-recurring distinctions in this traditional grid are broad tendencies only. Apply recognition criteria and substance. A small qualifying asset may be capital; a large recurring repair may be expense.

Concept / item	Meaning, condition or application
Receipts	Receipts
Capital Receipts	Capital Receipts

Historical formulation: Capital Receipts are from issue of Equity/ Preference share/ Capital Instruments or from sale of Disposal of fixed Assets/Long Term investment or from Grants received from Government for Building of Capital Assets. Capital receipts are not routed through Profit & Loss account. However profit/loss, if any, arising from such transactions is recorded in the P & L account.

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Classify by substance. Share issues are financing; asset-sale proceeds are not all profit, although gain/loss may enter P&L. Government grants and customer advances require the applicable recognition treatment; not every operating cash receipt is immediate revenue.

Concept / item	Meaning, condition or application
Revenue Receipts	Revenue Receipts

Historical formulation: Revenue Receipts are from day to day operation of the company or receipts where is no further obligation on the entry to perform certain actions. Revenue Receipts are routed through Profit and loss account.

Quick Revision

Connect the idea	Explain it
Expenditure can occur through cash, credit or...	Expenditure can occur through cash, credit or other consideration.
Expense is not synonymous with cash payment.	Expense is not synonymous with cash payment.
Capitalisation requires the applicable asset-recognition criteria....	Capitalisation requires the applicable asset-recognition criteria.
Capital expenditure can benefit more than one period.	Capital expenditure can benefit more than one period.

Original practice: explain your answer

1. Does a large repair bill automatically become capital expenditure?

Answer and reason: No. Determine whether it creates/replaces a recognised resource or merely maintains existing benefits. Amount and frequency alone are not decisive.

2. Why can necessary installation be included in equipment cost?

Answer and reason: It directly brings the asset to the location and condition necessary for intended operation, subject to the applicable recognition requirements.

Cost	Reasoned treatment
Necessary installation	Part of bringing equipment into working condition.

Cost	Reasoned treatment
Routine service	Maintains existing benefits; expense under the stated facts.

3. Are all research and development costs assets?

Answer and reason: No. Research is generally expensed under the relevant intangible-asset requirements; development requires the specified recognition criteria. Do not capitalise merely because future benefits are hoped for.

4. A machine carrying Rs.40,000 sells for Rs.45,000. Is the whole receipt profit?

Answer and reason: No. The Rs.45,000 cash receipt includes recovery of carrying amount. The simple disposal gain is Rs.5,000 before disposal costs and other adjustments.

5. A customer pays before the promised service. Is all cash automatically revenue?

Answer and reason: No. Analyse whether the entity still has an obligation. A customer advance can create a liability until the relevant revenue-recognition requirements are met.

Official reference: ICAI AS 26: intangible recognition | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Expenditure can occur through cash, credit or other consideration.	**15.** Professional fees may be directly attributable.
02. Expense is not synonymous with cash payment.	**16.** Replacement components need recognition and derecognition analysis.
03. Capitalisation requires the applicable asset-recognition criteria.	**17.** Major inspections can qualify when criteria are met.
04. Capital expenditure can benefit more than one period.	**18.** Routine servicing is generally a period expense.
05. Revenue expenditure generally concerns period consumption or maintenance.	**19.** Research is not automatically capitalised.
06. Size alone does not determine classification.	**20.** Development requires specified recognition conditions.
07. Frequency alone does not determine classification.	**21.** Training expenditure does not automatically create a recognised intangible.
08. Purchase price can form part of initial asset cost.	**22.** Capitalised cost is later depreciated/amortised when applicable.
09. Relevant non-refundable taxes can form part of cost.	**23.** The illustration initial equipment cost is Rs.1,15,000.
10. Directly attributable delivery can form part of cost.	**24.** A share issue is owner financing, not sales income.
11. Necessary site preparation can form part of cost.	**25.** Asset-sale proceeds and disposal gain are different amounts.
12. Installation and assembly can form part of cost.	**26.** Government-grant accounting depends on its nature and framework.
13. Relevant employee construction costs can be directly attributable.	**27.** Customer advances can create obligations before revenue.
14. Testing costs need the applicable recognition treatment.	**28.** Receipts must be classified by substance rather than cash movement alone.

MODULE A / A08

Bills of Exchange

A seller wants written evidence that a customer must pay later. A bill orders payment; a promissory note promises payment. Before memorising entries, identify who draws, accepts, holds and pays the instrument, then trace the obligation and any discounting cost to maturity.

Identify parties → Read term and date → Trace transfer/discount → Record settlement or dishonour

Understand it through a worked situation

B draws an accommodation bill on A for Rs.20,000 for three months. A accepts; B discounts it at 6% p.a. using the stated three-month convention. Discount = 20,000 x 6% x 3/12 = Rs.300; net proceeds Rs.19,700. B must fund A before maturity so A can honour Rs.20,000. The arrangement shifts liquidity; it does not create genuine trading revenue.

COMMON MISTAKE - CHECK THE REASON

A bill exists as a drawn instrument before acceptance; acceptance binds the drawee in the relevant way. A promise is not an order. Dishonour means non-acceptance or non-payment as applicable, not payment on time. Bearer wording in the NI Act must be read with overriding RBI Act restrictions.

Concepts, procedures and worked records

Types of Instruments of Credit

In a business, credit transactions play very important role. For manufacturing goods, manufacturer purchases raw materials, the majority of which will be on credit.

Credit may also be granted by a moneylender, a banker or financial institution. Credit is, generally, provided by obtaining, a written document called ‘Instrument of Credit’. The serves as a proof of existence of credit.

Bills of Exchange

Promissory Notes

Bills of Exchange

Concept / item	Meaning, condition or application
Drawer	Drawer: A person who draws the bill.
Drawee	Drawee: A person on whom the bill is drawn

Historical formulation: Payee: A person who is going to receive money.

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The payee is the named recipient under the instrument; subsequent negotiation/endorsement can affect the person entitled as holder.

Features of Bills of Exchange

Concept / item	Meaning, condition or application
A bill of exchange an instrument in writing.	A bill of exchange an instrument in writing.
It is drawn and signed by the maker i.e. drawer of the bill.	It is drawn and signed by the maker i.e. drawer of the bill.
Contains an unconditional order to a person i.e. drawee.	Contains an unconditional order to a person i.e. drawee.

Historical formulation: The specified amount is payable to the person whose name is mentioned in the bill or to his order or to the bearer.

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Read the NI Act wording with RBI Act section 31. Private issuance of bearer promissory notes is restricted; bearer-on-demand bills/notes cannot be treated as freely issuable merely because a definition mentions bearer wording.

Concept / item	Meaning, condition or application
It specifies the date by which amount...	It specifies the date by which amount should be paid. (Section 5 of Negotiable Instrument Act).
Payment of the bill must be in...	Payment of the bill must be in the legal currency of the country.

Historical formulation: It must be properly stamped.

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Stamp treatment depends on the instrument, tenor, place and applicable stamp law. Do not assume every negotiable instrument uses the same adhesive revenue stamp; cheques are treated differently.

Historical formulation: It must bear a revenue stamp.

Bills of Exchange Example

Mr. Abhinav srivastav draws a bill on Ms. Alpa jha for 3 months for Rs. 50,000, payable to Mr. Niraj kumar or his order on 15th April 2019.

Mr. Abhinav srivastav has ordered Ms. Alpa jha to pay Rs. 50,000 to Mr. Niraj kumar. If the order is acceptable to Ms. Alpa jha, he will write across the bill as follows:

Concept / item	Meaning, condition or application
Accepted	Accepted
Ms. Alpa jha	Ms. Alpa jha
Sector 56, Noida, UP	Sector 56, Noida, UP
17th April 2019	17th April 2019

Historical formulation: When the drawee writes such acceptance on the bill, it becomes a bill of exchange.in the above example Mr. Abhinav srivastav is the drawer of the bill, Ms. Alpa jha is the acceptor and Mr. Niraj kumar is the Payee. Ms. Alpa jha will pay the amount to Mr. Niraj kumar.

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Acceptance is important to the drawee's obligation; the instrument does not first come into existence only on acceptance. A bill is drawn as an order and may later be accepted.

Promissory Notes

A written undertaking by the buyer to make a payment on a specified date can take the form of a bill of exchange or a promissory note. We have seen earlier that a bill of exchange is drawn by the creditor and accepted by the debtor. A promissory notes, on the other hand, is written by the debtor (buyer) promising the creditor (seller) to pay a specified sum after a specified period. Thus, it can be defined as:

Features of Promissory Notes

Concept / item	Meaning, condition or application
An instrument in writing	An instrument in writing
Containing an unconditional undertaking	Containing an unconditional undertaking
Signed by the maker to pay a certain sum of money	Signed by the maker to pay a certain sum of money

Historical formulation: To or to the order of a certain person or the bearer of the instrument (section 4 of the Negotiable instrument Act)

Concept / item	Meaning, condition or application
In a case of Promissory notes, there are two parties	In a case of Promissory notes, there are two parties:
Maker	Maker: A person who makes the note and promises to make the payment.
Payee	Payee: A person who is to receive money.
Or	Or

Historical formulation: The holder: A holder is basically the person who holds the notes. He may be either the payee or some other person.

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A statutory holder is entitled in their own name to possession and to receive/recover the amount. Mere physical custody alone does not establish holder status.

Concept / item	Meaning, condition or application
Essential Elements of a Promissory Note	Essential Elements of a Promissory Note
Written notes	Written notes
Express undertaking	Express undertaking
Unconditional promise	Unconditional promise
Specific amount	Specific amount
Legal tender	Legal tender

Concept / item	Meaning, condition or application
Example	Example:

Promissory-note teaching form

Field	What the form contains
Heading	Promissory Note
Amount	The definite sum promised; write figures and words consistently.
Date	Date of execution.
Stamp area	Appropriate stamping subject to applicable law.
Term	“__ months after date, I promise to pay __ or order, the sum of __, for value received.”
Signature	Maker signs the unconditional undertaking.
Maker details	Name and address of maker.

Concept / item	Meaning, condition or application
Difference between Bills of Exchange and Promissory Note	Difference between Bills of Exchange and Promissory Note

Worked comparison / accounting record

Bills of Exchange	Promissory Notes
It is an unconditional order to pay	It is an unconditional promise to pay.
It is made by a creditor.	It is made by a debtor.
Acceptance by debtor is necessary	No acceptance is required
On dishonor of a bill, it is usually noted by the notary Public.	Nothing is not necessary.

QUALIFY THE OLDER COMPARISON

Noting, protest and notice of dishonour are different procedures. Do not learn the grid as an unconditional always/never rule: apply the NI Act requirements and exceptions, including the rules for foreign bills. A bill exists before acceptance; acceptance is important to the drawee's liability. Eligible time bills/notes receive grace; demand instruments do not.

Concept / item	Meaning, condition or application
Cheque	Cheque
Essential Features of cheque	Essential Features of cheque
A cheque must have to fulfill all...	A cheque must have to fulfill all the essential elements of a bill of exchange.
It must be payable to bearer or...	It must be payable to bearer or to order but in either case, it must be payable on demand.
The banker named pays it when it is presented for payment.	The banker named pays it when it is presented for payment.
The signature must tally with the specimen...	The signature must tally with the specimen sign of the drawer kept in the bank

Concept / item	Meaning, condition or application
A cheque must be dated.	A cheque must be dated.
A cheque drawn with a future is...	A cheque drawn with a future is valid but the same is payable on or after such specified period.
Difference between Bills of Exchange and Cheque	Difference between Bills of Exchange and Cheque

Worked comparison / accounting record

Bills of Exchange	Cheque
A bill of exchange can be drawn upon any person including a bank.	A cheque can be drawn only upon a bank.
A bill of exchange requires acceptance.	A cheque does not requires any acceptance
The acceptor of a bill of exchange is allowed three days of grace after the date maturity of the bill.	A cheque is always payable on demand
Notice of dishonor is necessary	Notice does not requires any stamp.
A bill of exchange must be stamped	A cheque does not require any stamp.

QUALIFY THE OLDER COMPARISON

Noting, protest and notice of dishonour are different procedures. Do not learn the grid as an unconditional always/never rule: apply the NI Act requirements and exceptions, including the rules for foreign bills. A bill exists before acceptance; acceptance is important to the drawee's liability. Eligible time bills/notes receive grace; demand instruments do not.

Concept / item	Meaning, condition or application
Term And Due Date Of A Bill	Term And Due Date Of A Bill

Every promissory note or bill of exchange which is not expressed to be payable on demand, at sight or on presentment matures on the date it falls due. This period of a bill is called ‘Term’ or ‘Tenor’ of the bill. The date of maturity in such cases is calculated after adding three days of grace to the actual period of the bill. Let us suppose, a bill is drawn on 1st March for a period of one month, then, its due date will be 1st April plus three days of grace, i.e. 4th April. If the due date falls on a public holiday say 26th January, then it becomes due on the previous working day, i.e. 25th January.

Accommodation Bill

Accommodation Bills are drawn and accepted with no consideration passed or received. The Bill, which is drawn just to oblige a friend, who is in need of money, of course without any trading activities, with sole intention of raising funds required for ready cash is known as Accommodation Bill.

The accommodating party, i.e., the drawee accepts the Bill drawn by the accommodated party (drawer). That is the Drawer of the accommodation bill can be called accommodated party and drawee can be called accommodating party. After the Bill is accepted, the drawer discounts it with a bank and obtains the cash.

Before the due date of the Bill, Drawer provides funds to the Acceptor, who honours the Bill. Since the acceptance is given without consideration and to help the accommodated

Recall link	Explain the distinction
1	The note maker promises payment.
2	A cheque is drawn on a specified banker and payable on demand.
3	Post-dating does not make a cheque payable before its date.
4	Stamp requirements depend on instrument and law.

Concept / item	Meaning, condition or application
party to raise the funds, the accommodated...	party to raise the funds, the accommodated party has to discharge the Bill by himself or provide funds to accommodating party.
Thus, there is always a mutual understanding...	Thus, there is always a mutual understanding between the parties and hence, these
bills are called Accommodation Bills.	bills are called Accommodation Bills.
Example	Example:

Mr. A accepted a bill for Rs 20,000 drawn by B to enable the latter to raise funds at three months on 1st October 2004. The bill was duly discounted by B at their Bank at 6% per annum. On the due date B remitted the amount to the acceptor and the Bill was duly met. Pass journal entries in the books of both the parties.

Accommodation bill: both parties' journal entries

Date / event	B: drawer / funded party	A: acceptor / accommodating party
1 Oct 2004: bill accepted	Bills Receivable Dr 20,000 / A Cr 20,000. Being bill drawn on A for three months.	B Dr 20,000 / Bills Payable Cr 20,000. Being acceptance of B's bill.
2 Oct: discounting (stated three-month convention)	Cash Dr 19,700; Discount on Bills Dr 300 / Bills Receivable Cr 20,000.	No entry merely because B discounts the bill.
4 Jan 2005: B funds A	A Dr 20,000 / Cash Cr 20,000. Being funds supplied to meet bill.	Cash Dr 20,000 / B Cr 20,000. Being cash received from B.
4 Jan: A honours bill	No additional entry in B's books for A's payment.	Bills Payable Dr 20,000 / Cash Cr 20,000. Being bill honoured at maturity.

Concept / item	Meaning, condition or application
Discount	Discount: 20,000 x 6/100 x 3/12 = Rs 300
Bill Books	Bill Books
Two types of Bill Books	Two types of Bill Books
Bills Receivable Book	Bills Receivable Book

Concept / item	Meaning, condition or application
Bills Payable Book	Bills Payable Book
Bills Receivable Book	Bills Receivable Book

Bills receivable book is a book where all the bills, which are received, are recorded and posted directly to the credit of respective customer’s account from there. The total amount of bills so received during the period, either at the end of the week or month, is to be posted to, in one lump sum, to the debit of the bills receivable account. The usual

Concept / item	Meaning, condition or application
form of bills receivable book, with imaginary...	form of bills receivable book, with imaginary figures is shown below.

Bills receivable book: each field in the illustrative record

Field	Original example / meaning
Serial number	1
Date of receipt	1 January 2020
From whom	A
Acceptor	A
Date of bill	1 January 2020
Term	1 month
Date due	Older illustration prints 1 January 2020, inconsistent with the term. A one-month after-date bill ordinarily matures 4 February 2020, subject to statutory holiday rules.
Where payable	Delhi
Amount	Rs.4,000
Ledger folio	Dash / no specific folio supplied.
How disposed of	Dash / no disposal specified.
Remarks	Dash / no additional remark supplied.

Concept / item	Meaning, condition or application
Bills Payable Book	Bills Payable Book

This is a book where all particular relating to the bills accepted are recorded and , posted from there, directly to the debit of the respective creditor’s account. The total amount of the bills so accepted during the period, either at end of the week or month, is to be posted in one lump sum to the credit of bills payable account. The usual form of

Concept / item	Meaning, condition or application
‘Bill payable book’ with imaginary figures,	‘Bill payable book’ with imaginary figures,

Bills payable book: field-by-field blank form

Field	Purpose / blank example
Serial number	Record identifier.
Date of receipt	Receipt/acceptance record date.
Drawn by	Drawer identity.
Payee	Person entitled to receive payment.
Date of bill	Instrument date.
Term	Stated tenor.
Date due	Calculated maturity.
Where payable	Place of payment.
Amount	Amount of bill.
L.F.	Ledger folio.
How disposed of	Settlement/disposal information.
Remarks	Further relevant information. The original form supplies no filled example.

Concept / item	Meaning, condition or application
Important Terms	Important Terms
Honouring of Bill	Honouring of Bill: When the drawee pays the amount of the bill on due date, the bill is said to be ‘Honoured Bills’.

Historical formulation: Dishonour of Bill: When the drawee pays the amount of the bill on due date, the bill is said to be ‘Honoured Bills’.

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Correct definition: dishonour involves non-acceptance or non-payment as applicable. Payment on the due date is honour, not dishonour.

Concept / item	Meaning, condition or application
Discounting of Bills	Discounting of Bills: The drawer may discount the bill with the bank before the due date. The bank charges discounting charges from the drawer at a certain rate.

Thus, at the time of discounting the bank deposits the net amount after charging such amount of discount in the account of the holder of the bill.

Discount formula

Quantity	Relationship
Discount	Bill amount x annual discount rate/100 x remaining months/12, under the stated simple-month convention.

Concept / item	Meaning, condition or application
Endorsement of bills	Endorsement of bills: Transfer of bill to same other person by the holder.
Retirement of bills	Retirement of bills: When a drawee pays the bill before its due date. It is called retirement of bill.
Renewal of bill	Renewal of bill: Renewal of bill of exchange is an act of cancellation of old bill before its maturity in return of a new bill, including interest, for an extended period. It is done by drawer on request of drawee.

Historical formulation: Accommodation of bill: An accommodation bill is a bill of exchange signed for by a person (the accommodation party) acting as a guarantor. The accommodation party is liable for the bill should the acceptor fail to pay at maturity. Accommodation bills are sometimes also referred to as windbills or windmills.

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The accommodation example must be read by actual signatures and capacities. Here A accepts and becomes acceptor; do not replace the legal obligations of drawer, acceptor and endorser with a generic “guarantor” label.

Concept / item	Meaning, condition or application
Notary Public	Notary Public: A notary public of the common law is a public officer constituted by law to serve the public in non-contentious matters usually concerned with estates, deeds, powers-of-attorney, and foreign and international business.
Rebate	Rebate: When a bill is paid by drawee before due date, same allowance is given to him. This allowance is called ‘Rebate’.

READ THE BILL'S DATE TERMS

The Abhinav/Alpa/Niraj illustration contains a 15 April 2019 reference and acceptance on 17 April 2019. Without unambiguous “after date” or “after sight” wording, do not manufacture a unique maturity date. Identify drawer, acceptor and payee, then use the actual instrument's tenor and starting date.

Quick Revision

Exam fact	Meaning / qualification
Endorsement without recourse	Sans recourse endorsement excludes the endorser's liability to the extent of the applicable law and wording.
Facultative endorsement	A waiver of notice of dishonour is a common facultative-endorsement example; read the actual waiver.
Instruments	Promissory notes, bills of exchange and cheques are the three named negotiable instruments in this revision list.
Paying-bank protection	NI Act section 85(1): specified order-cheque endorsement protection; section 85(2): specified bearer-cheque protection; section 85A: qualifying drafts. These are conditional protections, not protection for every forged drawer signature.
Alteration and crossing	Section 89 deals with specified payments where an alteration/crossing is not apparent; section 128 concerns payment of crossed cheques in the prescribed manner. Read good-faith, due-course and other applicable conditions.

Original practice: explain your answer

1. Who gives the order in a bill and who gives the promise in a note?

Answer and reason: The drawer orders the drawee to pay; the note's maker promises payment. The distinction determines the roles and obligations.

2. A one-month after-date bill is drawn on 1 March. What is its normal maturity?

Answer and reason: 1 April plus three days of grace = 4 April, subject to applicable holiday rules. A demand instrument does not receive those grace days.

3. Can acceptance dated 17 April fix the maturity of an after-date bill by itself?

Answer and reason: No. Identify whether the term runs after date or after sight and read the bill date. The two starting points can differ.

4. What is the discount in the Rs.20,000, 6%, three-month illustration?

Answer and reason: Rs.300 under its stated convention, leaving Rs.19,700 cash. An actual bank calculation may use exact days and applicable charges.

5. Is a collecting banker's role the same as guaranteeing payment?

Answer and reason: No. Collection, endorsement liability, statutory protections and any guarantee must be distinguished. Conditions such as payment in due course and good faith matter.

Official reference: Negotiable Instruments Act, 1881 | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. An instrument of credit provides written evidence of an obligation.	**15.** Maturity requires the correct after-date/after-sight starting point.
02. A bill contains an unconditional order.	**16.** Public-holiday maturity follows the applicable statutory rule.
03. A promissory note contains an unconditional undertaking.	**17.** Honour means due performance of payment.
04. The drawer draws the bill.	**18.** Dishonour can be non-acceptance or non-payment as applicable.
05. The drawee is the person ordered to pay.	**19.** Discounting converts a bill into net proceeds before maturity.
06. The acceptor is the drawee who accepts.	**20.** The simple discount formula needs rate and time units.
07. The payee is the named recipient of payment.	**21.** Illustration discount is Rs.300.
08. A holder must meet the statutory entitlement test.	**22.** Endorsement can transfer rights subject to law.
09. The note maker promises payment.	**23.** Retirement is payment before maturity.
10. A cheque is drawn on a specified banker and payable on demand.	**24.** A rebate can accompany early retirement.
11. Post-dating does not make a cheque payable before its date.	**25.** Renewal replaces an old bill under agreed conditions.
12. Stamp requirements depend on instrument and law.	**26.** Accommodation bills are not genuine trade-sale evidence.
13. Demand instruments do not receive days of grace.	**27.** Bills receivable and payable books collect different obligations.
14. Eligible time bills/notes ordinarily add three grace days.	**28.** Notice, noting and protest must be distinguished.

MODULE A / A09

Operational Aspects of Accounting Entries

A customer deposits cash. To the customer, money moves from cash into a bank asset. To the bank, cash increases and the amount owed to the customer increases. Always name whose books you are using before deciding debit and credit.

Identify bank perspective → Verify authority → Post account effects → Reconcile GL controls

Understand it through a worked situation

In the bank's books, a Rs.2,000 customer cash deposit is Cash Dr / Customer Deposit Cr. A same-branch cheque from B to A is B Deposit Dr / A Deposit Cr: individual balances change, but the combined SB control balance does not if both are within the same control category. In the full example, A's balance moves 9,000 +2,000 +5,000 +3,000 -4,000 -6,000 = Rs.9,000.

COMMON MISTAKE - CHECK THE REASON

Automated posting does not remove the need for authorisation, controls and reconciliation. A digital transaction may have no separate paper voucher while still requiring an electronic record and audit trail. A personal-account transfer can net to zero in one GL control even when both customer accounts change.

Concepts, procedures and worked records

Accounting Entries

Introduction

Concept / item	Meaning, condition or application
Ultimate objective of recording the financial transactions...	Ultimate objective of recording the financial transactions is to prepare the balance sheet and the P&L account
Purpose	Purpose: All the stakeholders get a fair picture of results of the operations of the enterprise during the accounting period as also the financial position at the end of the accounting period.
Always in terms of number of monetary units.	Always in terms of number of monetary units.
Debit or credit entry	Debit or credit entry: The accounting entry could be a debit entry or a credit entry.
Double entry system	Double entry system: Every credit/debit accounting entry should have one or more corresponding debit/credit entry. Each such pair of accounting entries affects two (or more) accounts in the ledger.
For example, if a customer deposits cash...	For example, if a customer deposits cash of Rs. 2,000 in a bank branch for credit

Concept / item	Meaning, condition or application
to his account, the pair of accounting entries	to his account, the pair of accounting entries:

Historical formulation: Bank a/c (Customer a/c) Dr. 2000

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Bank perspective correction: Cash A/c Dr Rs.2,000 / Customer Deposit A/c Cr Rs.2,000. The bank receives an asset and owes the customer more. Keep customer-book entries separate.

Historical formulation: To Cash A/c 2000

Concept / item	Meaning, condition or application
Branch level operations in the bank result...	Branch level operations in the bank result in initiating a large number of accounting entries and it is very important to know how these should be dealt with.
A peculiar feature of accounting entries in...	A peculiar feature of accounting entries in the bank is that these are :
1st entered in the ledger accounts concerned...	1st entered in the ledger accounts concerned and then in the journal.
In manual operations, the entries are entered...	In manual operations, the entries are entered in the physical ledgers by the staff concerned.

Concept / item	Meaning, condition or application
After that, all the entries in a...	After that, all the entries in a particular ledger head are entered in the journal (day book) and
finally, the total is entered in the...	finally, the total is entered in the control account concerned of the General Ledger which is used in preparing the balance sheet and the P&L account.

Any accounting entry in manual operations can only be made based on a physical voucher which is authenticated by the authorised officer of the branch.

In case of computerised operations, the accounting entry in the system is made by the staff concerned and authenticated by the official concerned. The system takes care of the remaining operations affecting the day books and the GL.

The branch staff has only to enter the accounting entry, originated at the branch, to the accounts concerned and all other operations till the preparation of financial statements

Historical formulation: are automatically performed by the system.

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Automation processes linked postings; it does not prove that input, authority, parameters or output are correct. Maker-checker, access, reconciliation and exception controls remain necessary.

But, it is still important to understand the manual system of accounting so that the staff concerned is clear about the process involved and is able to reply to the queries of the customers and auditors instead of claiming ignorance of the systems and procedures.

Concept / item	Meaning, condition or application
Peculiar Features Of Accounting System In Banks	Peculiar Features Of Accounting System In Banks
In the case of banks, the need...	In the case of banks, the need for the ledger accounts, especially those of customers, being accurate and up-to-date is much stronger than in most other types of enterprises.
A bank cannot afford to ignore its...	A bank cannot afford to ignore its ledgers particularly those containing the accounts of its customers and has to enter every transaction into the ledgers as soon as it takes place.
In the case of banks, relatively lesser...	In the case of banks, relatively lesser emphasis is placed on books of prime entry such as cash books or journals.
This is unlike most other types of...	This is unlike most other types of enterprises where books of prime entry are generally kept up-to-date while ledgers, including the general ledger and subsidiary ledgers for debtors, creditors, etc. are written afterwards.
Banks follow the accounting procedure of ‘voucher...	Banks follow the accounting procedure of ‘voucher posting’ under which the vouchers are straightaway posted to the individual accounts in the subsidiary ledgers.

Concept / item	Meaning, condition or application
At the end of each day, the...	At the end of each day, the debit and credit vouchers relating to a particular type of transaction (e.g. savings bank accounts, current accounts, demand loans, cash credit accounts, etc.) are entered on separate voucher summary sheets and the total thereof is posted to the respective control account in the general ledger.
The general ledger trial balance is prepared every day.	The general ledger trial balance is prepared every day.

Types of Transactions

Concept / item	Meaning, condition or application
Transactions in a bank are of two...	Transactions in a bank are of two types, cash and non-cash. In the latter case, also called ‘transfer transactions’, one or both of the accounts concerned may be of the customers or the internal accounts of the bank.
For example, if ‘A’ deposits a cheque...	For example, if ‘A’ deposits a cheque drawn in his favour by ‘B’, who is also a customer of the branch, the accounts of the two customers will be affected. On

the other hand, if ‘A’ deposits a draft drawn on the branch, the ‘Draft, account, an internal account of the bank, will be debited. Likewise, on payment of interest on deposit accounts, the ‘Interest Account’ at the branch will be debited and many personal accounts credited.

Concept / item	Meaning, condition or application
Vouchers	Vouchers

Both debit and credit operations on all accounts, either by customers or by the bank itself, are made by means of vouchers. There are two kinds of vouchers, one, which evidences only debit or credit to an account, and the other, which contains both debit and credit to different accounts. For the sake of convenience, the latter kind of vouchers may be called ‘composite vouchers’.

Concept / item	Meaning, condition or application
The debit vouchers are, broadly the following	The debit vouchers are, broadly the following:
Cheques issued by the customers.	Cheques issued by the customers.
Cheques/pay orders issued by the bank.	Cheques/pay orders issued by the bank.
Withdrawal forms received from the savings bank account holders.	Withdrawal forms received from the savings bank account holders.

Concept / item	Meaning, condition or application
Drafts issued by other branches of the...	Drafts issued by other branches of the bank payable at the branch.
Drafts issued by other banks on the...	Drafts issued by other banks on the branch, in terms of an approved arrangement between the two banks.

Concept / item	Meaning, condition or application
Dividend/interest warrants issued by the bank’s customers...	Dividend/interest warrants issued by the bank’s customers and payable by the branch in terms of an approved arrangement.
Travellers’ cheques issued by any branch of...	Travellers’ cheques issued by any branch of the bank which are presented to the branch for payment.
Drafts/pay orders issued by the branch itself...	Drafts/pay orders issued by the branch itself which are cancelled at the request of the customer and amount is refunded to him.
. Instruments like traveller’s cheques/gift cheques, etc.,...	. Instruments like traveller’s cheques/gift cheques, etc., of other banks which are paid by the branch in terms of an approved arrangement.
Letters of authority signed by the customers,...	Letters of authority signed by the customers, containing standing instructions.
Debit vouchers prepared by the branch on...	Debit vouchers prepared by the branch on its printed stationery which are authorised by a designated official of the bank and may also carry authority from the customers in some cases, if the debit is to his account at the branch.

Concept / item	Meaning, condition or application
In respect of realisation of collection instrument...	In respect of realisation of collection instrument sent to other branches of the bank, a debit advice (which may be known by different names in different banks) prepared by the other branch may itself act as a debit voucher.
Term deposit receipts presented for payment, renewal...	Term deposit receipts presented for payment, renewal or premature closure.
The credit vouchers which are also of...	The credit vouchers which are also of many kinds broadly encompass the following:
Pay-in-slips filled by the customers (depositors as...	Pay-in-slips filled by the customers (depositors as well as borrowers) for deposit of amounts in their accounts. Generally, the pay-in-slips are in a standard format adopted by the bank but there may be cases of a special kind of pay-in-slips in respect of some customers pursuant to a formal agreement between the bank and the customer.

Concept / item	Meaning, condition or application
Applications for issue of term deposits, demand...	Applications for issue of term deposits, demand drafts, RTGS/NEFT, banker's cheques, pay orders, gift cheques, travellers' cheques and other similar
instruments. Some of these applications may be...	instruments. Some of these applications may be made on behalf of the branch itself for the payments it has to make.

Concept / item	Meaning, condition or application
Challans for deposits into the accounts of...	Challans for deposits into the accounts of Central/State Government, e.g. on account of direct/ indirect taxes or under schemes like public provident fund, etc.
Credit vouchers prepared by the branch on...	Credit vouchers prepared by the branch on its printed stationery which are authorised by an official of the bank. Normally, these vouchers are signed on behalf of the branch only but there may be some instances where the customer concerned also signs on the voucher as evidence that the transaction actually pertains to him. Examples are: deposit of locker charges (credit to an income account of the bank), deposit of money with the bank for purchase of non-judicial stamps required for execution of documents in favour of the bank, etc.
On payment of collection instruments from other...	On payment of collection instruments from other branches of the bank, a credit advice (which may be known by different names in different banks) or a copy of the collection schedule received from the other branch may itself be treated as a credit voucher.
Accounting Systems of Different Banks	Accounting Systems of Different Banks
It is difficult to identify a single...	It is difficult to identify a single accounting system that describes all the features of systems in operation in different banks as the accounting systems of different banks vary in terms of hardware configuration, software capabilities, levels of hardware and software security, and nature of transactions processed.
The accounting system in a bank is...	The accounting system in a bank is designed keeping in view the nature and volume of operations and information needs of the stakeholders.

Concept / item	Meaning, condition or application
Every big bank has customized banking software...	Every big bank has customized banking software as per its own requirement and as such, the accounting systems differ amongst different banks.
Illustration	Illustration
PB branch of bank ABC Ltd. has a number of deposit accounts.	PB branch of bank ABC Ltd. has a number of deposit accounts.

Concept / item	Meaning, condition or application
Mr. A also has his SB account in that branch.	Mr. A also has his SB account in that branch.
On February 28, 2022, Mr. A had...	On February 28, 2022, Mr. A had the following transactions concerning his account:
Deposited Rs. 2,000 by cash	Deposited Rs. 2,000 by cash

Concept / item	Meaning, condition or application
Deposited cheque of Rs. 5,000 issued on...	Deposited cheque of Rs. 5,000 issued on the same branch by another customer, Mr. B
Cheque of Rs. 3,000 deposited earlier is paid through clearing	Cheque of Rs. 3,000 deposited earlier is paid through clearing
Cheque of Rs. 4,000 issued to Mr....	Cheque of Rs. 4,000 issued to Mr. C is received at the branch in clearing
Purchased draft for Rs. 6,000 on an...	Purchased draft for Rs. 6,000 on an outstation branch of the bank (Draft issued at par by the branch)

Customer A: all five movements on 28 February 2022

Particulars	Debit (Rs.)	Credit (Rs.)	Balance (Rs.)
Balance brought forward	-	-	9,000
Cash deposit	-	2,000	11,000
Transfer from customer B	-	5,000	16,000
Cheque realised through clearing	-	3,000	19,000
Cheque paid through clearing	4,000	-	15,000
Draft issued	6,000	-	9,000

Concept / item	Meaning, condition or application
(a) What will be the different entries...	(a) What will be the different entries in the account of Mr. A (assume opening balance of Rs. 9,000) ?
(b) Which other accounts will be affected...	(b) Which other accounts will be affected by each of the other entries?

(c) How the control account pertaining to Savings Bank, in the General Ledger, will be affected by the transactions in the account of Mr. A?

Concept / item	Meaning, condition or application
(a) The entries in the account...	(a) The entries in the account of Mr. A, due to the above transactions, are given in
the following table	the following table:
(b) The accounts affected by the transactions...	(b) The accounts affected by the transactions in the account of Mr. A will be as
under	under:
Deposit of Rs. 2,000 by cash will...	Deposit of Rs. 2,000 by cash will be credited to Mr. A's account and result in a debit entry of Rs. 2,000 in the cash account. This entry is part of the cash scroll of the cashier concerned. The total of the cash scroll is taken in the cash book.
Deposit of the cheque of Rs. 5,000...	Deposit of the cheque of Rs. 5,000 issued on the same branch by another customer, Mr. B, will result in a transfer credit entry of Rs.5000 in the account of Mr. A. The corresponding debit entry will be a transfer entry of Rs. 5,000 in the account of Mr. B.

Concept / item	Meaning, condition or application
Payment received through clearing for a Cheque...	Payment received through clearing for a Cheque of Rs. 3,000 deposited earlier will result in a credit entry (clearing-in) in the account of Mr. A and a debit entry of Rs. 3,000 in the account of the bank conducting the clearing house.
Cheque of Rs 4,000 issued to Mr....	Cheque of Rs 4,000 issued to Mr. B is received at the branch in clearing will result in debit to his account (clearing –out) and a credit entry of Rs 4,000 in the account of the bank conducting the clearing house.
Purchase of a draft for Rs. 6,000...	Purchase of a draft for Rs. 6,000 on an outstation branch of the bank at par, will result in debit entry of Rs. 6,000 in the account of Mr. A and credit entry of Rs. 6,000 in Inter- Office account/ Draft account
(c)At the end of the day, all...	(c)At the end of the day, all the vouchers pertaining to the transactions in all the

Savings Bank accounts at the branch, including those pertaining to the transactions in the account of Mr. A, will be entered in the SB Day Book.

The credit and debit summations of the Day Book will be entered in the respective columns of the SB control account in the GL and the balance derived.

Historical formulation: Separate vouchers are not prepared for ATM/Internet Banking/Mobile banking/system triggered standing instructions/interest application, transactions. Such transactions are processed and recorded by the system.)

CLARIFICATION / CHECKED 1 NOVEMBER 2026

No separate paper voucher does not mean no evidence. System-generated transactions require an electronic record, relevant authority/parameters and an audit trail.

Quick Revision

Exam fact	Meaning / qualification
Cash management	Collection, concentration and disbursement of cash; includes liquidity, cash-balance management and short-term investment choices.
Objective	Support revenue/profitability, cost efficiency and effective growth-supporting systems; these are objectives, not guaranteed outcomes.
Collections: paper and network	Local/outstation cheques; own/branch-location, correspondent/coordinator-location, house and outside-network collections; cash, invoices and capital-market collections.
Collections: historical electronic labels	The older list includes MICR, high-value zero-day clearing, ECS debit and post-dated-cheque collection. Treat discontinued/legacy channel labels as historical; verify present clearing arrangements rather than promising those old services.
Payments	Demand drafts/banker's cheques, customer cheques, locally payable/payable-at-par arrangements, RTGS/NEFT/ECS legacy wording, cash disbursement, intrabank and capital-market payments.
Payment-system development	Infrastructure, innovation and competition influence payment systems. Efficient cash management supports growth, subject to costs, controls and the institution's circumstances.

Original practice: explain your answer

1. In the bank's books, is a customer cash deposit Customer Dr / Cash Cr?

Answer and reason: No. Cash Dr / Customer Deposit Cr records the bank's asset and liability increases. The reverse perspective must not be mixed with this.

2. A and B are SB customers in the same control account. B pays A Rs.5,000. What is the net SB control change?

Answer and reason: Zero from that transfer alone: one deposit liability is debited and the other credited equally. Individual customer balances still need correct postings.

3. Why are customers' ledgers updated promptly?

Answer and reason: Available balances and customer transactions depend on accurate current records. Delayed posting can lead to wrong decisions and unauthorised payments.

4. Does system-generated interest need control because no paper voucher is prepared?

Answer and reason: Yes. Parameters, authorisation, processing evidence, exception review and audit trails remain important.

5. What happens when A buys a draft for Rs.6,000 from account funds?

Answer and reason: Debit A's deposit liability and credit the relevant draft/inter-office account under the bank's system. Trace the subsequent settlement rather than treating it as the bank's income.

Official reference: RBI IT governance and audit-trail directions | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Start by identifying whose books are being used.	**15.** Standing instructions require appropriate authority.
02. A bank deposit is normally a bank liability.	**16.** A bank-prepared voucher needs designated authorisation.
03. A customer cash deposit debits bank Cash.	**17.** Collection advices can support interbranch postings.
04. The corresponding deposit liability is credited.	**18.** Government challans identify particular receipt purposes.
05. A withdrawal reverses those asset/liability directions.	**19.** Term-deposit instructions can support payment or renewal entries.
06. Voucher posting traditionally updates subsidiary accounts first.	**20.** Income such as locker charges differs from deposit liabilities.
07. Day books summarise relevant daily movements.	**21.** Banks' systems differ in architecture and capability.
08. GL controls reconcile to underlying subsidiary records.	**22.** Stakeholder information needs influence system design.
09. Manual entries require proper supporting authority.	**23.** CBS can automate related day-book and GL updates.
10. Electronic entries require controls and audit evidence.	**24.** Automation does not prove the original entry was correct.
11. Cash and transfer transactions are different categories.	**25.** Illustration A starts with Rs.9,000.
12. A composite voucher records both debit and credit effects.	**26.** Its receipts are Rs.2,000, Rs.5,000 and Rs.3,000.
13. A cheque can evidence a debit to the drawer's account.	**27.** Its outflows are Rs.4,000 and Rs.6,000.
14. A pay-in slip can support a credit to an account.	**28.** Illustration A closes with Rs.9,000.

MODULE A / A10

Back Office Functions/Handling Unreconciled Entries in Banks

Branch A issues a draft that Branch B later pays. Each branch has one side of the inter-office story. Reconciliation links the originating entry to the responding entry and investigates anything unmatched; equal amounts alone are not enough to prove that the entries belong together.

Originate with reference → Receive response → Match evidence → Investigate ageing/exceptions

Understand it through a worked situation

A issues a Rs.5,000 draft: Customer Deposit Dr / Inter-office Cr. B pays by crediting the payee: Inter-office Dr / Payee Deposit Cr. The central reconciliation unit matches the reference and evidence. If the draft paid by B was forged and A never issued it, B's response has no legitimate originating entry. The unmatched item prompts investigation; it must not be force-matched to an unrelated Rs.5,000 item.

COMMON MISTAKE - CHECK THE REASON

Matching by reference supports control but does not prove that a transaction was authorised or genuine. Pointing accounts still need exception and parameter monitoring. Do not net a debit in one ageing/category bucket against an unrelated credit just to reduce the reported problem.

Concepts, procedures and worked records

Handling Unreconciled Entries In Banks

Introduction

Concept / item	Meaning, condition or application
Back office consists of administration and support...	Back office consists of administration and support personnel in a financial services company, who are not client facing.
They are a major contributor to the banking business.	They are a major contributor to the banking business.
With the introduction of computerisation in the...	With the introduction of computerisation in the banks, the roles of front office and back office are changing and many of the activities, which were previously performed by the front office, are now performed by the back office, resulting in cost savings and economies of scale as also freeing the time for the front office staff to focus on sales and servicing functions.
Also, computerisation has eliminated the need of...	Also, computerisation has eliminated the need of back office being a part of the branch.

Back offices may be located somewhere other than the bank branch or bank office.

Concept / item	Meaning, condition or application
One of the important functions of the...	One of the important functions of the back office is to reconcile the accounting entries specially the inter office entries.
Functions Performed By The Back Office	Functions Performed By The Back Office

Back offices carry out various functions to support the front office activities.

Concept / item	Meaning, condition or application
In specialised functions like Treasury operations and...	In specialised functions like Treasury operations and Forex, the back offices perform the mainstream role of directly supporting the trading room or front office by controlling confirmations and settlement transactions.
The back office functions relating to the...	The back office functions relating to the normal banking activities can be grouped
as under	as under:
Book keeping and accounting	Book keeping and accounting:
Transaction processing,	Transaction processing,
Maintenance of General Ledger and other books of account,	Maintenance of General Ledger and other books of account,

Concept / item	Meaning, condition or application
Balancing of branch accounts,	Balancing of branch accounts,
Reconciliation of entries and sub-systems,	Reconciliation of entries and sub-systems,
Preparation of financial statements.	Preparation of financial statements.
Deposits	Deposits:
Calculation and posting of interest,	Calculation and posting of interest,
Service charges,	Service charges,

Concept / item	Meaning, condition or application
Reminders for renewals of term deposits,	Reminders for renewals of term deposits,
nature of operation of account - single/jointly, etc.	nature of operation of account - single/jointly, etc.
Loans	Loans:
Processing end-to-end loan originations or any aspect...	Processing end-to-end loan originations or any aspect of loan servicing,
Loan modification,	Loan modification,

Concept / item	Meaning, condition or application
Default management and collections,	Default management and collections,

Concept / item	Meaning, condition or application
Calculation of EMIs,	Calculation of EMIs,
Calculation and posting of interest,	Calculation and posting of interest,

Historical formulation: Penal interest,

CLARIFICATION / CHECKED 1 NOVEMBER 2026

The list uses older “penal interest” terminology. RBI's penal-charges framework requires distinction between a penal charge and an additional penal interest component, subject to scope and effective dates; do not capitalise charges into interest mechanically.

Concept / item	Meaning, condition or application
Processing fee,	Processing fee,
Commission and prepayment charges,	Commission and prepayment charges,
Processes implementation for credit products,	Processes implementation for credit products,

Operational Limits,

Concept / item	Meaning, condition or application
Risk management, etc.	Risk management, etc.
Regulatory Compliance	Regulatory Compliance:
Identifying KYC gaps,	Identifying KYC gaps,
Customer grievance redressal system, etc.	Customer grievance redressal system, etc.
E- banking	E- banking:

Handling transactions through internet,

Concept / item	Meaning, condition or application
Mobile banking or ATMs,	Mobile banking or ATMs,
Card based payments, etc.	Card based payments, etc.
Other functions	Other functions:
Clearing, collection, remittances, etc.	Clearing, collection, remittances, etc.
Reconciliation Function In Banks	Reconciliation Function In Banks
The basic reconciliation functions in a bank...	The basic reconciliation functions in a bank can be divided into groups, as under:

Concept / item	Meaning, condition or application
Reconciliation of accounts for payments involving intermediaries	Reconciliation of accounts for payments involving intermediaries
Reconciliation of accounts with correspondent banks	Reconciliation of accounts with correspondent banks
Reconciliation of bank accounts with RBI and...	Reconciliation of bank accounts with RBI and other banks and institutions
Reconciliation of intra branch entries and sub-systems	Reconciliation of intra branch entries and sub-systems
Reconciliation of inter branch/office entries	Reconciliation of inter branch/office entries
Reconciliation Of Inter Branch/Office Entries	Reconciliation Of Inter Branch/Office Entries

Concept / item	Meaning, condition or application
Origination/Response (Reversal) of Inter Office Transactions Inter...	Origination/Response (Reversal) of Inter Office Transactions Inter office transactions mostly originate at branches.
Each branch may have a number of...	Each branch may have a number of transactions with other branches, as well as with the head office of the bank.
In many transactions, undertaken by the branch,...	In many transactions, undertaken by the branch, one leg of the transaction involved is Inter Office Account.

Concept / item	Meaning, condition or application
For example, when a draft is issued,...	For example, when a draft is issued, the account of the customer is debited and the Inter office account is credited. This draft is paid by the other branch by crediting the account of the payee and debiting the Inter Office account.
The Inter Office entries of both the...	The Inter Office entries of both the branches are reconciled and do not appear in the statement of unreconciled entries.
The major types of transactions, which result...	The major types of transactions, which result in Inter Office debit or credit entry,

Concept / item	Meaning, condition or application
are	are:
Issue of remittance instruments like drafts on other branches.	Issue of remittance instruments like drafts on other branches.
Payment of remittance instruments like drafts drawn...	Payment of remittance instruments like drafts drawn by other branches.
Payment to/receipts from other branches of the...	Payment to/receipts from other branches of the proceeds of instruments received/sent for collection/ realisation/clearing.
Transactions through NEFT, ECS and RTGS.	Transactions through NEFT, ECS and RTGS.
ATM transactions of the customer either at...	ATM transactions of the customer either at ATMs linked with other branches or with merchant establishments.

Concept / item	Meaning, condition or application
Transactions through payment gateways of ATM etc.	Transactions through payment gateways of ATM etc.
Payment of instruments like gift cheques/banker’s cheques/interest...	Payment of instruments like gift cheques/banker’s cheques/interest warrants/dividend warrants/ repurchase warrants/refund warrants/travelers cheques, etc., which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
Operations by the authorised branches on the...	Operations by the authorised branches on the bank’s NOSTRO accounts.
Foreign exchange transactions entered into by the...	Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.

Concept / item	Meaning, condition or application
Deposits and withdrawal of money by branches...	Deposits and withdrawal of money by branches from the currency chest maintained by another branch.
Cash sent to/received from other branches.	Cash sent to/received from other branches.

Concept / item	Meaning, condition or application
Head office interest receivable and payable by the branches.	Head office interest receivable and payable by the branches.
Profit/loss transferred by the branch to head office.	Profit/loss transferred by the branch to head office.
Government receipts and payments handled by the...	Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
Internet based transactions other than inter account...	Internet based transactions other than inter account transfers with the same branch.
Credit card related transactions of the customers.	Credit card related transactions of the customers.
Nostro Accounts of Indian branches maintained with...	Nostro Accounts of Indian branches maintained with overseas branches of the bank.

Concept / item	Meaning, condition or application
Capital Funds with the Overseas Branches.	Capital Funds with the Overseas Branches.
Head Office balances with the overseas branches...	Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
Transactions from Overseas Branches.	Transactions from Overseas Branches.
Payments made under LCs of other branches.	Payments made under LCs of other branches.
GST transactions of Bank branches within a...	GST transactions of Bank branches within a zone and Zonal or Head office.
Reconciliation of Inter – Office Transactions	Reconciliation of Inter – Office Transactions

Concept / item	Meaning, condition or application
A debit/credit Inter Office transaction, originated at...	A debit/credit Inter Office transaction, originated at one branch, should result in a corresponding credit/debit transaction (reversal entry) in the Inter Office account at the other branch.
There may be a time lag in...	There may be a time lag in the case of some types of transactions like drafts issued. Therefore, every entry in the Inter Office account should be reconciled with a corresponding entry in the account at another branch/office of the bank.
The unreconciled inter-office entries indicate the existence...	The unreconciled inter-office entries indicate the existence of errors or, more seriously, of frauds.
Illustration	Illustration
Branch A issues a draft for Rs. 5,000 on branch B of the bank.	Branch A issues a draft for Rs. 5,000 on branch B of the bank.
The account of the customer is debited...	The account of the customer is debited for Rs. 5,000 and the Inter office account is credited by Rs. 5,000.

Concept / item	Meaning, condition or application
The branch includes this entry in the...	The branch includes this entry in the daily statement of inter office account, submitted to the centralised reconciliation department(CRD).
This draft is paid after 2 days...	This draft is paid after 2 days by the branch B by crediting the account of the payee and debiting the Inter Office account as a responding entry.
Branch B sends the daily statement to...	Branch B sends the daily statement to the centralised reconciliation department and the responding entry of Rs.5,000 is included in it.
The central reconciliation department matches the originating...	The central reconciliation department matches the originating and responding entries and these do not appear in the statement of unreconciled entries prepared by the department.
What happens if branch A has not...	What happens if branch A has not issued the draft and the draft paid by the branch B is a forged one.
In this case, there will not be...	In this case, there will not be any entry pertaining to this draft in the daily statement of Branch A, while the daily statement of branch B will contain a responding entry of Rs.5,000.

Concept / item	Meaning, condition or application
The CRD will not be able to...	The CRD will not be able to match the responding entry and it will appear as an unreconciled entry in the statement prepared by the department.
Follow up by the staff of CRD...	Follow up by the staff of CRD will reveal the fact of payment of forged draft.

Concept / item	Meaning, condition or application
In core banking systems, office accounts are...	In core banking systems, office accounts are bifurcated between accounts which
have a requirement of entering a mandatory...	have a requirement of entering a mandatory reference number while passing the
entry (pointing) and accounts which do not...	entry (pointing) and accounts which do not have such a mandate (non-pointing).
In case of pointing accounts, the reconciliation...	In case of pointing accounts, the reconciliation process is easier as the entries can be knocked off based on the reference number and each outstanding entry outstanding on the reporting date can be identified.

Concept / item	Meaning, condition or application
In case of non-pointing accounts, reconciliation requires...	In case of non-pointing accounts, reconciliation requires manual intervention and tracking due to non-availability of a unique reference number. Thus in most of the above mentioned types of transactions, which need to be reconciled, the reconciliation is automatically executed by the system.

Historical formulation: As such, monitoring is required only in those cases, where manual intervention is required.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

All reconciliation arrangements require appropriate oversight. Automated pointing accounts still need monitoring of parameters, wrong references, duplicates, unmatched items and evidence quality.

Concept / item	Meaning, condition or application
The typical and most common types of...	The typical and most common types of errors observed in office accounts are as
under	under:
Recording of particulars in incorrect fields.	Recording of particulars in incorrect fields.
Posting of transactions in incorrect office accounts.	Posting of transactions in incorrect office accounts.
Errors in writing the amounts.	Errors in writing the amounts.
Double recording of the same transaction.	Double recording of the same transaction.

Concept / item	Meaning, condition or application
Squaring off the transaction by the same...	Squaring off the transaction by the same amount without checking the transactions.
Forced matching of transactions.	Forced matching of transactions.
RBI guidelines regarding Inter office entries	RBI guidelines regarding Inter office entries
Considering the fraud prone nature and the...	Considering the fraud prone nature and the fact that there are large number of transactions in inter-office account and the non-reconciliation is widely extended across the banks, RBI has taken a number of measures to achieve an expeditious reconciliation of these transactions by the banks concerned.
Non- reconciliation results in a ‘fraud risk factor’.	Non- reconciliation results in a ‘fraud risk factor’.
Certain objectionable practices observed by RBI in...	Certain objectionable practices observed by RBI in respect of office accounts are as

Concept / item	Meaning, condition or application
follows	follows:
Disguising the cash transactions of customers to...	Disguising the cash transactions of customers to avoid and bypassing reporting of Cash/Suspicious Transactions.
Misuse of funds and indulgence in window...	Misuse of funds and indulgence in window dressing by disbursal or repayment of loan through Office Account General Ledger.
Reference number keying in requirements not made...	Reference number keying in requirements not made mandatory in case of pointing accounts.
Opening of saving and current account and...	Opening of saving and current account and routing their transactions through office accounts.
Dummy debits to the office account and...	Dummy debits to the office account and credit to the borrowers account and then reversing the entries to maintain the “standard” status of borrower or to prevent the account from becoming NPA.

Concept / item	Meaning, condition or application
Netting off liability related GLs with debit...	Netting off liability related GLs with debit balances with credit
balances in other GLs resulting in disclosing...	balances in other GLs resulting in disclosing net outstanding in Financials of the Bank.

Concept / item	Meaning, condition or application
Many income accounts do not have debit...	Many income accounts do not have debit freeze or reference id for reversing
charges.	charges.

Historical formulation: RBI had instructed the banks to reconcile the entries outstanding in their inter branch accounts within a period of six months.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

These historical instructions must be read with the applicable current financial-statement directions and bank category. Keep ageing/category-wise debit exposure visible, do not offset unrelated category credits and apply the required Blocked Account treatment rather than assuming a general netting permission.

Historical formulation: Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head ‘Other liabilities and provisions–Others’ (Schedule 5).

Concept / item	Meaning, condition or application
While arriving at the net amount of...	While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted
against debit entries.	against debit entries.
Banks have been advised that any adjustment...	Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds a particular amount.
RBI had also advised the banks to...	RBI had also advised the banks to maintain, beginning April 1, 1999, category- wise (head-wise) accounts for various types of transactions put through inter- branch accounts so that the netting can be done category-wise.

Historical formulation: Further, considering the fact that an unreconciled debit entry in the Inter Office account may not represent an asset as a result of fraud or otherwise, the Reserve Bank of India vide its circular DBOD. No.BP.BC.73/21.04.018/2002-03 dated February 26, 2003 has advised the banks to make provision against the net debit balance in the inter-branch account in respect of entries outstanding for more than six months.

Historical formulation: Accordingly, banks are required to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31 and make provision equivalent to 100 percent of the aggregate net debit under all categories.

Concept / item	Meaning, condition or application
While doing so, the banks are required to ensure that	While doing so, the banks are required to ensure that:
The credit balance in the Blocked Account...	The credit balance in the Blocked Account created is also taken into account; and
The net debit in one category is...	The net debit in one category is not set-off against net credit in another category.

Quick Revision

Exam fact	Meaning / qualification
Computerisation objectives	Customer service, housekeeping, decision-making, productivity and profitability are linked objectives.
Central processing	A central repository can support corporate information, shared resources and management control. Centralisation needs access, availability and data-integrity controls.
Regional/zonal support	Branch profiles, interbranch reconciliation, credit monitoring and personnel information can be coordinated between branch and head office.
Head-office support	Operations, planning, personnel, international business and services require bank-level information; funds, investments, branch profiles and credit information are typical application areas.
CBS accounting interfaces	A central data pool can support MIS, ALM, risk management, central accounting, interbranch reconciliation and NPA monitoring. A common software version helps controlled changes; it does not make every interface cost-free or error-free.

Current interbranch treatment: keep two calculations separate

Decision	Applicable treatment
Scope and date	RBI commercial-bank financial-statement directions, 28 November 2025, updated 1 July 2026. Their definition excludes RRBs, SFBs, Payments Banks and Local Area Banks.
Old credits	Credits outstanding over five years move to Blocked Account; show under Other Liabilities and Provisions - Others.
Presentation	Exclude Blocked Account when netting remaining interoffice credits and debits for presentation.
Provision	For entries unreconciled over six months, calculate category-wise net positions, considering Blocked Account. Aggregate category net debits and provide 100%; do not offset another category's credit.
Authority and reserves	Blocked adjustments need two officials; above Rs.1 lakh, one must be from Controlling/Head Office. The balance counts for CRR/SLR.
Try it	Category X net debit Rs.80,000; Y net credit Rs.30,000: provision Rs.80,000, not Rs.50,000.

Original practice: explain your answer

1. Does back office have to sit inside the originating branch?

Answer and reason: No. Centralised processing can support many branches. Responsibility, evidence, service levels and control ownership still need to be clear.

2. Two unmatched entries have the same amount. Can they simply be squared off?

Answer and reason: No. Match the transaction identity, reference, dates and supporting evidence. Equal amounts can belong to unrelated transactions.

Evidence chain	What to verify
Originating entry	Amount, date, category and reference
Responding entry	Matching amount, account and authentic reference
Unmatched item	Age, reason, responsible office and escalation

3. A responding Rs.5,000 entry exists but no originator can be found. What is the next action?

Answer and reason: Investigate the underlying transaction, authority and settlement trail. A timing delay is one possibility; an error or forged instrument is another.

4. Does a pointing reference eliminate reconciliation risk?

Answer and reason: No. Wrong references, duplicate postings and inappropriate matching parameters can still defeat the control.

5. Why keep a separate Blocked Account for old credits?

Answer and reason: It preserves visibility and controlled treatment of the old liability-related balances. It should not be used to conceal debit exposure or allow unauthorised adjustments.

Official reference: RBI commercial-bank financial-statement directions | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Back office supports front-office business.	**15.** Unmatched entries can also indicate error or fraud.
02. Centralisation can create economies of scale.	**16.** The draft illustration is Rs.5,000.
03. Treasury back office controls confirmations and settlement.	**17.** A forged response lacks a valid originator.
04. Bookkeeping includes GL, balancing and reporting.	**18.** Pointing accounts use mandatory references.
05. Deposit support includes interest and charge processing.	**19.** Non-pointing accounts need additional tracking.
06. Loan support includes servicing, instalments and collections.	**20.** References must be accurate and enforced.
07. Compliance support can identify KYC gaps.	**21.** Duplicate entries can distort balances.
08. Digital payments require settlement and exception handling.	**22.** Wrong GL selection creates misclassification.
09. Reconcile intermediaries and correspondent accounts.	**23.** Forced matching defeats the purpose of reconciliation.
10. Reconcile RBI/other-bank balances.	**24.** Office accounts must not conceal customer cash transactions.
11. Reconcile intrabranch subsystems.	**25.** Dummy entries must not be used to avoid NPA recognition.
12. Reconcile interbranch/inter-office accounts.	**26.** Ageing and category are essential to the provision analysis.
13. An originating entry needs a matching response.	**27.** Old credits can require a separately controlled Blocked Account.
14. Time lag can create legitimate outstanding items.	**28.** System matching still requires control and exception monitoring.

MODULE A / A11

Bank Audit & Inspection

An audit is not just a search for arithmetic mistakes. In a bank, the auditor asks whether records support a fair financial picture, whether relevant requirements are met and whether controls address important risks. Evidence and professional judgement remain necessary even when every report is generated by a computer.

Understand risks → Plan evidence → Test and evaluate → Report and follow up

Understand it through a worked situation

A branch earns too little interest compared with its loan balances. A data-assisted recalculation can reveal a wrong rate parameter, a missing accrual or an unauthorised waiver. The auditor tests the cause and evidence, quantifies the effect, considers materiality and reports the finding. A system report saying “processed successfully” is not proof that the rate or underlying data was right.

COMMON MISTAKE - CHECK THE REASON

Auditors provide reasonable assurance within their engagement, not an absolute guarantee against fraud. Management owns controls and risk responses. RBIA evaluates how risks are managed; it does not transfer that ownership to internal audit. A statutory auditor cannot blindly substitute another audit report for appropriate evidence.

Concepts, procedures and worked records

Introduction

Concept / item	Meaning, condition or application
Book	Book: “An Introduction to Indian Government Accounts and Audit”
Issued by	Issued by: The Comptroller and Auditor General of India,
Defines audit as	Defines audit as: “An instrument of financial control. It acts as a safeguard on behalf of the proprietor (whether an individual or group of persons) against extravagance, carelessness or fraud on the part of the proprietor’s agents or servants in the realization and utilisation of the money or other assets and it ensures on the proprietor’s behalf that the accounts maintained truly represent facts and that the expenditure has been incurred with due regularity and propriety. The agency employed for this purpose is called an auditor.”
In India, the Companies Act, makes audit...	In India, the Companies Act, makes audit of company accounts compulsory.
Chapter X of the Companies Act, 2013...	Chapter X of the Companies Act, 2013 deals with the appointment of auditors, their removal, resignation, eligibility, qualification, disqualification, remuneration, powers and duties and auditing standards.
Role Of Audit and Inspection	Role Of Audit and Inspection

Concept / item	Meaning, condition or application
With the increase in the size of...	With the increase in the size of the companies and the volume of transactions, the main objective of audit shifted to ascertaining whether the accounts were true and fair, rather than true and correct.
Hence the emphasis was not on arithmetical...	Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts.
The later developments in auditing pertain to...	The later developments in auditing pertain to the use of computers in accounting and auditing.
With the advent of technology and rapid...	With the advent of technology and rapid changes taking place in technology and emergence of various risks, the importance of data analysis has increased to a great extent.

Computer Aided Audit Techniques (CAATs) have become a part of the audit to process data of audit significance and to improve the effectiveness and efficiency of the audit process.

Concept / item	Meaning, condition or application
Thus, while the overall objective and scope...	Thus, while the overall objective and scope of audit do not change simply because the
data is maintained on computers,	data is maintained on computers,

Concept / item	Meaning, condition or application
the procedures followed by the auditor in...	the procedures followed by the auditor in his study and evaluation of the accounting system and related Internal Controls
the nature, timing and extent of his...	the nature, timing and extent of his other audit procedures are affected in a Computerised Information System environment.
Audit procedures are now transformed from ‘Auditing...	Audit procedures are now transformed from ‘Auditing around the computer’ to ‘Auditing through the computer’.
The incidental objectives of auditing are detection...	The incidental objectives of auditing are detection and prevention of errors and frauds.

Concept / item	Meaning, condition or application
Limitations	Limitations:

Historical formulation: The auditor’s work involves exercise of judgment and he can only express an opinion. He has to depend on explanations by others.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Audits provide reasonable assurance, not absolute certainty or an assertion that an entire sector is fraudulent. Exercise professional judgement, obtain sufficient appropriate evidence and distinguish management's control responsibility from the auditor's role.

Concept / item	Meaning, condition or application
Certain non-monetary facts can’t exhibit the true position.	Certain non-monetary facts can’t exhibit the true position.

Auditor can’t check each and every transaction.

Concept / item	Meaning, condition or application
Audit involves a systematic and scientific examination...	Audit involves a systematic and scientific examination of the books of account and records of a business entity to confirm that the profit and loss account and the Balance Sheet are properly drawn up to exhibit a true and fair picture of the financial state of affairs of the business and results of the financial period.
It is also meant to cross check...	It is also meant to cross check that the applicable regulatory provisions have been adhered to.

Historical formulation: Audit provides comfort to the users of the financial statements of a business that the information available in the statements can be relied upon.

Concept / item	Meaning, condition or application
Banking sector deals with large amounts of...	Banking sector deals with large amounts of public monies exposed to various risks in its operations. It is important that the banking sector stays healthy, safe and stable.
Quality bank audit plays a crucial role to ensure this.	Quality bank audit plays a crucial role to ensure this.
Banking operations are mainly conducted at the...	Banking operations are mainly conducted at the branches, while other offices act as controlling authorities or administrative offices.
These offices lay down policies, systems and...	These offices lay down policies, systems and Internal Control procedures so that the conduct of business is in compliance with the statutory/regulatory provisions and in compliance of accepted accounting principles and practices that cover all transactions and economic events.
The transactions in banks are voluminous and...	The transactions in banks are voluminous and it should be ensured that in the system of recording, transmission and storage of information/data, is free of risks of errors, omissions, irregularities and frauds.
Bank managements continuously endeavour to make the...	Bank managements continuously endeavour to make the internal control systems robust, safe and secure.

Concept / item	Meaning, condition or application
Bank audit is the procedure of reviewing...	Bank audit is the procedure of reviewing the financial statements, services and procedures adopted by Banks as required under various legislations and the guidelines of Reserve Bank of India.
It is the routine procedure that all...	It is the routine procedure that all banks must undergo in order to ensure that they are in compliance with industry standards and regulatory norms.
Emergence Of Risk-Based Internal Audit (RBIA) and...	Emergence Of Risk-Based Internal Audit (RBIA) and Its Significance
The internal audit system in banks, historically,...	The internal audit system in banks, historically, concentrated on
Transaction testing,	Transaction testing,
Testing of accuracy	Testing of accuracy

Concept / item	Meaning, condition or application
Reliability of accounting records and financial reports,	Reliability of accounting records and financial reports,
Integrity, reliability and timeliness of control reports,	Integrity, reliability and timeliness of control reports,

Concept / item	Meaning, condition or application
Adherence to legal and regulatory requirements.	Adherence to legal and regulatory requirements.

However, in the changing scenario, the scope of internal audit has widened to evaluate the adequacy and effectiveness of risk management procedures and internal control systems adopted by the banks.

Concept / item	Meaning, condition or application
Thus, RBI vide circular dated December 27,...	Thus, RBI vide circular dated December 27, 2002, had introduced Risk-Based Internal Audit (RBIA) system in Scheduled Commercial Banks.
(SCBs) as part of their internal control framework.	(SCBs) as part of their internal control framework.
This was further supplemented vide circular dated...	This was further supplemented vide circular dated January 07, 2021.
This framework relies broadly on	This framework relies broadly on
Well-defined policy for internal audit,	Well-defined policy for internal audit,
Functional independence with sufficient standing,	Functional independence with sufficient standing,

Concept / item	Meaning, condition or application
Effective channels of communication	Effective channels of communication
Adequate audit resources with sufficient professional competence....	Adequate audit resources with sufficient professional competence.

The internal audit function of banks is expected to proactively identify the new risks to ensure that appropriate controls are in place to mitigate them.

The Guidance Note of Reserve Bank of India on RBIA/RBS states that the audit function should provide high quality counsel to management on effectiveness of risk management and internal controls including regulatory compliance by the Bank.

Historical formulation: The Risk-Based Internal Audit would not only offer suggestions for mitigating current risks but also anticipate areas of potential risks and plays an important role in protecting the bank from various risks.

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Internal audit independently evaluates and advises on risk management and controls. Management owns risks and mitigation decisions; the auditor must not become the operator of controls they audit.

Historical formulation: The implementation of Risk-Based Internal Audit would mean that greater emphasis is placed on the internal auditor's role in mitigating risks.

Concept / item	Meaning, condition or application
Risk-Based Internal Auditing is a methodology that...	Risk-Based Internal Auditing is a methodology that links internal auditing to an organisation's overall risk management framework.
RBIA allows internal audit to provides an...	RBIA allows internal audit to provides an assurance to the Board of Directors and the Senior Management on the quality and effectiveness of bank's internal controls, risk management and governance related systems and processes.
RBIA is not about auditing risks but...	RBIA is not about auditing risks but about auditing the management of risk.
It focuses on the process applied by...	It focuses on the process applied by the management team to respond to risks.
Focus is shifted from the historical internal...	Focus is shifted from the historical internal audit system of fullscale transaction testing to risk identification, prioritization of audit areas and allocation of audit resources in accordance with the risk assessment.
Not only covers assessment of risks at...	Not only covers assessment of risks at the branch level but also covers,

Concept / item	Meaning, condition or application
as an independent assessing authority,	as an independent assessing authority,
assessment of risks at the corporate level	assessment of risks at the corporate level
overall process in place to identify, measure,...	overall process in place to identify, measure, monitor and control risks.
Banks are encouraged to adopt the International...	Banks are encouraged to adopt the International Internal Audit standards, like those issued by the Basel Committee on Banking Supervision (BCBS) and the Institute of Internal Auditors (IIA).
To bring uniformity in approach followed by...	To bring uniformity in approach followed by the banks, as also to align the
expectations on Internal Audit function with the...	expectations on Internal Audit function with the best practices, RBI has issued

Concept / item	Meaning, condition or application
instructions to the banks, a gist of which is as under	instructions to the banks, a gist of which is as under:

Concept / item	Meaning, condition or application
Authority, Stature and Independence	Authority, Stature and Independence
Competence	Competence
Staff Rotation	Staff Rotation
Tenor for appointment of Head of Internal Audit	Tenor for appointment of Head of Internal Audit
Reporting Line	Reporting Line

Concept / item	Meaning, condition or application
Remuneration	Remuneration
Outsourcing	Outsourcing
Documentation	Documentation

Types Of Bank Audits

As banks accept deposit from the public and also lend funds, authenticity and reliability of accounts is a must for public confidence. Keeping this view in mind, banks are subjected to multiple types of audit. Bank Audit can be classified into three broad

Concept / item	Meaning, condition or application
categories	categories: -

Concurrent Audit

Internal Audit/Information System Audit

Statutory Audit

Concurrent Audit

Concept / item	Meaning, condition or application
Concurrent audit is an examination which is...	Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible.
It attempts to shorten the interval between...	It attempts to shorten the interval between a transaction and its examination by an independent person.

Historical formulation: It is a continuous audit, which goes on all the year around, usually conducted by external auditors (chartered accountants) on a monthly basis.

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Concurrent and internal audit have distinct purposes. Staffing and coverage follow applicable requirements and policy; the fact that both exist does not make one a universal substitute for the other.

Concept / item	Meaning, condition or application
In Concurrent Audit, daily basic transactions are...	In Concurrent Audit, daily basic transactions are examined and checked. This ensures that any irregularities are nipped in the bud. There is an emphasis in favour of substantive checking in Key areas rather than test checking.
Through Concurrent Audit, any irregularities or non-conformities...	Through Concurrent Audit, any irregularities or non-conformities are easily found out as and when they happen and are rectified immediately; thereby avoiding the piling up of irregularities which may become a huge problem for any branch when the year-end audit comes around.
Concurrent Auditors check daily maximum cash balance...	Concurrent Auditors check daily maximum cash balance adherence compliance, KYC norms compliance, proper documentation of new loan disbursements, whether new loans have been made as per rules and regulations, revenue leakages etc. among other things like putting any new RBI instructions to work. Any exceptions are reported in the Concurrent Audit Report.
Concurrent Audit is a measure to help...	Concurrent Audit is a measure to help a Branch to work smoothly and rectify any mistakes to avoid the cascading effect of the irregularities.
RBI’s Guidelines on Concurrent Audit System in Commercial Banks	RBI’s Guidelines on Concurrent Audit System in Commercial Banks

RBI has revised the guidelines on Concurrent Audit System in Commercial Banks vide RBI Circular Reference No. DBS.CO.ARS.No.BC.01/08.91.021/2019-20 dated 18th September 2019. Concurrent audit aims at shortening the interval between a transaction and its independent examination. It is, therefore, integral to the establishment of sound internal accounting functions and effective controls and is regarded as part of a bank’s early warning system to ensure timely detection of serious errors and irregularities, which also helps in averting fraudulent transactions and preventive vigilance in banks.

Concept / item	Meaning, condition or application
The revised guidelines cover the following	The revised guidelines cover the following:
Coverage	Coverage
Appointment of Auditors	Appointment of Auditors
Accountability	Accountability
Tenure	Tenure
Remuneration	Remuneration

Concept / item	Meaning, condition or application
Review of effectiveness of Concurrent Audit	Review of effectiveness of Concurrent Audit
Reporting System	Reporting System

Internal Audit/Information Systems Audit

Internal Audit

Concept / item	Meaning, condition or application
Internal Audit is generally undertaken by bank's...	Internal Audit is generally undertaken by bank's own staff and to some extent by the firms of Chartered Accountants.
Aimed	Aimed: At ensuring the accuracy and correctness of the books of account of banks.
One of the broad objectives	One of the broad objectives: Detection of frauds, along with detection of errors, omissions, irregularities etc.,

Internal auditor's job in banks: Invariably include detection of perpetrated frauds.

Historical formulation: It cannot be denied that frauds have virtually engulfed the entire banking sector be it public, private or foreign banks.

Concept / item	Meaning, condition or application
Considering the adoption of liberalised policy in...	Considering the adoption of liberalised policy in the Indian Economy and the sweeping changes in the banking scenario, an auditor's priorities should centre
around detection of frauds inter alia other...	around detection of frauds inter alia other important objectives of the

audit of banks.

Historical formulation: Many banks are conducting Internal Audits instead of Concurrent Audits or even in addition to the Concurrent Audits.

Concept / item	Meaning, condition or application
Important aspects to be considered about Internal Audit are	Important aspects to be considered about Internal Audit are:

Internal Audit’s important role in overall governance mechanism of the Banks,

Concept / item	Meaning, condition or application
Role of Risk-Based Internal Audit in evaluating...	Role of Risk-Based Internal Audit in evaluating & improving the effectiveness of Risk Management and governance processes
Risk-Based Internal Audit Procedures	Risk-Based Internal Audit Procedures
Role of Internal Audit in Risk Management	Role of Internal Audit in Risk Management
Evaluation of Financial Information through analysis of...	Evaluation of Financial Information through analysis of non-financial data

Auditing and Assurance Standards.

Information Systems Audit (IS)

Concept / item	Meaning, condition or application
In the past decade, with the increased...	In the past decade, with the increased technology adoption by Banks, the complexities within the IT environment have given rise to considerable technology related risks requiring effective management.
This led the Banks to implement an...	This led the Banks to implement an Internal Control Framework, based on various standards and their own control requirements and the current RBI guidelines.
As a result, Bank managements and RBI,...	As a result, Bank managements and RBI, need an assurance on the effectiveness of internal controls implemented and expect the IS Audit to provide an independent and objective view of the extent to which the risks are managed.
IS Audit is a process of collecting...	IS Audit is a process of collecting and evaluating evidence/information to determine
whether a computer system could	whether a computer system could:
Safeguard its assets (hardware, software and data)...	Safeguard its assets (hardware, software and data) through adoption of adequate security control measures;

Concept / item	Meaning, condition or application
Maintain data integrity	Maintain data integrity;
Achieve goals of the organisation effectively	Achieve goals of the organisation effectively; and

Concept / item	Meaning, condition or application
Result in the efficient use of the...	Result in the efficient use of the available information System resources.
Reserve Bank of India Guidelines on Information Systems Audit	Reserve Bank of India Guidelines on Information Systems Audit

Reserve Bank of India has been taking many initiatives in sensitising Banks to the risks and concerns that emerge from adoption of information Technology. Various Committee reports, instructions and circulars have been issued from time to time towards assisting banks in adopting sound Information System Audit policy framework and practices on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds.

Concept / item	Meaning, condition or application
Final guidelines in these areas were issued...	Final guidelines in these areas were issued by RBI vide its circular dated 29th April,

Historical formulation: 2011. These Guidelines cover the following areas:

CLARIFICATION / CHECKED 1 NOVEMBER 2026

The 2011 IT guidance is historical. RBI issued the IT Governance, Risk, Controls and Assurance Practices Directions on 7 November 2023, effective 1 April 2024 for the stated entities. Use the applicable updated directions for governance, audit trails, access, resilience and IS audit.

Concept / item	Meaning, condition or application
Information Technology (IT) Governance	Information Technology (IT) Governance
Information Security	Information Security

Information Systems Audit

Concept / item	Meaning, condition or application
Information Technology (IT) Operations	Information Technology (IT) Operations
Information Technology (IT) Services	Information Technology (IT) Services
Outsourcing	Outsourcing
Cyber Fraud	Cyber Fraud
Business Continuity Planning	Business Continuity Planning
Customer Awareness Programmes & Legal aspects	Customer Awareness Programmes & Legal aspects

Concept / item	Meaning, condition or application
Scope of IS Audit	Scope of IS Audit
Determining effectiveness of planning and oversight of...	Determining effectiveness of planning and oversight of IT activities
Evaluating adequacy of operating processes and Internal controls	Evaluating adequacy of operating processes and Internal controls
Determining adequacy of enterprise-wide compliance efforts, related...	Determining adequacy of enterprise-wide compliance efforts, related to IT policies and Internal Control procedures
Identifying deficient controls, recommend corrective action to...	Identifying deficient controls, recommend corrective action to address deficiencies and follow-up and to ensure that the management effectively implements the required actions.
Computer-Assisted Audit Techniques (CAATs)	Computer-Assisted Audit Techniques (CAATs)

IS Audit Function needs to enhance the use of CAATs, particularly for critical functions or processes carrying financial or regulatory or legal implications. The extent to which CAATs can be used will depend on factors such as efficiency and effectiveness of CAATs over manual techniques.

Concept / item	Meaning, condition or application
CAATs may be used in critical areas like	CAATs may be used in critical areas like:

Concept / item	Meaning, condition or application
Detection of revenue leakages	Detection of revenue leakages
Treasury Functions	Treasury Functions
Assessing impact of control weaknesses	Assessing impact of control weaknesses
Monitoring customer transactions under AML requirements	Monitoring customer transactions under AML requirements
Areas where large volume of transactions are reported	Areas where large volume of transactions are reported

Concept / item	Meaning, condition or application
CAATs may be used to perform the...	CAATs may be used to perform the following audit procedures among others:
Test of transactions and balances, such as...	Test of transactions and balances, such as recalculating interest
Analytical Review procedures, such as identifying inconsistencies...	Analytical Review procedures, such as identifying inconsistencies or significant fluctuations
Compliance tests of general controls	Compliance tests of general controls: testing set up or configuration of the operating system or access procedures to the programme libraries
Sampling programmes to extract data for audit testing	Sampling programmes to extract data for audit testing
Compliance tests of application controls such as...	Compliance tests of application controls such as testing functioning of a programmed control

Concept / item	Meaning, condition or application
Re-calculating entries performed by the entity’s accounting...	Re-calculating entries performed by the entity’s accounting Systems
Penetration testing	Penetration testing

Statutory Audit

Introduction As per the Banking Regulation Act, 1949, annual Financial Statements in the form of Profit and Loss Account and Balance Sheet are required to be audited in accordance with the requirements of applicable statutes.

Concept / item	Meaning, condition or application
Salient Features	Salient Features
It is conducted by a 'Statutory Auditor'...	It is conducted by a 'Statutory Auditor' - the word 'Statute' means - mandated or compulsorily required by any law or Act.
In case of Banks, sub-section (1) of...	In case of Banks, sub-section (1) of Section 30 of the Banking Regulation Act, 1949 requires that the Balance Sheet and Profit and Loss account of a banking company should be audited.
Independent audit of financial statements of Banks...	Independent audit of financial statements of Banks is important for a healthy, safe and sound banking system.

Historical formulation: Statutory audit does not look at the intricacies of the banking transactions (which are looked into by concurrent and Internal audits); instead they rely on the concurrent audit & internal Audit Reports and test checking to form their opinion.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

A statutory auditor remains responsible for sufficient appropriate audit evidence. Internal/concurrent reports may inform assessment, but cannot be blindly substituted for the auditor's own required procedures.

Concept / item	Meaning, condition or application
Statutory audit mainly looks at the loans...	Statutory audit mainly looks at the loans and advances, Compliance with Priority Sector Lending (PSL) requirements, CRR, SLR, CRAR
Stages in Statutory Audit	Stages in Statutory Audit

Historical formulation: There is a sea change in banking as use of technology and its continuous evolution has enabled banks to provide its customers comfort of anytime, anywhere banking. The auditor should not assume that the system generated information is correct and can be relied upon without evidence.

Concept / item	Meaning, condition or application
The stages in Bank/Statutory audit are	The stages in Bank/Statutory audit are:
Initial consideration by the statutory auditor	Initial consideration by the statutory auditor
Identifying and assessing the Risks of Material Misstatements	Identifying and assessing the Risks of Material Misstatements
Understanding the Risk Management Process	Understanding the Risk Management Process
Engagement - Team Discussions	Engagement - Team Discussions

Concept / item	Meaning, condition or application
Establishing the overall Audit strategy	Establishing the overall Audit strategy

Concept / item	Meaning, condition or application
Developing the Audit Plan	Developing the Audit Plan
Preparation of Audit Planning Memorandum	Preparation of Audit Planning Memorandum
Determining Audit Materiality	Determining Audit Materiality
Assessment of ability to continue as Going Concern	Assessment of ability to continue as Going Concern
Assessing the Risks of Fraud including Money Laundering	Assessing the Risks of Fraud including Money Laundering
Assessing Specific Risks	Assessing Specific Risks

Concept / item	Meaning, condition or application
Assessing Risks Associated with Outsourcing of Activities	Assessing Risks Associated with Outsourcing of Activities
Response to the Associated Risks	Response to the Associated Risks
Conformity to Basel III framework	Conformity to Basel III framework
Reliance on/review of other reports	Reliance on/review of other reports
Classification of NPAs (It should be based...	Classification of NPAs (It should be based on the record of recovery)

Historical formulation: Asset classification (It should be Borrower-wise and not facility-wise) In carrying out his Substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

These are broad audit/prudential statements. Apply the specific NPA rules and exceptions and the audit's risk/materiality-based scope; do not treat a summary as an unconditional rule for every exposure.

Types of Audit Reports to be issued by Statutory Auditors

Statutory Audit Report (As per SA 700/705/706 Issued by ICAI)

Concept / item	Meaning, condition or application
Long Form Audit Report (As per the...	Long Form Audit Report (As per the requirements of RBI guidelines)

Historical formulation: Tax Audit Report (As per Income-tax Act, 1961) RBI has revised the format of Long Form Audit Report vide its circular dated September 05, 2020

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Tax audit, tax provision review and GST compliance work are different. Income-tax Act, 1961 references remain relevant to the applicable earlier periods/transitions; the 2025 Act came into force on 1 April 2026. Do not assume every GST taxpayer still requires the former compulsory CA/CMA GST audit.

Concept / item	Meaning, condition or application
Appointment of Statutory Auditors in Banks	Appointment of Statutory Auditors in Banks

Historical formulation: Sub-section (1) of section 30 of the Banking Regulation Act, 1949 requires that the Balance Sheet and Profit and Loss of a banking company should be audited by a person duly qualified under any law for the time being in force to be auditor of companies. RBI prepares a panel of Chartered Accountants eligible for conducting statutory audit of banks based upon the data obtained from the Institute of Chartered Accountants of India. Inputs of Comptroller & Auditor General of India are also obtained before finalising the list. As per the provisions of relevant enactments:

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Appointment depends on the bank category, governing statute and applicable RBI process. The 27 April 2021 guidelines introduced a harmonised framework for specified entities, including annual RBI approval for commercial banks excluding RRBs and UCBs. Do not treat the brief panel/AGM/Board summary as the entire appointment process.

Historical formulation: The auditors of Private Banks are appointed at the Annual General Meeting of the shareholders.

Historical formulation: The auditors of Public Sector Banks are appointed by their Board of Directors. (As per RBI guidelines)

Some of the Important Auditing, Review and Other Standards applicable to the audit of Financial Statements as prescribed by the Institute of Chartered Accountants of India

Concept / item	Meaning, condition or application
are given below	are given below:

Concept / item	Meaning, condition or application
300 (Revised) Planning and Audit of Financial Statements	300 (Revised) Planning and Audit of Financial Statements
220 (Revised) Quality Control for an Audit...	220 (Revised) Quality Control for an Audit of Financial Statements
210 (Revised) Agreeing to terms of Audit Engagement	210 (Revised) Agreeing to terms of Audit Engagement
510 (Revised) Initial Audit Engagements - Opening balances	510 (Revised) Initial Audit Engagements - Opening balances
315 Identifying and Assessing the Risks of...	315 Identifying and Assessing the Risks of Material Misstatements through Understanding the entity and its environment

Concept / item	Meaning, condition or application
299 Responsibility of Joint Auditors	299 Responsibility of Joint Auditors
600 Using the work of Another Auditor	600 Using the work of Another Auditor
250 Consideration of Laws and Regulations in...	250 Consideration of Laws and Regulations in an Audit of Financial Statements
240 The Auditor’s Responsibilities Relating to Fraud...	240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
330 The Auditors Responses to Assessed Risks	330 The Auditors Responses to Assessed Risks
Various Other Types Of Audits Undertaken By Banks	Various Other Types Of Audits Undertaken By Banks

Concept / item	Meaning, condition or application
Other than Concurrent Audit, Internal Audit &...	Other than Concurrent Audit, Internal Audit & Statutory Audit, banks undertake the
following types of audits	following types of audits:

Revenue Audit (known as Income & Expenditure audit) Revenue Audit is usually conducted at Exceptionally Large/Very Large/Large and Medium branches and is aimed at identifying cases related to leakage of interest and other charges.

Concept / item	Meaning, condition or application
Stock and Receivables Audit In terms of...	Stock and Receivables Audit In terms of extant RBI guidelines, stock audits may be assigned to qualified professionals (Chartered Accountants/Cost Accountants/consultants) periodically, say annually to check on the stock and

Historical formulation: book debts statements submitted by the borrowers to the bank. Only large borrower accounts are normally are subjected to this audit.

CLARIFICATION / CHECKED 1 NOVEMBER 2026

Stock/receivables audit coverage follows applicable requirements, credit terms, risk and bank policy. It is not an absolute ban on examining other accounts.

Concept / item	Meaning, condition or application
Forensic Audit Forensic Audit is an examination...	Forensic Audit Forensic Audit is an examination and evaluation of a firm's or individual's financial information for use of evidence in court. Concept of Forensic Audit may be defined as "A concentrated audit of all the transactions of the entity to find the correctness of such transactions and to report whether or not any financial benefit has been attained by way of presenting an unreal picture.
Management Audit Management Audit is an assessment...	Management Audit Management Audit is an assessment of methods and policies of an organisation's management in the administration and the use of resources, tactical and strategic planning and employee and organisational improvement. The main objective of management audit is to see how far the objectives of management are fulfilled. It aims to ascertain whether sound management prevails throughout the organisation and evaluates its efficiency in the system of its operation.

Historical formulation: Tax Audit including Goods and Services Tax (GST) Audit This is an analysis of the tax returns submitted by an individual or business entity, to see if the tax Information and resulting income tax payment is valid. Statutory auditors of Banks usually deal with provision for Taxation & GST.

Quick Revision

Exam fact	Meaning / qualification
Environment	Hardware, software and data are core components; people and procedures are also important to control.
Risks	Incorrect decisions, interruption/loss of resources, privacy violations and direct financial loss from fraud.
Risk-prone areas	Errors/omissions in data or software, unauthorised disclosure and misuse of bank assets.
Computer-audit objectives	Safeguard assets, preserve data integrity and assess system efficiency; also consider effective achievement of organisational goals.
Control categories	Preventive controls reduce likelihood; detective controls identify events; corrective controls support response and recovery.
System-audit scope	Review compliance in operations, adequacy of procedures/controls and system integrity, including fraud-related weaknesses.
Audit trail	A chronological record of system events supports tracing and investigation; completeness, access, retention and review matter.
Electronic-record legal context	Older lists cite IPC 1860, Evidence Act 1872, Bankers' Books Evidence Act 1891 and RBI Act 1934. IPC/Evidence references need the 1 July 2024 BNS/BSA transition and savings context; do not present the old list as the complete current framework.

Original practice: explain your answer

1. What distinguishes concurrent audit from year-end statutory audit?

Answer and reason: Concurrent audit examines transactions near their occurrence as a control/early-warning mechanism. Statutory financial-statement audit supports the legally required independent opinion; objectives and reporting differ.

2. Does RBIA mean auditing only high-risk transaction amounts?

Answer and reason: No. It links audit priorities and resources to risk assessment and evaluates governance, risk management and controls at branch and corporate levels.

3. Which four broad IS-audit outcomes matter?

Answer and reason: Safeguarding assets, data integrity, effective achievement of organisational goals and efficient use of information-system resources.

4. A system-generated figure is internally consistent. Can the auditor accept it without testing?

Answer and reason: Not automatically. Consider source data, access, configuration, programmed controls, changes and the evidence needed for the audit purpose.

5. Is every accounting departure dealt with by the same modified opinion?

Answer and reason: No. The effect on the opinion depends on the nature of the matter, evidence, materiality and pervasiveness under the applicable auditing standards.

Official reference: RBI RBIA governance milestone, 7 January 2021 | checked 1 November 2026.

Official reference: RBI auditor-appointment milestone, 27 April 2021 | checked 1 November 2026.

Official reference: RBI IT governance directions, 7 November 2023 | checked 1 November 2026.

Official reference: ICAI SA 705 revised | checked 1 November 2026.

28 essential recall facts

FOUNDATIONS / 01-14	APPLICATION / 15-28
01. Audit supports confidence in financial information.	**15.** Concurrent audit shortens the examination delay.
02. True and fair is not a promise of exact perfection.	**16.** Concurrent audit is part of an early-warning/control approach.
03. Professional judgement is unavoidable.	**17.** Internal audit evaluates governance, risks and controls.
04. Reasonable assurance is not absolute assurance.	**18.** IS audit examines technology-related controls and evidence.
05. Management remains responsible for records and controls.	**19.** Safeguarding hardware, software and data is an IS-audit objective.
06. Audit evidence must support the conclusion.	**20.** CAATs can recalculate interest and test controls.
07. Computerisation changes procedures, not the fundamental objective.	**21.** Sampling does not remove the need for sufficient evidence.
08. CAATs can improve audit efficiency and coverage.	**22.** Statutory bank audit includes financial-statement opinion responsibilities.
09. Data integrity matters throughout recording and transmission.	**23.** Banking Regulation Act section 30 concerns audit of banking-company accounts.
10. RBIA links audit to the risk-management framework.	**24.** LFAR and statutory opinion serve different reporting purposes.
11. RBIA covers branch and corporate-level processes.	**25.** Auditor appointment depends on relevant law and RBI requirements.
12. Audit priorities should reflect assessed risks.	**26.** Revenue audit looks for interest/charge leakage.
13. Internal audit needs authority and independence.	**27.** Forensic work examines evidence for suspected wrongdoing.
14. Competence, resources and communication support effectiveness.	**28.** Findings need reporting, corrective action and follow-up.

MODULE B / B 01

Balance Sheet Equation

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A food-truck business receives owner capital Rs.50,000 and borrows Rs.25,000. Cash is Rs.75,000; equity is Rs.50,000 and loan liability Rs.25,000. Buying a truck for Rs.45,000 changes assets to cash Rs.30,000 plus truck Rs.45,000. Total assets remain Rs.75,000: the purchase exchanges one asset for another.

Change the situation

If the truck is instead bought on credit, cash stays Rs.75,000, truck is Rs.45,000 and liabilities rise to Rs.70,000. Assets Rs.1,20,000 equal liabilities Rs.70,000 plus equity Rs.50,000.

COMMON MISTAKE - WHY IT FAILS

An asset increase does not always mean profit. A loan increases assets and liabilities equally; owner capital increases assets and equity without creating sales income.

Build the connections

Idea	Why it matters
1	Assets equal liabilities plus equity.
2	Equity is the residual claim.
3	Liabilities represent present obligations.
4	An equation must balance after every entry.

Idea	Why it matters
1	Capital introduced is owner financing.
2	A loan is not sales revenue.
3	Cash purchases can exchange assets.
4	Credit purchases can increase liabilities.

Idea	Why it matters
1	Cash is an asset.

Idea	Why it matters
2	Equipment can be a non-current asset.
3	A receivable is a claim to consideration.
4	Asset definitions involve resources and control.

Idea	Why it matters
1	Drawings normally reduce owner equity.
2	Expenses generally reduce profit and equity.
3	Earned revenue can increase equity.
4	Profit is not identical to cash.

Idea	Why it matters
1	The example starts with Rs.75,000 cash.
2	The cash-bought truck costs Rs.45,000.
3	Remaining cash is Rs.30,000.
4	Assets still total Rs.75,000.

Idea	Why it matters
1	Classification depends on the reporting framework.
2	Current classification needs more than a label.
3	Recognition and measurement are separate questions.
4	A balanced equation does not prove accuracy.

Idea	Why it matters
1	A transaction may affect several accounts.
2	Equal debits and credits support dual effect.
3	Identify whose books are being prepared.
4	Check both sides after a changed scenario.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Accounting equation	A=L+E	Assets=A; outside liabilities=L; equity=E. Changes must reconcile too.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Balance Sheet Equation

An Accounting Equation is also called the Balance Sheet Equation. We all know that we record all the business transactions using the Dual Aspect concept. This means that each debit has an equal credit and vice-versa.

Concept / condition / application
Capital: It means the amount which the owner of business has invested in the firm and can claim from the firm.
Liability: It means the amount which the firm owes to outsiders. Long term liabilities are those liabilities which are payable after a long term. Current liabilities are those liabilities which are payable in near future (generally within one year).

Historical formulation: Asset: Assets are things of value owned. Fixed assets are those assets which are purchased for the purpose of operating the business but not for resale, e.g. Land, building, Plant and Machinery, etc. Current assets are those assets which are kept for short term for converting into cash or for resale, e.g, unsold goods, debtors, cash, bank balance, etc.

CLARIFICATION / 1 NOVEMBER 2026

Use the equation change by change. Equity need not change when assets and liabilities change equally. Asset recognition concerns a controlled economic resource under the applicable framework, not merely physical ownership.

Concept / condition / application
Assets = Liabilities + Capital (Owner’s Equity)
Liabilities = Assets- Capital or Capital = Assets – Liabilities

Example:

ABC starts the food truck. He puts Rs. 50,000 as a capital fund. He further loans Rs. 25,000 from a local credit vendor. Now, he has a total of Rs. 75,000, he then purchases a fully furnished truck for Rs. 45,000.

Concept / condition / application
Below is the ABC balance sheet for December 2017.

Food-truck financial position: 31 December 2017

Assets	Rs.	Claims	Rs.
Cash	30,000	Loan from credit union	25,000
Food truck	45,000	Owner equity	50,000
Total	75,000	Total	75,000

Concept / condition / application
Computation Of Balance Sheet Equation

If there is any change in the amount of the assets or the liabilities, the owners' claim or the capital is bound to change correspondingly. If assets increase and liabilities do not, the capital will increase; a reduction in the amount of assets or an increase in the amount of liabilities will mean a reduction in the amount of capital. Such balance sheet equations will be clearer by the various transactions given below:

Assets equal capital plus liabilities

Assets in the illustration	Claims in the illustration
Cash; bank; bills receivable; debtors	Capital + reserves and surplus; creditors
Stock in trade; furniture; machinery; building	Bills payable; outstanding expenses; bank overdraft
Relationship	Total assets = capital + liabilities; each list is illustrative.

Four transactions: reconcile every step

Event	Assets (Rs.)	Equity and liabilities (Rs.)
1. Commence with 20,000 capital	Cash 20,000	Capital 20,000
2. Buy 1,000 machinery for cash	Cash 19,000 +machinery 1,000=20,000	Capital 20,000
3. Buy 2,000 goods for cash	Cash 17,000 +machinery 1,000 +goods 2,000=20,000	Capital 20,000
4. Buy 5,000 goods on credit	Cash 17,000 +machinery 1,000 +goods 7,000=25,000	Capital 20,000 +creditor 5,000=25,000

Apply your understanding: original practice

1. Owner brings Rs.10,000. Is it trading profit?

Answer and reason
No. Debit Cash and credit owner capital. It finances the entity; no sale or service has been earned.

2. A machine is bought for Rs.8,000 cash. Does total asset value necessarily rise?

Answer and reason
No under the stated initial-cost facts. Cash decreases Rs.8,000 and equipment increases Rs.8,000.

3. A loan of Rs.20,000 arrives. What changes?

Answer and reason
Cash and loan liability each increase Rs.20,000. Equity is unchanged by receiving principal.

4. Assets are Rs.90,000 and outside liabilities Rs.35,000. Equity?

Answer and reason
Rs.55,000 = 90,000 - 35,000. This is the residual, not another outside debt.

5. Can an omitted transaction leave the equation balanced?

Answer and reason
Yes. Omitting both sides can preserve equality while understating or misstating the records.

Official reference: ICAI accounting framework | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Assets equal liabilities plus equity.	15. Earned revenue can increase equity.
02. Equity is the residual claim.	16. Profit is not identical to cash.
03. Liabilities represent present obligations.	17. The example starts with Rs.75,000 cash.
04. An equation must balance after every entry.	18. The cash-bought truck costs Rs.45,000.
05. Capital introduced is owner financing.	19. Remaining cash is Rs.30,000.
06. A loan is not sales revenue.	20. Assets still total Rs.75,000.
07. Cash purchases can exchange assets.	21. Classification depends on the reporting framework.
08. Credit purchases can increase liabilities.	22. Current classification needs more than a label.
09. Cash is an asset.	23. Recognition and measurement are separate questions.
10. Equipment can be a non-current asset.	24. A balanced equation does not prove accuracy.
11. A receivable is a claim to consideration.	25. A transaction may affect several accounts.
12. Asset definitions involve resources and control.	26. Equal debits and credits support dual effect.
13. Drawings normally reduce owner equity.	27. Identify whose books are being prepared.
14. Expenses generally reduce profit and equity.	28. Check both sides after a changed scenario.

MODULE B / B 02

Preparation of Final Accounts

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A trader has sales Rs.1,00,000, opening inventory Rs.20,000, purchases Rs.60,000 and closing inventory Rs.15,000. Cost of goods sold is 20,000 + 60,000 - 15,000 = Rs.65,000. Gross profit is Rs.35,000. Deduct operating expenses Rs.10,000 to obtain Rs.25,000 before other items. Closing inventory is both part of the cost calculation and an asset; it is not a second cash receipt.

Change the situation

If accrued but unpaid salary Rs.2,000 was omitted, recognise salary expense and a payable. Profit falls to Rs.23,000 and liabilities rise Rs.2,000; cash is unchanged.

COMMON MISTAKE - WHY IT FAILS

An agreeing trial balance checks arithmetic, not every recognition, valuation or classification. Adjustments must be reasoned through both the income statement and balance sheet.

Build the connections

Idea	Why it matters
1	Trial balance summarises account balances.
2	Equal totals do not prove correctness.
3	Final accounts need period-end adjustments.
4	Identify the applicable presentation format.

Idea	Why it matters
1	Trading results distinguish gross profit.
2	Cost of sales includes opening inventory.
3	Purchases need relevant adjustments.
4	Closing inventory reduces cost of sales.

Idea	Why it matters
1	Gross profit precedes operating expenses.

Idea	Why it matters
2	Net result includes relevant period expenses.
3	Accruals can arise before payment.
4	Prepayments concern unconsumed future benefits.

Idea	Why it matters
1	Closing inventory is also an asset.
2	Depreciation is normally non-cash allocation.
3	Bad debts reduce recoverable receivables.
4	Estimates require supporting evidence.

Idea	Why it matters
1	Outstanding salary creates a liability.
2	Drawings are separate from business expenses.
3	Capital purchases are not ordinary trading purchases.
4	A receipt is not automatically revenue.

Idea	Why it matters
1	Balance sheet reports a point in time.
2	Profit statement covers a period.
3	Assets and claims must reconcile.
4	Closing entries transfer temporary balances.

Idea	Why it matters
1	The case cost of sales is Rs.65,000.
2	The case gross profit is Rs.35,000.
3	Unrecorded salary reduces profit Rs.2,000.
4	Explain both effects of every adjustment.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Cost of goods sold	Opening inventory+net purchases+relevant direct costs-closing inventory	Use consistent inventory and cost recognition.
Gross profit	Net sales-cost of goods sold	Deduct relevant operating and other expenses to continue to final profit.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Preparation of Trial Balance

Historical formulation: The first step in the preparation of final accounts is the preparation of trial balance. So it is absolutely essential that we prepare the trial balance perfectly, so our final accounts do not contain any errors. Let us learn more about the methods and procedures of preparation of trial balance.

CLARIFICATION / 1 NOVEMBER 2026

Trial-balance agreement is an arithmetic check. Balanced errors, omissions and wrong classification/measurement can remain; adjustments and evidence are still necessary.

Concept / condition / application
Trial Balance

A trial balance is a bookkeeping worksheet-like account that reflects all the credit and debit balances of all the ledger accounts. Once we prepare this statement, we can prepare the final accounts of the company on the basis of this trial balance.

One other important use of the trial balance is that it can determine the arithmetic accuracy of the accounts. So if both columns of the trial balance tally, we can be reasonably assured of the accuracy of the accounts. It does not ensure that the accounts are free of all errors but it can at least establish mathematical accuracy.

Concept / condition / application
Trial Balance (ABC Trading as at 30 June 2018)

Worked record / comparison

General ledger A/C	Dr. Debit	Cr. Credit
Cash at bank	10000	
Inventory	40000	
Vehicles	30000	
Fixtures and Fitting	32000	
Accounts Receivable	15000	
Credit card Payment		12000
Account payable		15000
Bank Loan		50000
Sales		175,000
Purchases	60,000	
Advertising	5000	
Wages	65000	
Rent	15000	
Electricity	5000	
Owner Capital		25000
Total	277,000	277,000

Concept / condition / application
Adjustment Entries

An accountant or a bookkeeper makes adjustment entries either before preparation of trial balance or after preparation of trial balance.

Usually, adjustment entries are made after preparation of trial balance. In a case when he makes the adjustment entries after preparation of trial balance, he needs to treat each of the adjustment twice while preparing trading and profit and loss account and balance sheet.

In case adjustment entries made before preparation of trial balance, such adjustment appears in the trial balance. Also, such adjustments appear only once in the preparation of final accounts.

Concept / condition / application
Adjustment Entries Relating to Income and Expendure

Some of the expenses may have been incurred but not paid: For example- Salary for the month of March has been incurred during the month but will be paid in April. For this, adjusting entries, will be passed in the ledger by debit to charges (salary) account and credit to “Salary payable” account.

Some of the expenses may have been paid in advance but not incurred: If a payment has been made in advance i.e. it does not pertain to the accounting period in question, it is not treated as an expense, and the person who received the amount is treated as a debtor.

Some income may have accrued but not received: For example, interest accrued on a fixed deposit with the bank which will be paid by the bank on maturity along with the principal. For accounting the interest income, credit ‘Interest income’ ‘account and debit’ ‘interest receivable’ account.

Some incomes may have been received but not accrued: If an income has been received but not accrued, it should not be accounted for. For example, advance payment of rent by a tenant. This should not be taken into account. Therefore, rent account should be debited and ‘Advance rent Received’ account should be debited.

Idea	Why it matters
1	Balance sheet reports a point in time.
2	Profit statement covers a period.
3	Assets and claims must reconcile.
4	Closing entries transfer temporary balances.

Concept / condition / application
Preparation of Financial Statements from Trial Balance

If we have recorded all the transactions, their arithmetical accuracy has been checked by the trial balance and the required adjusting entries have been made, we should be able to find out the results of the operations during the accounting period (day year) and also know the financial position of the business at the close the year.

Concept / condition / application
This is done through preparing the Profit and loss account and the Balance sheet

(Both these are called the financial statements).

Entries Relating to Depreciation of Fixed Assets

Concept / condition / application
Before we can start preparing the financial statements, it is important to pass entries for depreciation to include it in the records as an expense.

Entries Relating to closing stocks

Every sales transaction results in reduction in available stocks and every purchase transaction increases the stocks available in the godown. However, the entries passed in the ledger, do not affect the stocks account:

Example-

Concept / condition / application
Purchase of goods worth Rs 2000 results in the following postings in the ledger-
Dr. Purchase A/C Rs. 2000
Cr. Cash A/c Rs. 2000
Similarly, sales of goods for Rs. 500 result in the following posting in the ledger-
Dr. Cash A/c Rs. 5000

Concept / condition / application
Cr. Sales A/c Rs 5000

As no entry is passed in the stocks account during the year, the balance in it remains the same as in the beginning of the year, i.e. the opening balance of the stock (this is a debit balance and is shown in the balance sheet of the last year as closing stock)

Concept / condition / application
As we will see in our discussion in the P/L account, the Profit= sales- (purchases+

opening stock-closing stock+ expenses)

In the above formula, all items, except the closing stock, are available from the ledger. As the amount of the closing stock in not available from the ledger, we will have to actually verify the available stock at the close of the year and value it. This is called ‘Inventory Valuation’ and has its impact on the Profit of loss of the firm during that year.

Entries Relating to other items

Other adjustments pertain to provision for bad and doubtful debts, writing off part fictitious assets like preliminary expanses etc. provisioning for contingent events etc.

Concept / condition / application
Preparation of Profit and loss account
Closing Entries

At the end of each accounting period, al; the income and expenses accounts should be closed by transferring the balance to the P & L account. The entries passed for this purpose are called Closing Entries.

Example: If the salary account is showing the debit balance of Rs 300000 a credit entry ‘By transfer to P&L account will be posted in this account and debit entry will be posted to P & L account. Thus balance in the salary account will become Nill.

Concept / condition / application
Trading Account

This is not a necessary step for preparation of the P & L account but many accountants prefer to prepare it. It forms part of the P & L account. A trading account takes into account only the direct costs associated with the materials in which the firm is dealing. The operating costs are not included. This means that we calculate the 'Cost of Goods Sold' and subtract it from the Revenue to arrive at what is called 'Gross Profit'. It is important to note here that under 'Cost of Goods Sold', we calculate the cost of only those goods which are sold and not the cost of entire goods purchased. If we have only purchased the goods during a year and not sold anything, there will be no cost

Concept / condition / application
associated with selling of goods as the purchase resulted in only increasing the inventory (Closing stock).
Cost of Goods Sold= (purchases + opening stock)- closing stock + expenses
Preparation of Profit and Loss account

There are prescribed formats for preparing Profit and loss accounts for all the companies in India. Such form is either provided in the Companies Act 2013 or the Banking Regulation Act or some other Act for specific types of companies. However, for other business entities, there is no prescribed format, Traditionally, all the formats used put sales and other incomes on the credit side and all the expenses on the debit side and arrive at the profit figure. This is achieved by passing the closing entries in respect of all the earnings and expenses accounts in the General Ledger so that the balances in all the remaining accounts in the GL, form the balance sheet, discussed in the next paragraphs. A typical format of a P & L account may be as under if the practice of preparation a Trading account is followed:

Profit and Account of ……..

Concept / condition / application
For the year ending …..2019…..
To salary ……. By Gross profit carried over
From Trading a/c ……
To electricity charges …… Gross Loss ……
To conveyance charges ……..

Concept / condition / application
To depreciation
To office charges ……
To other charges ……..
To Taxes
Net Profit ……..

Concept / condition / application
If the practice of preparing the Trading account is not followed, the format may look as under.

Profit and loss Account of ……

Concept / condition / application
For the year ending …….2019……
To opening stock …….. By sales ……..
To purchases ……. Less returns …….. ……..
Less returns ……. By closing stock ……..
To carriage inwards …….. Gross loss …….

Concept / condition / application
To cartage ……..
To dock charges ……..
To Wages ……..
To duty ……..
To Freight ……..

Concept / condition / application
To clearing charges ……..
To salary ……..
To electricity
To telephone charges
To conveyance charges

Concept / condition / application
To office charges ……..
To other charges …….
To taxes
Net Profit ……..
Profit and loss Appropriation account

Concept / condition / application
Net profit, as arrived at in the P&L A/c, is utilized by the company, for providing
dividend, dividend distribution tax, adjustments to income tax and transfer to reserves etc. This is done through the profit and loss Appropriation account.

Profit and loss Appropriation account is different from profit and loss account and is normally put before the net profit figure in the same statement. The net profit is transferred to the credit side of profit and loss appropriation account. Profit and loss account shows only the net profit or net loss from operations of business while the profit and loss appropriation accounts shows all non- operational adjustment.

Concept / condition / application
A typical format of this account is given below. The items included may vary from

company to company.

Worked record / comparison

Particulars	Amount	Particulars	Amount
To transfer to reserves	……	By last year's balance brought down	……
To debenture redemption reserve	……	By net profit of the year brought down	……

Worked record / comparison

To additional income tax provision for earlier year	……	By excess income tax provision of earlier years	……
To interim dividend	……		
To dividend/ Proposed dividend	……		
To surplus carried over to the balance sheet	……		
Total	……	Total	……

Concept / condition / application
Preparation of Balance Sheet

Below are the steps mentioned to prepare a balance sheet.

Compose a trial balance- It is a regular report included in any accounting programme. If it is a manual mode, then create a trial balance by transferring every general ledger account's ending balance to a spreadsheet.

Arrange the trial balance- It is important to arrange the initial trial balance to assure that the balance sheet similar to the relevant accounting structure. While using adjusting entries to adjust the trial balance all the entry should be completely recorded so the auditors can understand why it was made.

Discard all expense and revenue accounts- The trial balance includes expenses, revenue, losses, gains, liabilities, equity, and assets. Delete all from the trial balance except equity, liabilities, and assets. However, the deleted accounts are used to create an income statement.

Calculate the remaining accounts- In this stage, sum up all the trial balance account used to create a balance sheet. The typical line items used in the balance sheet are:

Concept / condition / application
Cash
Accounts receivable
Inventory
Fixed assets
Other assets

Concept / condition / application
Accounts payable
Accrued liabilities
Debt
Other liabilities
Common stock

Concept / condition / application
Retained earnings
Validate the balance sheet- The total for all assets recorded in the balance sheet should be similar to the liabilities and stockholders' equity accounts.
Present in the required balance sheet format

Worked record / comparison

Liabilities	Amount	Asset	Amount
Capital	.....	Fixed Asset-land, Bldg	.....
Loan Taken	.....	Current Assets	.....
Current Liabilities	.....	Cash/Bank B/s	.....
Outstanding Expenses	.....	Accounts Receivable (Debtors)	.....
Bank Overdraft	.....	Bills Receivable	.....
Account Payable (Creditors)	.....	Inventories (stock)	.....
	XYZ		XYZ

Apply your understanding: original practice

1. Why subtract closing inventory from goods available?

Answer and reason
Those goods have not been consumed through the period's sales under the stated assumptions. Their cost remains an asset.

2. Does salary paid next month belong next month if earned now?

Answer and reason
Under accrual accounting it belongs to the current period: Salary expense Dr / Salary payable Cr.

3. Gross profit Rs.35,000; operating expenses Rs.10,000. Result before other items?

Answer and reason
Rs.25,000. Gross profit is not yet the final profit.

4. Would buying equipment normally enter Purchases for resale?

Answer and reason
No. Classify by intended use and recognition criteria. Operating equipment is different from inventory held for sale.

5. Does closing inventory affect two statements?

Answer and reason
Yes. It reduces cost of sales and appears as inventory in financial position. These are linked effects, not double income.

Official reference: ICAI accounting framework | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Trial balance summarises account balances.	15. Bad debts reduce recoverable receivables.
02. Equal totals do not prove correctness.	16. Estimates require supporting evidence.
03. Final accounts need period-end adjustments.	17. Outstanding salary creates a liability.
04. Identify the applicable presentation format.	18. Drawings are separate from business expenses.
05. Trading results distinguish gross profit.	19. Capital purchases are not ordinary trading purchases.
06. Cost of sales includes opening inventory.	20. A receipt is not automatically revenue.
07. Purchases need relevant adjustments.	21. Balance sheet reports a point in time.
08. Closing inventory reduces cost of sales.	22. Profit statement covers a period.
09. Gross profit precedes operating expenses.	23. Assets and claims must reconcile.
10. Net result includes relevant period expenses.	24. Closing entries transfer temporary balances.
11. Accruals can arise before payment.	25. The case cost of sales is Rs.65,000.
12. Prepayments concern unconsumed future benefits.	26. The case gross profit is Rs.35,000.
13. Closing inventory is also an asset.	27. Unrecorded salary reduces profit Rs.2,000.
14. Depreciation is normally non-cash allocation.	28. Explain both effects of every adjustment.

MODULE B / B 03

Company Accounts - I

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A company issues 10,000 shares of face value Rs.10 at Rs.12, fully paid. It receives Rs.1,20,000: share capital Rs.1,00,000 and securities premium Rs.20,000. Issue price, face value and market price answer different questions. A shareholder owns shares; the company owns its own business assets.

Change the situation

If Rs.2 per share remains uncalled, it is not a cash receipt. Called-up, paid-up and subscribed capital must be distinguished rather than treating every authorised rupee as issued funding.

COMMON MISTAKE - WHY IT FAILS

Older company notes contain outdated section numbers and share-right limits. A company is defined in section 2(20), and a common seal is optional. Do not memorise the old 25% non-voting-share statement as the current differential-rights rule.

Build the connections

Idea	Why it matters
1	A company has separate legal personality.
2	Members own shares, not each company asset.
3	Perpetual succession differs from perpetual profitability.
4	A common seal is optional.

Idea	Why it matters
1	Liability depends on the company form.
2	Ownership and management can be separated.
3	Transfer restrictions depend on company category.
4	Read the memorandum and articles together.

Idea	Why it matters
1	Authorised capital is the permitted ceiling.

Idea	Why it matters
2	Issued capital is offered for subscription.
3	Subscribed capital is taken by subscribers.
4	Called-up capital is the amount demanded.

Idea	Why it matters
1	Paid-up capital reflects amounts credited paid.
2	Calls in arrears differ from calls in advance.
3	Face value differs from issue price.
4	Premium is not ordinary sales income.

Idea	Why it matters
1	Equity and preference shares differ in rights.
2	Preference does not guarantee every payment.
3	Voting rights require the applicable legal analysis.
4	Differential-rights conditions can change by law.

Idea	Why it matters
1	A rights issue concerns existing holders.
2	A bonus issue capitalises eligible reserves.
3	A share split changes denomination.
4	Capital transactions need proper authorisation.

Idea	Why it matters
1	The case capital is Rs.1,00,000.
2	The case premium is Rs.20,000.
3	Total case cash is Rs.1,20,000.
4	Check current law before using old limits.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Company

A company is an association of persons who contribute money or money's worth to a common stock and uses it for a common purpose. It is created by law and effected by law. It is a legal person just as much as much as an individual but with no physical existence.

Historical formulation: Section 20 of the Companies Act, 2013, defines a company as A company incorporated under this act, or under any previous company law.

CLARIFICATION / 1 NOVEMBER 2026

Correction: the company definition is in Companies Act section 2(20). A common seal is optional following the 2015 amendment.

Concept / condition / application
Features of a Joint stock Company
Incorporated association
Artificial person
Perpetual succession
Common seal

Historical formulation: Limited liability

CLARIFICATION / 1 NOVEMBER 2026

Company category, share class, articles and statutory exceptions matter. Do not assume every company form or every shareholder obligation has an identical limitation.

Concept / condition / application
Separation of management from ownership
Transferability of shares
Separate legal status
Large membership

Historical formulation: Minimum paid up capital: It is Rs 1 lakh Private LTD. Company and 5 lakhs for a Public LTD company.

CLARIFICATION / 1 NOVEMBER 2026

The oldRs.1 lakh private/Rs.5 lakh public minimum paid-up requirements were removed in 2015. They are not current universal incorporation minima; sector-specific capital rules can still apply.

Concept / condition / application
Types of companies

Worked record / comparison

On the basis of	On the basis	On the basis of
incorporation	of ownership	liability
Chartered company	Private company	Company limited by
		shares
Statutory company	Public company	Company Ltd. by
		guarantee
Registered company	Government company	Company with
		unlimited liability
Foreign company	Holding company	

Concept / condition / application
Chartered company: A chartered company is one that is established under a special charter issued by the King or Emperor or a Head of State. Such companies are not found in India. Chartered companies established in European countries are East India Company, Bank of England.
Statutory company: A statutory company is one that is created or incorporated by a special Act passed by the Central or State Legislature. The Statutory companies are owned by Government and are given independent legal status, e.g. Life Insurance Corporation of India, Air India, Food Corporation of India, etc.
Registered company: A company registered under the provisions of Companies Act is known as a registered company. In India, examples of companies registered under the Indian Companies Act are Tata Consultancy Services Ltd., WIPRO Ltd., Videocon International Ltd., Reliance Industries Ltd., and so on.
Foreign company: A Foreign company is a company which is incorporated outside India but has a place of business in India, e.g. Hongkong and Shanghai Banking Corporation Ltd.
Private company: A private company is a company that by its articles: (a) except in case of one person company limits the number of its members to two hundred, (b) restricts the right to transfer its shares, and (c) prohibits any invitation to the public to subscribe for any security of the company.

Concept / condition / application
Public company: Section 2 (71)(Chapter I) of the Indian Companies Act, 2013, defines a public company as a company which is not a private company. This means there is no restriction on the number of members and shares are freely transferable.
Government company: Any company in which not less than 51 per cent of the paid-up share capital is held by the Central Government or by any State Government or partly by Central Government and partly by one or more State Governments, is a Government Company.

Concept / condition / application
Holding company: Section 2 (46) (Chapter I) of the Companies Act 2013: a Holding company, in relation to one or more subsidiary companies, means a company of which such companies are subsidiary companies.
Associate Company: In relation to another company, Associate Company means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.
One Person Company: One Person Company means a company which has only one person as a member.

Concept / condition / application
Subsidiary company: Section 2(87) (Chapter I) of the Companies Act, 2013 defines a subsidiary company as a company in which the Holding Company (i) controls the composition of the Board of Directors: or. (ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.
Company limited by shares: It is a company in which liability of its members is limited by memorandum to the amount, if any, unpaid on the shares respectively held by them. Most of the companies in India are companies with limited liability.
Company limited by guarantee: It is a company in which liability of a member is fixed to a certain amount and he is liable to pay that much amount in the event of winding up of the company. This amount is called the ‘Guarantee’. Such companies are generally floated for the promotion of sports, education, religion, fine art, etc., and are essentially non-profit making organisations.
Company with unlimited liability: It is a company in which the liability of a member is unlimited. Such a company can be incorporated with or without share capital.
Partnership Vs Limited Liability Partnership (LLP)

Worked record / comparison

BASIS FOR COMPARISON	PARTNERSHIP	LIMITED LIABILITY PARTNERSHIP (LLP)
Meaning	Partnership refers to an arrangement wherein two or more person agree to carry on a business and share profits & losses mutually.	Limited Liability Partnership is a form of business operation which combines the features of a partnership and a body corporate.
Governed By	Indian Partnership Act, 1932	Limited Liability Partnership Act, 2008
Registration	Optional	Mandatory

Worked record / comparison

Charter document	Partnership deed	LLP Agreement
Liability	Unlimited	Limited to capital contribution, except in case of fraud.
Contractual capacity	It cannot enter into contract in its name.	It can sue and be sued in its name.
Legal Status	Partners are collectively known as firm, so there is no separate legal entity.	It has a separate legal status.
Name of firm	Any name	Name containing LLP as suffix
Maximum partners	100 partners	No limit
Property	Cannot be held in the name of firm.	Can be held in the name of the LLP.
Perpetual Succession	No	Yes
Audit of accounts	Not mandatory	Mandatory, only if turnover and capital contribution overreaches 40 lakhs and 25 lakhs respectively.
Relationship	Partners are agents of firm and other partners as well.	Partners are agents of LLP only.

PARTNERSHIP / LLP COMPARISON QUALIFICATION

The statutory ceiling and the prescribed ordinary-business partnership limit are different: rule 10 prescribes 50 persons, subject to applicable exceptions. The LLP audit shorthand also needs qualification: the commonly applicable thresholds are turnover exceedingRs.40 lakh OR contribution exceedingRs.25 lakh, not necessarily both. Check the applicable rule and exemptions.

Concept / condition / application
Classes of Share Capital
Share capital of a company limited by shares can be two kinds
Equity share
Preference share
Equity share capital means that part of share capital which is not preference share capital. Preference shares can be further classified as under:

Concept / condition / application
Cumulative
Redeemable

Concept / condition / application
Participating

Share capital can be classified in a different way as to:

Concept / condition / application
Authorised capital
Issued capital
Subscribed Capital
Called up capital
Paid-up capital

Concept / condition / application
Issue of Shares
Issue Of Share At Par

Worked record / comparison

Bank	Debited	…….
Share application	…….	credited
Share application	Debited	…….
share capital	…….	Credited
Over subscription		
share application	Debited	…….
share capital	…….	Credited
	…….	Credited
bank (refund)		
	…….	Credited
share allotment		

Concept / condition / application
Share Allotment/Share Call

Worked record / comparison

Share allotment a/c	Debited	…….
Share capital a/c		
	……	Credited
Bank a/c	Debited	……
Share allotment a/c		
	…….	Credited
Share call a/c	Debited	……
Share capital a/c	…….	Credited
Bank a/c	Debited	……
Share call a/c	……	Credited
Calls in arrears a/c	Debited	…….
Share allotment a/c		
	…….	Credited
Share call a/c		
	…….	Credited

Concept / condition / application
Issue of shares at premium

Worked record / comparison

Share application/	Debited	…….
allotment a/c		
	…….	Credited
Share capital A/c		
	…….	Credited
Share premium A/c		

Historical formulation: Issue of shares at discount

CLARIFICATION / 1 NOVEMBER 2026

Section 53 generally prohibits issuing shares at a discount, subject to specified statutory exceptions such as applicable sweat-equity and qualifying debt-restructuring provisions. The older illustrative discount journal is not a general permission to issue discounted equity.

Worked record / comparison

Share allotment A/c	Debited	.....
Discount on issue of shares A/c	Debited	.....
Share capital A/c	.....	Credited

Concept / condition / application
Forfeiture of shares

Worked record / comparison

Share capital A/c	Debited	.....
Call in arrears A/c		
		Credited
Forfeited shares A/c	.....	Credited

Worked record / comparison

Re-issue of shares	Field2	Field3
Bank A/c	Debited	.....
Forfeited shares A/c		
	Debited	.....
Share capital A/c	.....	Credited
Capital reserve A/c	.....	Credited

Worked record / comparison

Issue of Bonus shares	Field2	Field3
Capital Redemption Reserve	Debited	…….
A/c		
	Debited	…….
Share premium A/c		
	Debited	…….
Capital reserve A/c	Debited	…….
Gen Reserve A/c	Debited	…….
Profit & Loss A/c	…….	credited
Bonus to shareholders A/c		
Bonus to shareholders	Debited	…….
A/c	…….	credited
Equity share capital A/c		

Concept / condition / application
Non- Voting Shares
Section 43 of the Companies Act 2013, Provided that share capital of the company

shall consist of the following:

Concept / condition / application
Equity shares with voting rights
Equity shares with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed; and
Preference share capital

Historical formulation: The demand for non-voting equity shares has been made by several sections of the industry basically on the ground that they do exist in many other countries and also provide a measure to the management to tap a class of investors who are interested in higher dividend against absence of voting rights.

CLARIFICATION / 1 NOVEMBER 2026

The old non-voting-share list is historical. The 2019 differential-rights amendment raised the cap to 74% of total voting power; it is not a cap expressed as 25% of paid-up capital. Apply the actual rule, authorisation and remaining conditions.

There are some conditions for issue of non-voting equity share follow:

Concept / condition / application
Issue of non-voting equity shares shall be authorized by the Articles of Association of the company and approved by the shareholders at their general body meeting by passing a special resolution.
Special resolution must state the price at which the shares can be issued and higher rate of dividend which non-voting equity shares shall carry.
Such shareholders are entitled to all rights and bonus shares but do not enjoy voting rights.
Only 25% of the paid-up capital of the company can be issued as equity shares without voting rights.
Only a public company limited by shares can issue non-voting equity shares.

Concept / condition / application
Non company will be permitted to convert shares with voting rights into shares without voting rights.

Apply your understanding: original practice

1. 10,000 Rs.10 shares issued at Rs.12: premium?

Answer and reason
Rs.20,000 = 10,000 x Rs.2. Face-value capital is Rs.1,00,000; total proceeds Rs.1,20,000.

2. Does a shareholder directly own a company's delivery van?

Answer and reason
No. The company owns the van. The shareholder owns shares and the rights attached to them.

3. Is authorised capital all cash received?

Answer and reason
No. It is a ceiling. Issue, subscription, calls and payment determine actual capital funding.

4. Must every company use a common seal?

Answer and reason
No. The mandatory-seal description is historical; the Companies Act was amended to make it optional.

5. Is the old 25% non-voting-share cap a safe current rule?

Answer and reason
No. Differential-rights rules were amended; the 2019 change uses a 74% total-voting-power cap, subject to the other applicable conditions.

Official reference: Companies Act 2013 | checked1November2026.

Official reference: 2019 differential-rights amendment | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. A company has separate legal personality.	15. Face value differs from issue price.
02. Members own shares, not each company asset.	16. Premium is not ordinary sales income.
03. Perpetual succession differs from perpetual profitability.	17. Equity and preference shares differ in rights.
04. A common seal is optional.	18. Preference does not guarantee every payment.
05. Liability depends on the company form.	19. Voting rights require the applicable legal analysis.
06. Ownership and management can be separated.	20. Differential-rights conditions can change by law.
07. Transfer restrictions depend on company category.	21. A rights issue concerns existing holders.
08. Read the memorandum and articles together.	22. A bonus issue capitalises eligible reserves.
09. Authorised capital is the permitted ceiling.	23. A share split changes denomination.
10. Issued capital is offered for subscription.	24. Capital transactions need proper authorisation.
11. Subscribed capital is taken by subscribers.	25. The case capital is Rs.1,00,000.
12. Called-up capital is the amount demanded.	26. The case premium is Rs.20,000.
13. Paid-up capital reflects amounts credited paid.	27. Total case cash is Rs.1,20,000.
14. Calls in arrears differ from calls in advance.	28. Check current law before using old limits.

MODULE B / B 04

Company Accounts - II

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A company sells services for Rs.2,00,000, incurs employee cost Rs.80,000 and depreciation Rs.20,000, and pays interest Rs.10,000. Simplified profit before tax is Rs.90,000. These amounts explain performance, while notes explain policies, estimates and significant detail. The statement is more than a list of cash receipts and payments.

Change the situation

If Rs.30,000 of the services is still unpaid, profit under the stated accrual assumptions remains Rs.90,000 but cash collection is lower and a receivable arises. If the parent controls a subsidiary, group reporting requires a consolidation analysis, not simply adding investment and subsidiary net assets twice.

COMMON MISTAKE - WHY IT FAILS

Select the correct Schedule III division and accounting framework. Consolidated statements eliminate relevant intragroup balances and transactions; company, group and shareholder accounts are not interchangeable.

Build the connections

Idea	Why it matters
1	Profit statements cover a reporting period.
2	Financial position is measured at a date.
3	Use the applicable Schedule III division.
4	Notes form part of financial reporting.

Idea	Why it matters
1	Revenue recognition precedes collection analysis.
2	Employee expense differs from finance cost.
3	Depreciation differs from a new cash purchase.
4	Tax expense can differ from tax paid.

Idea	Why it matters
1	Material items need appropriate presentation.
2	Comparative information supports understanding.
3	Reclassification can require explanation.
4	Material retrospective changes need framework analysis.

Idea	Why it matters
1	Ind AS differs from the AS framework.
2	Other comprehensive income differs from ordinary profit.
3	Earnings per share has its own requirements.
4	Policies should explain relevant accounting choices.

Idea	Why it matters
1	Control is central to consolidation.
2	Parent and group statements differ.
3	Intragroup balances need elimination.
4	Non-controlling interests require separate treatment.

Idea	Why it matters
1	Investment-entity exceptions require careful reading.
2	Business combinations use their relevant standard.
3	Goodwill is not a balancing convenience.
4	Do not double-count subsidiary resources.

Idea	Why it matters
1	Case profit before tax is Rs.90,000.
2	Uncollected revenue can create receivables.
3	A complete statement set needs more than P&L.
4	Disclosure does not cure wrong recognition.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Part II—Statement of Profit and Loss
Name of the Company…… Profit and loss statement for the year ended ……(Rupees in…)

Historical profit-statement form: all fields

Particulars / historical subtotal	Note no.	Current period	Previous period
I. Revenue from operations		___	___
II. Other income		___	___
III. Total revenue(I+II)		___	___
IV. Expenses: cost of materials consumed		___	___
Purchases of stock-in-trade		___	___
Changes in inventories of finished goods, WIP and stock-in-trade		___	___
Employee benefits expense		___	___
Finance costs		___	___
Depreciation and amortisation expense		___	___
Other expenses		___	___
Particulars / historical subtotal	**Note no.**	**Current period**	**Previous period**
Total expenses		___	___
V. Profit before exceptional/extraordinary items and tax(III-IV)		___	___
VI. Exceptional items		___	___
VII. Profit before extraordinary items and tax(V-VI)		___	___
VIII. Extraordinary items: historical AS-format label		___	___
IX. Profit before tax(VII-VIII)		___	___

Particulars / historical subtotal	Note no.	Current period	Previous period
X. Tax expense: (1)current tax;(2)deferred tax		—	—

Particulars / historical subtotal	Note no.	Current period	Previous period
XI. Profit/(loss)from continuing operations(IX-X)		—	—
XII. Profit/(loss)from discontinuing operations		—	—
XIII. Tax expense of discontinuing operations		—	—
XIV. Profit/(loss)from discontinuing operations after tax(XII-XIII)		—	—
XV. Profit/(loss)for the period(XI+XIV)		—	—
XVI. Earnings per equity share: (1)basic;(2)diluted		—	—

FORMAT QUALIFICATION

This historical statement includes an extraordinary-item line. Do not use it as an Ind AS profit-statement template; Ind AS prohibits that category. Select the applicable Schedule III division and current amendments.

Concept / condition / application
General Instructions for Preparation of Statement of Profit and Loss

i)Apply to the income and expenditure a/c referred to in subclause (ii) of clause (40) of section 2 in like manner as they apply to a statement of profit and loss.

Concept / condition / application
ii)In respect of a company other than a finance company revenue from operations

shall disclose separately in the notes revenue from:

Concept / condition / application
Sale of products;
Sale of services;
Other operating revenues;

Less:

Concept / condition / application
Excise duty.
In respect of a finance company, revenue from operations shall include revenue from:
Interest; and
Other financial services.
Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

iii)Finance Costs

Finance costs shall be classified

Concept / condition / application
Interest expense;
Other borrowing costs;
Applicable net gain/loss on foreign currency transactions and translation.

iv)Other income

Concept / condition / application
Interest Income (in case of a company other than a finance company);
Dividend Income;
Net gain/loss on sale of investments;
Other non-operating income (net of expenses directly attributable to such income).

v)Additional Information

A Company shall disclose by way of notes additional information regarding

aggregate expenditure and income on the following items:

Concept / condition / application
(a) Employee Benefits Expense [showing separately
Salaries and wages,
Contribution to provident and other funds,
Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),
Staff welfare expenses].

Concept / condition / application
(b) Depreciation and amortization expense;
(c) Any item of income or expenditure which exceeds one per cent. of the revenue from operations or Rs. 1,00,000, whichever is higher;
(d) Interest Income;
(e) Interest expense;
(f) Dividend income;

Concept / condition / application
(g) Net gain/loss on sale of investments;
(h) Adjustments to the carrying amount
(i)To the auditor as
Auditor; Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
(j) Payments

Concept / condition / application
for taxation matters;
for company law matters;
for management services;
for other services; and
for reimbursement of expenses;

Concept / condition / application
(k) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities;

Historical formulation: (l) Details of items of exceptional and extraordinary nature;

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Choose the applicable Schedule III division and current amendments. Ind AS does not permit an extraordinary-item category. An older AS-format illustration is not automatically the correct Ind AS presentation.

Concept / condition / application
(m) Prior period items;

(ii) (a) In the case of manufacturing companies,

Concept / condition / application
Raw materials under broad heads.
Goods purchased under broad heads
(b)In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
(c)In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d)In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

Concept / condition / application
(e)In the case of other companies, gross income derived under broad heads.
(iii)In the case of all concerns having works in progress, works-in-progress under

broad heads.

iv)

Concept / condition / application
The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up.
The aggregate, if material, of any amounts withdrawn from such reserves.

(v)

Concept / condition / application
The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.
The aggregate, if material, of the amounts withdrawn from such provisions, as

no longer required.

Concept / condition / application
(vi) Expenditure incurred on each of the following items, separately for each item:
Consumption of stores and spare parts;
Power and fuel;
Rent;
Repairs to buildings;

Concept / condition / application
Repairs to machinery;
Insurance;
Rates and taxes, excluding, taxes on income;
Miscellaneous expenses

(vii)

Concept / condition / application
Dividends from subsidiary companies.
Provisions for
losses of subsidiary companies.
(viii) The profit and loss account shall also contain by way of a note the following

information, namely:

Concept / condition / application
(a)Value of imports calculated on C.I.F basis by the company during the financial year in respect of
Raw materials;
Components and spare parts;
Capital goods.
(b)Expenditure in foreign currency during the financial year on account of royalty, know- how, professional and consultation fees, interest, and other matters;

(c)Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d)The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

Concept / condition / application
(e)Earnings in foreign exchange classified under the following heads, namely:
Export of goods calculated on F.O.B. basis;
Royalty, know-how, professional and consultation fees;
Interest and dividend;
Other income, indicating the nature thereof.

Concept / condition / application
General Instructions for the Preparation of Consolidated Financial Statements
Where a company is required to prepare Consolidated Financial Statements, i.e.,
Consolidated balance sheet and consolidated statement of profit and loss,

the company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss.

Concept / condition / application
In addition, the consolidated financial statements shall disclose the information
Profit or loss attributable to “minority interest” and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.
Minority interests” in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.
Impact Of Ind as On Financial Statements

Indian Accounting Standard-1 (Ind AS-1), is about the presentation of financial

Concept / condition / application
statements. Ind AS-1 lists the following as a complete set of financial statements:
A balance sheet as at the end of the period
A statement of profit and loss for the period
Statement of changes in equity for the period
Statement of cash flows for the period

Concept / condition / application
Notes, comprising a summary of significant accounting policies and other explanatory information
Comparative information in respect of the previous accounting period and
A balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively.
Presentation of Balance sheet;
Ind AS-1 prescribes that the balance sheet shall include line items that present the

following amounts:

Concept / condition / application
Property, plant and equipment;
Investment property;
Intangible assets;
financial assets (excluding amounts shown under (e), (h) and (i));
Investments accounted for using the equity method;

Concept / condition / application
Biological assets within the scope of Ind AS 41 Agriculture;
Inventories;
Trade and other receivables;
Cash and cash equivalents;
The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations;

Concept / condition / application
Trade and other payables;
Provisions;
Financial liabilities (excluding amounts shown under (k) and (l));
Liabilities and assets for current tax, as defined in Ind AS 12, Income Taxes;
Deferred tax liabilities and deferred tax assets, as defined in Ind AS 12;

Concept / condition / application
Liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105;
Non-controlling interests, presented within equity; and
Issued capital and reserves attributable to owners of the parent.
It also provides the following guidelines regarding the balance sheet:

i)When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).

Concept / condition / application
ii)Current assets: An entity shall classify an asset as current when:
it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
it holds the asset primarily for the purpose of trading;
it expects to realise the asset within twelve months after the reporting period; or
the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

Concept / condition / application
iii)Current liabilities: An entity shall classify a liability as current when:
it expects to settle the liability in its normal operating cycle;
it holds the liability primarily for the purpose of trading;
the liability is due to be settled within twelve months after the reporting period; or
it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

iv)An entity shall disclose, either in the balance sheet or in the notes, further sub- classifications of the line items presented, classified in a manner appropriate to the entity’s operations.

Concept / condition / application
v)An entity shall disclose the following, either in the balance sheet or the

statement of changes in equity, or in the notes:

Concept / condition / application
(a)for each class of share capital:
The number of shares authorised;
The number of shares issued and fully paid, and issued but not fully paid;
Par value per share, or that the shares have no par value;
A reconciliation of the number of shares outstanding at the beginning and at the end of the period;

Concept / condition / application
The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
Shares in the entity held by the entity or by its subsidiaries or associates; and
shares reserved for issue under options and contracts for the sale of shares, including terms and amounts: and
(b) A description of the nature and purpose of each reserve within equity.
Presentation of Statement of Profit and Loss

Concept / condition / application
An entity should present a single statement of profit and loss, with profit or loss and other comprehensive ‘income presented in two sections.
The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.
Ind AS-1 prescribes certain line items amount of which should appear in this statement, at the minimum.

It also provides the following guidelines regarding this Statement:

Concept / condition / application
An entity shall present additional line items, headings and subtotals in the statement of profit and loss when such presentation is relevant to an understanding of the entity's financial performance.
An entity shall not present any items of income or expense as extraordinary items, in the statement of profit and loss or in the
Statement of Change in Equity
Paragraph 10 of Ind AS-1 : An entity is required to present a statement of changes in equity, as one of the financial statements.
Ind AS-1 prescribes the following information to be presented in the statement of changes in equity

Concept / condition / application
(a)Total comprehensive income for the period, showing separately the total amounts attributable to owners of the Parent and to non-controlling interests.
(b)for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with Ind AS 8; and

(c)for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately (as a minimum) disclosing changes resulting from:

Concept / condition / application
Profit or loss;
Other comprehensive income; and
Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.
Any item recognised directly in equity such as amount recognised directly in equity as capital reserve with paragraph 36 A of Ind AS.
Statement of Cash Flows

Concept / condition / application
This is also part of the set of financial statements as prescribed in Paragraph 10 of Ind AS-1.
Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.
Ind AS 7 sets out requirements for the presentation and disclosure of cash flow information.
Notes
Paragraph 10 of Ind AS-1: Notes are part of the set of financial statements as prescribed

This Standard mentions the following guidelines regarding Notes:

i)The notes shall:

Concept / condition / application
Present information about the basis of preparation of the financial statements and the specific accounting policies used;
Disclose the information required by Ind ASs that is not presented elsewhere in the financial statements; and
Provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

ii)An entity shall present notes in a systematic manner. An entity shall cross-reference each item in the balance sheet and in the statement of profit and loss and in the statements of changes in equity and of cash flows to any related information in the notes.

iii)An entity normally presents notes in the following order, to assist users to understand the financial statements and to compare them with financial statements of other entities:

Concept / condition / application
Statement of compliance with Ind ASs
Significant accounting policies applied
Supporting information for items presented in the balance sheet and in the statement of profit and loss and in the statements of changes in equity and of cash flows, in the order in which each statement and each line item is presented; and
Other disclosures, including:
a)Contingent liabilities (see Ind AS 37) and unrecognised contractual commitments; and

Concept / condition / application
b)Non-financial disclosures, e.g. the entity’s financial risk management objectives and policies (Ind AS 107).
Disclosure of accounting policies

An entity shall disclose in the summary of significant accounting policies:

Concept / condition / application
The measurement basis (or bases) used in preparing the financial statements, and
The other accounting policies used that are relevant to an understanding of the financial statements.
Presentation of Comparative Information
Paragraphs 38, 38 A and 38 B of Ind AS-1, prescribe the minimum comparative information in respect of preceding period, as under:
Para 38 of Ind AS-1: Except when Ind ASs permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements.

Para 38 A: An entity shall present, as a minimum,

Concept / condition / application
2 balance sheets,
2 statements of profit and loss,
2 separate statements of profit and loss,
2 statements of cash flows and
2 statements of changes in equity, and related notes.

Concept / condition / application
Para 38 B: In some cases, narrative information provided in the financial statements for the preceding period(s) continues to be relevant in the current period.
For example, an entity discloses in the current period details of a legal dispute, the outcome of which was uncertain at the end of the preceding period and is yet to be resolved.
Users may benefit from the disclosure of information that the.

Uncertainty existed at the end of the preceding period and from the disclosure of information about the steps that have been taken during the period to resolve the uncertainty.

Change in Accounting Policy, Retrospective Restatement or Reclassification

Para 40 A of Ind AS-1 : An entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38 A if:

Concept / condition / application
it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

Concept / condition / application
the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period.
Para 41 of Ind AS-1 mentions that if an entity changes the presentation or

classification of items in its financial statements, it shall reclassify comparative amounts unless reclassification is impracticable.

Concept / condition / application
When an entity reclassifies comparative amounts, it shall disclose (including as at the beginning of the preceding period):
The nature of the reclassification.
The amount of each item or class of items that is reclassified; and
The reason for the reclassification.
Para 42 states that when it is impracticable to reclassify comparative amounts, an

entity shall disclose:

Concept / condition / application
The reason for not reclassifying the amounts, and
The nature of the adjustments that would have been made if the amounts had been reclassified.
Preparation of Consolidated Financial Statements

Historical formulation: Ind AS-110 requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements.

CLARIFICATION / 1 NOVEMBER 2026

Control is the basis for consolidation under Ind AS 110, with its stated exceptions. Eliminate relevant intragroup balances/transactions and apply business-combination requirements separately.

Concept / condition / application
It defines the principle of control, and establishes control as the basis for consolidation;
It further sets out the accounting requirements for the preparation of consolidated financial statements; and defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity.
This Ind AS does not deal with the accounting requirements for business combinations and their effect on consolidation including goodwill arising on a business combination.

Apply your understanding: original practice

1. Compute the simplified pre-tax profit in the case.

Answer and reason
2,00,000 - 80,000 - 20,000 - 10,000 = Rs.90,000. Tax and other items were not supplied.

2. Does an unpaid customer automatically eliminate recognised revenue?

Answer and reason
No. Apply recognition and recoverability requirements. Collection timing alone does not decide earned revenue.

3. Why include comparative amounts?

Answer and reason
They help users assess changes over time. Changed classification may require reclassification and explanatory disclosure.

4. Why eliminate an intragroup receivable and payable?

Answer and reason
From the group perspective they are internal claims and obligations, not claims against an outside party.

5. Can an explanatory note make an incorrect asset valid?

Answer and reason
No. First apply recognition and measurement requirements; disclosure complements correct accounting.

Official reference: Companies Act 2013 | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Profit statements cover a reporting period.	15. Earnings per share has its own requirements.
02. Financial position is measured at a date.	16. Policies should explain relevant accounting choices.
03. Use the applicable Schedule III division.	17. Control is central to consolidation.
04. Notes form part of financial reporting.	18. Parent and group statements differ.
05. Revenue recognition precedes collection analysis.	19. Intragroup balances need elimination.
06. Employee expense differs from finance cost.	20. Non-controlling interests require separate treatment.
07. Depreciation differs from a new cash purchase.	21. Investment-entity exceptions require careful reading.
08. Tax expense can differ from tax paid.	22. Business combinations use their relevant standard.
09. Material items need appropriate presentation.	23. Goodwill is not a balancing convenience.
10. Comparative information supports understanding.	24. Do not double-count subsidiary resources.
11. Reclassification can require explanation.	25. Case profit before tax is Rs.90,000.
12. Material retrospective changes need framework analysis.	26. Uncollected revenue can create receivables.
13. Ind AS differs from the AS framework.	27. A complete statement set needs more than P&L.;
14. Other comprehensive income differs from ordinary profit.	28. Disclosure does not cure wrong recognition.

MODULE B / B 05

Cash Flow & Funds Flow

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

Profit is Rs.50,000 and includes depreciation Rs.10,000. Receivables rise Rs.8,000, inventory rises Rs.5,000 and trade payables rise Rs.3,000. Before tax and other adjustments, operating cash is 50,000 + 10,000 - 8,000 - 5,000 + 3,000 = Rs.50,000. Depreciation is added back because it reduced profit without consuming current-period cash.

Change the situation

If receivables instead rise Rs.18,000, operating cash falls to Rs.40,000. Profit can stay the same while more cash is tied up in customers. A machinery purchase is considered separately from operating adjustments.

COMMON MISTAKE - WHY IT FAILS

Cash flow, funds flow and profit are different measures. Do not classify interest by one universal rule: entity type and the applicable AS/Ind AS requirements matter.

Build the connections

Idea	Why it matters
1	Cash flow explains changes in cash equivalents.
2	Profit is not the same as cash.
3	Cash equivalents require qualifying characteristics.
4	Non-cash investing transactions need separate consideration.

Idea	Why it matters
1	Operating activities concern principal revenue operations.
2	Investing concerns relevant long-term resources.
3	Financing changes funding capital and borrowings.
4	Classification needs entity and framework context.

Idea	Why it matters
1	Direct method shows relevant gross receipts/payments.

Idea	Why it matters
2	Indirect method adjusts a profit measure.
3	Depreciation add-back reverses a non-cash charge.
4	It does not manufacture extra profit.

Idea	Why it matters
1	Increasing receivables usually consumes operating cash.
2	Increasing inventory usually consumes operating cash.
3	Increasing trade payables can conserve operating cash.
4	Use consistent signs and opening/closing dates.

Idea	Why it matters
1	Asset purchases differ from depreciation expense.
2	Loan principal differs from interest.
3	Dividends need the applicable classification.
4	Cash flow totals reconcile opening and closing cash.

Idea	Why it matters
1	Funds flow traditionally analyses working capital.
2	Working capital is current assets less current liabilities.
3	Transactions within current assets may not change it.
4	Long-term sources and uses require analysis.

Idea	Why it matters
1	The case operating cash is Rs.50,000.
2	More receivables can reduce cash without reducing sales.
3	Equal fixed-asset balances can hide purchases/disposals.
4	Reconcile movements rather than guessing from totals.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Indirect operating-cash bridge	Profit +relevant non-cash charges -non-cash gains +/-working-capital adjustments	Then include the relevant tax/other adjustments; do not double-count investing/financing items.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Introduction
A cash flow statement, prepared for a period, tells us the position of cash at the beginning and end of that period.

Historical formulation: Cash also includes Cash equivalents.

CLARIFICATION / 1 NOVEMBER 2026

A cash-flow statement reconciles cash and qualifying cash equivalents; it is not permission to prepare the underlying accounts on a cash basis. Applicability and exemptions depend on the framework/entity.

Concept / condition / application
Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
Information about the cash flow of an enterprise is useful in providing users of financial statements a basis to assess the ability of the enterprise to generate cash and cash equivalents.
Components Of Cash Flow
Let us take the example of a simple trading enterprise which starts its
business on 1/04/2022 with its assets and liabilities as under:

Worked figure / record

BALANCE SHEET AS AT THE END OF 1/04/2022

LIABILITES		ASSETS	
Capital	₹ 1,00,000	Cash	₹ 1,00,000

Concept / condition / application
On 2/04/2022, the firm buys wheat for Rs. 90,000 for cash and sells it for Rs.
95,000 on cash basis. Its balance sheet changes as under:

Worked figure / record

BALANCE SHEET AS AT THE END OF 2/04/2022

LIABILITES		ASSETS	
Capital	₹ 1,00,000	Cash	₹ 1,05,000
P& L account	₹ 5,000		

It is easy to see that there is a cash inflow of ` 5,000 during the day, due the trading activity, which we call "Operating activity" in Accounting parlance. On 3/04/2022, the firm buys wheat for ` 80,000 for cash and sells it for ` 85,000 on cash basis. It also purchases a weighing machine for ` 15,000 to facilitate its operations. Its balance sheet changes as under:

Worked figure / record

BALANCE SHEET AS AT THE END OF 3/04/2022

LIABILITES		ASSETS	
Capital	₹ 1,00,000	Cash	₹ 95,000
P& L account	₹ 10,000	Fixed assets	₹ 15,000

We can see that there is a cash outflow of Rs. 10,000 during the day, despite trading activity earning a profit of Rs. 5,000 and cash inflow of Rs. 5,000. This is because there was a cash outflow of Rs. 15,000 for purchasing fixed assets. So, the net result was an outflow of Rs. 10,000. This falls among the items which we group under "Investing activity" in Accounting parlance.

On 4/04/2022, the firm buys wheat for ` 75,000 for cash and sells it for ` 80,000 on cash basis. On the same day the proprietor withdraws capital of ` 10,000. Its balance sheet changes as under:

Worked figure / record

BALANCE SHEET AS AT THE END OF 4/04/2022

LIABILITES		ASSETS	
Capital	₹ 90,000	Cash	₹ 90,000
P& L account	₹ 15,000	Fixed assets	₹ 15,000

Concept / condition / application

We can see that there is a cash outflow of Rs. 5,000 during the day, despite trading activity earning a profit of Rs. 5,000 and cash inflow of Rs. 5,000.

This is because there was a cash outflow of Rs. 10,000 by way of reduction in capital. So, the net result was an outflow of Rs. 5,000

Concept / condition / application
This falls among the items which we group under “Financing activity” in Accounting parlance.
Such an activity will also affect the net cash flow of the firm

The activities of a business entity are grouped under 3 categories

Concept / condition / application
Operating activities: These are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Operating activities consist of inflows and outflows of cash resulting from transactions that affect a firm’s net profit or loss.
Investing activities: These include acquisition and disposal of long-term assets and other investments not included in cash equivalents. (Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.)
Financing activities: These include activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.
Cash Flow from Investing Activities
If an enterprise keeps on having positive cash flows from its operating activities for a very long time, its cash balance will become very high. We have to remember that while cash is a very desirable asset for liquidity, it is also the most unproductive asset and no enterprise would like to have huge cash balances.

Concept / condition / application
Investment of cash in fixed assets or financial assets is a way to deploy this cash. Cash outflows due to investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Cash inflows from investing activities means that there is a net decrease in such assets.

Examples of cash flows arising from investing activities are:

Concept / condition / application
Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;
Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

Historical formulation: Cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

CLARIFICATION / 1 NOVEMBER 2026

Under Ind AS 7, interest paid and interest/dividends received for a financial institution are operating cash flows. For other entities, interest paid is financing and interest/dividends received investing; dividends paid are financing. Check the applicable framework instead of importing another framework's options.

Concept / condition / application
Cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
Cash advances and loans made to other parties (other than advances and loans made by a financial institution);
Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);
Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Concept / condition / application
Cash Flow from Financing Activities

Financing activities can be useful in utilising the cash generated through operating of investing activities. These can also be utilises for increasing cash inflows in times of

need. Examples of cash flows arising from financing activities are:

Concept / condition / application
Cash proceeds from issuing shares or other equity instruments;
Cash payments to owners to acquire or redeem the entity’s shares;
Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;
Cash repayments of amounts borrowed; and
Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

Concept / condition / application
Legal Requirement Of Preparation Of Cash Flow Statement

Those business entities which are required to follow the Accounting Standards, have to prepare the cash flow statement also as it forms part of the set of financial statements. AS-3 and Ind AS-7 provide detailed

guidelines for preparing this statement. Cash flows are shown separately for each of the three categories of activities. As per the Ind AS- 7, which sets out requirements for the presentation and disclosure of cash flow information, an entity shall report cash flows from operating activities using either:

Concept / condition / application
The direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
The indirect method, whereby profit or loss is adjusted for the effects of transactions of a non- cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.
Other Important Points Mentioned in Ind AS-7
Some of the other important points mentioned in Ind AS-7 are as under:
Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Concept / condition / application
A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the loan element is classified as a financing activity.
The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.
The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities
The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity.
Cash flows arising from transactions in a foreign currency shall be recorded in an entity’s functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow. The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows. Cash flows denominated in a foreign currency are reported in a manner consistent with Ind AS 21.

Concept / condition / application
Cash flows from interest and dividends received and paid shall each be disclosed separately. These cash flows shall be classified in a consistent manner from period to period as either operating, investing or financing activities. The total amount of interest paid during a period is disclosed in the

Concept / condition / application
statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with Ind AS 23, Borrowing Costs.
Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.
The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.
Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Concept / condition / application
An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.
Format For Preparation Of Cash Flow Statement
For preparing this statement, items available in the Balance Sheet and the Profit and Loss Account can be used.
There is no prescribed format for preparation of cash flow statement. It may be different for different entities depending upon the peculiar nature of the activities.
An indicative format of the Statement of cash flows is as under:

Concept / condition / application
1. Cash flows from Operating Activities
(a) Operating income (EBIT)
(b) Add: Depreciation
(c) Subtract/add: profit/loss on sale of long term assets
(d) Add decrease in accounts receivables

Concept / condition / application
(e) Subtract Decrease in accounts payable
(f) Add/subtract decrease/increase in other items of current assets
(g) Add/subtract increase/decrease in other items of current liabilities
Net cash flow from operating activities (A)
2. Cash flows from Investing Activities

Concept / condition / application
(h) Sale of Long term assets
(i) Subtract Purchase of Long term assets
Net cash flow from operating activities (B)
3. Cash flows from Financing Activities
(j) Payment of dividend (-)

Concept / condition / application
(k) Increase in equity (+)
(l) Decrease in borrowings (-)
Benefits Of Cash Flow Information
Useful in understanding clearly the sources of an enterprise’s cash inflows and how this cash is being uitilised.
A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity.

Concept / condition / application
its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.
Useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess its future prospects.
Suppliers can use it to assess the liquidity position of an enterprise which is important to fund its operating expenses and pay its debts.
Bankers and other creditors can use it to decide the repayment schedules of their loans and advances and also stipulate covenants putting restrictions on certain expenses and investments.
Funds Flow Statements

Concept / condition / application
Each item in the balance sheet represents either source of funds or use of funds.
Source of funds: All items on the liabilities side
Use of funds: all items on the assets side (except cash)
Cash in the balance sheet represents the unutilized portion of funds, available to the enterprise.
If cash is also perceived as a use of funds, then all the uses of funds are equal to all the sources of funds.

Concept / condition / application
This perception of available cash, as a use of funds, is what causes the
Difference between Cash Flow Statement and Funds Flow Statement

Worked figure / record

Cash Flow Statement	Funds Flow Statement
1. Integral part of financial statements and is mandatory	1. Not a mandatory requirement and not a part of financial statements
2. Cash flows from operating, financing and investing activities to be shown separately	2. No such segregation is required.
3. Determines the cash position at the end of the accounting period	3. Determines the changes in working capital through a specified period.
4. Uses the cash system of accounting	4. Uses the accrual system of accounting
5. Helps in understanding the liquidity position of a business	5. Helps in assessing the long term financial strategy of a business

CASH FLOW IS NOT CASH-BASIS ACCOUNTING

The historical comparison calls cash flow “cash system of accounting”. A cash-flow statement reports cash movements but does not replace accrual-based underlying financial reporting. Applicability and exemptions depend on the entity/framework.

Concept / condition / application
Preparation Of Funds Flow Statements
For the purpose of preparing the funds flow statement, the information contained in the two subsequent balance sheets is organized into two principal groups;
Sources of funds and
Applications of the funds.

As mentioned in the previous paragraph, sources of funds are indicated by decrease in assets and increase in liabilities (including shareholder’s equity) over the previous year while applications of funds are associated with the increase in assets and decrease in liabilities (including shareholder’s equity) over the previous year. A funds flow statement can be prepared in various ways depending upon the end use and purpose. Bankers, normally, further classify both sources and uses of funds into Long term and Short term. This enables them to know if long term funds have been diverted for short term uses.

Concept / condition / application
So, an indicative format of funds flow statement, for the bankers, may be as under:

Worked figure / record

SOURCES OF FUNDS	USES OF FUNDS
1. LONG TERM SOURCES: a. Increase in equity b. Increase in Reserves c. Increase in long term borrowings d. Decrease in Non-current assets **Sub-total** 2. SHORT TERM SOURCES: a. Increase in Short term borrowings b. Decrease in current assets **Sub-total**	1. LONG TERM USES: a. Decrease in equity b. Decrease in Reserves c. Decrease in long term borrowings d. Increase in Non-current assets **Sub-total** 2. SHORT TERM USES: a. Decrease in Short term borrowings b. Increase in current assets **Sub-total**
TOTAL	**TOTAL**

DEFINE WHAT FUNDS MEAN

This is a broad sources-and-uses funding layout. In a traditional net-working-capital funds-flow statement, a transaction wholly within current assets/current liabilities does not itself change net working capital. Do not automatically treat every short-term movement in this diagram as a long-term source/application of working-capital funds.

Concept / condition / application

While preparing the funds flow statement, we have to take special care of the

following two aspects:

Historical formulation: Changes in fixed assets: While comparing the figures of two successive balance sheets, we have to take into account the depreciation charge during the year. We should also know if any assets have been sold during the year. For example: Assume that the figures of fixed assets shown in the balance sheets of 31/3/21 and 31/3/22 are same at ` 5,00,000. This may give the impression that there has been no long term source and use of funds on this account, during the year. But this is not correct. If the depreciation charged during the year is ` 60,000, it means that additional fixed assets of the same amount have been purchased during the year. So, in both sources and uses of funds, an amount of ` 60,000 is to be shown. Similarly, the amount received from sale of fixed assets is to be shown as a source.

CLARIFICATION / 1 NOVEMBER 2026

Equal opening/closing net fixed assets do not by themselves prove a unique purchase amount. Consider depreciation, disposals, revaluation and other movements; the simple inference requires those other movements to be absent.

Concept / condition / application
Change in Net worth: While comparing the figures of two successive balance sheets, we have to take into account the outgo on account of dividend or withdrawal of capital. For example: If the company has reduced its equity capital through buy back of shares, it may not be reflected correctly as the profit has been added to the reserves. Also, withdrawal of profits through dividend is to be shown as a use of funds while the entire net profit should be shown as a source of funds.

Apply your understanding: original practice

1. Why add depreciation in the indirect method?

Answer and reason
It reduced accounting profit but did not itself use cash in that period. The addition is a reconciliation adjustment.

2. Receivables rise Rs.8,000. Why subtract?

Answer and reason
Recognised revenue exceeds cash collected by that movement, assuming no other changes. More value is tied up in customers.

3. Is repaying loan principal an ordinary operating expense?

Answer and reason
No. It reduces a financing liability and cash; it is not the interest charge for using funds.

4. Can unchanged fixed assets prove no machinery was purchased?

Answer and reason
No. Depreciation, purchases, disposals and revaluation can offset. Trace the movement schedule.

5. What is net working capital for current assets Rs.90,000 and current liabilities Rs.60,000?

Answer and reason
Rs.30,000. This funds-flow measure differs from cash alone.

Official reference: MCA Ind AS 7 | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Cash flow explains changes in cash equivalents.	15. Increasing trade payables can conserve operating cash.
02. Profit is not the same as cash.	16. Use consistent signs and opening/closing dates.
03. Cash equivalents require qualifying characteristics.	17. Asset purchases differ from depreciation expense.
04. Non-cash investing transactions need separate consideration.	18. Loan principal differs from interest.
05. Operating activities concern principal revenue operations.	19. Dividends need the applicable classification.
06. Investing concerns relevant long-term resources.	20. Cash flow totals reconcile opening and closing cash.
07. Financing changes funding capital and borrowings.	21. Funds flow traditionally analyses working capital.
08. Classification needs entity and framework context.	22. Working capital is current assets less current liabilities.
09. Direct method shows relevant gross receipts/payments.	23. Transactions within current assets may not change it.
10. Indirect method adjusts a profit measure.	24. Long-term sources and uses require analysis.
11. Depreciation add-back reverses a non-cash charge.	25. The case operating cash is Rs.50,000.
12. It does not manufacture extra profit.	26. More receivables can reduce cash without reducing sales.
13. Increasing receivables usually consumes operating cash.	27. Equal fixed-asset balances can hide purchases/disposals.
14. Increasing inventory usually consumes operating cash.	28. Reconcile movements rather than guessing from totals.

MODULE B / B 06

Final Accounts of Banking Companies

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A bank earns loan interest Rs.3,00,000 and commission Rs.50,000, incurs deposit interest Rs.1,80,000 and operating costs Rs.70,000. Simplified profit before provisions/tax is Rs.1,00,000. A further loan-loss provision Rs.20,000 reduces it to Rs.80,000. Customer deposits are funding liabilities; loans to customers are bank assets.

Change the situation

If accrued loan interest is not recognisable under the applicable NPA rules, it cannot be treated like ordinary collected income. Reported profit must follow recognition rules and relevant prudential directions, not simply the system's accrual output.

COMMON MISTAKE - WHY IT FAILS

Bank financial statements use the Banking Regulation Act framework and relevant bank-category directions. Do not substitute a general company format, present old investment categories as universally current, or deduct an arbitrary doubtful-debt amount from a guessed advances category.

Build the connections

Idea	Why it matters
1	Bank deposits are normally liabilities.
2	Customer advances are normally assets.
3	Interest earned differs from other income.
4	Interest expended differs from operating expense.

Idea	Why it matters
1	Bank statements use prescribed forms and schedules.
2	Bank category affects applicable directions.
3	Section 29 concerns banking-company accounts.
4	Section 30 concerns their audit.

Idea	Why it matters
1	Submission and publication are separate requirements.
2	Signatures depend on the applicable provisions.
3	Capital differs from deposits and borrowings.
4	Reserves differ from specific provisions.

Idea	Why it matters
1	Cash balances differ from investments.
2	Contingent liabilities differ from recognised liabilities.
3	Advances have several disclosure classifications.
4	Classification totals must reconcile.

Idea	Why it matters
1	Interest recognition needs prudential analysis.
2	NPA accounting cannot rely on automatic accrual.
3	Rebate on bills concerns unearned discount.
4	Expense accruals affect liabilities.

Idea	Why it matters
1	Provision expense affects profit.
2	A provision is not a cash reserve account.
3	Schedules explain main-statement totals.
4	Comparatives and notes support interpretation.

Idea	Why it matters
1	The simplified pre-provision profit is Rs.1,00,000.
2	The case post-provision amount is Rs.80,000.
3	Current investment directions need separate checking.
4	Do not infer risk merely from one schedule total.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Companies
Introduction

Historical formulation: A banking company is generally governed by the provisions of the Companies Act, 2013 and specifically by the Banking Regulation Act.

CLARIFICATION / 1 NOVEMBER 2026

An impairment/provision is not automatically the whole doubtful amount, and the amount cannot be assigned to a guessed advances subcategory without evidence. Read the example's supplied assumptions separately from actual prudential requirements.

Concept / condition / application
The Banking Regulation Act of 1949 came into force on 16 th March, 1949 as a result of the long-felt need to regulate the banking business in India and protect the interests of number of depositors

The major institutions carrying on banking business, in India, include:

Concept / condition / application
Nationalised banks
State Bank of India
Foreign banks having branches in India
Co-operative banks
Regional Rural banks

Concept / condition / application
Private sector banks
Small Finance Banks (h)
Payments Banks
Definition and Functions of a Bank
Section 5 of the Banking Regulation Act and means: accepting of deposits of money from the public, for the purpose of lending or investment and the

Concept / condition / application
deposits are repayable on demand or otherwise by cheque, draft, order or otherwise.
Requirements Of Banking Companies As To Accounts And Audit
Preparation of Financial Statements and Accounting Date (Section 29)

Historical formulation: A Company registered under the Companies Act, 2013 is required to present its financial statements, i.e. balance sheet and profit and loss account in the formats laid down in the Schedule III annexed to the Companies Act. Similarly, banking company, (since it is a company) is also required to prepare and submit its accounts in a specified format.

CLARIFICATION / 1 NOVEMBER 2026

Banking-company statements use the Banking Regulation Act Third Schedule and applicable RBI directions. A general company Schedule III format is not a substitute.

Concept / condition / application
Signatures
Section 29 of the Act requires that the financial statements of banking companies incorporated in India should be signed by the manager or principal officer of the banking company and by at least three directors (or all the directors in case the number is less than three).
The financial statements of a foreign banking company are to be signed by the manager or agent of the principal office in India. The provisions of section 29 are also applicable to nationalised banks, State Bank of India, regional rural banks, private sector banks, small finance banks and payments banks.
Audit (Section 30)
Accounts must be audited by a person, duly qualified under any law, for the time being in force, to be an auditor of companies. However, every banking company is, before appointing, reappointing or removing any auditor, required to obtain the prior approval of the Reserve Bank of India.

Concept / condition / application
Submission of Accounts (Secs 31 and 32)
Three copies of the balance sheet and profit and loss account prepared

under Section 29 together with auditors' report under Section 30 must be submitted to the Reserve Bank of India within three months from the end of the period to which they refer. However, it can be extended up to a further period of three months by RBI (Section 31).

Concept / condition / application
Section 32 of the Act requires a banking company (but not other types of banks) to furnish three copies of its annual accounts and auditor's report thereon to the Registrar of Companies at the same time when it furnishes these documents to the RBI.
Publication of Accounts

Concept / condition / application
Rule 15 of the Banking Regulating (Companies) Rules, 1949 prescribes that accounts and auditors' report shall be published in a newspaper circulating in a place where a banking company has its principal office, within six months from

the end of the period to which they relate.

Concept / condition / application
Significant Features Of Accounting Systems Of Banks
System of recording, classifying and summarising the transactions in a bank is in substance no different from that followed in other entities having similar volume of operations.
However, in the case of banks, the need for the ledger accounts, especially those of customers, being accurate and up-to-date is much stronger than in most other types of enterprises.
In the case of banks, relatively lesser emphasis is placed on books of prime entry such as cash books or journals.
This is unlike most other types of enterprises where books of prime entry are generally kept up-to-date while ledgers, including the general ledger and subsidiary ledgers for debtors, creditors, etc. are written up afterwards.

Concept / condition / application
Banks follow the accounting procedure of 'voucher posting'.
Bankers' Books
According to Section 2 (3) of the Bankers' Books Evidence Act, 'Bankers' Books' include ledgers, day book, cash books, account books and all other books used in the ordinary business of a bank.
Generally, the following books are maintained by a bank to keep up-to-date records of its customers.
Cash Book

Concept / condition / application
All cash receipts and payments are recorded in the receiving cashier's cash book and paying cashier's cash book respectively.
After this, on the basis of pay-in slips received by the receiving cashier and cheques and withdrawals slips by the paying cashier, these transactions are entered first in the accounts of customers and after that Day Books are written. This is called the 'Slip System' of posting.
Ledger Book
General Ledger contains the total accounts of each ledger. Besides the GL, the

following ledger books are maintained:

Concept / condition / application
Current Accounts Ledger
FD Accounts Ledger
RD Accounts Ledger
Loan Ledger
Investment Ledger

Concept / condition / application
Bills discounted and purchased Ledger
Other Books
Clearing Register
Securities Register
Draft Register

Concept / condition / application
Bills for collection Register
Safe deposit vault Register
Dishonoured cheques Register
Letter of credit Register
Principal Books of Account

Concept / condition / application
The principal books of account, subsidiary books and statistical records generally maintained by banks are described in the following paragraphs.
General Ledger
Contains the control accounts of all personal ledgers, the profit and loss account and different assets and liabilities accounts.
There are certain additional accounts also (known as contra accounts) which are kept with a view to keeping control over transactions which have no direct effect on the assets and liabilities of the bank and represent the agency business handled by the bank on which it earns service charges, e.g. letters of credit opened, bills received or sent for collection, guarantees given, etc.
Profit and Loss Ledger

Concept / condition / application
Some banks maintain a profit and loss account in the general ledger and maintain separate books for each revenue or expense head/sub-head.
Some banks maintain columnar books having separate columns for each revenue and expense head/sub-head, while others maintain separate books for revenue and expense heads/sub-heads.
These books are prepared from vouchers.
The totals of debits and credits each day are posted to the profit and loss account in the general ledger from voucher summary sheets.
In some banks, the revenue accounts too are maintained in the general ledger itself,

Concept / condition / application
while in others, broad revenue heads are kept in the general ledger and their details are kept in subsidiary ledgers
For example, there are separate accounts for basic salary, dearness allowance and various other allowances, which are grouped together in the published accounts.
Similarly, various accounts comprising general charges, interest paid, interest received, etc. are maintained separately in the profit and loss ledgers.
Subsidiary Books

Personal Ledgers

Concept / condition / application
Each control account in the general ledger is supported by a subsidiary ledger (or more than one subsidiary ledger if the number of accounts is large).
Thus, in respect of control accounts relating to accounts of customers, subsidiary

ledgers are maintained for:

Concept / condition / application
Various types of deposit accounts (savings bank, current account, recurring deposits, etc.) which contain accounts of individual customers. Each account holder is allotted a separate folio in the ledger;
Various types of loan and related accounts (cash credit, term loans, demand loans, bills purchased and discounted, letters of credit, bank guarantees issued etc.) wherein the liability of each customer is reflected. Generally, there is no separate ledger for overdraft accounts which are granted in a current account.
Banks generally do not allot separate folios to each customer. The register is divided into various sections, each section for a particular period of deposit and/or the rate of interest payable on deposits.
The voucher summary sheets are prepared in the department which originates the transactions, by persons other than those who write the ledgers.
They are subsequently checked with the vouchers by persons generally unconnected with the writing of ledgers/registers or the voucher summary sheets.

Concept / condition / application
Bills Registers
Details of different types of bills are kept in separate registers which have suitable columns.
For example, bills purchased, inward bills for collection, outward bills for collection etc. are entered serially on a daily basis in separate registers.
In the case of bills purchased or discounted, party-wise details are also kept in a normal ledger form. This is done to ensure that the sanctioned limits of parties are not exceeded.
Entries in these registers are made by reference to the original documents.

Concept / condition / application
A voucher for the total amount of the transactions of each day is prepared in respect of each register. This voucher is entered in the day book.
When a bill is realised or returned, its original entry in the register is marked off.
A daily summary of such realisations or returns is prepared in separate registers whose totals are taken to vouchers which are posted in the day book.
In respect of bills for collection, contra vouchers reflecting both sides of the transaction are prepared at the time of the original entry, and this entry is reversed on realisation.
Outstanding entries are summarised at stipulated intervals and their totals agreed with the balances of the respective control accounts in the general ledger.

Concept / condition / application
Other Registers/Records

Concept / condition / application
There are different registers/records to record detailed particulars of various types of transactions.

These registers/records do not form part of the books of account but support the entries/balances in the various accounts. Some of the important registers/records relate to the following:

a)Drafts issued (separate registers may be maintained for drafts issued by the branch on other branches of the same bank and those on the branches of its correspondents in India or abroad

Concept / condition / application
b)Drafts paid
c)Issue and payment of:
Remittances
Bankers cheques/Pay orders/Traveller’s cheques/Gift cheques
Letters of credit

Concept / condition / application
Letters of guarantee Entries in these registers
Preparation And Presentation of Financial Statements Of Banks
A banking company is required to prepare financial statements in accordance with Schedule III of the Companies Act, 2013.
Banking Regulation Act has prescribed Form A, the format of a balance sheet and form B, the format of a profit and loss account.

Preparation of Balance Sheet

Concept / condition / application
Third Schedule: Form ‘A’ Form of Balance Sheet Balance Sheet as on 31 st March,...

Worked figure / record

Capital and Liabilities.	Schedule No.	₹
Capital	1	....
Reserves and Surplus	2	....
Minorities Interest	2A	
Deposits	3	....
Borrowings	4	....
Other Liabilities and Provisions	5	....
Total		

Assets	Schedule No.	₹
Cash and Balance with RBI	6	....
Balances with Banks and Money	7	....
at Call and Short Notice		
Investments	8	....
Advances	9	....
Fixed Assets	10	....
Other Assets	11	....
Goodwill on consolidation[1]		
Debit balance of Profit and Loss account		
Total		....
Contingent Liabilities	12	....
Bills for collection		

Schedule 1: Capital

i)For Nationalised banks: Capital

ii)For banks Incorporated outside India:

Concept / condition / application
Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)
Amount of deposit kept with RBI under Section 11(2) of the Banking Regulation Act, 1949

Total

III. For other banks:

Concept / condition / application
Authorised capital (.... shares of Rs.... each)....
Issued capital (.... shares of Rs.... each)....
Subscribed capital (.... shares of Rs.... each)....
Called-up capital (.... shares of Rs.... each)....
Less: Calls unpaid ....

Concept / condition / application
Add: Forfeited shares ....
Schedule 2: Reserves and Surplus Rs.

Historical formulation: i)Statutory reserves

CLARIFICATION / 1 NOVEMBER 2026

Distinguish the minimum statutory reserve requirement from the RBI requirement for the covered bank category. Current commercial-bank directions prescribe not less than 25% of net profit before appropriations to statutory reserve; do not assume the same rule applies to every bank category.

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

ii)Capital reserves

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

(III) Share premium

Concept / condition / application
Opening balance ....
Addition during the year ....
Deduction during the year

(IV) Foreign Currency Translation reserve

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

(V) Investment reserve

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

(VI) Special Reserve Under Income Tax Act

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

(VII) Revenue and other reserves

Concept / condition / application
Opening balance ....
Additions during the year ....
Deductions during the year ....

(VIII) Capital Reserve on consolidation

Concept / condition / application
Opening Balance ....
Additions during the year ....
Deductions during the year ....

(IX) Balance in profit and loss account ....

Total (I + II + III + IV + V+VI+VII+VIII+IX)

Concept / condition / application
Opening balances, additions and deductions since the last consolidated balance sheet shall be shown under each of the specified heads.
Where there is more than one subsidiary aggregation results in goodwill in some cases and Capital Reserves in other cases, net effect to be shown in Schedule 2 or Assets side after giving separate notes.
Schedule 2 A: Minorities Interest Rs.
Minority interest at the date on which the parent
subsidiary relationship came into existence ....

Concept / condition / application
Subsequent increase/ decrease ....
Minority interest on the date of balance sheet .....
Schedule 3: Deposits Rs.
(a)(I) Demand deposits
From banks ....

Concept / condition / application
From others ....
(II) Savings bank deposits: ....
(III) Term deposits
From banks ....
From others ....

Concept / condition / application
Total (I, II and III)
B. (i) Deposits of branches in India
(ii) Deposits of branches outside India ....
Includes deposits of Indian branches of subsidiaries
Includes deposits of foreign branches of subsidiaries

Concept / condition / application
Schedule 4: Borrowings Rs.

Borrowings in India

Concept / condition / application
Reserve Bank of India ....
Other banks ....
Other institutions and agencies ....

(II) Borrowings outside India ....

Concept / condition / application
Total (I and II) ....
Secured borrowings in I and II above: ....
Schedule 5: Other Liabilities and Provisions Rs.
Bills payable ....
Inter-office adjustments (net) ....

Concept / condition / application
Interest accrued ....
Deferred Tax Liabilities ....
Others (including provisions): ....
Total: ----------
Schedule 6: Cash and Balances with RBI Rs.

Cash in hand (including foreign currency notes) ....

Concept / condition / application
Balances with RBI in:
Current account ....
Other accounts ....
Total (I and II)

Schedule 7: Balance with Banks and Rs

Money at Call and Short Notice

In India

Balance with banks:

Concept / condition / application
In Current accounts ....
In other deposit accounts ....

(ii) Money at call and short notice:

Concept / condition / application
With banks ....

(b) With other institutions ....

Concept / condition / application
Total (I and II) ....

(II) Outside India

Concept / condition / application
In current accounts ....
In other deposit accounts ....
Money at call and short notice ....
Total (i, ii and iii) ....
Grand Total (I and II)....

Concept / condition / application
Schedule 8: Investments Rs.

(i)Investments in India in

Concept / condition / application
Govt. securities ....
Other approved securities ....
Shares ....
Debentures and bonds ....
Subsidiaries and/or joint ventures ....

Concept / condition / application
Others (to be specified) ....

Total:

....

(ii)Investment outside India in

Concept / condition / application
Govt. Securities (incl. local authorities) ....
Subsidiaries and/or joint ventures abroad ....
Other investment (to be specified) ....
Total ....
Grand Total (I and II)

(iii) Investment in India

Concept / condition / application
Gross value of Investments ....
Aggregate of Provisions for Depreciation ....
Net Investment ....

(IV) Investments outside India

Concept / condition / application
Gross value of investments ....
Aggregate of Provisions for Depreciation ....
Other investments (to be specified) ....
Schedule 9: Advances Rs.
A)(i) Bills purchased and discounted ....

Concept / condition / application
(ii) Cash credits, overdrafts and loans repayable on demand....
(iii) Term loans ....
Total: ....
B. (i) Secured by tangible assets ....
(ii) Covered by bank/Govt. guarantees ....

Concept / condition / application
(iii) Unsecured ....

Total: ....

C. (I) Advances in India:

Concept / condition / application
Priority sectors ....
Public sector ....
Banks ....
Others ....

Total: ----------

(II) Advances outside India:

Concept / condition / application
Due from banks ....
Due from others: ....
Bills purchased and discounted ....
Syndicated loans ....
Others ....

Concept / condition / application
Total....
Grand Total (C.I and C.II)....
Schedule 10: Fixed Assets Rs.

(i)Premises

Concept / condition / application
At cost as on 31 st March of the preceding year
Additions during the year .....
Deductions during the year .....
Depreciation to date ....

(IA) Premises under construction

(II) Other fixed assets (incl. furniture and fixture)

Concept / condition / application
At cost on 31 st March of the preceding year ....
Additions during the year ....
Deductions during the year ....
Depreciation to Date ....

(IIA) Leased Assets

Concept / condition / application
At cost as on 31 st March of the preceding year ....
Additions during the year including adjustments ....
Deductions during the year including provisions ....
Depreciation to date ....
Total (I and II) ....

Concept / condition / application
(IIIA) Capital-Work-in progress (Leased Assets)
net of Provisions ....
Total (I, IA, II, IIA & III) ....
Schedule 11: Other Assets Rs.
(I) Inter-office adjustments (net) ....

Concept / condition / application
(II) Interest accrued ....
(III) Tax paid in advance/tax deducted at source ....
(IV) Stationery and stamps ....
(V) Non-banking assets acquired in satisfaction of claims

....

Concept / condition / application
VI) Deferred Tax Assets ....
(VII) Others* ....
Total:

* In case there is any unadjusted balance of loss (i.e. when the loss exceeds the aggregate of capital, reserves and surplus), the same may be shown under this item under appropriate footnote.

Concept / condition / application
Schedule 12: Contingent Liabilities Rs.
(I) Claims against the bank not acknowledged as debts ....
(II) Liability for partly paid investments ....

Concept / condition / application
(III) Liability on account of outstanding
forward exchange contracts ....

Concept / condition / application
(IV) Guarantees given on behalf of constituents:
In India ....
Outside India ....
(V) Acceptances, endorsements and other obligations ....
(VI) Other items for which the bank is contingently liable ....

Concept / condition / application
Total: .....
Accounting Treatment Of Specific Items
Accounting treatment of some specific items in the profit and loss account and

balance sheet are being explained

Concept / condition / application
Bad Debts and Provisions for Doubtful Debts
Charged under the heading ‘Provision and Contingencies’ in the Profit and Loss account.
In the Balance Sheet, the advances are shown after deducting both bad debts and provision for bad debts.
The Schedule of Advances to be filled in by the branches contains a separate column regarding doubtful debts in respect of ‘bills purchased and discounted’, cash-credits and overdrafts, and unsecured loans.
However, while consolidating the Schedule of Advances at the head office level, for balance sheet purposes, the advances are shown net of any bad or doubtful debts.

Concept / condition / application
Provision for Taxation
Charged to the Profit and Loss Account under the heading ‘Provisions and Contingencies’, in the Balance Sheet, it will be shown under the heading ‘Other Liabilities and Provisions’, on the Liabilities side.
Rebate on Bills Discounted
This refers to unexpired discount. A banking company charges discount in advance for the full period of the bill of exchange or promissory note discounted with it.

The accounting entry made is as follows:

Concept / condition / application
Bills discounted and purchased a/c Dr.
To Customers' a/c
To Discount a/c Customer's account is credited with the net amount remaining after deducting the amount of discount.
The amount credited to the discount account represents the earning of the bank.
However, it may be possible that the bills discounted may mature after the close ofthe financial year. It will not be appropriate to take to the credit of the Profit and Loss account, that part of the discount charged, which relates to next year. An accounting entry is, therefore, passed for unearned discount in the following manner:

Concept / condition / application
Discount a/c Dr. To Rebate on Bills Discounted a/c (with the amount of unearned discount relating to the next period)
Rebate on bills discounted, if already appearing in the trial balance, is taken to the balance sheet on the 'liabilities side'.
However, if an adjustment has to be done after the preparation of the trial balance, in respect of rebate on bills discounted, the amount of such rebate (i.e. the unearned discount) will be deducted from the total discount in the profit and loss account and will also appear as a liability in the balance sheet.
Preparation Of Profit and Loss Account
Form 'B' Third Schedule

Concept / condition / application
Form of Profit and Loss Account
Profit and Loss Account for the Year Ended 31 st March, 20.....

Worked figure / record

	Schedule Number	Year Ended (₹)
I. Income:		
Interest Earned	13	.....
Other Income	14	.....
II. Expenditure:		
Interest Expended	15	.....
Operating Expenses	16	.....
Provisions and Contingencies	...	.....
Total		.....
III. Profit/Loss:		
Net Profit/(Loss) of the Year		.....
Profit/(Loss) brought forward		.....
Share of earnings/loss in Associates		.....
Consolidated Net profit/(loss) for the year before deducting Minorities' Interest	17	.....
Less: Minorities' Interest		.....
Consolidated profit/(loss) for the year attributable to the group		.....
Add: Brought forward consolidated profit/(loss) attributable to the group		.....
Total		.....
IV. Appropriations:		
Transfer to Statutory Reserves		.....
Transfer to other Reserves		.....
Transfer to Government/Proposed Dividend		.....
Balance Carried over to Balance Sheet		.....
Total		.....
Earnings per Share[1]		.....
Basic earnings per equity share		.....
Diluted earnings per equity share		.....

Concept / condition / application
Schedule 13: Interest Earned Rs.
Interest/Discount on Advances/Bills .....
Income on Investments .....
Interest on balances with RBI and other Inter-bank funds .....
Others .....

Concept / condition / application
Total .....
Schedule 14: Other Incomes Rs.
(i)Commission, Exchange and Brokerage .....
(ii)Profit on Sale of Investments .....

Less: Loss on Sale of Investments .....

Concept / condition / application
(III) Profit on Revaluation of Investments .....
Less: Loss on Revaluation of Investments .....
(IV) Profit on Sale of Land/Building and other Assets .....

Less: Loss on Sale of Land, Building and other Assets .....

Concept / condition / application
(V) Profit on Exchange transactions .....

Less: Loss on Exchange transactions .....

Concept / condition / application
(VI) Income earned by way of dividends, etc., from subsidiaries Companies and/or joint ventures abroad/in India .....
(VII) (a) Lease finance income .....
(b) Lease management fee .....
(c) Overdue charges .....
(d) Interest on lease rent receivables .....

(VIII) Misc. Income .....

Concept / condition / application
Total .....
Note: Under Items II to V loss figures be shown in brackets.
Schedule 15: Interest Expended Rs.
Interest on Deposits .....
Interest on RBI/Inter-Bank Borrowings .....

Concept / condition / application
Others .....
Total .....
Schedule 16: Operating Expenses Rs.
Payments to and Provisions for Employees .....
Rent, Taxes and Lighting .....

Concept / condition / application
Printing and Stationery .....
Advertisement and Publicity .....

(a) Depreciation on Bank's Property other than leased assets .....

(b) Depreciation on leased assets .....

Concept / condition / application
Depreciation on Bank's Property .....
Directors' Fees, Allowances and Expenses .....
Auditors' Fees and Expenses ..... (Including Branch Auditors)
Law Charges .....
Postages, Telegrams, Telephones, etc. .....

Concept / condition / application
Repairs and Maintenance .....
Insurance .....
Amortisation of Goodwill, if any .....
Other Expenditure .....
Total .....

Concept / condition / application
Disclosure Requirements Of Banks To Be Added As Notes To Accounts
In order to encourage market discipline, Reserve Bank has over the years developed a set of disclosure requirements which allow the market participants to assess key pieces of information on capital adequacy, risk exposures, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability.

Concept / condition / application
Banks are also required to comply with the Accounting Standard 1 (AS 1) on Disclosure of Accounting Policies issued by the Institute of Chartered Accountants of India (ICAI).
In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the information in the “Notes to Accounts”, a gist of which is given below.
Summary of Significant Accounting Policies’

Concept / condition / application
Summary of Significant Accounting Policies’ and ‘Notes to Accounts’ are to be shown under Schedule 17 and Schedule 18 respectively, to maintain uniformity.
The details are given in RBI Master Circular of July 1, 2015 on “Disclosure in Financial Statements –Notes to Accounts” Summary of Significant Accounting Policies Banks should disclose the accounting policies regarding key areas of operations at one place (under Schedule 17)
Gist of information to be disclosed in ‘Notes to Accounts’ (Schedule 18)
Capital
Investments

Concept / condition / application
Derivatives
Asset Quality
Business Ratios
Asset Liability Management
Exposures (To real estate sector, capital market, country exposure, single/group borrower limit exceeded by bank, unsecured advances)

Concept / condition / application
Disclosure of penalties imposed by RBI
Disclosure Requirements as per Accounting Standards where RBI has issued guidelines in respect of disclosure items for Notes to Accounts
Provisions and Contingencies
Floating Provisions
Draw Down from Reserves

Concept / condition / application
Disclosure of complaints
Disclosure of Letters of Comfort (LoCs) issued by banks

Concept / condition / application
Provisioning Coverage Ratio (PCR)
Bancassurance Business
Concentration of Deposits, Advances, Exposures and NPAs

Concept / condition / application
Sector-wise NPAs
Movement of NPAs
Overseas Assets, NPAs and Revenue
Off-balance Sheet SPVs sponsored
Unamortised Pension and Gratuity Liabilities

Concept / condition / application
Disclosures on Remuneration
Disclosures relating to Securitisation
Credit Default Swaps
Transfers to Depositor Education and Awareness Fund (DEAF)
Unhedged Foreign Currency Exposure

Concept / condition / application
Illustration 1 From the following particulars, prepare the profit and loss account
of ABC Bank Ltd., for the year ended 31 st March, 2022.

Worked figure / record

Income/Expenses	₹	*Income/Expenses*	₹
Commission charged	7,000	Interest on overdrafts	60,000
Discount on bills discounted	1,65,000	Interest on savings bank accounts	72,000
Audit fees	5,000	Postage telegram	2,000
Establishment expenses	60,000	Printing and stationery	3,000
Interest on loan	2,80,000	Unexpired discount on bills discounted	55,000
Interest on fixed deposits	2,98,000	Rent and taxes	22,000
Interest on cash credits	2,40,000	Sundry expenses	2,000

Concept / condition / application
Make a provision of Rs. 30,000 for doubtful debts

Concept / condition / application
ABC Bank Ltd. Profit & Loss Account for the year ended 31 st March, 2022

Worked figure / record

Dr. Cr.

		Schedule No.	₹
I.	Income		
	Interest Earned	13	6,90,000
	Other Income	14	7,000
	Total		6,97,000
II.	Expenditure		
	Interest Expended	15	3,70,000
	Operating Expenses	16	94,000
	Provision for Contingencies		30,000
	Total		4,94,000
III.	Profit:		
	Net profit for the year		2,03,000

Schedule 13: Interest Earned

Concept / condition / application
Discount on Bills discounted 1,65,000
Interest on:
Loans 2,80,000
Cash Credits 2,40,000
Overdrafts 60,000

Concept / condition / application
5,80,000
Less: Unexpired Discount on Bills Discounted 55,000
6,90,000

Schedule 14: Other Income

Concept / condition / application
Commission Charged 7,000

Schedule 15: Interest Expended

Concept / condition / application
Interest paid on:
Fixed Deposits 2,98,000
Savings Bank Accounts 72,000 3,70,000

Schedule 16: Operating Expenses

Concept / condition / application
Establishment Expenses 60,000
Audit Fees 5,000
Rent and Taxes 22,000
Postage and Telegrams 2,000
Printing and Stationery 3,000

Concept / condition / application
Sundry Expenses 2,000 94,000
Illustration 2 Prepare the Profit and Loss account of Modern Bank Ltd. for the
year ended 31 st March, 2022, from the following:

Worked figure / record

the following:

	₹
Interest on Fixed Deposits	1,62,410
Rebate on Bills discounted	29,000
Interest on Loans	45,000
Commission Charged to Customers	62,500
Establishment	15,000
Discount on Bills Discounted	89,000
Interest on Cash Credit	24,000
Amount Charged against Current Accounts	71,500
Directors' Fees	10,000
Audit Fees	20,000
Postage and Telegram	2,000
Printing and Stationery	4,000
Rent and Taxes	22,500
Interest on Overdrafts	71,000
Sundry Charges	1,500
Interest on Savings Bank Deposits	57,780

Schedule 13: Interest Earned

Concept / condition / application
Interest on:
Loan 45,000
Cash Credit 24,000
Overdrafts 71,000
1,40,000

Concept / condition / application
Discount on Bills discounted 89,000
Less: Rebate on Bill Discounted 29,000
60,000
Amount charged against current accounts 71,500
2,71,500

Schedule 14: Other Income

Concept / condition / application
Commission charged to customers 62,500

Schedule 15: Interest Expended

Concept / condition / application
Interest paid on:
Fixed Deposits 1,62,410
Savings Bank Deposits 57,780 2,20,190

Schedule 16: Operating Expenses

Concept / condition / application
Establishment Expenses 15,000
Director’s Fees 10,000
Audit Fees 20,000
Rent and Taxes 22,500
Postage and Telegrams 2,000 Printingand Stationery 4,000 SundryExpenses 1,500 75,000

Concept / condition / application
Modern Bank Ltd. Profit & Loss Account for the year ended 31 st March, 2022

Worked figure / record

	Schedule No.	₹
I. Income: Interest Earned	13	2,71,500
Other Income	14	62,500
Total		3,34,000
II. Expenditure: Interest Expended	15	
Operating Expenses	16	2,20,190
Provision for Contingencies		75,000
Total		2,95,190
III. Profit: Net Profit for the year		38,810

Illustration 3

The following are details of advances of Punjab Bank Ltd.,

Concept / condition / application
Bills Purchased and Discounted 15,00,000
Cash Credits, Overdrafts and Loans Repayable on Demand 20,00,000
Term Loans 5,00,000
The following are the other details of the above advances:
Secured by Tangible Assets 30,00,000

Concept / condition / application
Covered by Bank, Government and ECGC Guarantees 6,00,000
Unsecured 2,00,000 Doubtful Debts 2,00,000
Show how these items will appear in the Bank’s Final Accounts

Schedule 9: Advances Rs,

Concept / condition / application
A)1. Bills Purchased and Discounted 15,00,000
2. Cash Credits, Overdrafts and Loans Repayable on Demand 18,00,000
3. Term loans 5,00,000
Total (1, 2 and 3) 38,00,000
B)1. Secured by Tangible Assets 30,00,000

Concept / condition / application
2. Covered by Bank Guarantee and ECGC Guarantee 6,00,000
3. Unsecured 2,00,000
Total (1, 2 and 3) 38,00,000

Profit & Loss Account as on .....

Concept / condition / application
I. Income .....
II. Expenditure .....
III. Provision and Contingencies 2,00,000

ADVANCES ILLUSTRATION - MISSING ALLOCATION ASSUMPTION

The historical example starts withRs.40 lakh gross advances and showsRs.38 lakh afterRs.2 lakh doubtful debts, allocating the reduction to cash credits/overdrafts. The data do not identify that allocation or establish a 100% provision rate by themselves. Read theRs.38 lakh worked format as an assumed illustration, not a general provisioning instruction.

Apply your understanding: original practice

1. Why are customer deposits not bank revenue?

Answer and reason
The bank generally owes repayment. Receipt increases cash and a deposit liability, rather than earned income.

2. Calculate the case profit after the Rs.20,000 provision.

Answer and reason
3,00,000 + 50,000 - 1,80,000 - 70,000 - 20,000 = Rs.80,000 before tax and unspecified items.

3. Why defer unearned bills discount?

Answer and reason
The part relating to the unexpired period is not yet earned under the stated accrual treatment; separate it from current income.

4. Can every bank use the same regulatory directions without checking scope?

Answer and reason
No. Commercial banks, RRBs, co-operative banks, SFBs and Payments Banks can have different applicable directions.

5. Does a provision mean cash was moved to a separate account?

Answer and reason
No. It is an accounting recognition/measurement treatment. Funding and cash investment decisions are separate.

Official reference: RBI bank financial statements | checked1November2026.

Official reference: RBI commercial-bank investment directions | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Bank deposits are normally liabilities.	15. Advances have several disclosure classifications.
02. Customer advances are normally assets.	16. Classification totals must reconcile.
03. Interest earned differs from other income.	17. Interest recognition needs prudential analysis.
04. Interest expended differs from operating expense.	18. NPA accounting cannot rely on automatic accrual.
05. Bank statements use prescribed forms and schedules.	19. Rebate on bills concerns unearned discount.
06. Bank category affects applicable directions.	20. Expense accruals affect liabilities.
07. Section 29 concerns banking-company accounts.	21. Provision expense affects profit.
08. Section 30 concerns their audit.	22. A provision is not a cash reserve account.
09. Submission and publication are separate requirements.	23. Schedules explain main-statement totals.
10. Signatures depend on the applicable provisions.	24. Comparatives and notes support interpretation.
11. Capital differs from deposits and borrowings.	25. The simplified pre-provision profit is Rs.1,00,000.
12. Reserves differ from specific provisions.	26. The case post-provision amount is Rs.80,000.
13. Cash balances differ from investments.	27. Current investment directions need separate checking.
14. Contingent liabilities differ from recognised liabilities.	28. Do not infer risk merely from one schedule total.

MODULE B / B 07

Core Banking Systems & Accounting in Computerised Environment

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A CBS posts monthly interest to 10,000 accounts. Processing all entries quickly does not prove the rate parameter was correct. Reconcile account totals to the general ledger, review parameter authority and test exceptions. An unauthorised rate can create 10,000 consistently wrong entries.

Change the situation

If one branch loses connectivity, central data may still exist but service availability is affected. Recovery, continuity and controlled alternate procedures matter alongside confidentiality.

COMMON MISTAKE - WHY IT FAILS

Computerisation improves capability; it does not guarantee accurate inputs, freedom from fraud or complete security. Maker-checker controls, least privilege, audit trails, backups and tested recovery remain necessary.

Build the connections

Idea	Why it matters
1	Accounting systems capture financial transactions.
2	They support ledger and statement preparation.
3	Standards still apply in a computer system.
4	Automatic posting is not automatic correctness.

Idea	Why it matters
1	CBS centralises relevant banking information.
2	A customer view can span branches.
3	Interfaces need reconciliation.
4	System totals need underlying evidence.

Idea	Why it matters
1	Confidentiality restricts unauthorised disclosure.
2	Integrity protects correctness and completeness.
3	Availability supports timely authorised use.
4	These security aims can require different controls.

Idea	Why it matters
1	Least privilege limits access.
2	Maker-checker separates critical responsibilities.
3	Authentication differs from authorisation.
4	Privileged access needs particular oversight.

Idea	Why it matters
1	Audit trails record relevant events.
2	Logs need protection and review.
3	Backups need restoration testing.
4	Continuity planning addresses service interruption.

Idea	Why it matters
1	Change management controls system modifications.
2	Patch management addresses relevant vulnerabilities.
3	Migration needs reconciliation and validation.
4	Encryption requires sound key management.

Idea	Why it matters
1	Physical security complements logical controls.
2	Incident response needs escalation and evidence.
3	Outsourcing does not erase bank responsibility.
4	People and procedures matter alongside technology.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Environment
Computerised Accounting

An accounting system is one that performs the following functions:

Concept / condition / application
It captures business transactions in the form of accounting entries.
The accounting entries are then used to prepare financial statements.
The financial statements are prepared based on accounting standards.
Various financial reports are prepared from the data available in the financial statements.
Features of Computerized Accounting

Concept / condition / application
Speed

Historical formulation: Accuracy

CLARIFICATION / 1 NOVEMBER 2026

Automation improves processing capability but does not guarantee correct input, parameters, authorisation or freedom from fraud. Reconciliation, access control, audit trails, exceptions and tested recovery remain essential.

Concept / condition / application
Various informative reports can be generated
Economy
A Computerised system may be a single stand Along unit or a Multiple User, ie, LAN, WAN etc.
Terms used in Computerized Accounting
Data

Concept / condition / application
Record

Concept / condition / application
Data file or file
System
Advantages of Computerized Accounting
Accurate, High speed and low cost or operation

Concept / condition / application
Availability of various reports from the same accounting data
Error- free accounting
Automatic completion of all records by feeding only one entry into the computer
Multiple set of Printouts available
Disadvantages of Computerized Accounting

Concept / condition / application
Requirement of special Programme and Professional
Qualified staff required for Operations
Costly computer peripherals and stationery
Regular back-up is required as Data may be lost for various reasons
Computer viruses

Concept / condition / application
Functions performed by computerized accounting software available in the market
Tally versions such as 4, 4.5, 5, 5.4, 6.3, 7.2 and 8.2
Ex, accounting software
Bank 2000 for accounting needs for banks
B@NKS-24-core banking solution

Concept / condition / application
A.U.D.I.T.O.R and A.U.D.I.T.I.M.E cash basis software for professionals and their accounts
MEFCOMP accounting software for professional
Quick FA
Difference Between Computerised And Manual Accounting

Worked record / comparison

Basis For Comparison	Manual Accounting	Computerized Accounting
Meaning	Manual Accounting is a system of accounting that uses physical registers and account books, for keeping financial records.	Computerized Accounting is an accounting system that uses an accounting software, for recording financial transactions electronically.
Recording	Recording is possible through book of original entry.	Data content is recorded in customized database.
Calculation	All the calculation is performed manually.	Only data input is required, the calculations are performed by computer system.
Speed	Slow	Comparatively faster.
Adjusting entries	It is made for rectification of errors.	It cannot be made for rectification of errors.
Backup	Not possible	Entries of transactions can be saved and backed up
Trial Balance	Prepared when necessary.	Instant trial balance is provided on daily basis.
Financial Statement	It is prepared at the end of the period, or quarter.	It is provided at the click of button.

QUALIFY THE OLDER MANUAL / COMPUTER COMPARISON

Manual records can be copied/backed up. Computerised records can be corrected through authorised adjustment/reversal entries with an audit trail. Neither a daily trial balance nor a button-generated statement proves complete or correct accounting.

Concept / condition / application
Core Banking Components

Core Banking is delivered as a set of integrated core banking components that are then tailored to fit the institution’s individual business requirements. These components can be easily re-configured as business requirement change, protecting the orginisation’s strategic investment and maintaining a unified business approach.

Concept / condition / application
Core Bank components include
Core Bank financial institution infrastructure
Core Bank customer management and customer overview
Core Bank Account Administration

Concept / condition / application
Core Bank Payments

Concept / condition / application
Core Bank Management Information
Advantages of Core Banking
Makes the internal staff more competent.
Minimises human intervention thereby limiting errors.
Helps prevent frauds and thefts with real-time banking facilities.

Concept / condition / application
Reduces operational costs.
Aids in studying changing customer demands.
Facilitates decision making through reporting and analytics.
Information Security

Information Security is basically the practice of preventing unauthorized access, use, disclosure, disruption, modification, inspection, recording or destruction of information. Information can be physical or electrical one.

Concept / condition / application
Information system Security

Information systems security provides essential information for managing the security of an organization where information technology is an important factor. It is mainly for all the staff, who are the first-line support, responsible for the daily, efficient operation of security policies, procedures, standards and practices. It cover

Concept / condition / application
Logical Access Control
Physical security
Network Access Control
Password management
Asset Management

Concept / condition / application
E-mail security
Internet security

Concept / condition / application
Mobile computing
Network security
Application security

Concept / condition / application
Operating system security
Database administration and security
Desktop security
Malicious software
Incident response and management

Concept / condition / application
Security of electronic delivery channels
Wireless security
Change Management
Patch Management
Remote access

Concept / condition / application
Backup and archival
Capacity Management
IT asset/media management
Encryption
Application/data migration

Quick Revision: connected banking concepts

Connection	Meaning and qualification
Computerisation objectives	Customer service, housekeeping, decision-making, productivity and profitability are linked objectives, not guaranteed outcomes.
Standalone / multi-user	A standalone workstation serves a local user;multi-user arrangements permit concurrent users. Historical mini/mainframe/micro/supercomputer labels do not by themselves define modern deployment architecture.
Central processing	Central repositories and shared resources can support corporate information, resource utilisation, technical staffing and communication-link sharing. Costs and performance depend on actual design.
Branch automation	Supports service, housekeeping, local analysis and reports. Authorised transaction processing can update connected ledgers and generate passbooks, vouchers, statements and extracts. Single-window and connectedATMservices still need controls and availability.
Regional / zonal office	Coordinates branch profiles, interbranch reconciliation, credit monitoring and personnel information between branch and head office.
Head office	Operations, planning, personnel, international business and services can use systems for personnel/administration, funds, investments, branch profiles and credit information.
LAN / WAN	LANconnects local devices;WANlinks geographically separated locations. Nodes, clients and servers are roles. The old 150 metre/1 km/device-count limits are not universal modern network definitions.
Topology	Bus shares a medium;star connects endpoints to a central device;ring connects a loop. Link/node failure effects depend on the implementation and redundancy. Do not combine the old bus/ring failure statements into a universal rule.
Protocols / multiplexing	Protocols define formats, exchange rules, sequencing and relevant error/session behaviour. Ethernet and legacyTokenRing illustrate network technologies. Multiplexing combines/separates multiple communication streams.
Network services	Servers can share files, printers and communication resources. ALANdoes not guarantee no database duplication, no overload or low maintenance;design, security and operations determine the result.
Power protection	AUPSprovides limited continuity/power conditioning according to capacity. It supports safe operation or shutdown but cannot eliminate all risk of data loss or replace backups.
CBS business modules	Retail/customer, deposits, loans, bills, remittances, lockers, clearing, trade finance/forex, government business, corporate/service-branch operations, MISand business intelligence.

Connection	Meaning and qualification
CBS interfaces	ATMs, telebanking, cards, kiosks, Internet/call centre channels;treasury, IBR, central accounting, HRMS, ALM, credit appraisal/monitoring andNPAmanagement. OlderNDS/SFMS/RTGS/CFMSlabels describe integration contexts;verify current channels.
CBS benefits and limits	Central data can support warehousing, analytics, customer services, MIS, ALM, risk and management control. Acontrolled common software version supports changes and process redesign.
Infrastructure and cost	Central, recovery and branch infrastructure are required as designed. Branch servers may be unnecessary in some architectures. Initial investment can be high;later rollout may be cheaper but is not automatically cost-free.
Control reminder	Central backups andMIScan reduce local work, but branch accountability, interface reconciliation, continuity and access controls remain necessary.

Apply your understanding: original practice

1. Does a balanced CBS journal prove the interest rate was authorised?

Answer and reason
No. Debit and credit can agree even when a wrong parameter is applied. Test rate authority and calculations.

2. Which security objective is affected by an unavailable but unaltered database?

Answer and reason
Availability. Integrity and confidentiality may remain intact, but users cannot obtain required service.

3. Why test restoration rather than only checking backup success?

Answer and reason
A completed backup job does not prove usable recovery. Restoration tests data usability, dependencies and recovery procedures.

4. Why separate maker and checker access?

Answer and reason
It reduces the chance that one person can initiate and approve a critical unauthorised change without independent review.

5. What is the risk of an unreconciled interface?

Answer and reason
Transactions can be omitted, duplicated or mapped incorrectly between systems even when each system's internal totals balance.

Official reference: RBI ITgovernance | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Accounting systems capture financial transactions.	15. Authentication differs from authorisation.
02. They support ledger and statement preparation.	16. Privileged access needs particular oversight.
03. Standards still apply in a computer system.	17. Audit trails record relevant events.
04. Automatic posting is not automatic correctness.	18. Logs need protection and review.
05. CBS centralises relevant banking information.	19. Backups need restoration testing.
06. A customer view can span branches.	20. Continuity planning addresses service interruption.
07. Interfaces need reconciliation.	21. Change management controls system modifications.
08. System totals need underlying evidence.	22. Patch management addresses relevant vulnerabilities.
09. Confidentiality restricts unauthorised disclosure.	23. Migration needs reconciliation and validation.
10. Integrity protects correctness and completeness.	24. Encryption requires sound key management.
11. Availability supports timely authorised use.	25. Physical security complements logical controls.
12. These security aims can require different controls.	26. Incident response needs escalation and evidence.
13. Least privilege limits access.	27. Outsourcing does not erase bank responsibility.
14. Maker-checker separates critical responsibilities.	28. People and procedures matter alongside technology.

MODULE C / C 01

An Overview of Financial Management

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A firm must choose whether to buy a machine, how to finance it and how much cash to retain. A project needs Rs.1,00,000 now and returns Rs.60,000 at each of the next two year-ends. At 10%, present value is 60,000/1.10 + 60,000/1.10^2 = Rs.1,04,132.23; NPV is Rs.4,132.23. The decision compares value at the same date, not only total receipts.

Change the situation

At 15% the same cash flows have NPV about -Rs.2,457.47. A higher required return can change acceptance even though the physical project is unchanged.

COMMON MISTAKE - WHY IT FAILS

Profit maximisation alone ignores timing, risk and financing constraints. Value creation needs realistic incremental cash flows, an appropriate required return and responsible treatment of stakeholders.

Build the connections

Idea	Why it matters
1	Financial management concerns resource decisions.
2	Investment and financing decisions are linked.
3	Dividend decisions affect retained funding.
4	Liquidity supports continuity of operations.

Idea	Why it matters
1	Time value makes dates relevant.
2	Risk affects required return.
3	Value differs from accounting profit.
4	Cash-flow forecasts require assumptions.

Idea	Why it matters
1	Owners provide equity capital.

Idea	Why it matters
2	Creditors provide contractual funding.
3	Legal form affects rights and liability.
4	Company assets are separate from shareholders.

Idea	Why it matters
1	Short-term finance supports near-term needs.
2	Long-term finance supports enduring needs.
3	A market channels funds between participants.
4	Primary and secondary markets differ.

Idea	Why it matters
1	Intermediaries can transform maturities and risks.
2	Regulation does not remove commercial risk.
3	Agency problems arise from differing incentives.
4	Governance supports accountability.

Idea	Why it matters
1	Working capital decisions affect liquidity.
2	Capital budgeting examines long-term investment.
3	Cost of capital is an opportunity-cost benchmark.
4	Financial planning needs sensitivity analysis.

Idea	Why it matters
1	The case uses two year-end inflows.
2	At 10% its NPV is positive.
3	At 15% its NPV becomes negative.
4	Explain assumptions before recommending acceptance.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Management – An Overview
Introduction
When the business is started, the owners bring funds in the form of capital.
It has to raise further funds in the form of further issue of capital and borrowings.
The funds are needed for creating the fixed assets as well as for the working capital.

Concept / condition / application
How these funds are used most efficiently is also important.
The financial activities of a business organisation mainly relate to its assets, liabilities and revenues.
Planning, organizing, conducting and controlling all these financial activities of the organisation is the function of Financial Management.
Forms Of Business Organisation
The form of a business organisation is the choice of the owners/promoters.

Concept / condition / application
A business organisation may have any of the following forms:

Forms of business organisation

Form	Classification
Sole proprietary	Read legal personality, ownership, liability and taxation separately.
Partnership firm	Read legal personality, ownership, liability and taxation separately.
Limited liability partnership(LLP)	Read legal personality, ownership, liability and taxation separately.
Hindu undivided family	Read legal personality, ownership, liability and taxation separately.
Association of persons / body of individuals	Read legal personality, ownership, liability and taxation separately.
Company	Read legal personality, ownership, liability and taxation separately.
Co-operative society	Read legal personality, ownership, liability and taxation separately.

Concept / condition / application
Sole Proprietary
Owned and run by one person
There is no legal distinction between the owner and the firm.

Concept / condition / application
The business owner is referred to as the sole proprietor.
He/she exclusively owns all the assets and profits of the business.

Concept / condition / application
The profit of the firm is taxed as personal income of the proprietor.

Advantages:

Concept / condition / application
Subject to minimum regulations.
Simplest form of a business organisation.

Limitation:

Concept / condition / application
Limited capital as the resources of the proprietor are limited
Partnership Firm
Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.
Governed by the Indian Partnership Act, 1932.
As per Section 4 of the Indian Partnership Act

From this definition, the following points are clear:

An association of two or more persons An agreement/contract between the persons The agreement is to carry on a business with the object of sharing profits The business is to be carried on by all or any of them acting for all.

Concept / condition / application
The persons involved in the agreement are called partners and the entity created for the business is called partnership firm.
LIABILITY of each partner is unlimited unlike a Limited Liability Company (LLC).
Maximum member: The Indian Partnership Act does not mention anything but as per the Companies Act 2013 and The Companies (Miscellaneous) Rules, 2014, a partnership can have a maximum of 50 persons.
A company can also be a partner in a partnership firm.
The partnership firm may be registered but it is not mandatory.

Concept / condition / application
A partnership has no separate legal status apart from its partners
Limited Liability Partnership (LLP)
It is a newly established concept introduced in India by Limited Liability Partnership Act, 2008.
A Limited Liability Partnership (LLP) is a partnership in which some or all partners have limited liabilities.
It therefore has elements of partnerships as well as Limited Liability Companies.

Concept / condition / application
Registration: With Ministry of Corporate Affairs while registration of a partnership firm is done with Registrar of Firms.
Legal Entity: An LLP is a legal entity unlike a partnership firm which has no separate legal status apart from its partners.
In LLP, one partner is not liable for the acts of another partner.
Hindu Undivided Family (HUF)
Exists only in India and is governed by the provisions of the Hindu Law.

Concept / condition / application
It is different from a partnership firm as it comes into existence not out of any contract but birth in a Hindu family.
The firm is owned by the members of undivided Hindu family, called co-

parceners.

Concept / condition / application
Typically managed by the senior-most male member, also known as Karta or

Manager.

Concept / condition / application
For the sake of income tax, the HUF is considered as a separate entity and is taxed separately
Association of Persons or Body of Individuals
Association of Persons (AOP) means a group of persons, whether incorporated or not, who come together for achieving a common objective.
Members of the AOP can be natural or artificial persons.
Body of Individuals (BOI) means a group of individuals (natural persons), whether incorporated or not, who join together for earning income.

Concept / condition / application
Both AOP and BOI are treated as separate entity for the purpose of assessment under the Income Tax Act.
Company
A company is an association of persons who contribute money or money's worth to a common stock and use it for a common purpose.
Created by law and effected by law.
A legal person just as much as an individual but with no physical existence.

Concept / condition / application
Section 2 (20) (Chapter I) of the Companies Act, 2013, defines a company as - A company incorporated under this Act, or under any previous Company law.
Companies Act 2013 also permits formation of "One-Person Company" which has only one person as its member.

Co-operative society

Concept / condition / application
This can also be one form of a business organisation.
It is a form of business where individuals join hands for the promotion of their common goals.
Main objective: Mutual assistance and service.
A registered co-operative society is recognized as a separate legal entity by law.
It acquires an identity quite distinct and independent of its members.

Concept / condition / application
It can purchase and dispose of its assets. It can sue, and also can be sued.
The management of a co-operative society is vested in the management committee elected by the members of the society.
Financial Decisions In A Firm

Financial decisions in a firm mainly relate to the acquisition and utilization of capital funds in meeting the financial needs and overall objectives of the firm.

Therefore, the primary function of finance department is to acquire capital funds and put them to proper use, as per firm's objectives. Financial decisions in an organisation,

normally, relate to the following:

Concept / condition / application
Estimating the capital requirements
Deciding the capital structure/composition
Deciding on sources of funds
Use of long term funds
Corporate strategy/mergers and acquisitions

Concept / condition / application
Use of short term funds/Working capital management
Financial Control
Compliance
Decision of dividend/retained profit
Objectives Of Financial Management

The objectives of the financial management are to efficiently carry out all the functions mentioned above under scope of financial management. These objectives can be

summarised as under:

Concept / condition / application
To ensure adequate and timely supply of long and short term funds to the organisation, at reasonable cost.
To ensure optimum utilization of funds
To take sound capital investment decisions
To decide on optimum capital structure
To ensure statutory and regulatory compliance

Concept / condition / application
To ensure balance between shareholder benefits and organisational objectives
To ensure appropriate financial risk-management system
Fundamental Principles Of Finance

While discussing the principles of finance, let us keep in mind that finance is not the same as money lending. Lending is just one constituent of finance. So, the principles of finance should not be confused with principles of lending.

The main principles of finance are as under:

Concept / condition / application
Time Value of Money
Opportunity Cost of Money
Risk and Return
Liquidity and Return
Diversification

Concept / condition / application
Reducing asset-liability mismatch/Hedging
Cash flow
Building Blocks Of Modern Finance

Traditional approach: Finance functions consist of financial planning, raising of funds, allocation of funds, and financial control.

Concept / condition / application
The modern approach considers that the corporate finance function is built up on the four basic blocks mentioned as under:
Planning
Decision making
Organising and Directing
Controlling

Concept / condition / application
Risk-Return Trade Off
The risk-return tradeoff means that the potential return rises when a higher risk is taken, and vice versa.
Financial decisions of a firm are often guided by the risk-return trade off.
Risk is inherent in every investment, though its scale varies.
In order to increase the possibility of higher return, the firm needs to increase the risk taken and vice-versa

Concept / condition / application
Depending upon the risk-taking ability, investment objectives, and the time horizon available to achieve it, a firm has to find the optimal combination of risk and return in a financial decision.

Concept / condition / application
A proper balance between return and risk should be maintained to get optimum return from the investment.
Such balance is called Risk-Return Trade off and every financial decision involves this trade off.
Required Rate of Return
The firm has to decide on the rate of return it wants on its investment, below which it would not like to invest its money.

Concept / condition / application
The relationship between required rate of return and risk can be expressed

as under:

Required Rate of Return = Risk-free Return + Risk Premium

Concept / condition / application
Various tools are used in financial management for measuring the risk. One of these is the Standard Deviation.
Higher the risk, the higher the risk premium is, which pushes up the required rate of return.
While the investment in Government bonds is considered to be risk free as the interest rate is known and the risk of default is almost nil, investment in junk
bonds involves high risk because of high probability of default, though the yield is high due to low market rate
Business Ethics & Social Responsibility

Concept / condition / application
In general, ethics are concerned with classifying what is right and what is wrong.
Business ethics: Focus on what is right for the shareholders and stakeholders.
Drives the code of conduct of a company.
Normally, each company has a well-documented code of conduct applicable to both the business and to its employees.
Companies voluntarily adopt this code of conduct containing the principles of corporate ethics.

Concept / condition / application
These principles govern every aspect of the company’s dealings with government, other businesses, its employees, its customers and any other stakeholder.

Concept / condition / application
Social responsibility is different From business ethics as it focuses on the impact of firm's business on the environment and community.
Importance of business ethics
A company's perception in the eyes of stakeholders as well as the outsiders, is shaped by its business ethics.
Helps in not only in raising resources for the expansion of the business but also makes it a preferred partner for doing business.

Concept / condition / application
Helps to attract the best talent in the industry: high productivity and low attrition rates.
The customers of a business entity that treats them ethically, become repeat customers and build an ongoing relationship with the entity.
These customers recommend that entity to the people within their contact.
The brand value of an entity, known for its high ethical values, keeps growing and helps in increasing its market share
Principles of code of conduct/Ethics

The code of conduct, adopted by an organisation, is affected by both the nature of the company's business and its location. The broad principles of code of conduct or ethics,

in business, can be mentioned as under:

Concept / condition / application
Personal responsibility
Corporate responsibility
Corporate Transparency
Honesty
Integrity

Concept / condition / application
Promise-Keeping
Trustworthiness
Loyalty
Fairness
Concern for Others

Concept / condition / application
Respect for Others
Customer Prioritisation
Law Abiding
Community and Environmental Responsibility
Data Protection

Concept / condition / application
Whistle-blower Protection
Workplace Diversity and employee compensation
Emerging Role Of The Finance Manager In India

A finance manager of a firm deals with how the money is raised from investors, how that money is invested and how the investors are rewarded with suitable return on their investments.

Concept / condition / application
The key areas in which changes are taking place, are as under:
Selection of project
Raising Equity
Raising debt
Interest rate on debts

Concept / condition / application
Foreign exchange management:
Treasury operations
Coping with technological changes/data availability
Dealing with Rating Agencies
Investor communication

Apply your understanding: original practice

1. Why discount a future Rs.60,000?

Answer and reason
Money available now can earn a return. Discounting expresses the future amount at the present valuation date.

2. Does Rs.1,20,000 total receipts prove a Rs.1,00,000 project is good?

Answer and reason
No. Timing, risk, required return and relevant costs must be considered.

3. Why distinguish investment from financing?

Answer and reason
Investment decides how funds are used; financing decides how they are raised and what claims arise.

4. Does a higher required return usually increase this project's NPV?

Answer and reason
No. For its positive future inflows, a higher discount rate lowers present value and NPV.

5. Can a profitable business run out of cash?

Answer and reason
Yes. Receivables, inventory, debt repayments and investment can absorb cash despite accounting profit.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Financial management concerns resource decisions.	15. A market channels funds between participants.
02. Investment and financing decisions are linked.	16. Primary and secondary markets differ.
03. Dividend decisions affect retained funding.	17. Intermediaries can transform maturities and risks.
04. Liquidity supports continuity of operations.	18. Regulation does not remove commercial risk.
05. Time value makes dates relevant.	19. Agency problems arise from differing incentives.
06. Risk affects required return.	20. Governance supports accountability.
07. Value differs from accounting profit.	21. Working capital decisions affect liquidity.
08. Cash-flow forecasts require assumptions.	22. Capital budgeting examines long-term investment.
09. Owners provide equity capital.	23. Cost of capital is an opportunity-cost benchmark.
10. Creditors provide contractual funding.	24. Financial planning needs sensitivity analysis.
11. Legal form affects rights and liability.	25. The case uses two year-end inflows.
12. Company assets are separate from shareholders.	26. At 10% its NPV is positive.
13. Short-term finance supports near-term needs.	27. At 15% its NPV becomes negative.
14. Long-term finance supports enduring needs.	28. Explain assumptions before recommending acceptance.

MODULE C / C 02

Ratio Analysis

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A trader has current assets Rs.2,00,000, including inventory Rs.80,000, and current liabilities Rs.1,00,000. Current ratio is 2: 1. Assuming no other exclusions, quick assets are Rs.1,20,000 and quick ratio 1.2: 1. The ratios describe different liquidity buffers; neither proves that every customer will pay on time.

Change the situation

If Rs.40,000 of receivables is doubtful, reassess recoverability before celebrating the original ratios. If reported amounts are adjusted down by that amount, current ratio becomes 1.6 and quick ratio 0.8.

COMMON MISTAKE - WHY IT FAILS

A benchmark is a starting point, not a universal pass mark. Match definitions, periods, industry, seasonality, asset quality and numerator/denominator bases.

Build the connections

Idea	Why it matters
1	Ratios relate meaningful financial amounts.
2	Definitions must be consistent.
3	Liquidity differs from profitability.
4	Solvency concerns longer-term obligations.

Idea	Why it matters
1	Current ratio uses current assets/current liabilities.
2	Quick ratio excludes less-liquid current items.
3	Cash ratio is narrower still.
4	Asset quality matters to interpretation.

Idea	Why it matters
1	Inventory turnover needs a consistent cost basis.

Idea	Why it matters
2	Receivables turnover needs an appropriate sales basis.
3	Average balances may improve period comparisons.
4	Days ratios need a stated day convention.

Idea	Why it matters
1	Gross margin differs from net margin.
2	ROA and ROE use different resource bases.
3	Leverage can magnify returns and risk.
4	Interest cover needs a defined earnings measure.

Idea	Why it matters
1	Debt/equity depends on included debt.
2	DSCR definitions must be stated.
3	Trends help identify changes.
4	Peer comparison needs comparable accounting.

Idea	Why it matters
1	Seasonal balances can mislead.
2	Window dressing can distort a date-specific ratio.
3	One ratio cannot explain the whole business.
4	A high ratio can reflect idle resources.

Idea	Why it matters
1	The case current ratio is 2.
2	The case quick ratio is 1.2.
3	Doubtful receivables can weaken both ratios.
4	Explain the business cause of a movement.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
ROI / return on capital	Defined operating profit / defined capital employed x 100	State whether capital is average/closing and what adjustments apply.
EPS	Earnings attributable to ordinary equity / weighted-average ordinary shares	The simple numerator deducts relevant preference dividend; full EPS rules can require more adjustments.
P/E	Market price per share / earnings per share	Use compatible per-share bases; loss/zero EPS makes a simple multiple problematic.
Gross margin	Gross profit / net sales x 100	The denominator is sales, not cost.
Net margin	Defined net profit / net sales x 100	State pre/post-tax and operating/non-operating basis.
Fixed-asset funding ratio	Defined fixed assets / long-term funds	Interpret alongside the business and funding structure.
Debt/equity	Defined outside debt or liabilities / defined equity	Banking covenants can define components differently.
Current ratio	Current assets / current liabilities	Check classification and asset quality.
Quick ratio	Quick assets / current liabilities	Typically exclude inventory, prepayments and other non-quick items as defined.
Inventory turnover	Cost of goods sold / average inventory	If another convention uses sales, state it clearly.
Receivables turnover	Net credit sales / average trade receivables	Use appropriate net/average balances.
Collection period	Average receivables / annual credit sales xdays in year	Equivalent to days / receivables turnover using consistent definitions.
Interest cover	EBIT / interest charge	State included earnings and charges.
DSCR	Defined cash available for debt service / (interest +scheduled principal)	Actual loan agreements may specify a different numerator/denominator.
Dividend yield	Dividend per share / market price per share x 100	Not the same as total shareholder return.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Accounting Ratios

Accounting ratio is the comparison of two or more financial data which are used for analyzing the financial statements of companies. It is an effective tool used by the

shareholders, creditors and all kinds of stakeholders to understand the

profitability, strength and financial status of companies.

Concept / condition / application
Classification of Ratios

Accounting ratios can be classified on the following basis:

Concept / condition / application
Traditional Classification

The traditional classification has been on the basis of the financial statements, to which the determinants of a ratio belong. On this basis, the ratios could be classified as:

Concept / condition / application
Profit and loss account ratios, i.e, ratios calculated on the basis of the profit and loss account only.
Balance sheet ratios, i.e, ratios calculated on the basis of the figures of balance sheet only.
Composite ratios or inter-statement ratios, i.e, ratios based on figures of profit and loss account as well as the balance sheet.
Functional classification

Traditional basis of classification, as given above, has been found to be too crude and unsuitable because, analysis of balance sheet and income statement cannot be done in isolation. They have to be studied together in order to determine the profitability and solvency of the business. According to the order that ratios serve as a tool for financial analysis, they are now classified as:

Concept / condition / application
Profitability ratios,
Turnover or activity ratios, and

Concept / condition / application
Financial or solvency ratios

Financial ratios two categories:

Concept / condition / application
Short term Solvency Ratios are the ratios that disclose the financial position or solvency of the firm in the short period. Some accountants prefer to call them simply as ‘Liquidity Ratios’.
Long term Solvency Ratios are the ratios that disclose the financial position or solvency of the firm in the long period. Some accountants prefer to call them simply as ‘Solvency Ratios’.
Uses of Accounting Ratios
Simply financial Statements: Ratios simplify the comprehension of financial statement. Ratios tell the whole story of changes in the financial condition of the business.
Facilitate inter-firm comparison: Ratios provide data for inter-firm comparison. Ratios highlight the factors associated with successful and unsuccessful firms. They also reveal strong firms and weak firm, overvalued and under- valued firms.

Concept / condition / application
Facilitate intra-firm Comparison: Ratios also make possible comparison of the performance of the different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.
Help in planning: Ratios help in planning and forecasting. Over a period of time, a firm or industry develops certain norms that may indicate future success or failure.
Limitations of Accounting Ratios
The firm can make some year-end changes to their financial statements, to improve their ratios. Then the ratios end up being nothing but window dressing.
Ratios ignore the price level changes due to inflation. Many ratios are calculated using historical costs, and they overlook the changes in price level between the periods. This does not reflect the correct financial situation.

Concept / condition / application
Accounting ratios completely ignore the qualitative aspects of the firm. They only take into consideration the monetary aspects (quantitative)
There are no standard definitions of the ratios. So firms may be using different formulas for the ratios. One such example is Current Ratio, where some firms take into consideration all current liabilities but others ignore bank overdrafts from current liabilities while calculating current ratio
And finally, accounting ratios do not resolve any financial problems of the company. They are a means to the end, not the actual solution.

Concept / condition / application
Calculation and Interpretation of various Ratios
Profitability Ratios

Overall Profitability Ratio

It is also called as the ‘Return on Investment’. It indicates the percentage of return on the total capital employed in the business. It is calculated on the basis of the following

formula:

Concept / condition / application
×100
Capital Employee: Different meanings by different accountants.
Sum total of all assets whether fixed or current.
Sum total of fixed assets
Sum total of long term funds employed in the business i.e, Share+ Capital + Reserves and Surplus + Long term loans –(Non business assets+ fictitious assets)

Operating Profit: Means profit before ‘Interest and Tax’. The term ‘Interest’ means interest means ‘Interest on long term borrowings. Interest on short- term borrowings will be deducted for computing operating profit.

Earnings per share (EPS)

Concept / condition / application
EPS tells about the earning per equity share. It can be computed as follows:
Earning per share=Net profit after tax and Pref. dividend/ Number of equity shares

Price Earning (P/E) Ratio

Concept / condition / application
The ratio indicates the number of times the earning per share is covered by its market price. This is calculated according to the following formula:
Market price per equity share/ Earning per share

Gross Profit Ratios

Concept / condition / application
The ratio expresses the relationship between the gross profit and the net sales.
×100

Net Profit Ratio

Concept / condition / application
This ratio indicates net margin earned on a sale of Rs. 100. It is calculated as follows:
Net Operating Profit ×100
Solvency Ratios

A company is considered to be solvent or financially sound if it is in a position to carry on its business smoothly and meet all obligations, both long-term as well as short-term, without strain. The following are the important ratios for measuring the long-term solvency of a firm.

Concept / condition / application
Long –term Solvency Ratios: In order to determine the long term solvency of a business, the following ratios will be useful:
(i)Fixed Asset Ratio: The ratio is expressed as follows:
Fixed assets/ Long-term funds

Historical formulation: The ratio should not be more than 1. If it is less than 1, it shows that a part of the working capital has been financed through long-term funds. This is desirable to some extent because a part of working capital, termed as ‘Core Working capital’ is more or less of a fixed nature. The ideal ratio is 0.67.

CLARIFICATION / 1 NOVEMBER 2026

Benchmarks are contextual, not universal pass/fail limits. Define each ratio, check asset quality and compare consistent industry/period data.

Concept / condition / application
Fixed assets include ‘net fixed assets’ (i.e, original cost- depreciation to date) and trade investments including share in subsidiaries. Long term funds include share capital, reserves and long term loans.

(ii)Debt Equity Ratio: The debt-equity ratio is calculated to ascertain the soundness of the long-term financial policies of the company. It is also known as the ‘External- Internal’ equity ratio. It may be calculated as follows:

Concept / condition / application
Debt-equity ratio= External equities/ Internal equities

Short term Solvency Ratios

Concept / condition / application
The following ratios will be useful for determining the short-term solvency of a

business.

Concept / condition / application
Current Ratio: This ratio is an indicator of the firm's commitment to meet its short-term liabilities.
Current Assets/ Current liabilities
Liquidity Ratio: This ratio is also termed as 'acid test ratio' or 'quick ratio'. This ratio is ascertained by comparing the liquid assets (i.e, assets which are immediately convertible into cash without much loss) to current liabilities. Prepaid expenses and stock are not taken as liquid assets. The ratio may be expressed as:
Liquid assets/ Current liabilities
Turnover Ratios

Stock turnover Ratio: This ratio indicates whether the investment in inventories is efficiently used or not. It, therefore, explains whether investment in inventories is within proper limits or not.

Concept / condition / application
Cost of goods sold during the year/ Average inventory

Debtors 'Turnover Ratio (Debtors Velocity): Debtors are an important constituent of current assets and therefore, the quality of debtors, to a great extent, determines a firm's liquidity. Two ratios are used by financial analysis to judge this. They are:

Concept / condition / application
(i)Debtors, turnover ratio, and
(ii) Debt collection period ratio.

Debtor's turnover ratio is calculated as under:

Concept / condition / application
Credit sales/ Average accounts receivable

Debt collection period Ratio: The ratio indicates the extent to which the debts have been collected in the time. It gives the average debt collection period. The ratio is very helpful to the lenders because it explains to them whether their borrowers are collecting money within a reasonable time. An increase in the period will result in greater blockage of funds in debtors. The ratio may be calculated by any of the following methods:

Concept / condition / application
(i)Months (or days) in a year/ Debtors turnover
(ii)
Months (or days) in a year × Average accounts receivable Credit sales for the year
(iii) Account receivable/ Average monthly or daily credit sales
Different Users and Their Use of Ratios

Concept / condition / application
Accounting ratios used by a long-term creditor:
Fixed charges cover= Income before interest and tax/ Interest charges
Debt service coverage ratio= Cash profit available for debt service/ Interest + Principal payment instalment
Accounting ratios used by a bank granting a short-term loan:
Quick ratio= Quick assets/ Current liabilities

Concept / condition / application
Current ratio= Current assets/ Current liabilities
Accounting ratios used by shareholders:
Earnings per share= Profit available for equity shareholders/ No. of equity shares
Dividend yield ratio= Dividend per share/ Market price per share

Apply your understanding: original practice

1. Compute the case quick ratio.

Answer and reason
(2,00,000 -80,000)/1,00,000 =1.2. This assumes inventory is the only excluded current item.

2. Is a current ratio of 2 always ideal?

Answer and reason
No. Appropriate liquidity depends on operating cycle, cash access, asset quality and sector.

3. Why use average inventory for turnover?

Answer and reason
Sales/cost flow covers a period; an average stock measure can better represent resources used during it.

4. Can falling receivable days prove better collection?

Answer and reason
Not alone. Credit sales mix, write-offs, factoring and period definitions may also change the ratio.

5. Why define DSCR before calculating?

Answer and reason
Different conventions include different cash-available and debt-service components. An unexplained ratio can be misleading.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Ratios relate meaningful financial amounts.	15. Leverage can magnify returns and risk.
02. Definitions must be consistent.	16. Interest cover needs a defined earnings measure.
03. Liquidity differs from profitability.	17. Debt/equity depends on included debt.
04. Solvency concerns longer-term obligations.	18. DSCR definitions must be stated.
05. Current ratio uses current assets/current liabilities.	19. Trends help identify changes.
06. Quick ratio excludes less-liquid current items.	20. Peer comparison needs comparable accounting.
07. Cash ratio is narrower still.	21. Seasonal balances can mislead.
08. Asset quality matters to interpretation.	22. Window dressing can distort a date-specific ratio.
09. Inventory turnover needs a consistent cost basis.	23. One ratio cannot explain the whole business.
10. Receivables turnover needs an appropriate sales basis.	24. A high ratio can reflect idle resources.
11. Average balances may improve period comparisons.	25. The case current ratio is 2.
12. Days ratios need a stated day convention.	26. The case quick ratio is 1.2.
13. Gross margin differs from net margin.	27. Doubtful receivables can weaken both ratios.
14. ROA and ROE use different resource bases.	28. Explain the business cause of a movement.

MODULE C / C 03

Financial Mathematics - Calculation of Interest & Annuities

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

Invest Rs.10,000 for two years at 10% annually. Simple interest is 10,000 x.10 x 2 =Rs.2,000, so maturity isRs.12,000. Annual compounding gives 10,000 x 1.10^2 =Rs.12,100. The extraRs.100 is interest on the first year's interest. Always convert a percentage to a decimal before using a decimal-rate formula.

Change the situation

For two end-of-year payments ofRs.1,000 at 10%, PV=1,000/1.10 +1,000/1.10^2 =Rs.1,735.54. Move both payments one period earlier to make an annuity due: PV rises toRs.1,909.09.

COMMON MISTAKE - WHY IT FAILS

Match the periodic rate to the number of periods. A monthly rate cannot be paired with a count of years. Beginning-period and end-period payments need different timelines.

Build the connections

Idea	Why it matters
1	Principal is the amount initially invested.
2	Interest compensates for use of funds.
3	Simple interest uses principal throughout.
4	Compound interest includes prior interest.

Idea	Why it matters
1	SI=P x r x t with decimal r.
2	FV=P x(1+r)^n for matching periods.
3	PV=FV/(1+r)^n.
4	Rates and periods must use compatible units.

Idea	Why it matters
1	Nominal and effective rates differ.
2	More compounding periods can increase effective yield.
3	Day-count convention affects accrual.
4	Product methods weight balances by time.

Idea	Why it matters
1	An annuity has regular equal payments.
2	Ordinary annuity payments occur at period-end.
3	Annuity-due payments occur at period-start.
4	Draw a timeline before selecting a formula.

Idea	Why it matters
1	Annuity FV accumulates each payment.
2	Annuity PV discounts each payment.
3	Annuity-due value shifts one period.
4	At zero rate use the undiscounted payment sum.

Idea	Why it matters
1	Perpetuity is an indefinite payment stream.
2	Its simple PV formula needs positive appropriate rate.
3	Loan repayments can include principal and interest.
4	A reducing balance differs from flat interest.

Idea	Why it matters
1	The simple case maturity isRs.12,000.
2	The compound case maturity isRs.12,100.
3	Two-payment ordinary PV isRs.1,735.54.
4	Round final results consistently.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Simple interest	I=P x r x t; A=P+I	r is a decimal annual rate when t is in years.
Periodic compounding	A=P x(1+j/m)^(m x t)	j=nominal annual decimal rate;m=compounds/year;t=years.
Annual effective rate	(1+j/m)^m -1	Compare on the same annual basis.
Present value	PV=FV/(1+r)^n	r=rate/period;n=matching period count.
Ordinary annuity FV	C x((1+r)^n-1)/r	C paid at each period-end.
Ordinary annuity PV	C x(1-(1+r)^(-n))/r	Discount each end-period payment.
Annuity due	Ordinary-annuity value x(1+r)	Same count and rate, but each payment one period earlier.
Product interest	Sum(balance xdays) xannual rate /day-count base	Use the actual stated 360/365/other convention and correct dates.
Level perpetuity PV	C/r	Positive appropriate periodic rate; first payment one period from now.
Zero-rate annuity	C x n	Use this limiting case instead of dividing by zero.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

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Concept / condition / application
Mathematics — Calculation of Interest And Annuities
Meaning of Interest
Interest can be defined as the price paid by a borrower for the use of a lender’s money.
It is compensation paid to the depositor.
In another words, it is excess of money paid or received on deposits or borrowings.

Concept / condition / application
Interest is the price paid by a borrower for the use of a lender's money. If you borrow (or lend) some money from (or to) a person for a particular period you would pay (or receive) more money than your initial borrowing (or lending).
Types of Interest

Interest can be of two types:

Concept / condition / application
Simple Interest
Compound Interest
Simple Interest:
SI is interest earned on only the original amount, called Principal, lent over a period of time at a certain rate.

Worked figure / record

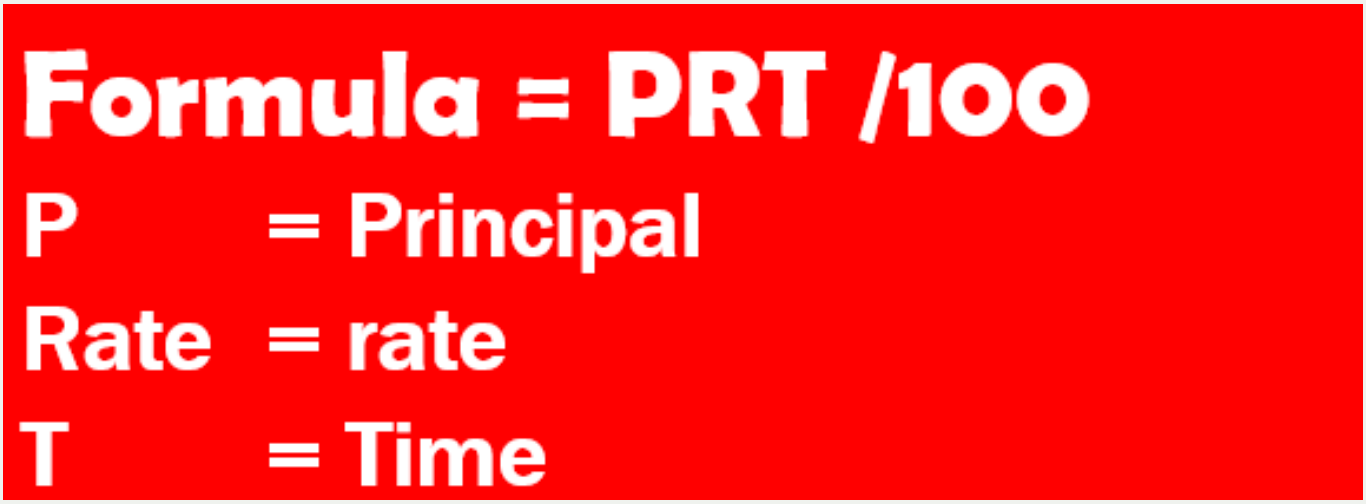


Illustration:

Concept / condition / application
Q.A student purchases a computer by obtaining a loan on simple interest.
The computer costs Rs. 60,000 and the interest rate on the loan is 12% per annum (simple). If, the loan is to be paid back after two years, calculate:
The amount of total interest to be paid,
The total amount to be paid back after 2 years,
Principal: 'P' = Rs. 60,000,

Interest rate: ‘R’ = 12% = 0.12,

Repayment time: T = 2 years

Interest =

Concept / condition / application
PRT = 60,000 × 0.12 × 2 = Rs. 14,400

Find the total amount to be paid back.

Concept / condition / application
Total repayments = Principal + 60000 +14400= Rs. 74,400

Simple interest questions can be solved by applying the following formulas:

I = P × rt

A = P + I Or,

A = P + Prt Or,

A = P(1 + rt)

I = A – P

Concept / condition / application
A: Accumulated amount (final value of a deposit) at the end of the period
P: Principal (initial amount of the deposit)
r: annual interest rate expressed as a decimal fraction
I: interest after t years

Illustration 2:

Concept / condition / application
Mohan invested Rs. 5,000 in a Company’s fixed Deposit with an interest rate of

9.8%. How much interest would he earn in 2 years?

Concept / condition / application
P = Rs.5,000,
r = 9.8%
t = 2 years

Answer

Concept / condition / application
I = P × rt
I = (Rs.5,000) (9.8%) (2) = Rs. 980
Hence, Mohan would earn Rs. 980 in 2 years.
Compound Interest:
CI is interest earned on any previous interests earned as well as on the Principal

lent. It is Interest on interest.

CI= P(1+i)^n- P

A= P(1+i)^n

Concept / condition / application
P = Principal (Initial amount you borrowed or deposited)
r = Annual rate of interest (expressed as fraction, e.g. 6 per cent per annum = 6/100 = 0.06)
n = Number of years for which the amount is deposited
A = Amount of money accumulated after n years including interest.

Frequently compounding of Interest

What if the interest is paid more frequently?

Concept / condition / application
The accumulated amount (A), at the end of one year will be:

Annually = P (1 + r) = Annual compounding

Quarterly = P (1 + r/4)4 = Quarterly compounding

Monthly = P (1 + r/12)12 = Monthly compounding

Concept / condition / application
Interest is computed on an account balance (i.e. a saving account).
However, when interest is added to the principal amount lying in the account versus returning it immediately to the customer, the interest itself will earn interest till the next date for computing the interest. This is known as the compounding of the interest or more simply stated as compound interest.
Compounding Interest: The time interval between which the interest is added to the account
The interest rate together with compounding period and balance in the account

determines how much interest is added in each compounding period.

Concept / condition / application
The basic formula is A = P (1 + r/n) nt
P = the principal
A = the amount accumulated (Principal + Interest)
r = the rate (expressed as fraction, e.g. 6 per cent = 0.06)
n = number of times per year the interest is compounded

Concept / condition / application
t = number of years for which the principal amount is invested
Note: The above explanation is more easily understandable by thinking in terms of a simplified compound interest. When the interest is only compounded once per year (n = 1)

illustration simplifies.

Concept / condition / application
A = P (1 + r)t A = 10,000 (1 + 0.06)1 = 10,600
The following table shows the final accumulated amount (A) after t = 1 year of an account initially with P = 10,000 at 6 per cent interest rate with given compounding (n)

Worked figure / record

	n	*A*
1	(yearly)	10,600
2	(semiannually)	10,609
4	(quarterly)	10,613
12	(monthly)	10,616
52	(weekly)	10,618

Concept / condition / application

If the applicable interest rate and the length of the deposit all remain the

same, more interest is earned by increasing the number of compounding periods per year.

Concept / condition / application

Special Note: When interest is compounded continually (in other words, when n approaches infinity) the compound interest equation takes the form A = Pert where e is approximately 2.71828 (the exponential number).

The Rule of 72: Allows you to determine the approximate number of years before your money doubles with yearly compounding. Here is how to do it; Divide the number 72 by the percentage rate you are paying on your debt (or earning on your investment).

Illustration:

You borrowed Rs.1,000 at 6% interest. Then, 72 divided by 6 is 12. That makes 12 the approximate number of years it would take for your debt to double to Rs. 2,000, if you did not make any payment.

Similarly, a saving account with Rs. 500 deposited in it, earning 4% interest and compounded yearly, will take 18 years for Rs. 500 to double to Rs. 1,000 if you do not make any further deposit, as 72 divided by 4 is 18.

Illustration

Concept / condition / application
The simple interest in 3 years and the compound interest in 2 years on a certain
sum at the same rate are Rs. 1,200 and Rs. 832 respectively. Find
The rate of interest,
The principal,
The difference between the C.I. and S.I. for 3 years

Concept / condition / application
(i)CI(2 year)– SI(2 year) = SI (2 year) * r /200 = PR^2/ 100^2
SI for 3 years = 1200
so for 2 years = 800
832 – 800 = 800* r/ 200
32 = 4 * r

Concept / condition / application
r = 8%
(ii)CI(2 year)– SI(2 year) = PR^2/ 100^2
32 = P*8^2/10000
= 5000
(iii) Amount due after 3 years = Rs. 5,000 × (1 + R)3 =

Concept / condition / application
= 5,000 × 1.2597
= Rs. 6,298.56
Hence, C.I. for 3 years = A – P = 6,298.56 – 5,000 = Rs. 1,298.56
The difference between the C.I. and S.I. for 3 years = `1,298.56 – 1,200 = Rs. 98.56

Illustration

Concept / condition / application
The population of an industrial town is increasing by 5% every year. If the
present population is 1 million, estimate the population five years hence. Also,

estimate the population three years ago.

Solution

Concept / condition / application
Present population, P = 1 million, rate of increase = 5% per annum Hence, the population after 5 years = 10,00,000 (1.05)5 = 12,76,280
Population three years ago = 10,00,000/(1.05)3 = 8,63,838
Since the population three years ago, compounded at 5 per cent, is equal to 1 million, today.
Fixed And Floating Interest Rates

There are two different modes of interest.

Concept / condition / application
Fixed Rates
Floating Rates also called as variable rates.

Fixed Rate:

Concept / condition / application
In the fixed rate, the rate of interest is fixed. It will not change during the entire period of the loan.
For example, if a home loan, taken at an interest rate of 12 per cent, is repayable in 10 years, the rate will remain the same for the entire tenure of 10 years even if the market rate increases or decreases. The fixed rate is, normally, higher than the floating rate, as it is not affected by market fluctuations.

Floating Rate:

Concept / condition / application
In the floating rate or variable rate, the rate of interest changes, depending upon the market conditions. Under floating rate, the interest rate is usually linked to a benchmark rate which could be the MCLR/base rate of the bank or any other benchmark rate of the banking industry.
It may increase or decrease depending upon the change in the benchmark rate.
For example, if a home loan is taken at an interest rate of 12 per cent, repayable in 10 years, in April 2021, and if the benchmark rate increases to 12.5 per cent in April, 2022, the interest rate of this loan will also be increased to 12.5 per cent. If the loan is under an EMI system, depending upon the change in interest rate, the repayment period varies, but equated monthly instalment remains the same. However, the borrower may choose to have the repayment period same and pay a higher EMI.
Front-End And Back-End Interest Rates
If the interest is deducted from the principal amount and only the net amount is disbursed, it is called front-end interest.

For example, when the bank discounts a bill, the interest applicable for the tenure of the bill is calculated and is deducted from the bill amount along with other charges and the net amount is paid to the customer.

However, the normal practice in banking industry is to charge back-end interest rate which means that the full amount of the loan is disbursed and the interest is charged subsequently on monthly/quarterly/agreed basis.

For example, in a term loan, the interest is calculated on the actual daily balances in the account during a period and applied at the end of the period. Obviously, the frontend

interest application results in effective interest rate being more as the borrower gets less amount for use whereas, the interest is applied on the full amount.

Concept / condition / application
Calculation Of Interest Using Products/Balances
Calculation of front-end interest like in bill discounting is easy as the amount is assumed to be constant over the entire period.
For example, if the tenure of the bill of Rs.2 lac is 3 months and the rate of discount is 16% p.a., the interest amount will be Rs.8,000.
In banks, many of the cases of deposit and loan accounts involve calculation of interest on the basis of daily balance in the customer’s account.
While this method was prevalent in case of the loan accounts, even in case of Savings Account, the interest is now required to be calculated on the basis of daily balances.

Concept / condition / application
In this method, the closing balance in the account is multiplied by the number of days for which that balance remains unchanged.
Such products are calculated for the entire period for which the interest is to be applied.

Concept / condition / application
The sum of such products is multiplied by the applicable interest rate and divided by 365(No. of days in a year).

The following illustration will clarify this. Illustration The following table

Concept / condition / application
shows date-wise closing debit balances in the cash credit account of customer
for the month of June 2022, and the calculation of products.

Worked figure / record

Date	Balance	No. of Days	Product
1/6/2019	10,000	5	50,000
6/6/2019	15,000	4	60,000
10/6/2019	12,000	5	60,000
15/6/2019	10,000	7	70,000
22/6/2019	22,000	4	88,000
26/6/2019	20,000	4	80,000
30/6/2019	18,000	1	18,000

CHECK THE DATE LABEL

The historical product table is labelledJune 2019 while its explanatory paragraph calls itJune 2022. Both shown calculations use the stated 30 day balance sequence and 365 day convention;the total product 426,000 givesRs.175.07 at 15%, orRs.175.1 to one decimal. Do not silently change an actual transaction date.

Concept / condition / application
The total of the products is 426,000.
If the interest rate is 15% p.a., the interest for the month of June 2022 will be (426,000 *0 .15)/365 = Rs. 175.1.
Alternatively,
[(10000 * 15% * (5/365)) + (15000 * 15% * (4/365)) + · · · + (18000 * 15% *(1/365) = 175.1
Annuities

Concept / condition / application
What are Annuities?

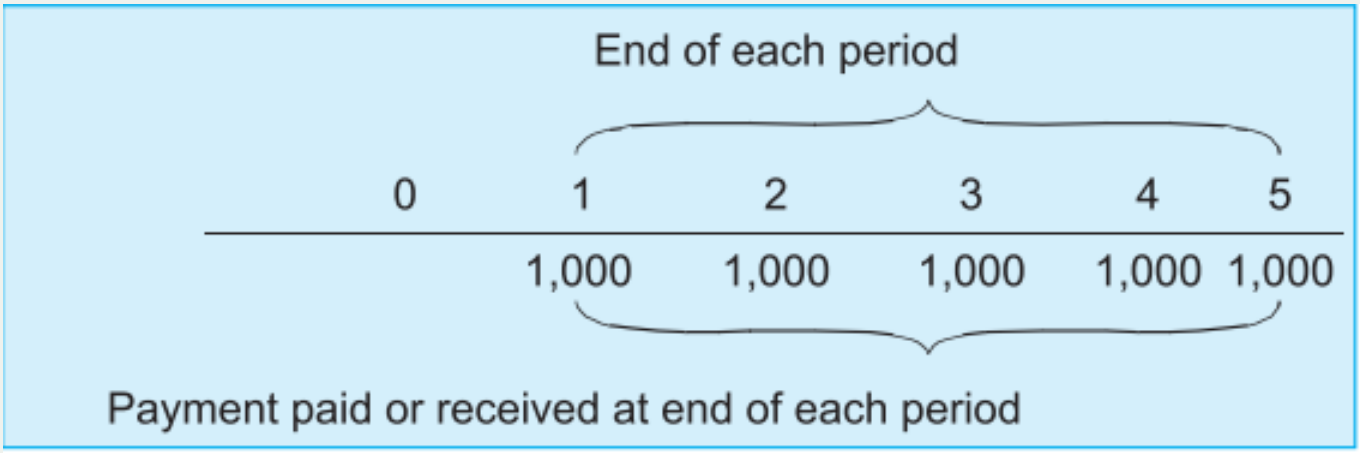
At some point in your life, you may have had to make a series of fixed payments over a period of time –such as rent or car payments-or have received a series of payments over a period of time, such as bond coupons. These are called annuities. (Regular periodic payment)

Concept / condition / application
Ordinary Annuity: Payment are required at the end of each period. For an illustration, straight bonds usually make coupon payments at the end of every six months until the bond's maturity date.
Annuity Due: Payments are required at the beginning of each period. Rent is an illustration of annuity due. You are usually required to pay rent when you first move in at the beginning of the month, and then on the first of each month thereafter.
Calculating The Future Value Of An Ordinary Annuity
If you know how much you can invest per period for a certain time period, the future value of an ordinary annuity formula is useful for finding out how much you would have in the future by investing at your given interest rate.
If you are making payments on a loan, the future value is useful for determining the total cost of the loan.

Let us now run through the illustration 1.

Consider the following annuity cash flow schedule:

Worked figure / record



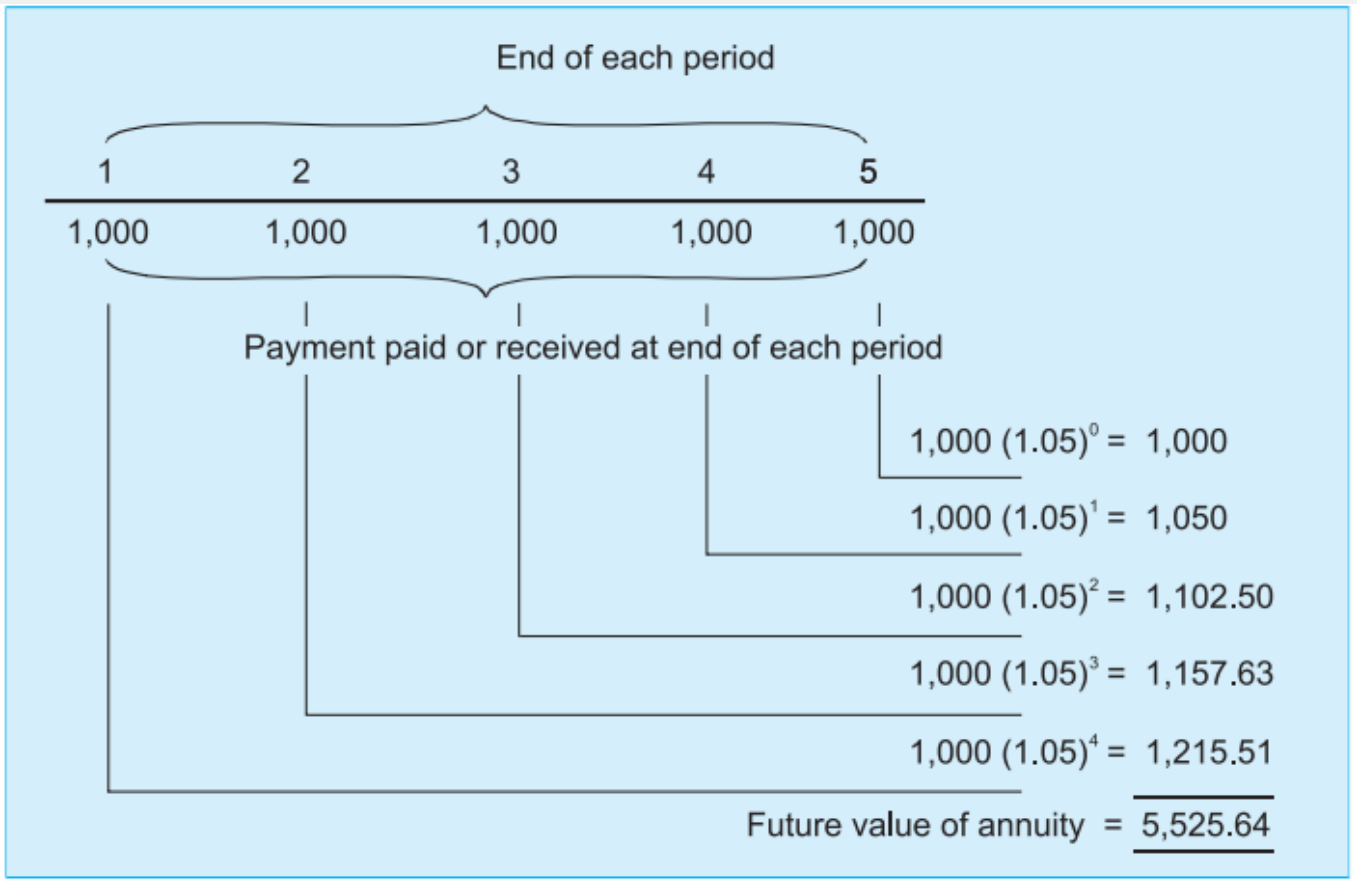
Concept / condition / application
In order to calculate the future value of the annuity, we have to calculate the future value of each cash flow.
Let us assume that you are receiving Rs. 1,000 every year for the next five years, and you invest each payment at 5%.

Concept / condition / application

The following diagram shows how much you would have at the end of the five-year

period:

Worked figure / record



Worked figure / record

$$\text{FV (Ordinary Annuity)} = C * \left[\frac{(1+i)^n - 1}{i} \right]$$

C = Cash flow per period

i = interest rate

n = number of payments

If we were to use the above formula for the illustration 1 above, this is the result:

$$\text{FV (Ordinary Annuity)} = 1,000 * \left[\frac{(1+.05)^5 - 1}{.05} \right]$$
$$= 1,000 * [5.53]$$
$$= 5,525.63$$

ANNUITY CHECK - FULL PRECISION THEN ROUND

ForRs.1,000 each period,5 periods and 5%: ordinaryFV=Rs.5,525.63;ordinaryPV=Rs.4,329.48;dueFV=Rs.5,801.91;duePV=Rs.4,545.95. Some older diagrams differ by a few paise because their intermediate factors were rounded. Use the native formula map and round the final result consistently.

Concept / condition / application
Q. If Rs. 10000 is deposited at the end every year, how much amount will be

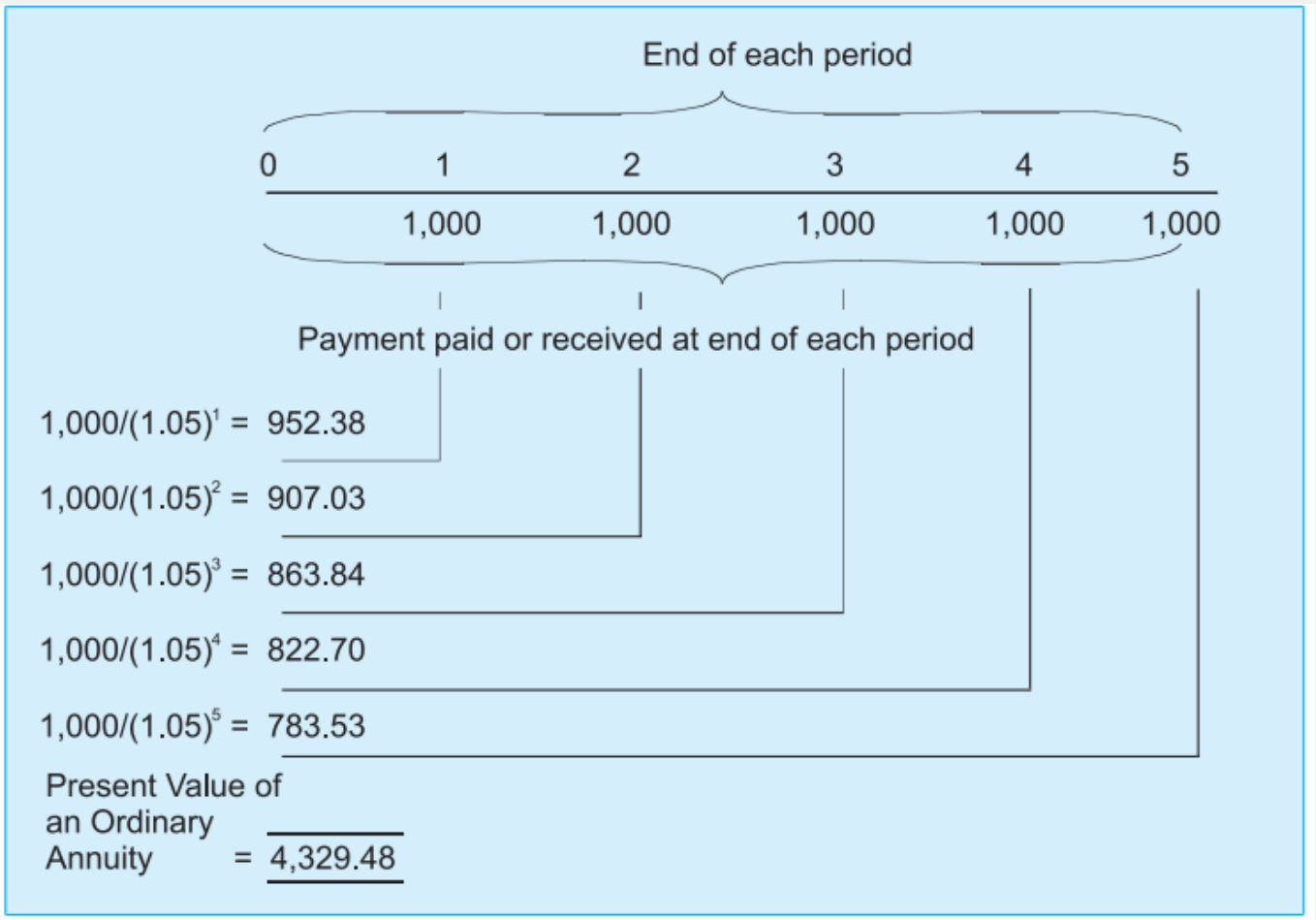
received after 5 years at 10% p.a. interest.

Concept / condition / application
= 10000 [1.10^5 -1]/ .10
= Rs.61051
Calculating The Present Value Of An Ordinary Annuity
If you would like to determine today’s value of a series of future payments, you need to use the formula that calculates the present value of an ordinary annuity.
You would use this formula as part of a bond pricing calculation.

Concept / condition / application
The PV of ordinary annuity calculates the present value of the coupon payments that you will receive in the future.

For the illustration

Worked figure / record



Worked figure / record

$$\text{PV (Ordinary Annuity)} = C * \left[\frac{(1+r)^n - 1}{r(1+r)^n} \right]$$

C = Cash flow per period

r = interest rate

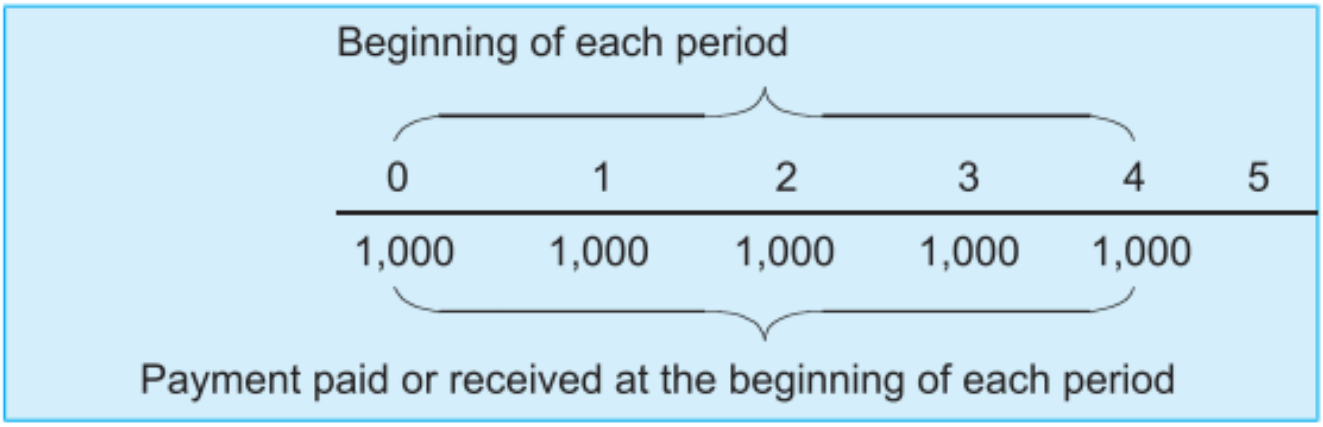
n = number of payments

The formula provides us with the PV in a few easy steps. Here is the calculation of the annuity represented in the diagram for Illustration 2:

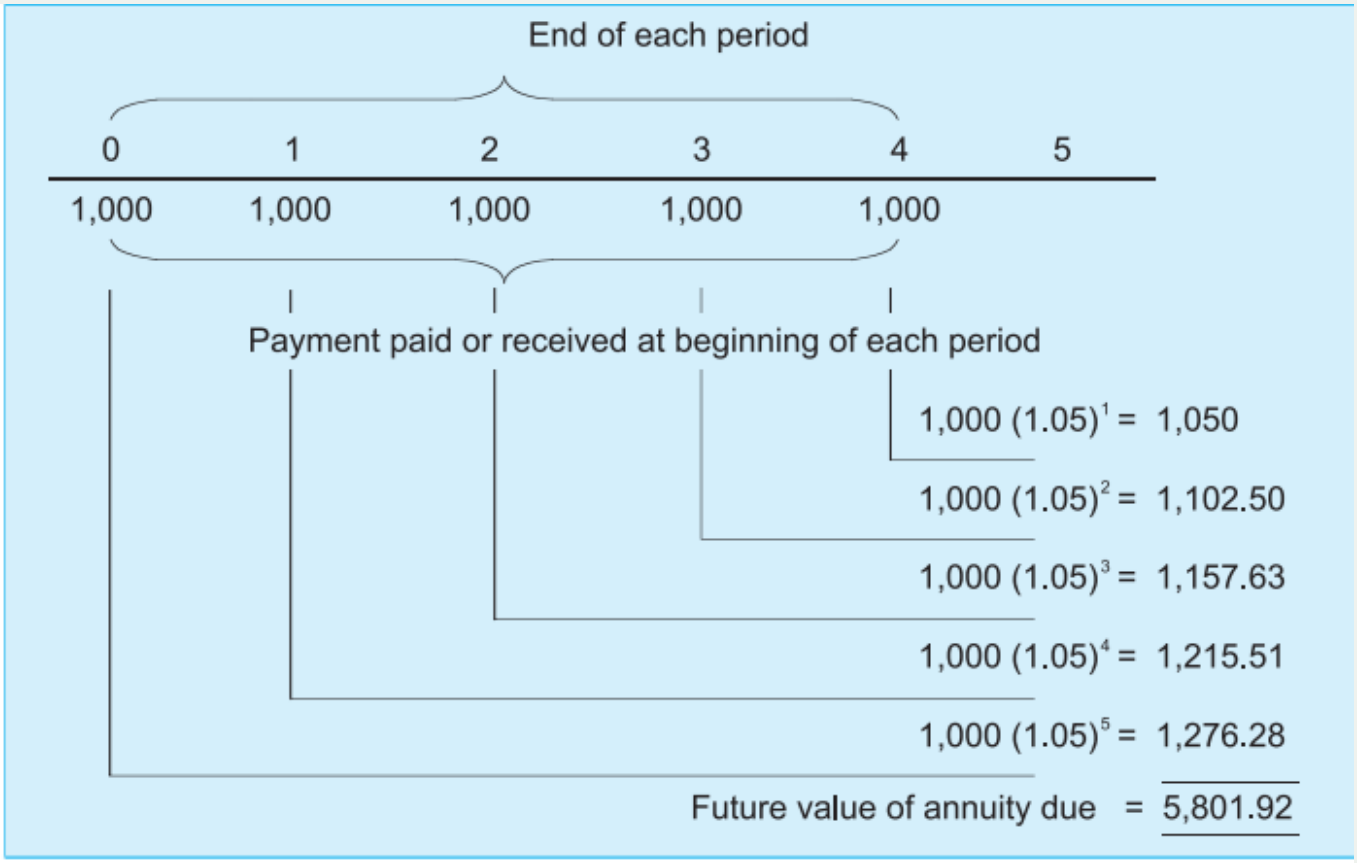
$$\begin{aligned}\text{PV (Ordinary Annuity)} &= 1,000 * \left[\frac{(1+.05)^5 - 1}{0.05(1.05)^5} \right] \\ &= 1,000 * \left[\frac{0.27628}{0.05(1.27628)} \right] \\ &= 1,000 * \frac{0.27628}{0.063814} \\ &= 1,000 * 4.3295 \\ &= 4,329.45\end{aligned}$$

Concept / condition / application
Calculating The Future Value Of An Annuity Due
When you are receiving or paying cash flows for an annuity due, your cash flow schedule would appear as follows: Since, each payment in the series is made one period sooner; we need to discount the formula one period later.
A slight modification to the FV-of-an-ordinary-annuity formula accounts for payments occurring at the beginning of each period.

Worked figure / record



Worked figure / record



Worked figure / record

$$FV\ (\text{Annuity Due}) = C * \left[\frac{(1+i)^n - 1}{i} \right] * (1+i)$$

Therefore,

$$FV\ (\text{Annuity Due}) = 1{,}000 * \left[\frac{(1+.05)^5 - 1}{.05} \right] * (1+.05)$$

$$= \text{Rs. } 1{,}000 * 5.53 * 1.05$$

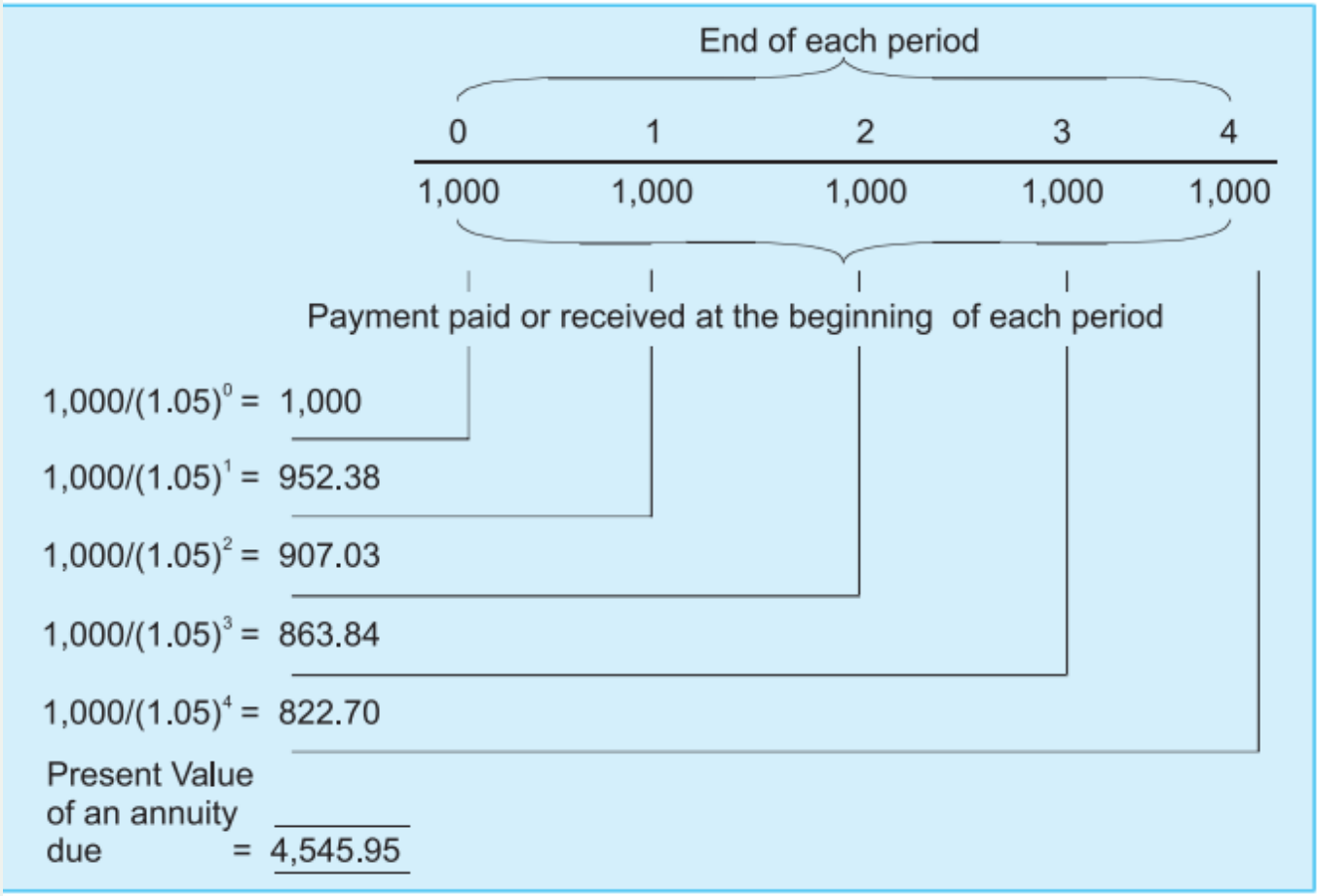
$$= \text{Rs. } 5{,}801.91$$

Concept / condition / application
Calculating The Present Value Of An Annuity Due

Concept / condition / application
For the present value of an annuity due, we need to discount the formula one period forward, as the payments are held for a lesser amount of time.
When calculating the present value, we assume that the first payment made was today.
We could use this formula for calculating the present value of your future rent payments as specified in a lease you sign with your landlord. Let us say for the illustration that you make your first rent payment at the beginning of the month
and are evaluating the present value of your five-month lease on that same day.

Your present value calculation would work as follows:

Worked figure / record



Worked figure / record

$$PV\ (\text{Annuity Due}) = C * \left[\frac{(1+r)^n - 1}{r(1+r)^n}\right] \times (1+r)$$

Therefore,

$$PV\ (\text{Annuity Due}) = 1{,}000 \times \left[\frac{(1.05)^5 - 1}{.05(1.05)^5}\right] \times 1.05$$

$$= 1{,}000\left[\frac{0.27628}{0.063814}\right] \times 1.05$$

$$= 1{,}000 \times 4.3295 \times 1.05 = 4{,}545.92$$

Annuity formula map

Measure	Ordinary annuity	Annuity due
FV	C x ((1+r)^n -1)/r	Ordinary FV x(1+r)
PV	C x (1-(1+r)^(-n))/r	Ordinary PV x(1+r)
Symbols	C=payment per period; r=rate per period; n=payment count	Ordinary=end-period; due=beginning-period
Historical label	The older formula summary repeats FV beside a present-value expression.	Use the corrected PV/FV distinction above.

Concept / condition / application
Repayment Of A Debt
A debt is required to be repaid as per the terms of the contract with lender.
In the banking industry in India, the following three methods of repayment are common.

Historical formulation: Equal monthly/quarterly installment of principal plus the interest applied during the period. Equated monthly/quarterly installment covering both the principal and the interest. Bullet/balloon repayment under which the entire loan amount is repaid at the end of the period with accumulated interest. Alternatively, the interest is paid periodically, as and when applied, and the principal amount of the loan is paid at the end of the contract period.

CLARIFICATION / 1 NOVEMBER 2026

Equal principal payments differ from equal total instalments. A reducing-balance loan computes interest on the outstanding principal; state the repayment convention and adjust final rounding.

These are discussed below in detail.

Equal monthly/quarterly installment of principal plus the interest applied during the period.

Illustration

Your friend has borrowed Rs.1,000 from you and wants to repay you on a monthly basis rather than the whole amount all at once at the end of the year. The important point here is that he will owe you less in principal each month.

Concept / condition / application
The applicable rate of interest 8% p.a. means 0.667% per month.
Calculation:
The principal payment each month will be Rs. 83.33 (1,000/12)
First month: Interest = 1,000 × 0.667% × 1 = 6.67 + 83.33 =Rs. 90.
The principal owed at the end of the month is Rs. 916.67.

Concept / condition / application
Second month: Interest = 916.67 × 0.667% × 1 = 6.11 + 83.33 = 89.44.
Third month: Interest = 833.34 × 0.667% × 1 = 5.56 + 83.33 = 88.89.

And so on for the twelve months.

Worked figure / record

Balance	Principal Payment	Interest Payment	Total Payment
1,000.00	83.33	6.67	90.00
916.67	83.33	6.11	89.44
833.34	83.33	5.56	88.89
750.01	83.33	5.00	88.33
666.68	83.33	4.44	87.77
583.35	83.33	3.89	87.22
500.02	83.33	3.33	86.66
416.69	83.33	2.78	86.11
333.36	83.33	2.22	85.55
250.03	83.33	1.67	85.00
166.70	83.33	1.11	84.44
83.37	83.33	0.56	83.89
	999.96	43.34	1,043.30

CLOSE THE ROUNDING BALANCE

Twelve principal payments ofRs.83.33 totalRs.999.96, leavingRs.0.04 of aRs.1,000 loan. With eleven payments atRs.83.33, the final principal payment must beRs.83.37 to close it, with interest calculated on the actual remaining balance under the agreed convention.

POPULATION EXAMPLE - ROUNDING CHECK

With present population 1,000,000 and 5% annual compound growth, the five-year projection is 1,000,000 x 1.05^5=1,276,281.56, or 1,276,282 people when rounded to a whole person. The older 1,276,280 figure uses a rounded factor. Three years earlier gives 1,000,000/1.05^3=863,837.60, or 863,838 people.

Apply your understanding: original practice

1. What creates the extraRs.100 under annual compounding?

Answer and reason

The first year'sRs.1,000 interest earns 10% in year two. Principal alone explains simple interest.

2. Can you use 12% annual nominal directly as a monthly rate?

Answer and reason
No. Under monthly nominal compounding, the periodic rate is 12%/12=1%, with the relevant monthly period count.

3. Why is an annuity due worth more at a positive rate?

Answer and reason
Each payment is received one period earlier, so it is discounted for one fewer period or accumulates for one more.

4. What happens to an annuity formula when the rate is zero?

Answer and reason
Use payment x number of payments. The usual formula containing division by the rate must be handled by its limit.

5. Does every equal principal instalment produce an equal total payment?

Answer and reason
No. If interest is on the reducing balance, equal principal plus declining interest normally produces falling total payments.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Principal is the amount initially invested.	15. Annuity-due payments occur at period-start.
02. Interest compensates for use of funds.	16. Draw a timeline before selecting a formula.
03. Simple interest uses principal throughout.	17. Annuity FV accumulates each payment.
04. Compound interest includes prior interest.	18. Annuity PV discounts each payment.
05. SI=P x r x t with decimal r.	19. Annuity-due value shifts one period.
06. FV=P x(1+r)^n for matching periods.	20. At zero rate use the undiscounted payment sum.
07. PV=FV/(1+r)^n.	21. Perpetuity is an indefinite payment stream.
08. Rates and periods must use compatible units.	22. Its simple PV formula needs positive appropriate rate.
09. Nominal and effective rates differ.	23. Loan repayments can include principal and interest.
10. More compounding periods can increase effective yield.	24. A reducing balance differs from flat interest.
11. Day-count convention affects accrual.	25. The simple case maturity isRs.12,000.
12. Product methods weight balances by time.	26. The compound case maturity isRs.12,100.
13. An annuity has regular equal payments.	27. Two-payment ordinary PV isRs.1,735.54.
14. Ordinary annuity payments occur at period-end.	28. Round final results consistently.

MODULE C / C 04

Financial Mathematics - Calculation of YTM

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A one-year bond paysRs.80 coupon andRs.1,000 redemption. At 10% required yield, price=(80+1,000)/1.10 =Rs.981.82. Its 8% coupon is fixed by par value; current yield is 80/981.82=8.15%, while YTM is 10% under these cash-flow assumptions. These percentages answer different questions.

Change the situation

If required yield falls to 8%, the same promisedRs.1,080 has priceRs.1,000. For unchanged promised positive cash flows, lower yield means higher price.

COMMON MISTAKE - WHY IT FAILS

Macaulay duration is a weighted average receipt time. Modified duration estimates percentage price sensitivity for small yield changes. The two are related but are not identical, and convexity matters for larger movements.

Build the connections

Idea	Why it matters
1	A bond price discounts promised cash flows.
2	Coupon rate applies to face value.
3	Current yield uses annual coupon/current price.
4	YTM solves a full cash-flow valuation.

Idea	Why it matters
1	Price and yield usually move inversely.
2	Discount bonds can have YTM above coupon.
3	Premium bonds can have YTM below coupon.
4	Par price links coupon and yield under matching assumptions.

Idea	Why it matters
1	Redemption amount may differ from quoted price.

Idea	Why it matters
2	Coupon frequency changes periodic cash flows.
3	Use periodic yield with periodic counts.
4	Clean and dirty prices differ by accrued interest.

Idea	Why it matters
1	Zero-coupon value discounts redemption only.
2	A perpetuity formula needs its stated assumptions.
3	Interpolation estimates a root.
4	A numerical solver can refine the answer.

Idea	Why it matters
1	YTM is not a guaranteed realised return.
2	Default and reinvestment assumptions matter.
3	Macaulay duration is a weighted receipt time.
4	Modified duration measures local price sensitivity.

Idea	Why it matters
1	Convexity improves larger-change approximation.
2	A zero-coupon Macaulay duration equals maturity.
3	Coupon payments generally shorten weighted receipt time.
4	A duration shortcut needs a yield convention.

Idea	Why it matters
1	Case price at 10% isRs.981.82.
2	Case current yield is about 8.15%.
3	At 8% required yield case price is par.
4	Explain percentage points versus percentage changes.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Annual-coupon bond price	P=sum(C/(1+y)^t)+F/(1+y)^n	C=annual coupon;F=redemption;n=years;y=annual yield.
Semiannual coupon bond	P=sum((C/2)/(1+y/2)^t)+F/(1+y/2)^(2 n)	A nominal annual yield compounded semiannually is assumed.
Current yield	Annual coupon/current bond price	It excludes the redemption gain/loss and timing effects.
Macaulay duration	sum(t xPV(cash flow at t))/price	Express t in the stated time unit.
Modified duration	Dmac/(1+y/m)	y=nominal annual yield with m compounds/year; conventions must match.
Small yield-change estimate	Change in price/price ≈ -Dmod xchange in yield	A 1 percentage-point change is 0.01, not 1.
Signed yield elasticity	Approximately -Dmod x y	A magnitude convention must be explicitly labelled.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Meaning of Debt

Debt means a sum of money due by one party to another. Most business need a mix of debt and equity to run their operations. This is called the capital structure of that

firm/company.

Debts can arise through bank borrowings, fixed deposits, bonds or other instruments. Where the amount is fixed and specific, and does not depend upon any future valuation to settle it.

Concept / condition / application
Bonds

Debt Capital Consists of mainly bonds and debentures.

Concept / condition / application
What are Bonds?
Bonds are issued by organizations generally for a period of more than one year to

raise money by borrowing.

Organizations in order to raise capital issue bond to investors which is nothing but a financial contract, where the organization promises to pay the principal amount and interest (in the form of coupons) to the holder of the bond after a certain date. (Also called maturity date). Some Bonds do not pay interest to the investors, however it is mandatory for the issuers to pay the principal amount to the investors.

Concept / condition / application
Why Investment is Important?

Every individual needs to put some part of his income into something which would benefit him in the long run. Investment is essential as unavoidable circumstances can arise anytime and anywhere. One needs to invest money into something which would guarantee maximum returns with minimum risks in future. Money saved now will help you overcome tough times in the best possible way.

Concept / condition / application
Characteristics of a Bond
Face value: Also known as, the par value and stated on the face of the bond. It represents the amount borrowed by the firm, which it promises to repay after a specified period.
Coupon rate: A bond carries a specific rate of interest, which is also called as the coupon rate.
Market value: A bond may be traded on a stock exchange. Market value is the price at which the bond is usually bought or sold in the market. Market value may be different from the par value or the redemption value.
Redemption Value: The value, which the bondholders gets on maturity. Is called the redemption value, A bond is generally issued at a discount (less than par value) and redeemed at par.

Concept / condition / application
Maturity date: Maturity date refers to the final date for the payment of any financial product when the principal along with the interest needs to be paid to the investor by the issuer.
Types of Bonds

Following are the types of bonds:

Concept / condition / application
Fixed Rate Bonds: In Fixed Rate Bonds, the interest remains fixed through out the tenure of the bond. Owing to a constant interest rate, fixed rate bonds are resistant to changes and fluctuations in the market.
Floating Rate Bonds: Floating rate bonds have a fluctuating interest rate (coupons) as per the current market reference rate.
Zero Interest Rate Bonds: Zero Interest Rate Bonds do not pay any regular interest to the investors. In such types of bonds, issuers only pay the principal amount to the bond holders.
Inflation Linked Bonds: Bonds linked to inflation are called inflation linked bonds. The interest rate of Inflation linked bonds is generally lower than fixed rate bonds.
Perpetual Bonds: Bonds with no maturity dates are called perpetual bonds. Holders of perpetual bonds enjoy interest throughout.

Concept / condition / application
Subordinated Bonds: Bonds which are given less priority as compared to other bonds of the company in cases of a close down are called subordinated bonds. In cases of liquidation, subordinated bonds are given less importance as compared to senior bonds which are paid first.
Bearer Bonds: Bearer Bonds do not carry the name of the bond holder and anyone who possesses the bond certificate can claim the amount. If the bond certificate gets stolen or misplaced by the bond holder, anyone else with the paper can claim the bond amount.
Covered bond: Covered bond are backed by cash flows from mortgages or public sector assets. Contrary to asset-backed securities the assets for such bonds remain on the issuers balance sheet.
A Government Band: A government band, also called Treasury bond, is issued by a national government and is not exposed to default risk.
Optionality In Bonds

Concept / condition / application
Occasionally a bond may contain an embedded option; that is, it grants option-like

features to the holder or the issuer:

Concept / condition / application
Callability: Some bonds give the issuer the right to repay the bond before the maturity date on the call dates. This is call option. These bonds are referred to as callable bonds. Most callable bonds allow the issuer to repay the bond at par. With some bonds, the issuer has to pay a premium, the so-called call premium.
Putability- Some Bonds give the holder the right to force the issuer to repay the bond before the maturity date on the put dates. This is put option. These are referred to as retractable or putable bonds.
Valuation of Bonds

A security/Bond can be regarded simply as an asset that pay a series of dividends or interests over a period. Therefore, the value of any security can be defined as the present value of these future cash streams, i.e, the intrinsic value of an assets is equal to the present value of the benefits associated with it. It is quite clear that the holder of a bond receives a fixed annual interest payment for a certain value (equal to par value) at the time of maturity. Therefore the intrinsic value of the present value of a bond is

Worked figure / record

$$V_0 = \sum_{t=1}^{n} \frac{I}{(1+kd)^t} + \frac{F}{(1+kd)^n}$$

Concept / condition / application
Vo=intrinsic value of the bond
I= Annual interest payable on the bond
F= Redeemable value of the bond
n= Maturity period of the bond
kd= Cost of capital

Note: Solving the problems related to bond valuation, usually Present value Interest Factor of Annuity pertaining to the applicable interest rate are provided. PVIF represents the discount value of one Rupee for the period concerned and interest rate while PVIFA represents the present value of an ordinary annuity for the period concerned and interest rate. Example- PVIF (10%, 6) means present value of one Rupee to be received after 6 periods at the interest rate of 10% period. PVIFA (10%,6) means present value of an ordinary annuity one Rupee per period for 6 period at the interest rate of 10% per period.

Example:

A bond, whose par value is Rs 1000, bears a coupon rate of 12% and has a maturity period of 3 years. The required rate of return on the bond is 10%. What is the value of this bond?

Solution-

Concept / condition / application
Annual interest payable= 1000* 12%=120
Principle repayment at the end of 3 years= Rs 1000
The value of the bond
120(PVIFA 10%, 3 yrs) + 1000 (PVIF 10%, 3 yrs)
=120(2.487)+1000(0.751)

Concept / condition / application
=298.44+ 751
=1049.44
Bond Value with Semi- Annual Interest

If the Bond carries a semi-annual, as the amount of the half-yearly interest can be reinvested, the value of such bonds would be more the value of bonds with an annual interest payment. Hence, by multiplying the numbers of years to maturity by two and dividing the (i) annual interest payment, (ii) discount rate by two we can modify bond valuation formula as follows:

Worked figure / record

$$V_0 = \sum_{t=1}^{2n} \frac{I/2}{(1 + kd/2)^t} + \frac{F}{(1 + kd/2)^n}$$

Example:

A bond, whose par value is Rs 1000 bears a coupon rate of 12% payable semiannually and has a maturity period of 3 years. The required rate of return on bonds is 10%. What is the value of this bond?

Solution-

Concept / condition / application
Semi-annual interest payable= 1000*12%/2=60
Principal repayment at the end or 3 years=1000
The value of the bond
=60(PVIFA 10%/2, 6 dps)+ 1000(PVIF 10%/2, 6 pds)
=60 (5.0746)+ 1000 (0.746)

Concept / condition / application
=304.48+ 746
=1050.48
Current Yield on Bond
Current yield represents the prevailing interest rate that a bond or fixed income security is delivering to its owners.

The formula for current yield is defined as follows:

Concept / condition / application
CY = Annual interest payment / Current Bond Price

For example, let's assume a particular bond is trading at par, or 100 cents on the dollar, and that it pays a coupon rate of 3%. In this case, the bond's current yield will also be 3% (as shown below).

Concept / condition / application
CY = 3 / 100 = 3.00%

However, let's now assume that the same bond is trading at a discount to its par value. For the sake of example, let's say investors can now purchase the bond for just 95 cents on the dollar. In this case, even though the bond will still be paying a 3% coupon, its current yield will actually be slightly higher (as shown below):

Concept / condition / application
CY = 3 / 95 = 3.16%

As another example, let's say the bond is trading at a premium to its face value -- 110 cents on the dollar. In this case, even though the bond will still be paying a 3% coupon, its current yield will actually be quite a bit lower (as shown below):

Concept / condition / application
CY = 3 / 110 = 2.73%

Concept / condition / application
Use our Yield to Call (YTC) Calculator to measure your annual return if you hold a particular bond until its first call date.
Use our Yield to Maturity (YTM) Calculator to measure your annual return if you plan to hold a particular bond until maturity.
Yield-To- Maturity of Bond

It is the rate of return earned by an investor, who purchases a bond and holds it until the maturity. The YTM is the discount rate, which equals the present value of promised cash flows to the current market price/ Purchase price.

Example:

Consider a Rs 1000 par value bond, whose current market price is Rs 850/-, The bond carries a coupon rate of 8% and has the maturity period of 9 yrs. What would be the rate of return that an investor earns if he purchase the bond and holds until maturity?

Solution:

Concept / condition / application
If kd is the yield to maturity then,
850=80 (PVIFA kd %, 9 yrs)+1000 (PVIF kd, 9 yrs)
To calculate the value of kd, we have to try several values:
=80(PVIFA 12%, 9)+1000(PVIF 12% , 9)
=80*5.328+1000*(0.361)

Historical formulation: =426.24+361=787.24

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Interpolation needs parentheses: y≈y_low+(y_high-y_low)x(P_low-P_market)/(P_low-P_high). It is approximate; the exact yield solves the cash-flow price equation. Retain stated rounded factors only as an illustration.

Concept / condition / application
Since, the above value is less than 850, we have to try with value less than 12%. Let us try with kd=10%
=80(PVIFA 10%,9)+ 1000(PVIF 10%,9)
=80*5.759+1000*0.424
=884.72

Form the above it is clear that kd lies between 10% and 12%. We have to use linear interpolation in the range of 10% and 12%. Using it, we find that kd is equal to the following:

Concept / condition / application
=10%+(12%-10%)*884.72-850/884.72-787.24
=10%+2%*34.72/97.48
=10.71%
Therefore, the yield to maturity is 10.71%
Duration of Bond

Concept / condition / application
What Is The Duration Of A Bond?

Historical formulation: The duration of a bond expresses the sensitivity of the bond price to changes in the interest rate. In other words, the bond duration measures the movement in the price of the bond for every 1% change in the interest rate.

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Distinguish Macaulay duration (cash-flow-weighted time) from modified duration (local price sensitivity). The 1 percentage-point yield shortcut is an approximation with a stated yield convention; zero-coupon Macaulay duration equals maturity.

The unit of bond duration is expressed in years. Also, the price of the bond and the interest rates are inversely related. Therefore, if a bond has a duration of 5 years, it signifies that for every 1% increase in the interest rate, the price of the bond will fall by

5% and vice-a-versa. The greater is the bond duration, the greater will be the amplification in the movement of bond price for every single unit of change of the interest rates.

There is a simple way of computing the desired duration period:

Concept / condition / application
Determine the cash flows from holding the bond.
Determine the present value of these cash flows by discounting the flows with discount rate. (YTM)
Multiply each of the present values by respective numbers of years left before the present value is received.
Sum these products up and divide by the present value to get the duration of the bond.
Properties of Duration

Concept / condition / application
Duration is less than the term to maturity
Bond’s duration will be equal to its term to maturity if and only if it is a zero coupon bond
The duration of perpetual bond is equal to (1+r)/r, where r=current yield of the bond’

Concept / condition / application
Longer a coupon paying bond’s term to maturity, the greater the difference between its term to maturity and duration.
Duration and YTM are inversely related.

Concept / condition / application
Lager the coupon rate, smaller the duration of a bond
An increase in the frequency of coupon payments decrease the duration, while a decrease in frequency of coupons increases it. Duration of a bond declines as the bond approaches maturity.
Bond Price Volatility

The sensitivity of the bond price to changes in the interest rates is called “Bond Volatility”. Bond prices and YTM are inversely related. Therefore, instantaneous changes in market yields cause prices to changes in the opposite direction. The extent of change in the bond princes for a change in YTM measures the interest rate risk of a bond. The interest rate risk is a function of the interest rate elasticity. Interest rate elasticity (IE) can be defined as:

Historical formulation: IE= Percentage change in price for bond In period t/Percentage change in yield to maturity for bond

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For a plain fixed-cash-flow bond, signed price/yield elasticity is negative: approximately -Dmod x y. With annual compounding, Dmod=Dmac/(1+y). If using a magnitude, explicitly omit the sign rather than claiming a positive expression is negative.

Concept / condition / application
Interest rate elasticity is always a negative number, due to the inverse relationship between YTM and bond prices.
Bond price elasticity can also be computed with the help of following mathematical formula:
IE= D* YTM/1+YTM

The above equation suggests that the duration and interest rate elasticity of a bond are directly related. Anything that causes the duration of a bond to increase will also increase the bond’s interest rate elasticity.

PRECISION CHECK FOR THE OLDER BOND EXAMPLES

Using full-precision discounting, theRs.1,000 par,12% coupon, three-year bond at 10% yield isRs.1,049.74 with annual coupons, andRs.1,050.76 with semiannual coupons and a 5% half-year yield. OlderRs.1,049.44/Rs.1,050.48 results reflect rounded table factors. ForRs.80 annual coupon, Rs.1,000 redemption, nine years andRs.850 price, the numerical YTM is about 10.6749%;the older 10.71% is a rounded-factor linear interpolation estimate.

Apply your understanding: original practice

1. Why is the case bond below par at 10%?

Answer and reason
Its 8% coupon is below the required return; a lower purchase price compensates through the redemption gain.

2. Is current yield the same as YTM?

Answer and reason
No. Current yield considers coupon/current price; YTM also incorporates redemption and payment timing.

3. What happens to this bond's price when yield falls?

Answer and reason
It rises because the same future cash is discounted at a lower rate.

4. Does Macaulay duration 5 mean an exact 5% price fall for a 1 percentage-point yield rise?

Answer and reason
No. Modified duration, with matching yield convention, provides a local approximation; larger changes require convexity analysis.

5. Is a YTM calculation proof of the actual realised return?

Answer and reason
No. Actual payment, sale price, holding period and reinvestment outcomes can differ from valuation assumptions.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. A bond price discounts promised cash flows.	15. Interpolation estimates a root.
02. Coupon rate applies to face value.	16. A numerical solver can refine the answer.
03. Current yield uses annual coupon/current price.	17. YTM is not a guaranteed realised return.
04. YTM solves a full cash-flow valuation.	18. Default and reinvestment assumptions matter.
05. Price and yield usually move inversely.	19. Macaulay duration is a weighted receipt time.
06. Discount bonds can have YTM above coupon.	20. Modified duration measures local price sensitivity.
07. Premium bonds can have YTM below coupon.	21. Convexity improves larger-change approximation.
08. Par price links coupon and yield under matching assumptions.	22. A zero-coupon Macaulay duration equals maturity.
09. Redemption amount may differ from quoted price.	23. Coupon payments generally shorten weighted receipt time.
10. Coupon frequency changes periodic cash flows.	24. A duration shortcut needs a yield convention.
11. Use periodic yield with periodic counts.	25. Case price at 10% isRs.981.82.
12. Clean and dirty prices differ by accrued interest.	26. Case current yield is about 8.15%.
13. Zero-coupon value discounts redemption only.	27. At 8% required yield case price is par.
14. A perpetuity formula needs its stated assumptions.	28. Explain percentage points versus percentage changes.

MODULE C / C 05

Financial Mathematics - Forex Arithmetic

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A bank quotes USD/INR 83.20/83.30: it buys USD atRs.83.20 and sells USD atRs.83.30, assuming the quotation is INR perUSD. A customer buysUSD 1,000 and pays 1,000 x 83.30 =Rs.83,300 before charges. SellingUSD 1,000 instead yieldsRs.83,200. First identify base currency, price currency and the bank's side.

Change the situation

If the ask becomes 83.50, the same purchase costsRs.83,500, an extraRs.200. Inverting a bid/ask quote requires taking reciprocals and reversing the sides; do not invert each number without reordering.

COMMON MISTAKE - WHY IT FAILS

Forward points are a price differential, not a certain forecast of the future spot rate. Direct/indirect labels need a stated home-currency perspective.

Build the connections

Idea	Why it matters
1	Every exchange quote has two currencies.
2	State what one unit buys.
3	Bid is the quoting dealer's buying side.
4	Ask is the dealer's selling side.

Idea	Why it matters
1	Customer purchase uses the appropriate ask.
2	Customer sale uses the appropriate bid.
3	A spread is not the same as total profit.
4	Charges may be additional.

Idea	Why it matters
1	Direct quotation uses home currency per foreign unit.

Idea	Why it matters
2	Indirect quotation reverses that perspective.
3	Reciprocal quotes reverse bid/ask sides.
4	Cross rates must cancel currency units.

Idea	Why it matters
1	Spot and forward have different value dates.
2	Forward premium depends on quote orientation.
3	Forward discount is the opposite differential.
4	Interest differentials influence forward relationships.

Idea	Why it matters
1	Covered parity needs matching tenors and assumptions.
2	Approximate forward points differ from exact parity.
3	Day-count conventions affect interest comparisons.
4	Swap rate terminology needs context.

Idea	Why it matters
1	Arbitrage requires executable prices and costs.
2	Rounding can matter for large notionals.
3	A forward can hedge an identified exposure.
4	A hedge can also carry counterparty/liquidity risks.

Idea	Why it matters
1	Case USD purchase costsRs.83,300.
2	Case USD sale yieldsRs.83,200.
3	A 0.20 ask increase costsRs.200 onUSD 1,000.
4	Do not treat a forward as a guaranteed forecast.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Customer buys base currency	Base amount xdealer ask	For price-currency units per 1 base-currency unit.
Reverse quote	New bid=1/old ask;new ask=1/old bid	Sides reverse when inverting.
Covered forward relationship	F=S x(1+r_price x t)/(1+r_base x t)	Simple money-market rates, compatible periods, and no frictions assumed.
Approximate forward points	F-S≈S x(r_price-r_base) x t	An approximation;identify quote orientation and day count.
Cross rate	Multiply/divide so intermediate currency units cancel	Use executable bid/ask sides consistently.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Mathematics /Forex Arithmetic
Foreign Exchange’
‘Foreign Exchange’ refers to the general mechanism by which a bank converts the currency of one country into that of another.
Foreign trade gives rise to foreign exchange.
Foreign trade is transacted (i.e. expressed and paid for) either in the currency of the exporter’s country or that of the importer’s country or that of a third country (like Pound Sterling, US Dollars, etc.), acceptable to both the exporter and the importer.

Concept / condition / application
Fundamentals Of Foreign Exchange

There are three fundamental aspects of this general mechanism of foreign

exchange

Concept / condition / application
Almost every country has its own currency (legal tender, distinctive unit of account) and the useful possession of the currency, can normally be had only in that country, in which it passes.
The exchange from one currency for another is, mostly, put through by the banks by means of bookkeeping entries carried out in the two centres concerned.
Almost all exchanges of one currency for another are effected with the help of credit instruments.
Indian Forex Market
The exchange rate movements in the Indian forex market do not necessarily follow the international trend, particularly in the short run.

Concept / condition / application
The main reason for this is the restriction on the free flow of capital into or out of the country.

Prior to the modified 'Liberalised Exchange Rate Management System' (LERMS), the Reserve Bank fixed the buying and selling rates and the market would remain within the ceiling and the floor, thus fixed by the Reserve Bank.

Concept / condition / application
However, at present, the forces of demand and supply in the local interbank market drive the exchange rate.
Direct And Indirect Quote
A currency quotation is the price of a currency in terms of another currency.
For example, $1 = Rs 75.00, means that one dollar can be exchanged for Rs. 75.00.
Alternatively, we may pay Rs 75.00 to buy one dollar.

Concept / condition / application
A foreign exchange quotation can be either a direct quotation and or an indirect quotation, depending upon the home currency of the person concerned.
A direct quote is the home currency price of one unit of the foreign currency.
Thus, in the aforesaid example, the quote $1 = Rs. 75.00 is a direct quote for an Indian national.
An indirect quote is the foreign currency price of one unit of the home currency.
Some Basic Exchange Rate Arithmetic

Concept / condition / application
Cross Rate

Concept / condition / application
If a person wants to remit Euros from India, and as a banker, and for argument sake, rupees/Euros are not normally quoted and therefore, what we have to do is first buy dollars against the rupees and the same dollars will be disposed of overseas to acquire the Euros.
Chain Rule
Calculation of the cross rate is based on a common sense approach. However, it can be reduced to a rule known as the chain rule with similar steps.
Value Date

Concept / condition / application
The value date is a date on which the exchange of currencies actually takes place. Based on this concept, we have the following types of exchange rates.
Cash/ready: It is the rate when an exchange of currencies takes place on the date of the deal.
TOM: When the exchange of currencies takes place on the next working day, i.e. tomorrow it is called the TOM rate.
SPOT: When the exchange of currencies takes place on the second working day after the date of the deal, it is called the spot rate.
Forward rate: If the exchange of currencies takes place after a period of spot date, it is called the forward rate. Forward rates generally are expressed by indicating a premium/discount for the forward period.

Concept / condition / application
Premium: When a currency is costlier in forward or say, for a future value date, it is said to be at a premium. In the case of the direct method of quotations, the premium is added to both the selling and buying rate.
Discount: If currency is cheaper in the forward or for a future value date, it is said to be at a discount. In the case of a direct quotation, the discount is (deducted) subtracted from both the rates, i.e. buying and selling rates.
Forward Exchange Rates
As discussed earlier, an exchange rate is the price at which currency can be bought or sold for another currency.
The date on which the values are exchanged can be any date starting from the date of transaction onwards.

Concept / condition / application
Generally, the exchange rates are quoted on a spot basis, i.e. the settlement takes place on the 2 nd working day after the date of transaction.
The exchange rate for settlement on a date beyond the spot is naturally different and the same is called the forward rate.

Forward rate has two components:

Historical formulation: Spot rate Forward points reflecting the interest rate differentials adjustment for different settlement dates.

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Specify quote orientation, currency units, tenor and day count. Forward points are added/subtracted under that orientation; a forward price is not a guaranteed future spot forecast. The simple differential shortcut is approximate.

Concept / condition / application
Forward Points
Let us suppose that the spot rate of US$/Euro is
Spot Euro 1 = US$ 1.2180
the exchange rate 3 months forward is
3 months Euro 1 = US$ 1.2330

Concept / condition / application
The difference of 150 points referred to are the forward points.

The following factors determine the forward points:

Supply and demand for the currency for the settlement date. If there are more buyers for a particular date than sellers, the forward points will be different from the situation if there were more sellers than buyers for that particular settlement date. Market view, i.e. expectations, about the future and developments likely to take place in interest rates and foreign exchange. The interest rate differential between the countries, for the period in question, whose currencies are being exchanged. However, if there are no controls on capital flows, the interest rate differential between the two currencies is the most dominant factor in determining the forward points.

This is based on the simple logic of a trade off between the interest earned on one currency and the opportunity foregone to earn interest on another currency.

Concept / condition / application
Let us take an example for illustrating as to how forward differential points

arises:

Concept / condition / application
Spot Euro 1 = US$ 1.5000
Interest, Euro @ 3% per annum,
US$ @ 6% per annum.
Suppose someone borrows Euro 100 for one year @ 3% per annum converting it
into US$ and places the same as a deposit for one year @ 6%, his cash flows will

be as under:

Worked figure / record

	Euro		US$	
	Inflow	Outflow	Inflow	Outflow
Spot borrowing	+ 100			
Sells Euros		–100	+ 150	
One year hence interest		– 3	+ 9	
Total		**– 103**	**+ 159**	
Sells US$ One year @ 1.50 Net gain	+ 106 Euro 3			–159

Concept / condition / application
Thus, a person can make Euro 3 in one year by borrowing Euro and converting the same into US$ and after one year converting US$ again into Euro.
However, it is being presumed that US$/Euro rate continues to be same for spot and one year forward.
The US$/Euro rate will be: Euro 103 = US$159 i.e. Euro 1 = 159/103
= US$ 1.5436
Thus, 0.0436 represents the forward differential between spot and one year forward.

Concept / condition / application
Arbitrage
Arbitrage is an operation by which one can make risk free profits by undertaking offsetting transactions.
Arbitrage can be in interest rates, i.e. borrow at one centre and lend at another at a higher rate.
Arbitrage can occur in exchange rates also. However, with the present day efficient communication system, arbitrage opportunities are very rare.
In the above example forward rate, i.e.

Concept / condition / application
Euro 1 = US$ 1.5436, would perfectly offset the interest rate differential and can

be calculated as follows:

Concept / condition / application
Principal + interest of US$ investment = US$ 159
Principal + interest of Euro loan = Euro 103
Therefore, Euro 103 = US$ 159 Or
Euro 1 = US$ 159/103 = US$ 1.5436
Calculating Forward Points

Concept / condition / application
We can calculate the approximate forward points for a given forward period with

the help of the following information:

Concept / condition / application
Spot exchange rate = 1.5000
Interest rate differential = 3% per annum
Forward period = 90 days
No. of days in an year (360 or 365) = 360 days
The formula is as follows

Worked figure / record

$$\frac{\text{Spot rate} \times \text{Interest rate differential} \times \text{Foward period}}{100 \times \text{No. of days in the year}}$$

$$\frac{1.500 \times 3 \times 90}{100 \times 360} = 0.01125$$

Forward differential, is also known as the ‘Swap Rate’. Three months forward rate for a US$/Euro can be calculated by adjusting spot rate with the forward differential.

Concept / condition / application
Interest differential from forward points:
The formula for calculating the interest rate differential from the forward points is

as under:

Worked figure / record

$$\text{Interest rate differential} = \frac{\text{Forward points} \times \text{No. of days in the year} \times 100}{\text{Spot rate} \times \text{Forward period}}$$

Continuing the above example, we have

$$= \frac{0.01125 \times 360 \times 100}{1.50 \times 90} = 3\% \text{ per annum}$$

Concept / condition / application
Premium and Discount
forward exchange rates are quoted when the value date in the foreign exchange transaction is beyond the spot date.
Spot exchange rate and forward rates are different.
The difference between spot rate and forward rate is known as the forward differential and the same can be at a premium or a discount. Let us illustrate this with the help of spot and forward exchange rates:
Spot inter-bank rate US$ 1 = Rs. 74.8450

Concept / condition / application
3 months forward US$ 1 = Rs. 74.8725

Thus, if one has to buy 3 months forward US$ against rupees he has to pay more for the same US$ by 0.0275. To understand this, it can be said that the three months forward US$ is costlier by Rs. 0.0275 as compared to spot. Therefore, US$ is at a premium in forwards vis-à-vis rupee.

Concept / condition / application
In case of direct quotations, a premium is always added, i.e. added to both buying and selling side.
Take another situation when the inter-bank quotes are as under:
Spot US$ 1 = Rs. 74.8450
3 months forward US$ 1 = Rs. 74.7950
It is clear from the above quotes that one US$ is available for lesser rupees as compared to the spot.

Concept / condition / application
In other words, it can be said that US$ is cheaper in forward as compared to spot, i.e. US$ is at a discount vis-à-vis rupees.
If one buys US$ 1 now, then 3 months forward he has to pay a lesser amount in rupee terms by 0.0500.
In case of direct quotations, a discount is always deducted, i.e. deducted both from the buying and selling side.

Apply your understanding: original practice

1. Which side applies when the customer buysUSD?

Answer and reason
The bank sellsUSD, so use itsUSD ask: 83.30 in the case.

2. Why can't you reverse a two-way quote without changing sides?

Answer and reason
The reciprocal of the old ask becomes the new bid, and the reciprocal of the old bid becomes the new ask.

3. What is the customer's cost forUSD 1,000 at 83.50?

Answer and reason
Rs.83,500 before charges. MultiplyUSD byINR/USD so units cancel.

4. Does a forward premium guarantee that spot will rise?

Answer and reason
No. Forward pricing reflects contractual pricing and funding relationships; future spot is uncertain.

5. Why specify 360 or 365 days?

Answer and reason
Interest accrual and annualisation depend on the stated convention; inconsistent day counts distort comparisons.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Every exchange quote has two currencies.	15. Forward discount is the opposite differential.
02. State what one unit buys.	16. Interest differentials influence forward relationships.
03. Bid is the quoting dealer's buying side.	17. Covered parity needs matching tenors and assumptions.
04. Ask is the dealer's selling side.	18. Approximate forward points differ from exact parity.
05. Customer purchase uses the appropriate ask.	19. Day-count conventions affect interest comparisons.
06. Customer sale uses the appropriate bid.	20. Swap rate terminology needs context.
07. A spread is not the same as total profit.	21. Arbitrage requires executable prices and costs.
08. Charges may be additional.	22. Rounding can matter for large notionals.
09. Direct quotation uses home currency per foreign unit.	23. A forward can hedge an identified exposure.
10. Indirect quotation reverses that perspective.	24. A hedge can also carry counterparty/liquidity risks.
11. Reciprocal quotes reverse bid/ask sides.	25. Case USD purchase costsRs.83,300.
12. Cross rates must cancel currency units.	26. Case USD sale yieldsRs.83,200.
13. Spot and forward have different value dates.	27. A 0.20 ask increase costsRs.200 onUSD 1,000.
14. Forward premium depends on quote orientation.	28. Do not treat a forward as a guaranteed forecast.

MODULE C / C 06

Capital Structure and Cost of Capital

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A firm financesRs.1,00,000 with 60% equity costing 12% and 40% debt costing 8%. Assume debt interest is deductible at a 30% tax rate, with no limitations. After-tax debt cost=8% x(1-.30)=5.6%; WACC=.60 x 12% +.40 x 5.6% =9.44%. The weights sum to 100%, and the debt tax adjustment is explicit.

Change the situation

Without a usable interest tax shield, debt cost stays 8% and WACC becomes 10.4%. A tax benefit cannot be assumed merely because a formula includes a tax-rate symbol.

COMMON MISTAKE - WHY IT FAILS

Debt can lower an average funding cost while increasing financial risk. The illustrative tax rate is an assumption, not a statement of the current corporate tax rate for every company.

Build the connections

Idea	Why it matters
1	Capital structure combines long-term funding claims.
2	Equity and debt have different rights.
3	Debt servicing can create fixed commitments.
4	Leverage can magnify shareholder outcomes.

Idea	Why it matters
1	Cost of capital is a required-return measure.
2	Debt cost should reflect relevant financing terms.
3	A tax shield requires actual eligibility.
4	Preference cost differs from ordinary dividend growth.

Idea	Why it matters
1	Equity is not free because dividends are discretionary.

Idea	Why it matters
2	Retained earnings have opportunity cost.
3	Dividend-growth models require suitable assumptions.
4	CAPM links systematic risk and required return.

Idea	Why it matters
1	Beta is not total risk.
2	Risk-free rate and market premium need coherent inputs.
3	WACC combines weighted component costs.
4	Weights must sum to one.

Idea	Why it matters
1	Market and book weights can differ.
2	Project risk must fit the discount rate.
3	Marginal cost concerns new financing.
4	Issue costs can affect net proceeds.

Idea	Why it matters
1	EBIT differs from earnings after interest.
2	EBIT/EPS analysis needs shares and financing assumptions.
3	Indifference points are not complete decisions.
4	Liquidity and covenants also constrain leverage.

Idea	Why it matters
1	Case after-tax debt cost is 5.6%.
2	Case WACC is 9.44%.
3	Without its assumed shield WACC is 10.4%.
4	Sensitivity analysis reveals assumption dependence.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
After-tax debt cost	kd x(1-T)	Only with a usable tax shield; use relevant marginal rate.
Perpetual preference cost	Preference dividend / net proceeds	Under the simple irredeemable model.
Dividend-growth equity cost	ke=D 1/P 0+g	Needs sustainable constant-growth assumptions.
CAPM	ke=rf+beta x(expected market return-rf)	Market premium and risk-free inputs must be coherent.
WACC	sum(weight xcomponent required return)	Weights add to 1;match cash flows, risk and tax basis.
Simple EPS	((EBIT-interest)x(1-T)-preference dividend)/ordinary shares	An illustrative financing comparison, not a substitute for full EPS rules.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
and Cost Of Capital
Introduction
A business firm needs money to carry on its business.
The money is required for creating fixed assets like factory building, plant and machinery, office equipment etc.
For creating these assets, the firm has to arrange for money which cannot be repaid in a short period of time.

Concept / condition / application
Money is also required for current assets like purchasing raw materials, converting them into finished goods and selling on credit to customers.
These current assets are partly financed by the short term sources of money like credit by suppliers and bank overdrafts. But a portion is to be financed by long term sources also.

Concept / condition / application
So, the firm has to arrange for money for long term for two purposes:
1 st: Creating fixed assets and
2 nd: Partly financing the current assets required to be held by the firm, also called the working capital.

Concept / condition / application
The long term sources of capital, used by the firm to part finance the total working capital requirements is the margin money or better known as the Net Working Capital (NWC).
Meaning of Capital Structure
This long term money required by the firm is known as the capital.

Now, this long term money can be from two sources:

Concept / condition / application
EQUITY or owner’s money
DEBT

DIFFERENCE: Equity is the risk capital put in the business by the owners who get return on their investment by way of profits earned by the firm while the debt providers are not owners of the firm and they lend the money to the firm on agreed terms of repayment and interest payment.

The purpose of these lenders is to earn interest on their surplus funds and at the same time not to take any business risk as they do not share profit or loss of the firm.

Concept / condition / application
Capital Structure is referred to as the proportion of debt and equity in the total long term funds raised by the firm.

Illustration:

Concept / condition / application
A firm starts its business by raising total long term funds of Rs. 500 lakh, to meet its

requirements, as under:

Concept / condition / application
Equity capital Rs.200 lakh
Debt capital Rs. 300 lakh
This gives a capital structure of 60% debt capital (300/500) and 40% equity capital (200/500)
Leverage/Gearing
If the ratio of debt capital is very high, it is called Highly Leveraged or highly geared firm.

Concept / condition / application
If the ratio of debt capital is low; it is called a Low Leveraged or low geared firm.

Examples of debt capital are:

Concept / condition / application
Term loans.
Debentures,
Corporate deposits,
Fixed deposits from public, etc.

Examples of equity capital include:

Concept / condition / application
Partners’ capital in a firm,
Equity and preference shares issued by a company,
Retained (undistributed) profits.
Factors Influencing Decision On Capital Structure Of A Firm

The decision on proportion of debt and equity, as also the instruments through which these two are to be sourced, is influenced by various factors, the main of which are

as under:

Concept / condition / application
Norms prevailing in the financial system:
The banks and financial which are the prominent source of debt financing, have their lending policies and norms .
They will not permit a borrowing firm to violate the prescribed debt equity norms.
For example, if a company applies for a term loan to set up cement factory with 90% debt and 10% equity, the Indian lender will not approve it and ask the company to improve the structure of the project (to say 60% debt and 40% equity).
In capital market also, the investors will not subscribe to the debt or equity instruments of a company if the debt equity proportion is beyond a reasonable point.

Concept / condition / application
Rating agencies also take note of the proportion of debt and equity, in their analysis, while assigning a rating to any financial instrument of the company
Degree of control:
If the promoters of a company, do not want to dilute their voting rights beyond a point, they will not issue further equity capital to outsiders.
In such a case, they will prefer additional funds by issuing debt instruments like debentures.
Trading on Equity

Concept / condition / application
This concept is based on the premise that the firm will earn more profit by deploying funds than the cost of those funds.
For example, if the cost of borrowing Rs. 1 crore is Rs. 12 lakh in a year, the firm will earn Rs. 15 lakh by investing 1 crore during the year. The surplus of Rs. 3 lakh will be additional profit for the owner over and above the profit earned by investing the capital which they have brought in the firm.
Thus, more the debt taken by a firm, more will be the profit on each rupee of the equity capital. Trading on equity means taking advantage of equity capital to borrow funds on reasonable basis.
Cost of Debt
Debt is like a double edged sword.

Historical formulation: Companies want to take advantage of the fact that interest paid on debt is tax-deductible. But, a high proportion of debt results in increased return on each unit of equity capital only when business conditions are good.

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Tax percentages in numerical illustrations are assumptions, not a universal current corporate rate. A debt tax shield requires actual deductibility and usability under applicable law.

Concept / condition / application
Adverse business conditions, over a prolonged period of time, result in debt cost affecting the viability and ultimately the solvency of the firm.
Size of the firm and its business plans
The capital structure of a firm also depends on the size of the firm, its business model and market practices also.
A firm with little intention of future expansion, may not keep a high equity capital base and may prefer higher proportion of debt because the debt is easier to be repaid.
Reduction in equity capital is more difficult as share buy-back is subject to strict regulatory compliance and is a slow process.

Concept / condition / application
Theories/Approaches On Capital Structuring

There are many theories/approaches which establish the relationship between financial leverage, weighted average cost of capital and the total value of the firm.

Net Income Approach

Net Operating Income Approach and

Traditional Position

Concept / condition / application
Net Income Approach
Net Income Approach was put forth by David Durand.
This approach assumes that the cost of debt and the cost of equity remain same irrespective of the proportion of debt and equity.
As the cost of debt < the cost of equity, the overall cost of capital (WACC) can be decreased through higher debt proportion, thus increasing the value of the firm
Net Operating Income Approach (NOI)

Concept / condition / application
Net Operating Income Approach, developed by David Durand, assumes that the WACC or the value of a firm remains unaffected by the change of debt proportion in the capital structure.

Concept / condition / application
According to this approach, the benefit that a firm derives by debt is negated by the simultaneous increase in the required rate of return by the equity shareholders as the increased debt increases the risk perception of the firm, mainly bankruptcy risk.
According to this approach, the market value is dependent on the operating income and the business risks of the firm.
Both these factors are not impacted by the financial leverage.
Financial leverage does not impact the operating income of the firm. Therefore, change in proportion of debt and equity does not make any change in the value of the firm.

Concept / condition / application
Traditional Position
The traditional position takes into account a different but more realistic approach towards cost of debt capital and cost of equity capital. According to this approach, when the proportion of debt capital increases in the capital structure of a firm, the cost of debt will start increasing beyond a point.
This is because the creditors will be wary of higher risk due to enhanced leverage of the firm.
This theory also assumes that the cost of equity capital also increases with increasing leverage.
It remains constant up to a certain level of leverage, gradually increases thereafter and beyond a point, shows sharp increase.

Concept / condition / application
Due to this type of relationship between leverage and costs of debt and equity capitals, as the leverage of a firm increases, WACC may show decline up to a point, remain constant up to another point and increase thereafter

Assumptions in the Approaches on Capital Structuring

Concept / condition / application
Both Net Income and Net Operating Income approaches assume that the increase in debt will not affect the risk perception of the creditors and the rate of interest (cost) of debt will not change with leverage. However, the traditional approach assumed otherwise
All firms distribute the entire profit to the equity holders.
For the sake of simplicity, total capital is assumed to be comprising of only debt capital and equity capital.
There is no income tax, individual as well as on the firm.
The business conditions will remain same so that the operating profit is not changed.

Concept / condition / application
There is no transaction cost and the frim can change its capital structure whenever it wants so.

Concept / condition / application
There are no redeemable sources in the capital composition of the firm and will continue for long time.
Capital market is perfect and all investors are rational.
Taxation & Capital Structure
When determining a firm's capital structure, taxation must be taken into consideration.

Concept / condition / application
As we have discussed earlier, Earnings Before Interest and Tax (EBIT) of a firm will not be affected by the capital structure of the firm.
If a firm has EBIT of Rs. 100 lakh with 100% debt and 0% equity, it will have the same EBIT of Rs. 1 lakh with capital structure of 0% debt and 100% equity.
What will change is the net profit of the firm i.e. the profit after paying interest and tax.

Illustration:

Firm ABC, having total capital of Rs. 2 lakh, has EBIT of Rs. 1 lakh for the year. Income tax for the firm (Corporate tax) is at 25%. Rate of interest on debt is 12% p.a.

Let us consider the following 3 scenario:

Concept / condition / application
Scenario A: Debt 100%, Equity capital 0%
Scenario B: Debt 50%, Equity capital 50%
Scenario C: Debt 0%, Equity capital 100%

Worked figure / record

Particulars	Scenario A	Scenario B	Scenario C
EBIT	1,00,000	1,00,000	1,00,000
Debt	2,00,000	1,00,000	0
Equity Capital	0	1,00,000	2,00,000
Interest@12%	24,000	12,000	0
Profit before Tax	76,000	88,000	1,00,000
Tax @ 25%	19,000	22,000	25,000
Profit after Tax (income on equity capital)	57,000	66,000	75,000
Total income on both debt and equity capital	81,000	78,000	75,000

Concept / condition / application
It can be observed from the above table that the combined income on debt and equity capital increases as the leverage of the firm increases.

This is because of 100% tax exemption provided under the IT Rules on interest paid on debt. So, should the firms go for more debt capital in comparison to the equity capital? The answer is not so simple. We have discussed earlier the perils of disproportionately

high debt for the firm, including the risk of bankruptcy. Also, as the leverage increases, the investors will have a higher risk perception of the firm and the cost of debt and equity capital may not remain same, as assumed in above.

Concept / condition / application
Concept Of Cost Of Capital
The capital of a firm represents its long term sources of funds, shown in the balance sheet as liabilities. It consists of both debt capital and the equity capital.
The common perception is that the equity capital of a firm does not involve any cost as it is under no legal obligation to pay to the equity holders. Also, it can be argued that the equity capital includes retained profits, which are earned by the firm and so no cost is involved in using such funds.
But, let us think from the point of view of equity holders. They have taken more risk by investing in the firm compared to any other investor. The debt capital investors are assured of a fixed return irrespective of whether the firm earns profits or not. They have legal rights to recover their money from the assets of the firm The preference share-holders also get an assured return on their investment as also preference over the equity share-holders in case of liquidation of the firm.
When providers of equity capital are taking maximum amount of risk and also foregoing the opportunity cost of their capital, they expect that the firm will earn for them more than what other investors are getting. If the firm fails to do so, the equity capital investors may like to put their money in other investment avenues.

Concept / condition / application
That is why it is said that the cost of equity capital is more than the prevailing market cost of preference and debt capital.
Whereas, calculating the cost of preference and debt capital is comparatively simpler, arriving at the cost of equity capital is often a difficult exercise as the risk premium expected by equity capital investors depends on the perception of the investors, to a considerable extent.
Why it is important to know the correct cost of capital of the firm?
It is important because it provides a benchmark above which the firm should earn from its business.

Historical formulation: For example, if the firm is appraising an investment proposal on the premise that the cost equity capital is zero, it may approve a project which gives a low rate of return.

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Equity and retained earnings have an opportunity cost even if no fixed cash dividend is promised.

Concept / condition / application
The cost of capital should correctly represent the opportunity cost of the various components of capital structure of the firm to arrive at the correct benchmark for the firm to evaluate investment proposals.
Cost Of Debt Capital
If the firm raises a term loan from a bank or a financial institution, the rate of interest is transparently known.
Term loans are not traded in the secondary market and the bank has already fulfilled its expectations of returns on its funds by quoting the interest rate on the term loan.
Therefore, no calculation is involved in arriving at the cost of this and the rate of interest charged by the bank is taken as the cost.

Concept / condition / application
PROBLEM: In case of bonds and debentures.
But what we are talking here is the rate expected by the investors from these debentures in the secondary market.
That rate will depend on the coupon rate as also investors' perception of firm's risk profile and prevailing market conditions.
The return on a bond/ debenture, purchased by an investor in the secondary

market, is equal to Yield to Maturity (YTM) of that bond/debenture,

Concept / condition / application
The formula for which is: The computation of YTM by this formula involves trial and error.

The approximate YTM can be calculated by using the formula:

Concept / condition / application
YTM = {Annual interest payment + (M – P)/n}/ (0.6 × P + 0.4 × M)
where M is the Maturity value,
P is the present market value and
n is the number of years left to maturity.

Illustration:

Concept / condition / application
A firm's debentures with face value of Rs.100 and coupon of 10% p.a. are having a
current market price of Rs.90. The number of years left to maturity are 4 years.

What is the cost of debt capital for the firm?

Concept / condition / application
YTM = {Annual interest payment + (M – P)/n}/ (0.6 × P + 0.4 × M)
YTM = {10+ (100-90)/4}/(0.6 × 90 + 0.4 × 100)
= (10+2.5)/(54 + 40) = 12.5/94
= 13.30%
Cost Of Preference Capital

Concept / condition / application
Preference capital carries a fixed rate of interest (called dividend), like debentures but has higher risk perception as it comes after secured creditors in receiving money in case of liquidation of the firm.
The interest paid is also not tax deductible.
As in the case of debentures, the approximate cost of preference capital (YTM)

can be calculated by using the same formula:

Concept / condition / application
YTM = {Annual interest payment + (M – P)/n}/ (0.6 × P + 0.4 × M)
where M is the Maturity value,
P is the present market value and
n is the number of years left to maturity.
Here the underlying assumption is that the firm will pay the dividends every year and the preference shares will be redeemed on the due date.

Concept / condition / application
Cost Of Equity Capital
An operating firm can get additional equity capital through internal accruals and/or through issue of fresh equity.
Issue of additional equity capital involves a floatation cost which may be low in case of a rights issue and high in case of a public issue of equity shares.

Concept / condition / application
For the sake of simplicity, here we will assume the floatation cost to be 0 which means that the cost of equity capital is same in both the cases of retained earnings and additional issue of equity shares.
As a company has no commitment to pay any assured dividend every year, the estimation of cost of equity capital becomes difficult.

Concept / condition / application
There are many approaches used for this estimation. Some of the widely used

methods are:

Concept / condition / application
Capital Asset Pricing Model (CAPM) approach
Bond Yield plus Risk Premium approach
Dividend Growth Model approach
Earning Price Ratio approach
Capital Asset Pricing Modelling (CAPM) approach

Concept / condition / application
According to this approach, the required rate of return on the equity of a particular company depends on three factors viz.
risk free rate of return,
Beta of a company’s share price
the prevailing expected return on a portfolio of equity shares, in the capital market.
The beta is based on the changes in the return on share of the company vis-à-vis the changes in the return on market portfolio.

Concept / condition / application
Higher beta denotes higher sensitivity of return on company’s share. Market portfolio denotes a mix of representative basket of shares of different companies, widely traded in the capital market.

The formula used is:

Concept / condition / application
Required rate of return = Risk free return + Beta (Expected return on market portfolio- Risk free return)
Ra=Rrf+βa × (Rm−Rrf)
where: Ra=Expected return on a security
Rrf=Risk-free rate
Rm=Expected return of the market

Concept / condition / application
βa=The beta of the security (Rm−Rrf)=Equity market premium

Illustration

If the Risk free return is 12% p.a. and the expected return on market portfolio is 16%, what will be the required rate of return on a company's equity capital which has a beta of 1.50?

Concept / condition / application
the required rate = 12 + 1.50 (16-12) = 12 + 6 =18%
Bond Yield plus Risk Premium approach
Under this approach, an equity risk premium is added to the yield on long term bonds of the firm.
While the yield on long term bonds of the firm are known in the market, decision on equity risk premium is a matter of individual investor perception.

Illustration

Concept / condition / application
If the yield on long term bonds of the firm is 12% p.a. and the equity risk premium is 4%, what will be the required rate of return on firm's equity capital?
The required rate = 12 + 4 =16
Dividend Growth Model approach
This approach assumes that the
current market price of firm's equity = Present value of all the dividends expected to be paid by the firm in future, discounted at the required rate of

return.

Concept / condition / application
This approach assumes that there will be a study growth in dividend paid by the firm, every year.

The formula, with this assumption is as under:

Concept / condition / application
Present market value = Dividend in first year/ (required rate of return – growth rate per year)
Required rate of return = (present market value/Dividend in first year) + growth rate per year

Illustration

If the present market value of Rs.10 face value, equity shares of the firm is Rs. 100, dividend expected in the first year is 10%. and the expected growth rate in dividend is 4% every year, what will be the required rate of return on firm's equity capital?

Concept / condition / application
The required rate = (100/10) + 4 = 14%
Earning Price Ratio approach
Under this approach, the required rate of return is calculated as under:
Required rate of return = Expected earnings per share for the next year/ Present market price of share

Illustration

If the present market value of equity shares of the firm is Rs. 100 and the expected earnings per share for the next year is Rs. 15. what will be the required rate?

Concept / condition / application
RRR = 15/100 = 0.15 = 15%
Weighted Average Cost Of Capital (WACC)
Once we have estimated the cost of each component of capital of a firm, the WACC is arrived at by multiplying the proportion of each component with its cost and adding them.

Illustration

Concept / condition / application
The capital structure of a firm is as under: Equity capital 40% Preference capital 10% Debt capital 50%
The cost of each is estimated as under: Equity capital 20% Preference capital 15% Debt capital 10%
WACC = (20 × 0.4 + 15 × 0.1 + 10 × 0.5) = 8 + 1.5 + 5 = 14.5%
Factors Affecting The WACC
The factors affecting the Weighted Average Cost of Capital of a firm can be

classified under 2 categories,

Concept / condition / application
Internal factors and the external factors.

Internal factors:

Concept / condition / application
The internal factors affecting the Weighted Average Cost of Capital are:
Capital structure policy Capital investment policy Dividend policy

External factors:

Concept / condition / application
The external factors affecting the Weighted Average Cost of Capital are:
Prevailing interest rates in the market Risk perception and market risk premium Rates of corporate and personal taxes

Apply your understanding: original practice

1. Compute the case after-tax debt cost.

Answer and reason
8% x(1-.30)=5.6%, assuming full usable deductibility and the stated tax rate.

2. Are retained earnings costless?

Answer and reason
No. Shareholders forgo alternatives. Retention has an opportunity cost even without a new issue.

3. Why should WACC weights add to 100%?

Answer and reason
They represent the complete financing mix being valued; otherwise the average is misweighted.

4. Can the firm use its WACC for every risky new project?

Answer and reason
Not automatically. The discount rate must reflect project risk, cash-flow definition and funding assumptions.

5. Does more debt guarantee higher shareholder value?

Answer and reason
No. Tax effects, distress risk, covenants, flexibility and operating uncertainty must all be considered.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Capital structure combines long-term funding claims.	15. WACC combines weighted component costs.
02. Equity and debt have different rights.	16. Weights must sum to one.
03. Debt servicing can create fixed commitments.	17. Market and book weights can differ.
04. Leverage can magnify shareholder outcomes.	18. Project risk must fit the discount rate.
05. Cost of capital is a required-return measure.	19. Marginal cost concerns new financing.
06. Debt cost should reflect relevant financing terms.	20. Issue costs can affect net proceeds.
07. A tax shield requires actual eligibility.	21. EBIT differs from earnings after interest.
08. Preference cost differs from ordinary dividend growth.	22. EBIT/EPS analysis needs shares and financing assumptions.
09. Equity is not free because dividends are discretionary.	23. Indifference points are not complete decisions.
10. Retained earnings have opportunity cost.	24. Liquidity and covenants also constrain leverage.
11. Dividend-growth models require suitable assumptions.	25. Case after-tax debt cost is 5.6%.
12. CAPM links systematic risk and required return.	26. Case WACC is 9.44%.
13. Beta is not total risk.	27. Without its assumed shield WACC is 10.4%.
14. Risk-free rate and market premium need coherent inputs.	28. Sensitivity analysis reveals assumption dependence.

MODULE C / C 07

Capital Investment Decisions/Term Loans

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A machine costsRs.1,00,000 now and generatesRs.60,000 at each of two year-ends. At 10%, PV inflows=Rs.1,04,132.23 and NPV=Rs.4,132.23. Undiscounted payback is 1 year plus 40,000/60,000=1.667 years if second-year receipts arise evenly for that interpolation. NPV measures value; payback measures a recovery time.

Change the situation

If an extraRs.10,000 working-capital investment is required now and recovered at year 2, add-10,000 at time 0 and+10,000 at year 2. Its incremental NPV is-10,000+10,000/1.10^2=-Rs.1,735.54.

COMMON MISTAKE - WHY IT FAILS

IRR is the rate that makes NPV zero; it is not cash flows minus investment divided by a single discount term. Sunk costs, opportunity costs, timing and terminal recoveries need explicit treatment.

Build the connections

Idea	Why it matters
1	Capital budgeting compares long-term alternatives.
2	Relevant cash flows are incremental.
3	Sunk costs are normally excluded.
4	Opportunity costs can be relevant.

Idea	Why it matters
1	Initial outlay occurs at its actual date.
2	Working capital can require additional investment.
3	Terminal recovery needs realistic assumptions.
4	Taxes and disposal effects require analysis.

Idea	Why it matters
1	NPV discounts each dated net cash flow.

Idea	Why it matters
2	Positive NPV signals value under assumptions.
3	IRR solves NPV equal to zero.
4	Multiple sign changes can cause IRR problems.

Idea	Why it matters
1	Payback ignores later receipts in its simple form.
2	Discounted payback includes time value.
3	ARR uses accounting measures and defined denominators.
4	Profitability index relates value to outlay.

Idea	Why it matters
1	Mutually exclusive projects can conflict in rankings.
2	Scale and timing affect comparison.
3	Use cash flows consistent with discount rate.
4	Debt principal is not operating project cash flow.

Idea	Why it matters
1	Sensitivity changes one assumption at a time.
2	Scenarios change coherent sets of assumptions.
3	Term lending needs repayment-capacity analysis.
4	Security does not replace cash-flow assessment.

Idea	Why it matters
1	Case NPV at 10% isRs.4,132.23.
2	Case simple payback is about 1.667 years.
3	Delayed working-capital recovery has a present cost.
4	Interpret results rather than repeating a formula.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
NPV	-C 0+sum(Ct/(1+r)^t)	Discount each dated incremental cash flow.
IRR	Solve 0=-C 0+sum(Ct/(1+r)^t) for r	It is a rate root, not a cash-amount formula.
Simple payback	Full periods before recovery+unrecovered amount/next period inflow	Fractional-period interpolation assumes a within-period pattern.
Profitability index	PV of relevant future net inflows / initial outlay	Define convention carefully when later outlays exist.
ARR	Defined average accounting profit / defined investment x 100	Average versus initial investment conventions differ.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Decisions/Term Loans

Choose the cash-flow tool

Cash-flow pattern	Tool	Reason
Single amount	PV/FV of a single sum	One dated payment
Equal regular amounts	Annuity	Repeated equal payments at equal intervals
Unequal amounts	NPV cash-flow schedule	Discount each dated amount separately

Two five-year cash-flow patterns

Year	Regular flow (Rs.)	Irregular flow (Rs.)
1	10,000	10,000
2	10,000	15,000
3	10,000	12,000
4	10,000	8,000
5	10,000	15,000

Concept / condition / application
Discounted cash flow Techniques for Investment Appraisal

Historical formulation: This chapter sets out two main discounting techniques of investment appraisal namely the net present value (NPV) method and the internal rate of return (IRR) methods. Two main assumptions that are made in discussing the two techniques, are as follows:

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IRR is the rate solving 0=-C 0+sum(Ct/(1+r)^t), not a direct expression for a cash amount. Multiple sign changes can cause multiple or absent useful IRRs; NPV uses the relevant opportunity cost.

Concept / condition / application
That the sums of moneys, resulting from an investment, that accrue in future, are know with certainty.
That there is no inflation.
Net present value

NPV method involves comparing the present value of the future cash flows of an investment opportunity with the cash outlay that is required to finance the opportunity. In this ways, we determine whether the investment opportunity provides a surplus, when the cash flows are measured in present value terms.

The stages involved in using the NPV method are as follows:

Concept / condition / application
Estimate all future net cash flows (revenue minus cost) associated with an investment opportunity.
Convert these net cash flow figures to their present value equivalents by discounting at the appropriate discount rate;
Add all the present value figures of future cash flows;
Subtract from this value, the initial cost of investment

Worked figure / record

$$NPV = -C_0 + \frac{C_1}{1+r} + \frac{C_2}{(1+r)^2} + \ldots + \frac{C_T}{(1+r)^T}$$

$-C_0 = Initial\ Investment$
$C = Cash\ Flow$
$r = Discount\ Rate$
$T = Time$

Net Present Value(NPV) is a formula used to determine the present value of an investment by the discounted sum of all cash flows received from the project. The formula for the discounted sum of all cash flows can be rewritten as

Worked figure / record

$$NPV = \sum_{i=1}^{n} \frac{Cash\ Flow_i}{(1+r)^i} - Initial\ Investment$$

Concept / condition / application
Positive NPV: In this situation, the present value of cash inflows is greater than the present value of cash outflows. This is an ideal situation for investment
Negative NPV: In this situation, the present value of cash inflows is less than the present value of cash outflows. This is not an ideal situation and any project with this NPV should not be accepted.
Zero NPV: In this situation, the present value of cash inflows equals the present value of cash outflows. You may or may not accept the project.
Question: An Investor invested Rs. 8 lac in a project that gives profit of Rs.2 lakh
in the 1 st year , Rs. 2.60 lac in 2 nd year & Rs. 4 lac in the 3 rd year. At 10% discount

rate, what is NPV?

NPV worked record: read the rounded factors

Year	Outflow (Rs.)	Inflow (Rs.)	PV factor	Printed PV (Rs.)
0	8,00,000	-	1	-8,00,000
1	-	2,00,000	0.909	1,81,000
2	-	2,60,000	0.826	2,14,760
3	-	4,00,000	0.751	3,00,400
Total inflow PV	-	-	-	6,96,960

RECONCILE THE SOURCE TABLE

The year 1 printedPV ofRs.1,81,000 is a typographical error: 2,00,000 x 0.909=Rs.1,81,800. Using that corrected row and the other printed rounded factors gives totalPV Rs.6,96,960 andNPV minusRs.1,03,040. At a full-precision 10% discount rate, the three inflows have totalPV Rs.6,97,220.14 andNPV minusRs.1,02,779.86. Both corrected methods reject this project at 10%;the difference is rounding, not a different decision.

Concept / condition / application
Question: ABC Co Ltd. Is considering a new piece of machinery costing Rs. 8000
and it will produce a cash flow of Rs.1200 each year for next 12 years. What is NPV

if discount rate is 10%

Concept / condition / application
PV = A/r [1 – 1/ (1+r)^n]
= 1200/.1 [1- 1/ (1.1)^12
= 8176
NPV = 8176- 8000
= 176

Concept / condition / application
Internal Rate of Return (IRR)
The internal rate of return (IRR) is a discounting cash flow technique which gives a rate of return earned by a project.
The internal rate of return is the discounting rate where the total of initial cash outlay and discounted cash inflows are equal to zero. In other words, it is the discounting rate at which the net present value (NPV) is equal to zero.

Concept / condition / application
How is the Internal Rate of Return computed?

For the computation of the internal rate of return, we use the same formula as NPV. To derive the IRR, an analyst has to rely on trial and error method and cannot use analytical methods. With automation, various software (like Microsoft Excel) is also available to calculate IRR. In Excel, there is a financial function that uses cash flows at regular intervals for calculation.

IRR: rate solving the valuation equation

Item	Correct relationship
Equation	0 = -C 0 + sum(Ct/(1+r)^t), for t=1...n
Unknown	r is the IRR; solve the equation for r.
Historical error	The older image writes IRR as a cash-flow/outlay expression divided by a discount term. That expression is not a valid definition of IRR.
Method	Compute NPVs at trial rates, bracket a root and refine; non-conventional flows need care.

The rate at which the cost of investment and the present value of future cash flows match will be considered as the ideal rate of return. A project that can achieve this is a profitable project. In other words, at this rate the cash outflows and the present value of inflows are equal, making the project attractive.

Concept / condition / application
For independent investment opportunities,
if the IRR > cost of capital, then the project should be undertaken, since a rate of return is being earned by the project that is greater than the amount that has to be paid out to the providers of capital. Thus, the project is earning a surplus over and above the cost of funds and thus shareholders' wealth will be increased.
If the IRR < cost of capital, then the project, should not be undertaken, as going ahead with the project will have the result of reducing the shareholders' wealth.
For mutually exclusive investment opportunities, the IRR decision rule involves undertaking that investment that has the highest IRR, provided that the IRR is greater than the cost of capital.
According to number of studies, IRR is more widely used than NPV. The main reason for this appears to be that people in business are more used to thinking in terms of rates of return than in terms of NPVs or surpluses.

Concept / condition / application
IRR = R 1 + NPV / (NPV 1 – NPV 2) * (R 2- R 1)
R 1 = Lower discount rate chosen
R 2 = Higher discount rate chosen

Concept / condition / application
Question: The NPV of a project is Rs. 2 lac at 10% discount rate & (-) .5 lac at 11%

discount rate. Calculate IRR of the project

Concept / condition / application
= 10 + 2 / [2 – (-) .5] * (11-10)
= 10 + .8 * 1
= 10.8 = 11%
Non-Discounted Cash Flow Methods For Investment Appraisal

Historical formulation: Payback Period Method

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State the denominator and cash-flow timing. ARR uses accounting profit; simple payback ignores time value and post-payback receipts. They do not measure the same thing as NPV.

Concept / condition / application
All investment appraisal techniques are seeking to identify whether the cash flows, resulting from an investment, are sufficient to make the investment worthwhile.
The payback method adopts the most straightforward approach to this problem.
It simply seeks to measure the length of time that will be taken before the receipts from the investment are sufficient to payback the cost of the investment.
The receipts from the investment are measured as the net cash flows resulting from the project being undertaken (i.e., the difference between the total amount of cash receipts and total amount of cash outlays in each period).

To illustrate the use of the payback method, consider two potential

Concept / condition / application
investment projects that each cost 50,000 and those that have net cash

flows as follows:

Worked figure / record

Year	Project A Cash Flows	Project B Cash Flows
1	7,500	10,000
2	20,000	10,000
3	15,000	10,000
4	7,500	10,000
5	3,000	10,000
6	0	10,000
7	0	10,000
8	0	10,000
9	0	10,000
10	0	10,000

Concept / condition / application
Examination of the net cash flows of the two projects tells us that the initial outlays of 50,000 is recouped in four years for the project A and in five years for the project B,
Thus, the project A has a payback period of 4 years and the project B has a payback period of five years.
To use payback method, it is necessary first to establish a payback period within which all acceptable projects must recoup the outlay of the investment.

For example, a business, with a considerable potential cash flow problems and severe capital rationing, may opt for a short payback period, say 3 years. In this case, neither the project A nor B, would be acceptable.

Concept / condition / application
In contrast, if a 4 year payback period were chosen, then the project A would be acceptable, but project B would not be, while a 5 year payback
Would make both the projects acceptable to the company.
Payback method has several shortcomings that make its use highly undesirable

It takes no account of the time value of money The choice of the payback period is arbitrary With the payback, the only cash flows to be considered are those that fall in the payback period Using payback may well lead to an increase in risk, since by demanding rapid payback, companies are building in a bias towards the acceptance of risky projects.

Concept / condition / application
Question: A firm requires an initially cash outflow of Rs.20000 & cash inflow for 5 years are Rs.5000, 7000, 6000, 6000, 8000. Calculate Payback period?

Payback: accumulate cash inflows

Year	Cash inflow (Rs.)	Cumulative inflow (Rs.)
1	5,000	5,000
2	7,000	12,000
3	6,000	18,000
4	6,000	24,000
5	8,000	32,000

Concept / condition / application
In 3 years recover = 18000
Next 2000 = 2000/6000 = 1/3
= 3.33 years
Question: A project cost is Rs. 190000 and its scrap value is Rs.10000. It yield an
annual cash flow of Rs. 20000 for 10 years. Calculate its payback period?

Concept / condition / application
Project Cost – Scrap Value / Annual Cash Flow
= 190000 – 10000/ 20000
= 9 years
Question: XYZ is planning to start a project which requires the total outlay of
Rs.15 lakh to purchase machinery having a life of 10 years and salvage value is

Concept / condition / application
100000
Year ending profit before dep & Tax is 2 lakh
Tax rate = 30%
Calculate Annual cash flow and Payback period?

Solution

Concept / condition / application
Cash Outflow = 15 lakh – 1 lakh = 14 lakh
PBD&T = 2 lakh
(-) Dep = 15 lakh- 1 lakh / 10 = 1.4 lakh
PBT = 60000
(-)Tax = 18000

Concept / condition / application
PAT = 42000
Annual Cash Inflow = 42000 + 1.4 lakh = 1.82 lakh
Accounting Rate of Return Method (ARR)

Accounting Rate of Return (ARR): The accounting rate of return (also known as Average Rate of Return or Simple Rate of Return) measures the profitability of an investment by using the accounting profit given in the financial statements.

It is computed as under:

ARR = Average profit after tax / Average value of investment

Concept / condition / application
Average accounting profit is the arithmetic mean of accounting income expected to be earned during each year of the project's life time.
It should be noted that the accounting income is arrived after providing for depreciation whereas in other methods like NPV or IRR, we take the cash flows of the project into consideration.
Average investment may be calculated as the sum of the beginning and ending book value of the investment divided by 2 (the underlying assumption being that the book value is getting reduced under the straight line method of depreciation).
For example: If investment in a project is Rs. 10 lac, the life of the project is 6
years and the scrap value is Rs. 1 lac, the average investment will be Rs. (10

Concept / condition / application
lac- 1 lac) divided by 2, i.e. Rs. 4.5 lac. In this example, if the scrap value is
estimated at Rs, 0, the average investment will be Rs. 5 lac.
Another variation of ARR formula uses initial investment instead of average investment.

Concept / condition / application
Under this method, a project will be accepted if its Accounting Rate of Return is higher than the minimum rate of return set by the management.
This method can also be used to rank various projects on the basis of their ARRs. The project having a higher ARR will be ranked higher than the project having a lower ARR.

Advantages:

Concept / condition / application
Like Payback period method, this method is simple to understand and involves simple calculations.
It considers the entire stream of income over the life of the project for evaluating the profitability of the project.
Question: A company is planning to start a business which requires Rs. 100000 to

purchase of machinery having a life of 5 years.

Concept / condition / application
Next 5 years expected profit before dep & tax = 100000, 50000, 40000, 30000,
25000. Income tax @30%. Calculate ARR?

Accounting profit: deduct depreciation and tax

Year	PBD&T	Depreciation	PBT	Tax	PAT
1	1,00,000	20,000	80,000	24,000	56,000
2	50,000	20,000	30,000	9,000	21,000
3	40,000	20,000	20,000	6,000	14,000
4	30,000	20,000	10,000	3,000	7,000
5	25,000	20,000	5,000	1,500	3,500
Total					1,01,500

Concept / condition / application
= (101500/5) / (100000/2) *100
= 40.6%
Important Points About Term Loans

Concept / condition / application
Banks provide term loans normally for acquiring the fixed assets like land, building, plant and machinery, infrastructure etc., (personal loans, consumption loans, educational loans, etc., being exceptions) while the working capital loans are provided for sustaining the working capital, i.e. current assets level.
In exceptional cases, banks provide term loans for current assets also. This is called Working Capital Term Loan (WCTL). As we are aware, the business enterprise is supposed to bring a part of its funds required to maintain the desired level of current assets from its long term sources (capital or term liabilities), called NWC, so that the stipulated current ratio can be maintained. If the enterprise is not able to bring in the required amount of NWC, it will feel liquidity crunch and business operations will be affected. In such cases, banks may provide WCTL.

Concept / condition / application
Working capital loans are normally sanctioned for one year but are payable on demand. Term loans are payable as per the agreed repayment schedule, which is stipulated in the terms of the sanction. Therefore, for the purpose of matching assets and liabilities of the bank, term loans are considered long term assets while working capital loans are considered as short term assets.
As a term loan is expected to be repaid out of the future cash flows of the borrower, the DSCR assumes great importance while considering term loans, while for working capital loans, the liquidity ratios assume greater importance
There is no uniform repayment schedule for all term loans. Each term loan has its own peculiar repayment schedule depending upon the cash surplus of the borrower. Thus, in case of a salaried person, where income level is constant, the repayment can be through EMI system and in case of a farmer, the repayment of principal and interest may coincide with the cropping pattern.
In case of industrial enterprises, normally, banks stipulate monthly/quarterly repayment of principal along with all the accumulated interest.
Project Appraisal

Project appraisal can be broadly taken in the following steps:

Concept / condition / application
Appraisal of Managerial Aspects
Technical Appraisal
Economic Appraisal
Appraisal of Managerial Aspects:
The appraisal of managerial aspects involves seeking the answer to the following

questions:

What are the credentials of the promoters? What is the financial stake of promoters in the project? Can they bring additional funds in case of contingencies arising out of delay in project implementation and changes in market conditions? What is the form of business organisation? Who are the key persons to be appointed to run the business?

Concept / condition / application
Technical Appraisal:

The technical feasibility of a project involves the following aspects:

location Products to be manufactured, production process Availability of infrastructure Provider of technology Details of proposed construction Contractor for project execution Waste disposal and pollution control Availability of raw materials Marketing arrangements

Concept / condition / application
Economic Appraisal:

The economic/financial feasibility of a project involves the following aspects.

Return on Investment: The usual methods used are the NPV, IRR, payback period, cost benefit ratio, accounting rate of return, etc Break-even Analysis: A project with a high break-even point is considered riskier compared to the one with lower break-even point. Sensitivity Analysis: As market conditions are uncertain, a small change in the prices of raw materials or finished goods may have a drastic impact on the viability of a project. Sensitivity analysis examines such impact.

Concept / condition / application
Infrastructure Projects

The sectors included in the definition of “Infrastructure” are as per the Gazette Notifications issued by the Ministry of Finance, Government of India, from time to

time.

Presently, the following infrastructure sectors qualify under ‘infrastructure

lending':

Concept / condition / application
Transport: This includes Roads and bridges, Ports, Inland Waterways, Airport, Railway Track, tunnels, viaducts, bridges and Urban Public Transport (except rolling stock in case of urban road transport).
Energy: This includes Electricity Generation, Electricity Transmission, Electricity Distribution, Oil pipelines, Oil/Gas/Liquefied Natural Gas (LNG) storage facility and Gas pipelines.
Water & Sanitation: This includes Solid Waste Management, Water supply pipelines, Water treatment plants, Sewage collection, treatment and disposal system, Irrigation (dams, channels, embankments etc.), Storm Water Drainage System and Slurry Pipelines.
Communication: This includes Telecommunication (Fixed network), Telecommunication towers, Telecommunication & Telecom Services.
Social and Commercial Infrastructure: This includes Education Institutions (capital stock), Hospitals (capital stock), Common infrastructure for industrial parks, SEZ, tourism facilities and agriculture markets, Fertilizer (Capital investment), Post-harvest storage infrastructure for agriculture and horticultural produce including cold storage, Terminal markets, Soil-testing laboratories, Cold Chain, Hotels and Convention Centers with certain restrictions regarding project cost.

Concept / condition / application
Disbursal Of Term Loans
If the term loan is to be disbursed in one go, e.g., purchase of a machine/ready house, the borrower is asked to deposit his margin with the bank, his loan account is debited by the amount of the loan and the entire amount to be paid to the buyer, is remitted to him by the bank.
If any amount has already been paid to the buyer by the customer, satisfactory proof, like details of bank account etc. of this payment is obtained, and this is considered to be a part of his contribution (margin).
In exceptional cases, like personal loans or consumption loans, the amount may be credited to the account of the customer with the bank.
In cases where the execution of the project is spread over a period of time, the disbursement is normally related to the progress of the project.

Concept / condition / application
RBI guidelines in respect of disbursement of project loans are as under:
At the time of financing projects banks generally adopt one of the following methodologies as far as determining the level of promoters' equity is concerned.

Promoters bring their entire contribution upfront before the bank starts disbursing its commitment. Promoters bring certain percentage of their equity (40% – 50%) upfront and balance is brought in stages. Promoters agree, ab initio, that they will bring in equity funds proportionately as the banks finance the debt portion. RBI has advised the banks to have a clear policy regarding the Debt Equity Ratio (DER) and to ensure that the infusion of

Concept / condition / application
equity/fund by promoters should be such that the stipulated level of DER is maintained at all times.
Syndication Of Loans
The term ‘Syndication’ is normally used for sharing a long-term loan to a borrower by two or more banks.
This is a way of sharing the risk, associated with lending to that borrower, by the banks and is generally used for large loans.
The borrower, intending to avail the desired amount of loan, gives a mandate to one bank (called Lead bank) to arrange for sanctions for the total amount, on its behalf.

Concept / condition / application
The lead bank approaches various banks with the details.
These banks appraise the proposal as per their policies and risk appetite and take the decision.
The lead bank does the liaison work and common terms and conditions of sanction may be agreed in a meeting of participating banks, arranged by the lead bank.
Normally, the lead bank charges ‘Syndication fee’ from the borrower.

Consortium lending relationship

Party	Relationship
Bank 1 / Bank 2 / Bank 3 / Bank 4	Participating lenders to the same borrower
Lead bank	Coordinates the consortium under the agreed arrangement
Borrower	Receives lending subject to terms and each lender's responsibilities

Quick Revision: connected banking concepts

Connection	Meaning and qualification
Documentation purpose	Evidence the obligation, authority, repayment, security and contractual rights. Correct documents support enforceability and operational clarity.
Older document grouping	The notes groupDPNs, agreements and forms. This is a teaching classification, not an exhaustive list of every required document.
DPN / agreement / authority	ADPNcontains a promise under its terms;agreements record relevant loan/rate/repayment/security/default terms;authority forms document instructions or permissions.
Completion sequence	Select the correct documents, check stamping, complete accurate details, obtain valid execution and complete applicable legal formalities.
Legal qualification	Stamp duty, company-charge filing, mortgage registration and limitation depend on instrument, jurisdiction, dates and statutory conditions. Do not treat the older 30 day/4 month/3 year summaries or part-payment statements as a complete current legal checklist. Penal-charge rules also need their applicable framework.

Apply your understanding: original practice

1. What is IRR?

Answer and reason
A discount rate for which the sum of discounted project net cash flows, including the initial outlay, equals zero.

2. Why can a sunk survey cost be excluded?

Answer and reason
It has already been incurred and does not change between the future alternatives. Relevant opportunity costs still matter.

3. Why include recovered working capital at the end?

Answer and reason
It is a future incremental cash release if the stated recovery actually occurs.

4. Does a shorter payback always maximise value?

Answer and reason
No. Simple payback ignores time value and cash flows after recovery; NPV can rank projects differently.

5. Can collateral alone prove a term loan is repayable?

Answer and reason
No. Evaluate sustainable cash generation, debt service, risks and structure. Security is a secondary protection.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Capital budgeting compares long-term alternatives.	15. ARR uses accounting measures and defined denominators.
02. Relevant cash flows are incremental.	16. Profitability index relates value to outlay.
03. Sunk costs are normally excluded.	17. Mutually exclusive projects can conflict in rankings.
04. Opportunity costs can be relevant.	18. Scale and timing affect comparison.
05. Initial outlay occurs at its actual date.	19. Use cash flows consistent with discount rate.
06. Working capital can require additional investment.	20. Debt principal is not operating project cash flow.
07. Terminal recovery needs realistic assumptions.	21. Sensitivity changes one assumption at a time.
08. Taxes and disposal effects require analysis.	22. Scenarios change coherent sets of assumptions.
09. NPV discounts each dated net cash flow.	23. Term lending needs repayment-capacity analysis.
10. Positive NPV signals value under assumptions.	24. Security does not replace cash-flow assessment.
11. IRR solves NPV equal to zero.	25. Case NPV at 10% isRs.4,132.23.
12. Multiple sign changes can cause IRR problems.	26. Case simple payback is about 1.667 years.
13. Payback ignores later receipts in its simple form.	27. Delayed working-capital recovery has a present cost.
14. Discounted payback includes time value.	28. Interpret results rather than repeating a formula.

MODULE C / C 08

Equipment Leasing/Lease Financing

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

An asset can be purchased now forRs.1,00,000 or leased for two year-end payments ofRs.55,000. At 10%, the rent PV is 55,000/1.10+55,000/1.10^2=Rs.95,454.55. This is only a preliminary comparison: ownership residual value, maintenance, taxes, deposits and contract restrictions have not yet been included.

Change the situation

If a purchased asset could be sold forRs.20,000 at year 2, its simplified net purchase PV is 1,00,000-20,000/1.10^2=Rs.83,471.07. The omitted residual value can reverse the initial preference.

COMMON MISTAKE - WHY IT FAILS

Legal title, commercial risk allocation, tax treatment and financial-reporting recognition are different questions. Under Ind AS 116, a lessee generally recognises a right-of-use asset and lease liability, subject to applicable exceptions; old off-balance-sheet shorthand is unsafe.

Build the connections

Idea	Why it matters
1	A lessor provides the right to use.
2	A lessee receives that right.
3	Legal title need not transfer.
4	Contract terms define rights and obligations.

Idea	Why it matters
1	Finance and operating classifications depend on framework.
2	Lessor and lessee accounting can differ.
3	Ind AS 116 changed lessee recognition.
4	Qualifying exemptions require careful application.

Idea	Why it matters
1	A lease payment can contain multiple components.

Idea	Why it matters
2	Deposits and initial costs may matter.
3	Residual value can change economics.
4	Maintenance responsibilities affect comparison.

Idea	Why it matters
1	Lease-versus-buy uses comparable cash flows.
2	Use a consistent valuation date.
3	Use a suitable discount rate.
4	Do not double-count financing costs.

Idea	Why it matters
1	Tax deductions require legal eligibility.
2	Sales-and-leaseback has separate requirements.
3	Leveraged leasing can involve additional funding parties.
4	Domestic/international labels describe different dimensions.

Idea	Why it matters
1	Cancellation terms affect enforceability and risk.
2	Lease financing does not eliminate all risk.
3	Obsolescence risk depends on actual terms.
4	Service agreements are not automatically leases.

Idea	Why it matters
1	Case rent PV isRs.95,454.55.
2	Ignoring residual value can mislead.
3	Case purchase PV with residual isRs.83,471.07.
4	State exclusions before choosing an alternative.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Comparable lease cost	PV of relevant after-tax lease outflows minus relevant benefits	Include deposits, service components, taxes and contract-specific risks.
Comparable ownership cost	Initial purchase +PV(relevant running/other costs)-PV(residual and other benefits)	Avoid counting a financing cost twice in cash flow and discount rate.

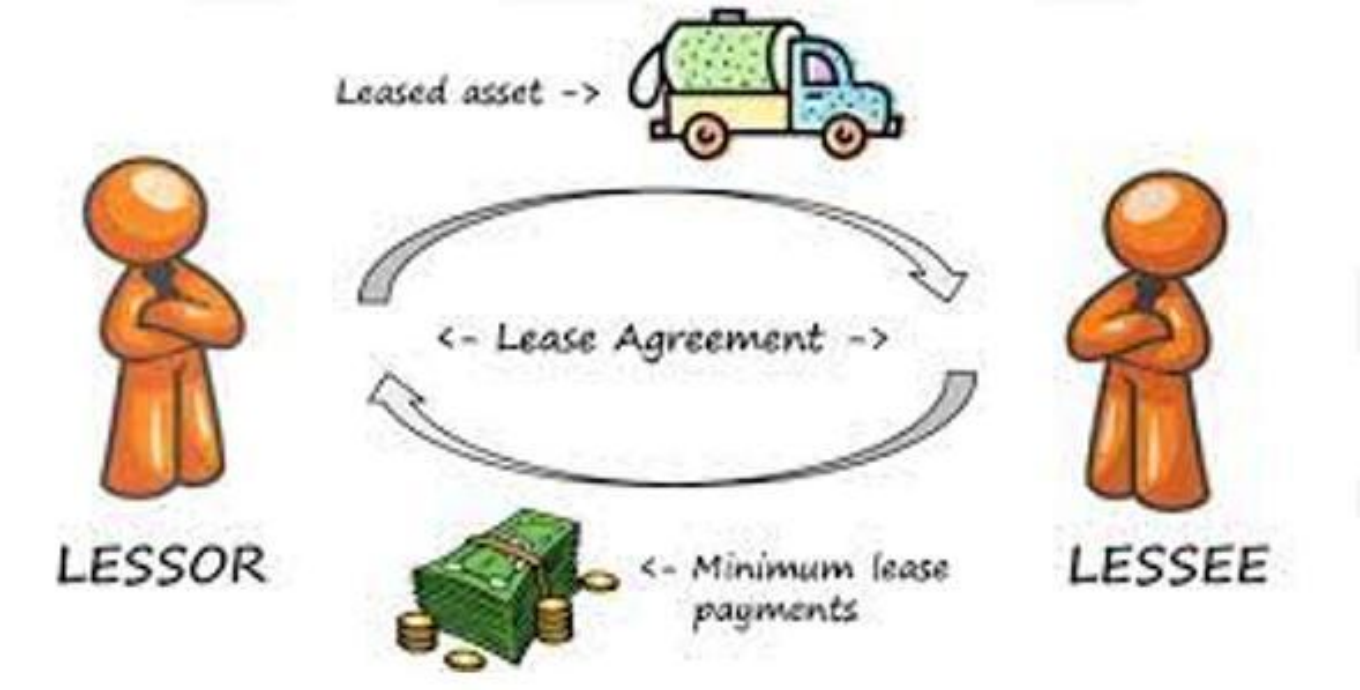
Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Lease Financing
Meaning Of Lease
A lease is a contract under which one party agrees to allow use of its property to another party, for a specific period of time, on agreed payment terms. The party which owns the property is called Lessor and the party which gets right to use the asset, is called Lessee.
The agreed payment for the right to use the property is called the lease rental. The property to be leased may be land, building, animal, industrial equipment or any other fixed or movable asset

Worked figure / record



Concept / condition / application
Features Of A Lease
Legal: It is a legal, binding contract containing the terms on which one party agrees to allow use of its property by another party.
Guarantees: It guarantees the lessee use of the property and guarantees the lessor regular payments for a specified period, in exchange for allowing use of its property.
A lease can be residential lease, which is normally same for all tenants, or commercial lease, which is often of various types.
Breaking a lease contract involves legal consequences

Concept / condition / application
Types Of Leases
As pet Accounting Standard Ind AS 116, “A lessor shall classify each of its leases as

Historical formulation: either an operating lease or a finance lease”.

CLARIFICATION / 1 NOVEMBER 2026

Older operating/finance lease descriptions must be separated from Ind AS 116 lessee accounting. Lessees generally recognise a right-of-use asset and lease liability, subject to applicable short-term/low-value exceptions. Lessor treatment and legal title require separate analysis.

Lease classifications use different dimensions

Perspective	Categories
Accounting	Operating / finance under the applicable framework; Ind AS 116 lessee treatment needs separate analysis
Financing arrangement	Leveraged
Transaction form	Sale and leaseback
Geography	International / domestic
Termination	Non-cancellable / cancellable

Concept / condition / application
Leveraged lease

Worked figure / record



Concept / condition / application
TO PURCHASE AN ASSET
May Borrow all or majority of money
Owner
3 parties: the lessor, lessee, and the lender.
Out of each lease payment from the lessee, one portion is passed on to the lender for debt servicing and the other portion is received by the lessor. The leased asset is charged to the lender as also the lease rentals payable by the lessee.

Domestic lease,

Concept / condition / application
All parties involved in lease transaction, are domiciled in India.
If any party is not domiciled in India, it is called an international lease or cross- border lease.
An international lease may have implications like country risk and currency risk.
A cancellable lease is one that can be cancelled as per the terms contained in the lease agreement.
A non-cancellable lease is one that is cancellable only upon the occurrence of some remote contingency or, with the permission of the lessor or, if the lessee enters into a new lease for the same or an equivalent asset with the same lessor.

Concept / condition / application
A Wet lease is one in which the lessor operates the equipment and is responsible for its insurance, maintenance etc
In a Dry lease, all these functions are responsibilities of the lessee.

Historical formulation: Under a Sale and Lease-back transaction, the asset owned by one party is sold to the other party and simultaneously taken back on lease. So, practically, the possession does not change, only the ownership is transferred. This method is used to unlock value of assets of a firm. Sale and leaseback transactions came under a lot of criticism during 1990 s, when transactions in junk assets were made at very high values and labeled as sale and leaseback transactions.

CLARIFICATION / 1 NOVEMBER 2026

Ownership, tax deductions, risk transfer and accounting recognition are different questions. A lease does not automatically transfer legal title or give every party the same depreciation/tax benefit.

Concept / condition / application
Finance Lease
It is also known as capital lease or sale lease.
lessor and lessee agree that the ownership of the leased asset will be transferred to the lessee on completion of the lease period.
It is a method of providing finance where the lessor buys the asset, not for its own use but for use by the lessee, for an agreed period.
Practically results in substantially transferring the risks and rewards of ownership of the asset to the lessee.

Concept / condition / application
Lessee own the leased asset for a major part of its economic life, without being its legal owner.

Title versus right of use

Party	Clarified relationship
Lessor	Generally retains legal title unless terms transfer it.
Lessee	Receives the contracted right to use; legal title need not pass.
Historical ownership arrow	The original ownership arrow should not be read as automatic transfer of title in every lease.

The accounting standard, Ind AS 116, defines a finance lease as: “A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset”.

Concept / condition / application
Illustration The situations under which a lease is normally classified as a finance

lease are:

Concept / condition / application
The ownership of the asset is transferred to the lessee by the end of the lease term.
The lessee has the option to purchase the asset at a price which is substantially lower than the fair value, and it is reasonably certain that the option will be exercised.
The lease term is for the major part of the economic life of the asset.
The present value of the minimum lease payments at the inception of the lease, amounts to substantial fair value of the leased asset, or more.
The leased asset is of a such a specialised nature that it can be used only the lessee.

Concept / condition / application
The lessee has right to cancel the lease and the lessor’s losses due to the cancellation, are borne by the lessee.
The lessee has the right to continue the lease for a secondary period at a rent which is substantially lower than market rent.
Operating Lease

The accounting standard, Ind AS 116, defines an operating lease as: “Alease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset”.

Concept / condition / application
Lease classification is made at the inception date and is reassessed only if there is a lease modification.
An operating lease is classified as wet lease if the lessor provides the know-how and related services for operating the asset and takes care of its insurance, maintenance etc.
Otherwise, it is classified as dry lease

Illustration

Concept / condition / application
The lease term is substantially less than the economic life of the asset.
The lessee has right to cancel the lease without paying any substantial penalties.
Rationale For Leasing
The borrowing capacity is not reduced:
Leasing is useful to a lessee in strengthening its borrowing capacity and thereby permitting the firm to raise more debt capital, given the firm’s existing equity base.

Concept / condition / application
Since the obligation created under the operating lease arrangement is not reflected as debt in the balance sheet, the firm’s debt equity ratio does not deteriorate.
However, under a finance lease, the accounting standards require the firm to include the value of assets and the resulting liability in the balance sheet.
Lenders are also aware of the implications of the lease financing making it difficult for the lessee firms to increase their borrowing power.
Availability of full finance:
Banks and financial institutions, normally, insist on substantial margin to be brought in by the firm, for purchasing an asset.

Concept / condition / application
In leasing, there is no such need and the firm gets the asset without arranging capital for margin money.
Therefore, a firm experiencing shortage of funds can acquire assets more quickly under leasing arrangement than in buying.
Convenience:
Lease financing, especially the operating lease, is regarded a more convenient form of acquiring an asset compared to purchasing that asset.
This is even more relevant if the asset is to be used for short duration compared to its useful life, because the lessee has not to go through the tedious process of buying and then selling the asset.

Concept / condition / application
Also, the time taken for acquiring an asset through lease route is normally much less compared to that under purchase by arranging a term loan or other type of debt.
Avoiding risk of obsolescence:
Improved designs and technological advances make present equipment inefficient and expensive to operate, compared to the newly developed equipment.
Leasing offers the advantage of passing this risk of obsolescence to the lessor.
Tax Advantage

Concept / condition / application
Lease financing is also used by many firms as a tax planning device to reduce tax liability.
Normally, the lessee firm is benefitted if it can charge off the cost of an asset more rapidly through lease rentals than through depreciation charges.
Financial Flexibility and cash flows:

Concept / condition / application
As the firm can choose from a variety of leasing products available, it can address its needs and requirements regarding cash flows, transaction structure, cyclical fluctuations, expansion plans, profitability etc., by selecting the most suitable products.
Leasing allows a firm to match its cash outflow on rental payments for leased equipment, with its revenue receipts, in a better way.

Concept / condition / application
Less restrictive covenants:
The restrictive covenants on a lessee are much less if an asset is acquired through lease, compared to its acquisition through other means of financing.
For example, a term lending institution or bank may put restrictions regarding payment of dividends, future expansion, managerial appointments, personal guarantees of promoter directors etc.
Contents Of A Lease Agreement
The lease agreement is a written agreement between the lessor and the lessee stating the terms and structure of the lease.

Concept / condition / application
All the future actions of lessor and lessee, relating to the leased asset are guided by this agreement.
Therefore, it is very carefully drafted envisaging all the future situations. Contents of a lease agreement are different for different assets and different types of leases. A lease agreement typically contains the details relating to the following aspects:
Particulars of the Parties
In case of leveraged lease, tripartite agreement etc., third party information should also be included.
Description of the Asset:

Concept / condition / application
This also includes details regarding scope and validity of manufacturer’s warranty.
Equipment Delivery and Installation:
The agreement should clearly mention about the delivery and installation of equipment at the beginning, as also the end of the lease.
Primary Period, Effective Date and Renewal:
The agreement should be specific on these aspects.

Concept / condition / application
Initial/ Security Deposit, Lease Rental and Payment Terms:

This also includes interest payable on security deposit, mode and frequency of payment, rent escalation clause and penalty in case of delay in payment of lease rental.

Concept / condition / application
Transferability of ownership:
The agreement should mention regarding transfer of ownership at the end of the lease period.
Repair and Alteration:
The party which will bear the cost of repair and alteration, should be specified.
Insurance/ Government Dues:

Concept / condition / application
The agreement should mention about who will pay the cost of insuring the asset, as also. the municipal dues, property taxes, etc.
Sub-Lease/Restricted Activities:
The activities, including sub-lease of the asset, which are not permitted by the lessee, should be specified.
Surrender/Termination of Lease Agreement:

If the asset can be surrendered during the period of the lease, the penalties payable should be specified. Also, the circumstances, under which any party can terminate the agreement, details about the notice period and compensation should be specified.

Concept / condition / application
Default and arbitration:
Details of consequences of default and arbitration should be specified.
Legal Aspects Of Leasing
Definition: Transfer of Property Act and Indian Registration Act, covers only the property and not equipment.
In absence of a separate law for equipment leasing: bailment in the Indian Contract Act may be construed to be applicable to equipment leasing contracts.

Concept / condition / application
As per this Act, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee, unless specified in the lease contract.
GST On Lease Transactions

As per Sec 7 of the CGST Act, 2017, the expression supply includes all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business.

Concept / condition / application
From this, it is clear that the lease is covered within the meaning & scope of “supply”

and it is taxable.

Concept / condition / application
GST does not differentiate between a Finance lease and an Operating Lease. GST

rates on lease transactions are as under:

Nil rate on lease of industrial plots, provided by the State Government Industrial Development Corporations or Undertakings to industrial units and Leasing of Agro Machinery/ Vacant land. GST on Lease transactions which will be covered under the category of “Supply of Goods” and “Supply of Services” is chargeable at same rate as on supply of similar goods and services.

Concept / condition / application
Income Tax Implications Of Lease
Income Tax rules do not differentiate between a Finance lease and an Operating

Lease. Income Tax implications of a lease transaction are as under:

In a lease transaction, the lessor is eligible for depreciation on the asset, as he owns the assets. The lessee, therefore, will not be eligible to claim any depreciation.

Concept / condition / application
In sale and leaseback transactions, income Tax rules permit depreciation on the
sold asset’s depreciated value rather than the actual value of the sales

transaction.

Concept / condition / application
The entire lease rentals are taxed as income of the lessor. The lessee is entitled to treat the rentals as expenses.
Accounting Of Lease Transactions In Books Of Lessor
Ind AS 116 prescribe es the following in respect of Accounting of Lease Transactions

in Books of lessee:

Concept / condition / application
For Finance leases

Initial recognition: At the commencement date, a lessor shall recognise assets held under a finance lease in its balance sheet and present them as a receivable at an amount equal to the net investment in the lease. The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately. A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. The implication of Ind AS 116 is that the leased asset is not capitalised in the balance sheet of lessor, despite being its owner. It is presented as a receivable equal to the net investment in the lease, which is the present value of lease

Idea	Why it matters
1	Tax deductions require legal eligibility.
2	Sales-and-leaseback has separate requirements.
3	Leveraged leasing can involve additional funding parties.
4	Domestic/international labels describe different dimensions.

Concept / condition / application
rentals receivable from the lessee. The discount rate applied for calculating the present value is the interest rate implicit in the lease.

Illustration

ABC Ltd. purchases an equipment for Rs. 100 lakh and leases it to XYZ Ltd. for a period of 10 years. The initial cost incurred by ABC Ltd. in negotiating and arranging the lease is Rs. 6 lakh. Lease rental is Rs.18 lakh per year. The useful life of the machine is 10 years and the residual value of the equipment is nil. No initial payment is involved. The interest rate implicit in the lease is 10% p.a. How this lease will be treated in its books, by ABC Ltd.?

Answer:

The present value of the lease rentals of Rs.18 lakh per year, for 10 years is Rs. 6.145*18 = Rs. 110.61 lakh at the discount rate of 10% p.a. (by using the Annuity table, PVIFA = 6.145) Therefore, in the balance sheet of ABC Ltd, an amount of Rs. 110.61 lakh will be shown as receivables from the lease asset.

Concept / condition / application
For Operating leases

Lessors present assets, given under operating leases, in their balance sheet according to the nature of the asset. Initial direct costs incurred by lessors in negotiating and arranging an operating lease, are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income. The depreciation policy for depreciable leased assets should be consistent with the lessor's normal depreciation policy for similar assets. Lessor should recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor may apply

another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

Illustration

ABC Ltd. purchases an equipment for Rs. 100 lakh and leases it to XYZ Ltd. for a period of 3 years. The initial cost incurred by ABC Ltd. in negotiating and arranging the lease is Rs. 6 lakh. Lease rental is Rs. 18 lakh per year. The useful life of the machine is 10 years and the company follows the policy of straightline method of depreciation. How this lease and rentals will be treated in its books, by ABC Ltd.?

Idea	Why it matters
1	Case rent PV isRs.95,454.55.
2	Ignoring residual value can mislead.
3	Case purchase PV with residual isRs.83,471.07.
4	State exclusions before choosing an alternative.

Answer:

Concept / condition / application
The carrying cost of the equipment, in the balance sheet of ABC Ltd., will be Rs. 106 lakh (purchase cost of Rs. 100 lakh and initial cost of Rs. 6 lakh).
The depreciation charged will be Rs. 10 lakh per year using the straight line method.
The lease rental of Rs. 18 p.a. will be charged as expenses if straight line method of accounting for lease rentals is used.
Accounting Of Lease Transactions In Books Of Lessee
The distinction between a finance and an operating lease, as far as accounting treatment in the books of lessee is concerned, has been removed by Ind AS 116.

Concept / condition / application
Ind AS 116 prescribes the following in respect of Accounting of Lease Transactions

in Books of lessee:

Concept / condition / application
At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.
At the commencement date, a lessee shall measure the right-of-use asset at cost.
The cost of the right-of-use asset shall comprise: The amount of the initial measurement of the lease liability, Any lease payments made at or before the commencement date, less any lease incentives received, Any initial direct costs incurred by the lessee; and, An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

Initial measurement of the lease liability, mentioned in 3 (a) above: At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

Concept / condition / application
In the statement of profit and loss, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset.
Exemptions: A lessee may elect not to apply the above accounting requirements to:
Short-term leases; and leases for which the underlying asset is of low value

In case of opting for such exemption, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

Apply your understanding: original practice

1. Why is the cheaper rent PV not a complete decision?

Answer and reason
It omits residual proceeds, maintenance, tax and other contract differences. Compare all relevant incremental effects.

2. Who is the lessee?

Answer and reason
The party obtaining the right to use the asset under the lease; the lessor provides that right.

3. Does no legal ownership mean no recognised asset under Ind AS 116?

Answer and reason
No. A lessee generally recognises a right-of-use asset and lease liability, subject to applicable exemptions.

4. Why discount a residual sale value?

Answer and reason
It is future money. Deduct its present value from the purchase alternative when it is a relevant expected receipt.

5. Does every service contract contain a lease?

Answer and reason
No. Analyse whether the contract conveys control of the use of an identified asset for a period in exchange for consideration.

Official reference: ICAI explanation of Ind AS 116 | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. A lessor provides the right to use.	15. Use a suitable discount rate.
02. A lessee receives that right.	16. Do not double-count financing costs.
03. Legal title need not transfer.	17. Tax deductions require legal eligibility.
04. Contract terms define rights and obligations.	18. Sales-and-leaseback has separate requirements.
05. Finance and operating classifications depend on framework.	19. Leveraged leasing can involve additional funding parties.
06. Lessor and lessee accounting can differ.	20. Domestic/international labels describe different dimensions.
07. Ind AS 116 changed lessee recognition.	21. Cancellation terms affect enforceability and risk.
08. Qualifying exemptions require careful application.	22. Lease financing does not eliminate all risk.
09. A lease payment can contain multiple components.	23. Obsolescence risk depends on actual terms.
10. Deposits and initial costs may matter.	24. Service agreements are not automatically leases.
11. Residual value can change economics.	25. Case rent PV isRs.95,454.55.
12. Maintenance responsibilities affect comparison.	26. Ignoring residual value can mislead.
13. Lease-versus-buy uses comparable cash flows.	27. Case purchase PV with residual isRs.83,471.07.
14. Use a consistent valuation date.	28. State exclusions before choosing an alternative.

MODULE C / C 09

Working Capital Management

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A manufacturer holds inventory for 30 days, collects customers in 40 days and pays suppliers after 25 days. Simplified cash conversion cycle=30+40-25=45 days. AtRs.10,000 relevant operating cash cost per day, an illustrative 45 day funding need isRs.4,50,000, assuming even flows and no other adjustments.

Change the situation

Reducing collection time to 30 days shortens the cycle to 35 days and the illustrative need toRs.3,50,000. Faster collection releasesRs.1,00,000 in this simple model without changing annual sales.

COMMON MISTAKE - WHY IT FAILS

Gross working capital and net working capital differ. A rule-of-thumb cycle estimate is not a complete sanctioned bank-finance assessment or a promise that all inventory and debtors are eligible security.

Build the connections

Idea	Why it matters
1	Gross working capital concerns current assets.
2	Net working capital subtracts current liabilities.
3	Permanent needs differ from seasonal needs.
4	Operating cycle links inventory and collection.

Idea	Why it matters
1	Cash cycle also reflects supplier credit.
2	More collection days can increase funding need.
3	More inventory days can tie up funds.
4	Supplier credit can reduce the cash gap.

Idea	Why it matters
1	Liquidity and profitability can conflict.

Idea	Why it matters
2	Overinvestment can reduce returns.
3	Underinvestment can disrupt production.
4	Cash budgets identify dated shortfalls.

Idea	Why it matters
1	Inventory management concerns cost and availability.
2	Receivable management includes credit policy.
3	Payable management requires agreed payment terms.
4	Short-term funding brings refinancing risk.

Idea	Why it matters
1	Long-term funding can support permanent current assets.
2	Matching maturities is a financing principle.
3	Spontaneous finance arises through operations.
4	Bank finance needs applicable eligibility analysis.

Idea	Why it matters
1	Collateral value differs from cash generation.
2	Growth can consume working capital.
3	Seasonality affects peak requirements.
4	Assumptions need sensitivity testing.

Idea	Why it matters
1	Case cash cycle is 45 days.
2	Case simplified need isRs.4,50,000.
3	Ten-day faster collection releasesRs.1,00,000.
4	Actual cash patterns can be uneven.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Net working capital	Current assets-current liabilities	Gross working capital instead describes current assets.
Cash conversion cycle	Inventory days+receivable days-payable days	Use compatible valuation and day bases.
Simple funding estimate	Relevant daily operating cash cost xcash-cycle days	A teaching estimate, not a complete bank-limit assessment.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Management
Introduction

Historical formulation: The role of a financial manager does not stop with arranging long term sources of finance for creation of fixed assets to enable the firm to carry out its intended business operations.

CLARIFICATION / 1 NOVEMBER 2026

Permanent current-asset needs can be funded partly by long-term resources. The financing mix also depends on liquidity, refinancing risk, cost, security and bank terms; no single maturity rule decides every case.

Concept / condition / application
The money is also required for purchasing raw materials, converting them into finished goods and selling on credit to customers.

Current assets and their funding

Current-asset form	Funding connection
Raw materials / WIP / finished goods / receivables	Together form important parts of the operating current-asset cycle.
Short-term sources	Supplier credit, bank overdraft, public deposits, intercorporate deposits, commercial paper and factoring, subject to eligibility and risk.
Long-term sources	Can support the more stable/permanent portion of current assets.

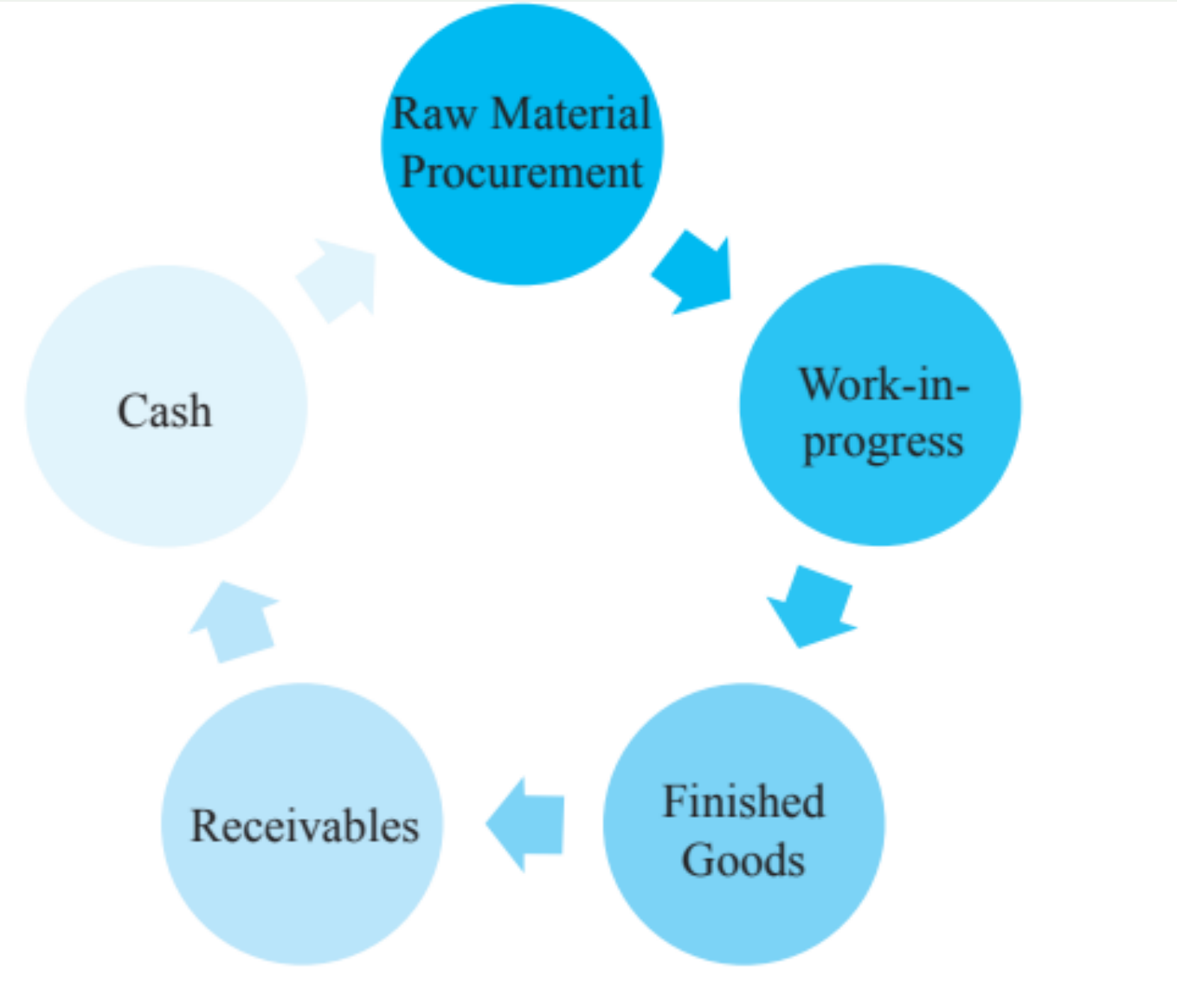
Concept / condition / application
A portion of these current assets is to be financed Financial management of working capital involves management of both current assets and the sources to finance them.
Working Capital Cycle

The normal operations of a business enterprise consist of some or all of the actions like, purchase of raw materials, processing/conversion of raw materials into finished goods, selling these goods on cash/ credit basis, receive cash on sale or end of credit period and again purchase raw materials. This is called working capital cycle. The length of

this cycle depends on:

Concept / condition / application
The stocks of raw materials required to be held.
The work in process, which in turn depends on the process involved in manufacturing/processing to convert the raw materials into finished goods.
The credit required to be provided to the purchasers.
The longer the working capital cycle, the more is working capital requirement, i.e., the need for maintaining the current assets.

Worked figure / record



Concept / condition / application
Current Assets Of A Firm
Current assets depends on various factors. The main factors that influence the

need of working capital in a business are as under:

Concept / condition / application
Nature of Business:
Public utility undertakings such as electricity, water supply and railways require very little working capital finance because they sell their services on cash terms. They supply services not products, and very little funds are tied up in inventories and receivables.
On the other hand, trading and financial firms require less investment in fixed assets but need large sums as working capital and fixed investments.
Size of the business:
Greater the size of the business, greater is the requirement of working capital.

Concept / condition / application
Production Policy:
If the policy is to keep production steady-not geared to peak and non-peak nature of business-then there will be an accumulation of inventories in the off peak season.
An average production level will help take care of this issue by ensuring the surplus of production in off peak season is disposed of during the peak season.
Seasonal variations:
Generally, during the busy season, a unit will require larger working capital than in slack season.

Concept / condition / application
Operating/Working capital cycle:
It is the duration of the operating cycle that determines the requirements of working capital.
Longer the cycle larger is the requirement of working capital.
The cycle duration decides the carry of inventory, the amount of labour and costs, and other expenses.
For example, if the firm has to import raw material, it may have to maintain a bigger stock, to take care of supply disruptions.

Concept / condition / application
Similarly, if industry practice is to provide 3 months' credit to customers, it will also have to do so.
In general, the current assets required to be held by a frim, can be classifies as

under:

Concept / condition / application
Cash & cash equivalents
Inventory
Receivables
Other current assets
Sources Of Finance For Current Assets

Concept / condition / application
The following are the main sources of finance for acquiring current assets;
Firm’s own working capital funds
Accruals
Trade Credit
Working Capital Advance by Commercial Banks/ Financial Institutions

Concept / condition / application
Public Deposits
Inter-Corporate Deposits
Rights Debentures for Working Capital
Commercial Paper
Factoring

Concept / condition / application
Forfaiting
Working Capital Assessment By Banks
First step in any method of assessment of working capital limits: Deciding on the Level of Turnover of the firm
In case of existing enterprises, the past performance is used as a guide to make an assessment and In case of new enterprises, this is based on the production capacity, proposed market share, availability of raw materials, industry norm, etc.
Despite analysis of all the data, accurate estimate of future turnover is often an area of disagreement between the bank and the borrower.

Concept / condition / application
Based on the projected turnover, banks adopt various methods for assessing the working capital needs of a firm

Quick Revision: connected banking concepts

Connection	Meaning and qualification
Factoring	Connects financing and collection/administration of receivables;recourse and risk allocation depend on the agreement.
Forfaiting	Financing against qualifying export receivables, typically without recourse to the exporter for the transferred debtor-credit risk, subject to terms and exceptions.
Operating-cycle assessment	Follow cash through raw material, WIP, finished goods and receivables. Inventory/receivable values and their dates affect financing needs.
Funding-form distinctions	Working-capital facilities and term finance can have different drawing, repayment and security structures;the product name does not replace the contract.
Older lending limits	The supplementary notes'Rs.10 crore assessment threshold,15%/40% exposure limits and rigid tenor bands are historical shorthand. They are not presented here as current universal bank-sanctioning rules.
Avoid false generalisations	More current assets do not always reduce profitability;the effect depends on returns, liquidity, operations and risk. A cash-flow statement measures cash flows even when reconciled from accrual records.

Apply your understanding: original practice

1. Compute the case cash cycle.

Answer and reason
30 inventory days+40 collection days-25 supplier days=45 days.

2. Why subtract supplier credit days?

Answer and reason
Suppliers finance that portion of the operating period before cash payment is required.

3. Does rising sales always improve liquidity?

Answer and reason
No. Growth can require more inventory and receivables before cash is collected.

4. Are all current assets equally liquid?

Answer and reason
No. Cash, overdue receivables, obsolete stock and prepayments have different liquidity characteristics.

5. What is net working capital if current assets areRs.5 lakh and current liabilitiesRs.3 lakh?

Answer and reason
Rs.2 lakh. This is a balance-sheet measure, not the entire cash budget or automatic borrowing eligibility.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Gross working capital concerns current assets.	15. Payable management requires agreed payment terms.
02. Net working capital subtracts current liabilities.	16. Short-term funding brings refinancing risk.
03. Permanent needs differ from seasonal needs.	17. Long-term funding can support permanent current assets.
04. Operating cycle links inventory and collection.	18. Matching maturities is a financing principle.
05. Cash cycle also reflects supplier credit.	19. Spontaneous finance arises through operations.
06. More collection days can increase funding need.	20. Bank finance needs applicable eligibility analysis.
07. More inventory days can tie up funds.	21. Collateral value differs from cash generation.
08. Supplier credit can reduce the cash gap.	22. Growth can consume working capital.
09. Liquidity and profitability can conflict.	23. Seasonality affects peak requirements.
10. Overinvestment can reduce returns.	24. Assumptions need sensitivity testing.
11. Underinvestment can disrupt production.	25. Case cash cycle is 45 days.
12. Cash budgets identify dated shortfalls.	26. Case simplified need isRs.4,50,000.
13. Inventory management concerns cost and availability.	27. Ten-day faster collection releasesRs.1,00,000.
14. Receivable management includes credit policy.	28. Actual cash patterns can be uneven.

MODULE C / C 10

Derivatives

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A buyer needsUSD 10,000 in three months and fixes an illustrative forward rate ofINR 83/USD. Contractual rupee cost isRs.8,30,000 before charges. If spot later becomes 85, the forward protects against aRs.20,000 increase; if spot is 81, the buyer gives up aRs.20,000 favourable movement. The objective can be certainty rather than winning every market outcome.

Change the situation

A call option may preserve upside for its buyer, but its premium is a real cost. A payoff and a profit calculation differ because profit must include premium and relevant costs.

COMMON MISTAKE - WHY IT FAILS

A derivative transfers selected risks; it does not remove counterparty, liquidity, basis or operational risk. A CDS transfers specified credit risk subject to its contract; it is not an unconditional guarantee against every loss.

Build the connections

Idea	Why it matters
1	Derivatives derive value from an underlying.
2	A forward is a negotiated future commitment.
3	A futures contract is standardised for exchange trading.
4	Margin supports performance and settlement.

Idea	Why it matters
1	Daily settlement can create liquidity demands.
2	An option buyer has a contractual right.
3	An option writer has a contingent obligation.
4	Calls and puts confer different rights.

Idea	Why it matters
1	Premium is different from exercise price.
2	Notional amount is not necessarily market value.
3	Payoff differs from profit after costs.
4	Hedging offsets a selected exposure.

Idea	Why it matters
1	Speculation deliberately assumes market exposure.
2	Arbitrage needs executable price differences.
3	Basis risk can leave residual exposure.
4	Counterparty default can disrupt a hedge.

Idea	Why it matters
1	A swap exchanges defined cash-flow obligations.
2	Interest-rate swaps need a stated reference basis.
3	Currency swaps can involve multiple currencies.
4	CDS protection depends on defined credit events.

Idea	Why it matters
1	Clearing reduces selected risks, not all risks.
2	Leverage can magnify losses.
3	Documentation and authority are essential.
4	Valuation and accounting need their framework.

Idea	Why it matters
1	Case forward cost isRs.8,30,000.
2	At 85 spot it avoidsRs.20,000 extra cost.
3	At 81 spot it forgoesRs.20,000 saving.
4	Judge hedge success against its risk objective.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Introduction
A derivative is a financial instrument whose value is derived from an underlying asset.
The derivatives do not have any direct value of themselves.
Their value is based on the expected future price movements of the underlying assets.
Derivatives are often used as instruments to hedge risks, like fluctuations in stock, bond, commodity and index prices, changes in foreign exchange rates, interest rates, etc.

Concept / condition / application
For regulatory purposes, derivatives have been defined in the Reserve Bank of India Act, as follows: “Derivative means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called “underlying”), or a combination of more than one of them and includes interest rate swaps,

forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such

Concept / condition / application
other instruments as may be specified by the Bank from time to time”.
Characteristics of Derivatives

A Derivative has the following 3 main characteristics:

Concept / condition / application
Their value changes in response to the change in a specified ‘underlying’ asset
High leverage and of being complex in their pricing and trading mechanism. They require no or little initial net investment
It is settled at a future date
Functions of Derivatives
Transfer of Risk: Derivatives shift the risk from the buyer of the derivative product to the seller and as such are very effective risk management tools

Concept / condition / application
Price Discovery: Derivatives improve the liquidity of the underlying instrument. Derivatives perform an important economic function viz. price discovery.
They provide better avenues for raising money.
They contribute substantially to increasing the depth of the markets.
Users of Derivatives

The main players in a financial market include

Concept / condition / application
Hedgers,
Speculators
Traders.

Hedging can be done in two ways

Concept / condition / application
Fixing a price (the linear way)
Taking an insurance (non-linear or asymmetric way).

Hedgers:

Historical formulation: They use derivatives markets to reduce or eliminate the risk associated with price of an asset. Majority of the participants in derivatives market belongs to this category.

CLARIFICATION / 1 NOVEMBER 2026

A hedge transfers selected risks. Counterparty, liquidity, basis, operational and legal risks can remain. CDS protection is conditional on the actual credit-event and settlement terms.

Speculators:

Concept / condition / application
They transact futures and options contracts to get extra leverage in betting on future movements in the price of an asset.
They can increase both the potential gains and potential losses by usage of derivatives, in a speculative venture.

Arbitrageurs:

Concept / condition / application
Their behaviour is guided by the desire to take advantage of a discrepancy between prices of more or less the same assets or competing assets in different markets.
If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.
Derivatives Markets
There are two distinct groups of derivative contracts based on their market:
Over-the-counter (OTC) derivatives:

Concept / condition / application
Contracts that are traded directly between two eligible parties, with or without the use of an intermediary and without going through an exchange.
The parameters of the contract, like the size, maturity etc., are not standardised and are mutually agreed to between the parties to a contract.
Exchange-traded derivatives:
Derivative products that are traded on an exchange.
The maturity and size of these products are standardized by the Exchange.

Concept / condition / application
Regulators Of Derivatives

In India, different derivatives instruments are permitted and regulated by various regulators, like Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Forward Markets Commission (FMC).

Concept / condition / application
RBI: To regulate the interest rate derivatives, foreign currency derivatives and credit derivatives.
SEBI: Regulates Stock market
FMC: Regulates commodities futures market.
Merged with SEBI with effect from September 28, 2015.
Types Of Derivatives

The derivatives broadly consist of forwards, futures, swaps and options.

Concept / condition / application
Forwards
Forwards are definitive purchases and/or sales of a currency or commodity for a future date.
Forward contracts are OTC contracts.
Forwards are useful in avoiding liquidity risk, price variations and avoiding losses in case of a downside.
Disadvantage: Contract has to be performed in full and has attendant credit risk and market risk.

Concept / condition / application
Forwards are most useful in forex transactions where a spot transaction can be covered for a contrary move in the forward market.
Futures
Futures contract is an agreement to buy or sell an asset for a certain price at a certain time in future.
It is similar to forward contract.
While a forward contract is traded over the counter,

Concept / condition / application
A futures contract is traded on an exchange.
It has standardized contract parameters.
Futures contracts are highly liquid and can be closed out easily.
In India, futures contracts are available and traded on the Stock Exchanges and commodity exchanges.
Available on currencies, bonds, interest rates, stock indices, commodities etc.

Concept / condition / application
Pricing Futures: The price of any futures contract has three essential components.

These are:

Concept / condition / application
The spot price of the underlying asset
The cost of financing, storing, insuring and transporting the asset
The income if any, earned from the asset
Taking all these three factors into account futures price(FP) will be
Spot price (SP) + financing and other costs – income if any. F.P = S.P + Costs – Income

Concept / condition / application
Swaps
In financial markets, the two parties to a swap transaction contract to exchange cash flows.
A swap is a custom tailored bilateral agreement in which cash flows are determined by applying a prearranged formula on a notional principal.

Swaps are generally of the following types:

Interest Rate Swap:

Concept / condition / application
Where cash flows at a fixed rate of interest are exchanged for cash flows linked to a floating rate over a period of time. There is no exchange of principal.

Currency Swap:

Concept / condition / application
Where cash flows in one currency are exchanged for cash flows in another currency.
The major difference between a generic interest rate swap (IRS) and a generic currency swap is that the latter includes not only the exchange of interest rate
payments but also the exchange of principal amounts both initially and on termination.

Basis Swaps:

Concept / condition / application
Where cash flows on both the legs of the swap are referenced to different floating rates

Swaps can be used:

To create either synthetic fixed or floating rate liabilities or assets To hedge against adverse movements As an asset liability management tool To reduce the funding cost by exploiting the comparative advantage that each counterparty has in the fixed/floating rate markets

Concept / condition / application
Options
An option is a contract, which gives the buyer (holder) the right, but not the obligation, to buy or sell specified quantity of the underlying assets, at a specific (strike) price on or before a specified time (expiration date).
The underlying may be physical commodities like wheat/rice/cotton/gold/oil or financial instruments like equity stocks/stock index/bonds etc.

Concept / condition / application
The price paid by the buyer to the seller to acquire the right to buy or sell is

called Premium.

Concept / condition / application
Exercise Date is the date on which the option is actually exercised.
In case of European Options the exercise date is same as the expiration date while in case of American Options, the options contract may be exercised any day between the purchase of the contract and its expiration date.
An option can be a call option or a put option.
A call Option: Gives the buyer the right to buy specified quantity of the underlying asset at the strike price on or before expiration date. The seller has the obligation to sell the underlying asset if the buyer of the call option decides to exercise his option to buy.
A Put option: Gives the buyer the right to sell specified quantity of the underlying asset at the strike price on or before expiry date.

Concept / condition / application
The seller of the put option has the obligation to buy the underlying asset at the strike price if the buyer decides to exercise his option to sell.
Important Derivative Products In Indian Financial Market
Forward Rate Agreement (FRA)
A FRA is a forward contract on the interest rate.
It is a financial contract to exchange interest payments based on a fixed interest rate with payments based on floating interest rate like 3 m MIBOR.

Concept / condition / application
The exchange of payments is based on a notional principal of the FRA. Thus,

there are 2 legs in a FRA:

Concept / condition / application
The fixed leg The floating leg.

Illustration

Let us assume that a corporate wants to borrow a sum of Rs. 1 crore for a period of six months starting three months from today. Its main concern is that the six months interest rate may rise in three months time and hence it wants to lock in a rate right today for a future borrowing commitment.

It enters into a 3 Vs 9 FRA with a counterparty for a notional amount of Rs.1 crore. If the counterparty quotes, say, 6.25/6.50 for a 3 Vs 9 FRA, the corporate buys the FRA at 6.50 which effectively means that it is locking itself for 6.5% for the above borrowing commitment.

If on the date of settlement, which is the date three months from today when the borrowing commitment has to be met, the benchmark rate agreed to by the counterparties settles, say, at 7.00%, the corporate's view on the interest rate has come true and it is paid by the seller of FRA the difference of 0.50% (7 - 6.5) on the notional principal for a period of 6 months discounted at 7%. On the other hand, if the benchmark interest rate settles at, say,6.25% on the settlement date, the corporate pays the seller of FRA the difference of 0.25% (6.5-6.25) on the notional principal of Rs. 1 crore discounted at 6.25%. Thus in both the cases (whether interest rate rises or falls) the corporate's effective borrowing rate remains unchanged at 6.5%.

Idea	Why it matters
1	Clearing reduces selected risks, not all risks.
2	Leverage can magnify losses.
3	Documentation and authority are essential.
4	Valuation and accounting need their framework.

Concept / condition / application
Salient Points of FRA
As FRAs are OTC contracts, it is easy to customise the size and periods to suit the needs of the customer. Further, as the commitment is only to settle the interest differential, the credit risk with the counter party is minimal
FRAs are used to hedge short term interest rate risk. FRAs do not enjoy very liquid markets. At times, it may become difficult to dispose of an FRA in the market at competitive prices.
A FRA is a contract between two parties by which they agree to settle between them the interest differential on a notional principal on a future settlement date for a specified future period
A person who has a commitment to borrow money at a future point of time buys a FRA to protect himself against interest rate risk and a person who has a commitment to lend money at a future point of time sells a Forward Rate Agreement to hedge his interest rate exposure.

Concept / condition / application
FRAs can be used effectively to lock in interest rates and thus manage the gaps between rate sensitive assets and liabilities of the balance sheet. Thus they are very useful in Asset Liability Management.
Plain Vanilla Interest Rate Swaps
A Plain Vanilla Swap is the simplest form of Interest rate swaps where a
fixed rate is exchanged for a floating rate or vice versa on a given notional

principal at pre-agreed intervals, during the life of the contract.

Concept / condition / application
Important RBI guidelines regarding interest rate swaps are as under:
Banks can undertake IRS as a product for their own balance sheet management or for market making.
Banks may also offer these products to corporates for hedging their own balance sheet exposures.
Banks should ensure adequate infrastructure and risk management systems before venturing into market making activities.
The Bench Mark rate should necessarily evolve on its own in the market and require market acceptance.

Concept / condition / application
The parties are free to use any domestic money or debt market rate as benchmark rate provided the methodology of computing the rate is objective, transparent and mutually acceptable.
There is no restriction on the minimum or maximum size of notional principal amounts.
There is no restriction on the tenor as well.
Banks are required to maintain capital for FRAs and IRS
Salient points of Interest rate swaps

Concept / condition / application
An interest rate swap is a series of FRAs.
The notional principal is not normally exchanged between the counterparties in an FRA and IRS.
An Interest Rate Swap is a contract between two parties whereby they agree to exchange a stream of interest payments on a notional principal for a given period at pre-agreed intervals of time.
Buying an IRS means choosing to pay Fixed and receive Floating.
Prices of IRS are quoted in terms of the fixed leg.

Concept / condition / application
Pricing of IRS is based on the present value of fixed rate cash flows and floating rate cash flows.
Interest Rate Options
Interest Rate options are fundamentally of two types, the Cap and the Floor.
A Cap is an interest rate option in which the buyer of the option, with the intention of locking himself to a ceiling in interest costs for his borrowing, reserves the right to receive the difference in interest rate on a notional principal in case the interest rate on the underlying borrowing goes higher than the ceiling he has chosen at pre-agreed periodic intervals for a given time maturity.

Illustration

Concept / condition / application
To illustrate, let us say we have issued a bond for Rs. 100 crore and raised money in the market at a floating rate of 6 Mibor + 50 basis points.
And let us assume that we have invested the money at fixed rate of 8%. We have also agreed to pay the investors in our bond interest at 6 monthly intervals and the maturity of the bond is say 5 years.
This means that we have an interest rate risk for the next 5 years in case the 6 m Mibor goes higher and higher.
If the 6 m Mibor is currently 5%, our return is 8 - 5.5 =2.5%.
However, if 6 m Mibor were to go higher at future points of time, our return would go down below 2.5% till the interest rate reaches 7.5%, when we would just break even.

Concept / condition / application
Beyond 7.5% level in Mibor, we will make a negative spread.
In order to eliminate this risk we may buy a CAP at, say, 7.0%. This means that we are sure of getting a spread of at least 0.5% in the above structure and any movement in 6 m Mibor beyond 7% will result in our being compensated by the seller of the CAP.
The 6 m Mibor rate is prevailing on each of the 6 monthly coupon payment dates and if it is higher than 7%, the difference on the notional principal will be paid by the seller of the CAP.
However, if the 6 m Mibor is less than 7%, we choose not to exercise the option and hence we need not pay the seller the difference as is obtaining in an FRA or an IRS.
Salient Points of Interest Rate Options

Concept / condition / application
Separation of liquidity from return exposure
Allows the option purchaser to acquire or shed exposure to the underlying asset without the necessity to purchase or sell the asset itself.
The option contract is also inherently leveraged in that the full face value of the underlying asset is controlled through the payment of a premium that represents a percentage of the face value.
The key element of the option contract is the ability of an option buyer to get asymmetric exposure to price fluctuations in the underlying asset.
The option contract is off balance sheet to the parties entering the transaction.

Concept / condition / application
Credit Default Swaps (CDS)

Concept / condition / application
This is a bilateral contract in which the risk seller (lending bank) pays a premium to the buyer for protection against credit default or any other specified credit event resulting in loss in the value of an underlying debt instrument.
The protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier.
Normally, CDS is a standardized instrument of ISDA (International Swaps and Derivatives Association).
The credit events defined by ISDA are, bankruptcy, failure to pay, restructuring, obligation acceleration, obligation repudiation/moratorium etc.

Concept / condition / application
As per RBI guidelines, only plain vanilla CDSs are allowed.

Credit default swap relationship

Participant	Role
Investor / risk bearer	Has the underlying credit exposure.
Protection arrangement: CDS	Transfers specified credit-event risk under its terms.
Institution / counterparty	Provides contractual protection, subject to its own ability and obligation to perform.

Market-makers and users are not allowed to deal in any structured

Concept / condition / application
financial product with a credit derivative as one of the components or as an

underlying.

The following debt instruments are eligible to be a reference/ deliverable

obligation in a CDS contract:

Concept / condition / application
Commercial Papers, Certificates of Deposit and Non-Convertible Debentures of original maturity up to one year;
Rated INR corporate bonds (listed and unlisted); and
Unrated INR bonds issued by the Special Purpose Vehicles set up by infrastructure companies.
Asset-backed securities/mortgage-backed securities and structured obligations such as credit enhanced/ guaranteed bonds, convertible bonds, bonds with call/put options etc. are not permitted as reference and deliverable obligations.

Apply your understanding: original practice

1. Why can a hedge lose money while succeeding?

Answer and reason
A derivative loss can offset a favourable change in the underlying exposure. Assess the combined position and risk objective.

2. What is the forward buyer's cost in the case?

Answer and reason
USD 10,000 xINR 83/USD=Rs.8,30,000 before charges.

3. Is an option buyer required to exercise an uneconomic right?

Answer and reason
Normally the buyer can choose not to exercise, but premium and contract terms still matter.

4. Why can futures require cash before final maturity?

Answer and reason
Margin and mark-to-market settlement can create interim liquidity requirements.

5. Does a CDS protect every business loss?

Answer and reason
No. Protection is governed by specified reference obligations/entities, credit events, settlement and other contractual conditions.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Derivatives derive value from an underlying.	15. Basis risk can leave residual exposure.
02. A forward is a negotiated future commitment.	16. Counterparty default can disrupt a hedge.
03. A futures contract is standardised for exchange trading.	17. A swap exchanges defined cash-flow obligations.
04. Margin supports performance and settlement.	18. Interest-rate swaps need a stated reference basis.
05. Daily settlement can create liquidity demands.	19. Currency swaps can involve multiple currencies.
06. An option buyer has a contractual right.	20. CDS protection depends on defined credit events.
07. An option writer has a contingent obligation.	21. Clearing reduces selected risks, not all risks.
08. Calls and puts confer different rights.	22. Leverage can magnify losses.
09. Premium is different from exercise price.	23. Documentation and authority are essential.
10. Notional amount is not necessarily market value.	24. Valuation and accounting need their framework.
11. Payoff differs from profit after costs.	25. Case forward cost isRs.8,30,000.
12. Hedging offsets a selected exposure.	26. At 85 spot it avoidsRs.20,000 extra cost.
13. Speculation deliberately assumes market exposure.	27. At 81 spot it forgoesRs.20,000 saving.
14. Arbitrage needs executable price differences.	28. Judge hedge success against its risk objective.

MODULE D / D 01

Taxation: Income Tax/TDS/Deferred Tax

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

Assume a person has final tax liability Rs.50,000 for the relevant period, supported TDS credit Rs.35,000 and advance tax Rs.10,000. The balance before other credits, interest or fees is 50,000-35,000-10,000=Rs.5,000. TDS is a collection mechanism and credit; it is not automatically the final tax. Identify the taxpayer, income period, applicable Act and regime first.

Change the situation

If valid TDS credit is insteadRs.45,000, total prepaid tax becomesRs.55,000 and the simple excess isRs.5,000, subject to return processing and other adjustments. More TDS does not create more taxable income.

COMMON MISTAKE - WHY IT FAILS

The older 1961 Act section references and AY 2021-22 forms in the reading are historical. The 2025 Act applies from 1 April 2026 to the relevant new tax years, with transition rules for earlier periods. Do not use an old section number, threshold or form as a current universal rule.

Build the connections

Idea	Why it matters
1	Tax computation begins with person and period.
2	Residence affects the relevant income scope.
3	Taxable income differs from cash receipts.
4	The applicable Act depends on transition rules.

Idea	Why it matters
1	Income-tax Act 2025 operates from 1 April 2026.
2	Earlier periods retain relevant 1961 Act treatment.
3	Tax year terminology needs correct period mapping.
4	Section numbers are not interchangeable across Acts.

Idea	Why it matters
1	Salary and business income require different rules.
2	House-property and capital-gain rules differ.
3	Other-sources income needs its own analysis.
4	Classify income before applying deductions.

Idea	Why it matters
1	Exemption differs from deduction.
2	Deduction eligibility depends on conditions.
3	Old and new regimes have different rules.
4	A slab rate is not the rate on every rupee.

Idea	Why it matters
1	TDS is tax collected at source.
2	The deductor and deductee have different duties.
3	TDS credit needs correct reporting and entitlement.
4	TDS does not necessarily settle final liability.

Idea	Why it matters
1	Advance tax differs from self-assessment tax.
2	Returns reconcile income, tax and credits.
3	Correct forms depend on person and income.
4	Refund and loss carry-forward have their conditions.

Idea	Why it matters
1	Current tax differs from deferred tax.
2	AS 22 uses timing-difference analysis.
3	Ind AS 12 uses temporary-difference analysis.
4	A deferred-tax asset needs recognition criteria.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Simple balance tax	Final tax liability-valid credits/prepayments	Interest, fees, refund adjustments and other rules may alter the final amount.
Deferred-tax measurement	Relevant reversing difference xapplicable tax rate	Recognition/measurement depend on AS 22 orInd AS 12;not every difference creates a recognised asset.

Dated tax bridge: choose the correct period

For tax year 2026-27, section 202 of the 2025 Act uses the following new-regime bands for the stated eligible persons. These are marginal bands, not a flat rate on all income. Special-rate income, rebates, surcharge, cess, permitted deductions and regime choice require separate analysis.

Total income band (Rs.)	Marginal rate
Up to4,00,000	Nil
4,00,001-8,00,000	5%
8,00,001-12,00,000	10%
12,00,001-16,00,000	15%
16,00,001-20,00,000	20%
20,00,001-24,00,000	25%
Above24,00,000	30%

A marginal slab calculation is only one stage. Do not describeRs.12 lakh as the basic nil-rate slab merely because a qualifying rebate may change final liability.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Historical formulation: Tax/TDS/Deferred Tax

CLARIFICATION / 1 NOVEMBER 2026

AS 22 uses timing differences; Ind AS 12 uses temporary differences between carrying amounts and tax bases. Recognition of deferred-tax assets requires the applicable recoverability criteria. A permanent difference does not simply become a deferred-tax asset.

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

Concept / condition / application
Overview Of Income Tax Act
Every person who earns or gets an income in India is subject to income tax.
NRI are also subject to Income tax on their income earned in India.

Historical formulation: The levy of income tax in India is governed by the Income Tax Act, 1961 and

CLARIFICATION / 1 NOVEMBER 2026

Historical tax references: map the relevant period to the applicable Act. Income-tax Act 2025 applies from 1 April 2026 with transition rules; old section numbers, regime descriptions, forms, filing thresholds and exceptions must not be treated as current universal instructions.

Concept / condition / application
Income Tax Rules, 1962.
The finance budget, presented every year in the month of February, brings various amendments in Income-tax Act, 1961.
Such amendments, if approved, become part of the income tax Act.

This Act contains detailed provisions on important topics like

Computation of income, Exemptions and deductions available, Tax slabs, Calculation of tax liability, Formats of return forms applicable to different assessee, etc.

Concept / condition / application
Tax Deducted At Source (TDS)
As per the Income Tax Act, any company or person making a payment, is required to deduct tax at source, at the rates prescribed by the income tax department, if the payment exceeds certain threshold limits.
The provisions of TDS apply to several payments like salary, interest, commission, brokerage, dividend payments, professional fees, royalty, etc.

TDS roles

Role	Meaning
Deductor	Person/company required to deduct tax before/at the relevant payment or credit under applicable law.
Deductee	Person receiving the payment and eligible to claim relevant tax credit.
Flow	Gross amount -> tax deducted/remitted + net amount paid; reconcile reporting and credit.

Concept / condition / application
It is the deductor's responsibility to deduct TDS before making the payment and deposit the same with the government
Each deductor (except when tax is deducted under Section 194-IA) is required to obtain a Tax Deduction Account Number (TAN).
TDS is required to be deducted irrespective of the mode of payment-cash, cheque or credit-and is linked to the TAN of the deductor and PAN of the deductee.
There are separate rules for individuals for deducting TDS when they make rent payments or pay fees to professionals like lawyers and doctors.
TDS is a kind of advance tax paid by the deductee.

Concept / condition / application
For the deductees, the deducted TDS is claimed as a tax paid and a refund can be claimed if the tax liability is less than the TDS.
Tax Collected At Source (TCS)
Tax collected at source (TCS) represents the tax collected by a seller from the buyer at the time of sale.
Section 206 C of the Income-tax act specifies the categories of goods and the
% age of TCS to be collected by the seller from the buyers.

For example

Concept / condition / application
TCS on Liquor of alcoholic nature, made for consumption by humans, is 1% and on Tendu leaves it is 5%.

Exempts certain buyers from the scope of TCS.

Concept / condition / application
Public sector companies, Central or State Governments, Embassies etc.
Int of 1% in case of delay: If the tax collector, who is responsible for collecting the tax, does not collect the tax or after collecting doesn't pay it to the government before or on the due dates, he is liable to pay interest of 1% per

month.

Concept / condition / application
Submit quarterly TCS return (Form 27 EQ) in respect of the tax collected by him in a particular quarter.
The interest on delay in payment of TCS to the government should be paid before filing of the return.
Form 27 D: The tax collector has to provide a TCS certificate to the purchaser of the goods.

Historical formulation: Section 206 (1 H): Introduced in October 2020 for collecting TCS from the buyers of goods who makes a payment of more than Rs 50 lakhs towards sale consideration in the financial year.

CLARIFICATION / 1 NOVEMBER 2026

The older sale-of-goods TCS rule under section 206 C(1 H)ceased to apply from 1 April 2025. Do not continue it from this historical note. Income-tax TCS and GSTe-commerce TCS are separate regimes with different applicable provisions.

Concept / condition / application
206 CCA: Inserted in 2021 for collecting a higher rate of TCS for non-filers of the income tax return in the last two years.
TCS under GST
Important provisions in this regard, effective from 1 st Oct 2018, are as under:
Any dealer or traders selling goods online would get the payment from the online platform after deducting an amount tax @ 1% under IGST Act. (0.5% in CGST & 0.5% in SGST)
The tax would have to be deposited to the government by 10 th of the next month.

Concept / condition / application
All the dealers/traders are required to get registered under GST compulsorily.
Classification Of Income Tax Payers
For the purpose of income tax, the term, ‘Person’, as mentioned in Section 2 of IT Act,

includes the following:

Concept / condition / application
An individual: An individual means a natural human being and also includes a person of unsound mind.
A Hindu undivided family: Under Hindu Law, an HUF is a family which consists of all persons lineally descended from a common ancestor and includes their wives and unmarried daughters. Jain and Sikh families are treated as HUF under the Act, even though they are not governed by the Hindu Law.
A Company: Both domestic and foreign companies are included under this classification. An individual and a company are not taxed at the same rate. Individuals are taxed on the basis of tax slabs at different rates The income-tax paid by domestic and foreign companies, on their income in India, is corporate income tax (CIT)
A Firm or LLP: Under the partnership law, a Firm is not a legal entity. However, for income tax as well as GST, it is a separate legal entity. Thus, a firm is regarded as a unit of assessment. A limited liability partnership (LLP) is a body corporate formed and incorporated under the Limited Liability Partnership Act, 2008. It is a legally separated entity from that of its partner. All firms and LLPs are, presently,

taxed at a flat rate of 30%.

An association of persons (AOP) or body of individuals (BOI), whether incorporated or not: Here it is important to note that an AOP or BOI is deemed to be a person, whether or not, it was formed or established or incorporated

with the object of deriving income, profits or gains.

Concept / condition / application
Trust created wholly for charitable or religious purposes are allowed various benefits under the Income Tax Act, inter-alia, and exemption u/s 11.
A local authority: A local authority means the Municipalities and Panchayats etc.
Artificial Juridical Person (AJP): If an Assessee does not fall under any of the other categories that are included in the definition of Person then it is regarded as an Artificial Juridical Person. These entities are not natural persons but separate entities as per law. The tax liability of a person depends upon his legal status and above mentioned categories. Different rates of tax are prescribed for different categories.
Classification Of Income Heads
For the purpose of Income Tax, the income is categorised in to five heads, as

under:

Concept / condition / application
Income from Salary:

Historical formulation: Income from salary and pension is covered under this head. The amount is arrived at after allowing standard deduction of Rs. 50,000, a deduction in respect of any allowance in the nature of an

entertainment allowance (subject to certain conditions), and deduction of any sum paid on account of a tax on employment.

CLARIFICATION / 1 NOVEMBER 2026

The oldRs.50,000 salary standard-deduction statement is not universal. For the new regime the relevant allowance is up toRs.75,000 or salary, whichever is lower, under the applicable provisions;the normal-regime amount and other conditions differ. Match the period, Act and regime.

Concept / condition / application
Income from House Property:
This consists mostly of rental income. The taxes levied by any local authority in respect of the property, are allowed to be deducted.
The amount of any interest payable on borrowed capital is also allowed to be deducted.
Profits and gains of Business or Profession:
This is when you are self - employed, work as a freelancer or contractor, or you run a business.

Concept / condition / application
Life insurance agents, doctors, chartered accountants, and lawyers who have their own practice, tuition teachers, architects etc., Corporates, Banks, Insurance Companies and Financial Institutions are taxed under this head.
Income from Capital Gains:
Income from sale of a capital asset such as mutual funds, shares, house property, and agricultural land is included under this head.
Where a shareholder receives any money or other assets from the company on its liquidation, he shall be chargeable to income-tax under this head.
Income from Other Sources:

Concept / condition / application
Consists of income from savings bank account, fixed deposits, winnings from competitions etc. Gross total income is the total income earned by the assessee during any financial year.
It is the sum total of all incomes earned by the Assessee under each of the above mentioned heads of income.
Incomes Not Included In Total Income
In computing the total income of any person, any income falling within any of
the clauses of Section 10 of the IT Act are not included.

Concept / condition / application
Some of these incomes: Agricultural income, share of a partner in the total income of the firm, the value of any travel concession or assistance received by an individual, gratuity received, sum received on voluntary retirement or termination of service, payment from an approved superannuation fund, scholarships granted to meet the cost of education
Deductions To Be Made In Computing Total Income

Chapter VIA specifies the exemptions available for deductions from the Gross Income for the arriving at the taxable income of the Assessee to calculate the income tax liability.

Concept / condition / application
These deductions are specified in sections 80 C to 80 U. Some of these deductions are

mentioned below:

Concept / condition / application
Section 80 C: Deduction in respect of life insurance premia, deferred annuity, contributions to provident fund, subscription to certain equity shares or debentures, etc. The aggregate amount of deductions under section 80 C, section 80 CCC and sub-section (1) of section 80 CCD is limited to Rupees one hundred and fifty thousand.
Section 80 D: Deduction in respect of health insurance premia.
80 E: Deduction in respect of interest on loan taken for higher education.
80 G: Deduction in respect of donations to certain funds, charitable institutions, etc.
80 QQB: Deduction in respect of royalty income, etc., of authors of certain books other than text-books 80 RRB: Deduction in respect of royalty on patents.

Concept / condition / application
80 TTA: Deduction in respect of interest on deposits in savings account.
80 TTB: Deduction in respect of interest on deposits in case of senior citizens.
80 U: Deduction in case of a person with disability.
New Tax Regime
Through the Finance Act 2020, a new section 115 BAC has been inserted in the IT Act, wherein an individual gets an option to choose between the existing

Concept / condition / application
tax rates and the new concessional tax rates by foregoing prescribed exemptions or deductions.

In 2019 - Section 115 BAA, has been inserted in the IT Act: benefit of a reduced corporate tax rate to domestic companies. It states that domestic companies have the option to pay tax at a rate of 22% (plus applicable surcharge and cess), from the FY 2019-20 onwards if they adhere to certain conditions specified.

Concept / condition / application
The domestic companies who do not wish to avail of this concessional rate immediately can opt for the same after the expiry of their exemptions/incentives.
However, once a company opts for the concessional tax rate under this section, it cannot subsequently withdraw from it.
Filing IT Return
It is mandatory to file the income tax returns for residents and NRIs whose gross
total income (before allowing any deductions under section 80 C to 80 U) exceeds threshold exempt income for that assessment year.

Concept / condition / application
It is also mandatory if an income tax refund is to be claimed or a loss under a head of income is to be carried forward.
It is also mandatory in case of a Resident individual having an asset or financial interest in an entity located outside of India.
It is mandatory for a company or a firm irrespective of whether it has income or loss during the financial year.
If after furnishing the return, a person finds any mistake, omission or any wrong statement, the return can be revised within prescribed time limit.
e-Filing of return is mandatory.

Concept / condition / application
However, paper returns can be filed by those who are above 80 years of age and do not have any income from regular business or profession.
Applicable Form Of Income Tax Return (ITR)
Particulars of income earned during a financial year and taxes paid on such income are provided to the IT Department.
If the tax already paid > that payable, a refund is claimed.
Certain losses can also be carry -forward to the next assessment year.

Concept / condition / application
Different forms of returns of income are prescribed for filing of returns depending on the status of the person and the nature of income.
For the assessment year 2021-22 (i.e., financial year 2020-21) ITR – 1 to ITR -7 have been prescribed.
Deferred Tax

Concept / condition / application
The taxable income and accounting income may not be the same as the taxable income is calculated in accordance with tax laws while the accounting income is calculated by applying the accounting policies.
The differences can be classified into permanent differences and timing differences.

Concept / condition / application
Permanent differences
Originate in one period and do not reverse subsequently.
For example: if the tax law does not allow an item of expenditure, the disallowed amount will result in a permanent difference.
Timing differences originate in one period and are eligible for reversal in subsequent period/s.
The Deferred Tax is brought into accounts to make the clear picture of current tax and future tax.

Concept / condition / application
This deferred tax results into inclusion of either the Deferred Tax Assets or the Deferred Tax Liabilities in the balance sheet.
As per Ind AS, Deferred Tax liabilities should not be classified as current liabilities and Deferred Tax assets should not be classified as current assets.

Apply your understanding: original practice

1. What remains payable in the basic case?

Answer and reason
Rs.5,000 before other adjustments: 50,000-35,000-10,000. Reconcile each credit to supporting records.

2. Is TDS always an additional tax beyond income tax?

Answer and reason
No. It is generally a collection and credit mechanism against the relevant final liability, subject to the law.

3. Can a 1961 Act section number be assumed identical in the 2025 Act?

Answer and reason
No. Use the official mapping and transition guidance; the new Act reorganises provisions.

4. Is every accounting expense immediately tax-deductible?

Answer and reason
No. Deductibility and timing follow applicable tax law. Differences may be permanent or reversing.

5. Does every reversing difference automatically justify a deferred-tax asset?

Answer and reason
No. Apply the relevant AS/Ind AS recognition, measurement and recoverability requirements.

Official reference: Income-tax 2025 transition | checked1November2026.

Official reference: 2026 rates official FAQs | checked1November2026.

Official reference: MCA Ind AS 12 | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Tax computation begins with person and period.	15. Old and new regimes have different rules.
02. Residence affects the relevant income scope.	16. A slab rate is not the rate on every rupee.
03. Taxable income differs from cash receipts.	17. TDS is tax collected at source.
04. The applicable Act depends on transition rules.	18. The deductor and deductee have different duties.
05. Income-tax Act 2025 operates from 1 April 2026.	19. TDS credit needs correct reporting and entitlement.
06. Earlier periods retain relevant 1961 Act treatment.	20. TDS does not necessarily settle final liability.
07. Tax year terminology needs correct period mapping.	21. Advance tax differs from self-assessment tax.
08. Section numbers are not interchangeable across Acts.	22. Returns reconcile income, tax and credits.
09. Salary and business income require different rules.	23. Correct forms depend on person and income.
10. House-property and capital-gain rules differ.	24. Refund and loss carry-forward have their conditions.
11. Other-sources income needs its own analysis.	25. Current tax differs from deferred tax.
12. Classify income before applying deductions.	26. AS 22 uses timing-difference analysis.
13. Exemption differs from deduction.	27. Ind AS 12 uses temporary-difference analysis.
14. Deduction eligibility depends on conditions.	28. A deferred-tax asset needs recognition criteria.

MODULE D / D 02

Goods & Services Tax

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

For a teaching example assume a taxable intra-State service valueRs.10,000 at total GST 18%, split 9% CGST and 9% SGST. Output tax isRs.1,800. IfRs.600 of appropriately usable eligible input credit is available and all conditions are met, the simplified cash payment isRs.1,200. Rate, place of supply and credit eligibility must be established before doing arithmetic.

Change the situation

For an inter-State supply at the same assumed total rate, the invoice usesIGSTRs.1,800 rather than theCGST/SGSTpair. Credit utilisation must still follow the prescribed order and restrictions.

COMMON MISTAKE - WHY IT FAILS

Older rate lists, Rs.1.5 crore return-frequency thresholds and CENVAT wording are not a current GST rulebook. GST is levied on the taxable supply value; input credit can reduce cascading, but tax is not literally computed only on a trader's margin in every case.

Build the connections

Idea	Why it matters
1	GST is a supply-based indirect-tax framework.
2	Taxable event differs from income-tax profit.
3	Intra-State and inter-State treatment differ.
4	Place of supply is central to that distinction.

Idea	Why it matters
1	CGSTandSGSTnormally share intra-State tax.
2	IGSTapplies to relevant inter-State supplies.
3	UTGSTrequires its applicable territorial context.
4	Imports and exports have special rules.

Idea	Why it matters
1	Exemption differs from zero-rating.
2	Registration depends on applicable conditions.
3	A GSTINidentifies a registration.
4	Distinct registrations can have supply consequences.

Idea	Why it matters
1	Input credit has eligibility conditions.
2	Blocked credit cannot be assumed usable.
3	Credit utilisation follows legal ordering.
4	An invoice alone may not establish entitlement.

Idea	Why it matters
1	Value and time of supply affect tax.
2	Rate notifications depend on classification and date.
3	A Council recommendation needs legal implementation.
4	Older slab lists are not permanently complete.

Idea	Why it matters
1	Return filing differs from tax payment.
2	QRMPis quarterly returns with monthly payment.
3	Interest differs from late fee.
4	Banking-service exemptions need specific analysis.

Idea	Why it matters
1	The case output tax isRs.1,800.
2	The case assumed usable credit isRs.600.
3	The simplified cash amount isRs.1,200.
4	Bank 50% ITCoption needs scope and proviso analysis.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Output tax	Applicable taxable value xapplicable notified rate	Classify supply, place and date first.
Simplified cash payment	Output liability-appropriately usable eligible credit	Observe statutory eligibility, blocked credits and utilisation ordering.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Tax
Introduction
Taxation is the process adopted by a government to levy and collect taxes from individuals, business entities and other organisations in the country.
Due to Federal structure, both the Central and State governments are involved in determining the various aspects of taxation, in India.
Over the last few years, various policy reforms have been undertaken by the Central and State governments to streamline the process of taxation

Tax families

Direct tax	Indirect tax
Income tax is a principal example.	GST is a principal example.
Statutory liability and economic incidence need analysis.	Collection through the supply chain does not remove statutory obligations.

Concept / condition / application
Direct tax
Tax imposed directly on a taxpayer and it is required to be paid to the government directly by the taxpayer.
Cannot be transferred or shifted to another person.

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

For example, the income tax paid by an individual is considered a direct tax because the burden of the tax falls solely on the individual who has a taxable income and he cannot shift the tax to others.

Historical formulation: Others: corporate tax, wealth tax, property tax, capital gains tax, and securities transaction tax (STT).

CLARIFICATION / 1 NOVEMBER 2026

Older rate lists are historical. The 2025 rate rationalisation changed many goods/services from 22 September 2025 with specified exceptions. Determine classification, date, place and the applicable notified rate; a short slab list is not a current rate directory.

Concept / condition / application
Indirect taxes

Which can be shifted to another person/entity. It is not the tax levied on the income or profit but on the goods and services rendered. Can be shifted from one individual/entity to another.

Concept / condition / application
For example, a sales tax paid by the buyer in a retail setting is not paid directly by

the buyer.

Concept / condition / application
It is collected by the seller from the buyer and paid to the government.
implementation of goods and services tax (GST) regime from 01 July 2017 has resulted in replacing all forms of indirect taxes, imposed on goods and services by the state and central governments.
Other levies which were applicable on inter-State transportation of goods have also been done away in the GST regime.
Difference Between Direct Tax and Indirect Tax

Worked record / comparison

Parameter	Direct tax	Indirect tax
Tax Imposition	This tax is directly the taxpayer’s income.	This tax on taxpayers for the goods and services availed or purchased.

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

Worked record / comparison

Payment course	This tax is directly paid to the government.	This tax is indirectly paid to the government through an intermediary.
Paying Entity	These taxes are paid by individuals and businesses.	These taxes are paid by end-consumers.
Rate of Payment	The rate of tax is decided by the government based on profit and income.	Tax rates are the same for everyone.
Transferability of tax	This type of tax is non-transferrable.	This type of tax is transferable.
Nature of Tax	This is a progressive type of tax. This tax rate increases with an individual's profit and income.	This is a regressive type of tax, which means the tax rate is not affected by the individual's income.
Types of tax	Income tax, wealth tax, corporate tax, etc.	Sales tax, service tax, value added tax, etc.
Tax Collection	Collecting this type of tax is difficult.	Tax collection is relatively easier.

Concept / condition / application
Goods And Services Tax (GST)
Introduced: From 01 July 2017
A large number of Central and State taxes got amalgamated into a single tax.
Easier to administer and encourages a shift from the informal to formal economy.
GST is intended for the unification of the various indirect taxes, prevailing in the country.

Concept / condition / application
Also aims at reducing the physical interface and lower the cost of compliance.
GST is levied on all transactions such as sale, transfer, purchase, barter, lease, or import of goods and/or services.
Comprehensive tax subsuming almost all the indirect taxes except a few State taxes.
Not in regime: crude oil, petroleum products, electricity and Alcoholic liquor for human consumption.
India adopted a dual GST model, meaning that taxation is administered by both the Union and State Governments.

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

There are 4 types of GST in India, as mentioned below:

GST components

Component	Context
CGST	Central share in the relevant intra-State structure
SGST	State share in the relevant intra-State structure
UTGST	Relevant Union Territory counterpart where applicable
IGST	Relevant inter-State/import structure; place-of-supply rules matter

Concept / condition / application
Transactions made within a single state are levied with Central GST (CGST) by the Central Government and State GST (SGST) by the State governments.
For inter-State transactions and imported goods or services, an Integrated GST (IGST) is levied by the Central Government and they give the share of State or Union Territory.
UGST is applicable for Union Territories like Chandigarh, Andaman and Nicobar Islands etc.
GST is a destination based tax on consumption of goods and services. Therefore, taxes are paid to the state where the goods or services are consumed and not to the state in which they were produced.
The tax would accrue to the taxing authority which has jurisdiction over the place of consumption, which is also termed as place of supply.

Concept / condition / application
GST Council
It is the Governing body
Chairman: Union Finance Minister
Includes the Minister of State (Revenue) and the State Finance Ministers.
Main decision making body

Concept / condition / application
Recommendation on issues like which goods and services may be taxed, or exempt from GST, GSR rates, etc.
Input tax credit
The concept of GST is based on permitting set-off for the tax paid on the inputs and this is given effect through the input tax credit against the amount of a dealer’s output tax. The related tax liability of the dealer can be arrived at by deducting input tax credit from tax collected on supplies during the payment period.
Who is liable to pay GST?

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

Supplier of goods or services

Concept / condition / application
In specified cases like imports and other notified supplies, the liability may be cast on the recipient under the reverse charge mechanism.
In cases of intra-State supply of services, the liability to pay GST may be cast on e-commerce operators through which such services are supplied.
Also Government Departments making payments to vendors above a specified limit, are required to deduct tax (TDS) and E-commerce operators are required to collect tax (TCS) on the net value [i.e. aggregate value of taxable supplies of goods and/ or services but excluding such value of services on which the operator is made liable to pay GST under Section 9(5) of the CGST Act, 2017] of supplies made through them and deposit it with the Government.
Under the system of GST, the threshold limit is Rs. 20 lakh (Rs. 10 lakh for
north eastern states, Uttarakhand, Sikkim and Himachal Pradesh). Suppliers below the threshold limit are not required to register or pay tax.

Concept / condition / application
When does liability to pay GST arise?
Section 12: Liability to pay arises at the time of supply of Goods as
Section 13: At the time of supply of services
The time is generally the earliest of one of the three events, namely receiving payment, issuance of invoice or completion of supply.
Different situations envisaged and different tax points have been explained in the aforesaid sections.

Historical formulation: Who has to file GST Returns?

CLARIFICATION / 1 NOVEMBER 2026

The oldRs.1.5 crore return-frequency summary is historical. QRMPallows eligible taxpayers up toRs.5 crore aggregate turnover to file quarterlyGSTR-1/GSTR-3 B with monthly payments, subject to conditions. Check actual filing eligibility and due dates.

Concept / condition / application
Every person registered under GST will have to file returns in some form or other.
A registered person will have to file returns either
monthly (normal supplier)
quarterly basis (Supplier opting for composition scheme).
An Input Service Distributor will have to file monthly returns showing details of credit distributed during the particular month.

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

Concept / condition / application
A person required to deduct tax (TDS) and persons required to collect tax (TCS) will also have to file monthly returns showing the amount deducted/collected and other specified details.
A non-resident taxable person will also have to file returns for the period of activity undertaken.
There are separate returns required to be filed by special cases such as composition dealers.
Since Banks are service providers, Composite Scheme is not applicable to them.

The returns to be filed are as under:

Details Return Forms Periodicity Return for registered persons with aggregate turnover of more than Rs. 1.50 crores GSTR-1 and GSTR-3 B Monthly Return for registered persons with aggregate turnover up to Rs. 1.50 crores GSTR-1 Quarterly

Return for registered persons with aggregate turnover up to Rs. 1.50 crores GSTR- 3 B Monthly The system requires that one must manually enter details in the return - GSTR-1.

Historical formulation: Late Fees :

CLARIFICATION / 1 NOVEMBER 2026

Late fee and interest are different. Interest depends on the applicable legal provision, liability base, timing and exceptions; do not label every delay charge a late fee or mechanically charge all gross tax in every case.

If GST Returns are not filed within time, interest on delayed payment of tax is payable @ 18% per annum. It has to be calculated on the amount of tax liability from the next day of due date of return till the date of payment

Concept / condition / application
Advantages Of GST
Less complex and administer: Complexity of the tax structure due to multiplicity of taxes and tax rates will be reduced considerably. Administration of taxation system in the country will be more effective.
Make industry more competitive: GST will make the Indian trade and industry more competitive as it is expected to reduce cost of production and inflation in the economy.
Better compliance: GST is aimed at broadening the tax base and also at better tax compliance.
Online form: The foundation of the GST regime in India is a comprehensive IT system. All tax payer services such as Registrations, Payments, Returns etc. will be available to the taxpayers online. This will make the compliance easy and transparent.

Concept / condition / application
Uniform structure: It will improve the ease of doing business as the GST will ensure that indirect tax rates and structures are uniform across the country.
Reduction in price: Elimination of cascading of taxes will result in reduction in prices of goods and services

HISTORICAL REFERENCE DETAIL / READ THE DATED CLARIFICATIONS

Historical formulation: GST is charged only on the component of value addition at each stage to ensure that there is no ‘tax on tax’.

CLARIFICATION / 1 NOVEMBER 2026

GST is calculated on taxable supply value under the law; eligible input credit can reduce cascading. Do not calculate every transaction's output GST only on its accounting margin.

Concept / condition / application
GST Provisions With Respect To Banks
Service sectors are impacted more by the GST than the manufacturing or trading sectors.
Owing to the nature and volume of operations provided by banks, GST compliance is quite difficult to implement.
Some of the issues and impacts pertaining to the provisions of GST Law are as

below.

Due to widespread number of branches, the registration is a hassle. However, under GST, such Banks are required to obtain a separate registration for each state where they operate.

compliance burden about filing of returns has also increased substantially in terms of payments of taxes, the periodicity of returns, number of return formats and level of details required in these returns.

Input Tax Credit is leveraged and de-leveraged

Historical formulation: Earlier, Banks and NBFCs by and large, opted for the option of reversal of 50% of the CENVAT credit availed against inputs and input services whereas CENVAT credit on capital goods could be availed with no reversal conditions.

CLARIFICATION / 1 NOVEMBER 2026

Use GST input-tax-credit terminology. The banking 50% option is conditional on eligible credit and the applicable statutory provisos/clarifications; it is not a blanket reversal of every invoice or every same-PAN supply.

Concept / condition / application
Under GST, 50% of the CENVAT credit availed against inputs, input services, and capital goods is to be reversed, which leaves them with a position of reduced credit of 50% on capital goods thereby increasing cost of capital.
Assessment and Adjudication has become bothersome The assessment is done by the respective state regulators under which the respective branch is registered.

Now, every registered branch of banks must justify its position on chargeability in the respective State and reason for utilizing input tax credit in different States.

Concept / condition / application
As more than one adjudicating authority is involved under GST, each authority may hold a different opinion on the same underlying issue.
Issues related to revenue recognition under GST
Account Linked Financial Services
Non-Account Linked Financial Services
Actionable Claims

Concept / condition / application
GST on banking Transaction fees

Apply your understanding: original practice

1. What is the case total output tax?

Answer and reason
Rs.10,000 x 18%=Rs.1,800, based on the expressly assumed taxable rate and value.

2. Is output tax simply 18% of the seller's margin?

Answer and reason
No. Compute tax on the applicable taxable value, then apply eligible credit under the legal rules.

3. Does a lower notified output rate automatically erase previously valid credit?

Answer and reason
No universal rule applies. Analyse credit eligibility, utilisation and any required reversal, especially if supplies become exempt.

4. Can every bank simply reverse 50% of every invoice?

Answer and reason
No. The optional banking ITC mechanism, eligible-credit base, blocked-credit rules and applicable same-PAN proviso/clarifications must be examined.

5. Does QRMPmean tax is paid only once a quarter?

Answer and reason
No. Eligible users file quarterlyGSTR-1/GSTR-3 Band generally make monthly tax payments under the scheme.

Official reference: GST Council 2025 rate-change FAQs | checked1November2026.

Official reference: GST portal QRMP | checked1November2026.

Official reference: CBICbanking FAQs | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. GST is a supply-based indirect-tax framework.	15. Credit utilisation follows legal ordering.
02. Taxable event differs from income-tax profit.	16. An invoice alone may not establish entitlement.
03. Intra-State and inter-State treatment differ.	17. Value and time of supply affect tax.
04. Place of supply is central to that distinction.	18. Rate notifications depend on classification and date.
05. CGSTandSGSTnormally share intra-State tax.	19. A Council recommendation needs legal implementation.
06. IGSTapplies to relevant inter-State supplies.	20. Older slab lists are not permanently complete.
07. UTGSTrequires its applicable territorial context.	21. Return filing differs from tax payment.
08. Imports and exports have special rules.	22. QRMPis quarterly returns with monthly payment.
09. Exemption differs from zero-rating.	23. Interest differs from late fee.
10. Registration depends on applicable conditions.	24. Banking-service exemptions need specific analysis.
11. A GSTINidentifies a registration.	25. The case output tax isRs.1,800.
12. Distinct registrations can have supply consequences.	26. The case assumed usable credit isRs.600.
13. Input credit has eligibility conditions.	27. The simplified cash amount isRs.1,200.
14. Blocked credit cannot be assumed usable.	28. Bank 50% ITCoption needs scope and proviso analysis.

MODULE D / D 03

An Overview of Cost & Management Accounting

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A workshop uses direct materialRs.20,000, direct labourRs.10,000 and direct expensesRs.2,000. Prime cost isRs.32,000. Add factory overheadRs.8,000 for works costRs.40,000 under these simplified facts. If administration and selling/distribution costs areRs.3,000 andRs.2,000, total cost isRs.45,000. A 25% markup on cost givesRs.56,250 selling price.

Change the situation

A 25% margin on sales instead requires price 45,000/(1-.25)=Rs.60,000. Markup and margin use different denominators even when the percentage number is the same.

COMMON MISTAKE - WHY IT FAILS

A cost is direct or indirect relative to a specified cost object. Fixed cost is constant in total only within a relevant range and period; it is not fixed per unit for every output.

Build the connections

Idea	Why it matters
1	Cost accounting measures and analyses costs.
2	Management accounting supports internal decisions.
3	Financial accounting serves broader reporting purposes.
4	The boundaries overlap but purposes differ.

Idea	Why it matters
1	A cost object is what cost is measured for.
2	Direct costs can be economically traced.
3	Indirect costs need suitable allocation.
4	Traceability depends on the cost object.

Idea	Why it matters
1	Material, labour and expenses are cost elements.

Idea	Why it matters
2	Direct elements form prime cost.
3	Factory overhead adds production support cost.
4	Cost-sheet stages need clearly stated inclusions.

Idea	Why it matters
1	Fixed total cost assumes a relevant range.
2	Variable total cost changes with activity.
3	Mixed costs have fixed and variable elements.
4	Unit cost depends on activity and allocation.

Idea	Why it matters
1	Historical costing uses incurred amounts.
2	Standard costing compares with predetermined benchmarks.
3	Marginal costing distinguishes variable and fixed costs.
4	Absorption includes relevant fixed production overhead.

Idea	Why it matters
1	ABCuses activities and cost drivers.
2	A driver should reflect resource consumption.
3	Relevant cost changes between alternatives.
4	Sunk cost normally does not.

Idea	Why it matters
1	Case prime cost isRs.32,000.
2	Case total cost isRs.45,000.
3	Case 25% markup price isRs.56,250.
4	Case 25% sales-margin price isRs.60,000.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Prime cost	Direct material+direct labour+direct expenses	Classify relative to the cost object.
Works cost	Prime cost+relevant factory overhead +/-WIP adjustments	State the particular cost-sheet convention.
Cost of sales	Relevant production/finished-stock cost+applicable administration and selling/distribution cost	Match included cost scope to decision/reporting purpose.
Markup price	Cost x(1+markup rate on cost)	A markup uses cost as denominator.
Margin price	Cost/(1-sales-margin rate)	A margin uses sales as denominator.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
& Management Accounting
Cost Accounting
Concept of cost
To a consume: cost means the purchase price.
For the producer of a product or provider of a service: the cost means the expenditure incurred for producing the product or providing the service.

Concept / condition / application
Costing means ascertaining these costs incurred in producing this specific product or providing this specific service.
Cost may involve various elements like materials, labour, energy, transport, depreciation etc.
Meaning of cost accountancy
For an organisation producing only one product, the costing exercise may be simple as the cost per unit can be arrived at by dividing total cost by the number
of units produced. But, for an organisation producing multiple products, the costing exercise may be a bit complicated as the

Concept / condition / application
costs are to be allocated properly to each product.
For example, if the total cost on fuel and electricity is Rs. 20 lakh, and there are 5 types of products manufactured in the factory, it will be not be correct to allocate Rs. 4 lac to each type of the product group.
We will have to conduct proper study of the manufacturing process of each type of products and keep proper records for the correct allocation of cost.
Cost Accounting deals with this aspect.
Involves identifying, measuring, recording, allocating and communicating economic information, related to a product or service, in terms of money.

Concept / condition / application
Objectives of cost accounting
The main objective of cost accounting is to ascertain the cost of each product

manufactured or service provided by an organisation.

Why analyse costs?

Objective	Practical use
Record, analyse and classify	Understand expenditure on products and services.
Determine unit cost	Measure a unit, operation, process or department.
Compare actual with benchmark	Identify relevant deviations, avoidable waste and losses.
Support management	Inform specific and longer-term economic decisions.

Concept / condition / application
Advantages and scope of cost accounting
Cost accounting provides decision making information to the management in various areas.

Some of these are as under:

Deciding the price of products and services

Decide on eliminating/ reducing production of certain products

and increasing production of some others

Reducing wastages of materials and other resources

Inventory management

Comparing actual costs with cost standards or estimates

Develop strategies during recession or intense competition

Concept / condition / application
Elements of cost
There are various methods of classifying the cost elements of a product or service.
The classification of the elements of cost based on the nature of these elements is as

under:

Elements and traceability

Element	Direct	Indirect
Material	Traceable material input	Supporting/pooled material
Labour	Traceable labour input	Supporting/pooled labour
Expenses	Other traceable costs	Overheads requiring allocation
Principle	Traceability is relative to the cost object.	Classification is not determined by the name alone.

Material

Concept / condition / application
In is of two types: direct material cost and indirect material cost.
Direct material Cost : Major part of the finished product.
For example: For producing a car, various components are purchased/manufactured.
The cost of these components is direct material cost.
Indirect material Cost: Ancillary to production and do not form part of the finished product.

Concept / condition / application
For example: While manufacturing a car, machines consume lubricants and welding electrodes are used to weld steel sheets and components.
These consumables do not directly form part of the car but are necessary in producing it.

Labour cost

Also is classified into direct labour and indirect labour cost.

Concept / condition / application
Direct labour cost: Wages paid to workers who are directly engaged in the production process and their time is traceable to units of products.
For example, wages paid to workers in the car factory for production of components and their assembly.
Indirect labour cost cost is the cost of labour employed for the purpose of carrying tasks incidental to production of goods or rendering the services.
For example: In a car factory, the cost of labour employed in the stores, administration, security etc. is classified as indirect labour cost.

Expenses

These also are classified as direct or indirect.

Concept / condition / application
Direct expenses: incurred on a specific cost unit and are identifiable with the cost unit.
For examples: The cost incurred in designing a special car model can be attributed to the number of cars of that model produced.
Indirect expenses are those expenses which cannot be directly or conveniently allocated to a specific cost unit.
For examples: Expenses incurred on rent, taxes, insurance, lighting etc. in a car factory can be treated as indirect expenses as these cannot be attributed to a particular model of cars being manufactured in the factory.
The classification of the elements of cost based on their association with the

volume of production is fixed, variable and semi-variable cost.

Concept / condition / application
Fixed costs: These are the costs which, during a period, do not depend on the volume of production or the level of activity. For example: The insurance premium paid for the factory building and other fixed assets remains the same irrespective of the number of cars produced during the year.
Variable costs: These are the costs which, depend directly on the volume of production or the level of activity. For example: The cost of engines will be directly proportional to the number of cars produced during the year.
Semi-variable costs: Such costs qualities of both fixed and variable costs. Because of their partly variable nature, they increase with the volume but they do not increase in direct proportion to increase in output, due to their partly fixed nature. For example: If the production of cars doubles in the factory, the administrative department will also have to employ more staff but the increase will not be 100%.
Cost Centre
Cost centre is the smallest organisational sub-unit for which separate cost allocation can be made.

Concept / condition / application
Chartered Institute of Management Accountants(CIMA), London, describes a cost centre as: “A production or service location, function, activity or item of equipment whose costs may be attributed to cost units”.
In other words, a cost centre is one of the many convenient units into which the whole production facility has been divided for the purpose of costing the goods produced.
Each such unit consists of a specific production centre, or a department or a sub- department or, specific type of machinery or a group of persons.
For example can be a bank branch where cash department can be considered as one cost centre while the loan department can be another cost centre.
Classified as Productive, Unproductive or Mixed Cost Centres.

Concept / condition / application
Productive cost centre is actually engaged in making the products.
Unproductive cost centre does not directly contribute in making the product but provides essential support to the productive centres.
Mixed cost centre is sometimes involved directly in contributing to the manufacture of the product and sometimes in providing service to the productive departments.
Cost Unit
It refers to measure of cost.

Concept / condition / application
For example, a transport company may quote its rate per kilometre while a sugar manufacturing company may quote the rate for each ton or kilogram.
CIMA defines a unit of cost as “a unit of product or service in relation to which costs are ascertained”.
Therefore, whenever we have to do costing of a product or service, we decide a unit of that product or service for which the costing will be done.
Thus, sugar manufacturer will find the cost of producing one ton or kilogramme of sugar while the transport company will add up all the cost elements involved in covering a distance of one kilo meter.
The cost units are usually the units of physical measurements like number, weight, area, length, value, time etc.

Concept / condition / application
An example of time being the cost unit is finding the hourly cost of a machining centre. Similarly, if a factory is producing chemicals, its cost unit can be a litre or a gallon. In case of crude oil, the commonly used cost unit is barrel.
Methods of Costing
Depending on the type and nature of the product, the costing method adopted by

organisations are different.

Costing methods

Method	Typical object
Job	Distinct job
Batch	Batch of similar units
Operation	Specified operation
Process	Continuous process
Unit / single-output	Homogeneous output unit
Service	Service unit
Multiple / composite	Combination of methods
Departmental	Department

Concept / condition / application
Technique of Costing

Costing techniques

Technique	Teaching distinction
Historical / conventional	Incurred costs
Standard	Predetermined benchmarks and variances
Absorption	Relevant variable and fixed production costs
Marginal	Variable cost/contribution analysis
Uniform	Consistent methods across participating entities
Direct / indirect costs	Traceability classifications; do not confuse these with output methods
ABC	Activity-based allocation through drivers

Concept / condition / application
Cost Accounting Standards
As financial accounting standards protect the interests of outside users, they have gained wide and also statutory acceptance.
However, the cost accounting system generates information primarily for internal use and the primary users of cost information are the managers of the company.
Therefore, the principles and practices relating to cost accounting, which evolved over years, have not gained the acceptability and status enjoyed by the financial standards.
In India, the Cost Accounting Standards (CAS) have been issued by the Institute of Cost Accountants of India (ICoAI).

Concept / condition / application
The Preface to Cost Accounting Standards issued by the ICoAI has set out the following objectives to be achieved through CAS To provide better guidelines on standard cost accounting practices; To assist cost accountants in preparation of uniform cost statements; To provide guidelines to bring standard approach towards maintenance of cost accounting records under various statutes; To assist the management to follow the standard cost accounting practices in the matter of compliance with statutory obligations; and To help Indian industry and the government towards better cost management.
Difference Between Financial Accounting and Cost Accounting

Worked figure / record

Financial Accounting	Cost Accounting
Takes care of the statutory requirements like the Companies Act and Income-tax Act.	Generally voluntary except that for some manufacturing industries, it is now obligatory to keep cost records as per the Companies Act.
Aims at providing suitable information to various stakeholders of the business organisation, such as owners, investors, creditors, tax authorities	Purpose is mainly to meet the requirements of management
Concerned with revealing the profits and losses of the organisation as a whole	concerned with the unit costs and profitability of different products. In cost accounting, the emphasis is more on planning and control.
Statements are normally prepared quarterly, half yearly or annually.	no such standard and the reports may be prepared even on daily basis
Most of the transactions covered are external transactions	mostly concerned with internal transactions
deals with actual figures and not the estimates	accounting deals with estimates also as a part of budgetary control.

PURPOSES, NOT ABSOLUTE BOUNDARIES

Financial reporting uses estimates as well as actual transactions. Cost records can be legally required for specified entities. Cost accounting also supports planning;management accounting also uses historical data. Read this comparison as predominant purposes, not absolute restrictions.

Concept / condition / application
Management Accounting

Meaning and evolution of Management Accounting

Concept / condition / application
Management of any business organisation has to take various decision every day regarding transactions and events like sales, purchases, production volumes, outsourcing, pricing, controlling expenses, addition or disposal of fixed assets etc.
Most of these transactions and events can be measured and expressed in money values and affect the working and position of the organisation.
Therefore, these need to be reported to the management.
Management accounting relates to measurement, recording and analysing all those aspects of an organisation which are important for the management to take decisions on conducting the business of the organisation efficiently and effectively.
As per the definition of management accounting, given by Robert Anthony, “Management accounting is concerned with accounting information which is useful to management”.

Concept / condition / application
The basic data for management accounting comes from the same accounting system which is established for financial accounting and cost accounting systems but the scope of providing information and reports is much wider.
Statistical and mathematical techniques are also used in management accounting in addition to the accounting techniques.
The evolution of Management Accounting has its roots in the industrial revolution of the 19 th century, which placed new pressures on companies through capital markets, creditors, regulatory bodies, and taxation.
As the operations became more complex due to expansion of product lines, forward looking companies felt increasing need for
Objective of Management Accounting

The basic objective of management accounting is to assist the management in carrying out its duties efficiently by identifying, interpreting and presenting the relevant information. The information presented by management accounting can be broadly used for the following purposes (as mentioned by CIMA, London):

Concept / condition / application
Formulating strategy;
Planning and controlling activities;
Decision taking;
Optimising the use of resources;
Disclosure to shareholders and others external to the entity;

Concept / condition / application
Disclosure to employees;
Safeguarding assets.
Scope of Management Accounting

The scope of providing information and reports under management accounting is much wider than under the financial accounting and cost accounting systems. Statistical and mathematical techniques, including budgetary control, are also used in management accounting in addition to the accounting techniques. Some of the important tasks,

which fall under the scope of management accounting, are as under:

Concept / condition / application
Management accountancy involves developing financial accounting, cost accounting, tax accounting and information systems to meet the changing needs of management functions.
Management accountancy compiles, analyses, interprets and presents accounting and other data to make it understandable and usable to the management for planning.
Management accountancy helps in communicating management plans to the various levels in the organisation.
Management accountancy also helps in developing an effective system of feed- back reports. Such reports help in analysing the reasons and responsibilities for deviations so that appropriate corrective measures can be taken.
Management accounting also provides system of evaluating the performance of the management itself. This helps not only the owners and investors but also helps management in self-appraisal of their performance.

Concept / condition / application
Tools and Techniques of Management Accounting
As the operations became more complex, the companies felt increasing need for management-oriented reports and improved tools and techniques in management accounting have been devised based on the new requirements.
This is a continuing process and improved tools and techniques continue to evolve with increase in complexity and needs of the businesses.
Presently, the main tools and techniques used in management accounting are as

under:

Concept / condition / application
Financial Planning
Selecting appropriate tool for decision making
Financial Statement Analysis
Statistical and Graphical Techniques
Selecting appropriate method of reporting

Concept / condition / application
Difference Between Management Accounting and Cost Accounting

Worked figure / record

Cost Accounting	Management Accounting
The scope of cost accountancy is lesser. Cost accounting relates more to the ascertainment, allocation, and accounting aspects of costs,	The scope of management accounting is much wider . It relates more to the impact and effect aspects of costs.
Mainly about short-term planning	Concerned with both short-range and long-range planning.
Cost accounting data provides a base for applying the methods of management accounting to make the data more purposeful for management decisions.	Management accounting makes use of additional tools and techniques available to it, compared to those available for cost accounting. For example, the tools like standard costing, break-even analysis, marginal costing etc. are used in cost accounting, additional tools like ratio analysis, cash and funds flow analysis, trend analysis etc. are available for management accounting.
Included in management accounting	Both financial accounting as well as cost accounting are included in management accounting, which also takes care of tax accounting and capital budgeting.
Depends mostly on historical costs	Tends to be futuristic accounting.

PURPOSES, NOT ABSOLUTE BOUNDARIES

Financial reporting uses estimates as well as actual transactions. Cost records can be legally required for specified entities. Cost accounting also supports planning;management accounting also uses historical data. Read this comparison as predominant purposes, not absolute restrictions.

Apply your understanding: original practice

1. What is prime cost in the case?

Answer and reason
20,000+10,000+2,000=Rs.32,000: direct material, labour and expenses.

2. Why can factory rent be indirect to a product?

Answer and reason
It supports multiple products and may not be economically traceable to one unit; allocate using an appropriate basis.

3. Does fixed total cost mean fixed cost per unit?

Answer and reason
No. Within the relevant range, total fixed cost can stay constant while cost per unit falls as output rises.

4. Why is 25% markup not 25% margin?

Answer and reason
Markup divides profit by cost; margin divides profit by sales. The denominators differ.

5. When is a cost relevant to a decision?

Answer and reason
When it changes between the feasible future alternatives, including relevant opportunity costs.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Cost accounting measures and analyses costs.	15. Mixed costs have fixed and variable elements.
02. Management accounting supports internal decisions.	16. Unit cost depends on activity and allocation.
03. Financial accounting serves broader reporting purposes.	17. Historical costing uses incurred amounts.
04. The boundaries overlap but purposes differ.	18. Standard costing compares with predetermined benchmarks.
05. A cost object is what cost is measured for.	19. Marginal costing distinguishes variable and fixed costs.
06. Direct costs can be economically traced.	20. Absorption includes relevant fixed production overhead.
07. Indirect costs need suitable allocation.	21. ABCuses activities and cost drivers.
08. Traceability depends on the cost object.	22. A driver should reflect resource consumption.
09. Material, labour and expenses are cost elements.	23. Relevant cost changes between alternatives.
10. Direct elements form prime cost.	24. Sunk cost normally does not.
11. Factory overhead adds production support cost.	25. Case prime cost isRs.32,000.
12. Cost-sheet stages need clearly stated inclusions.	26. Case total cost isRs.45,000.
13. Fixed total cost assumes a relevant range.	27. Case 25% markup price isRs.56,250.
14. Variable total cost changes with activity.	28. Case 25% sales-margin price isRs.60,000.

MODULE D / D 04

Costing Methods

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A process inputs 1,000 units at total costRs.10,000. Expected normal loss is 100 units with no scrap value. Cost per expected good unit=10,000/900=Rs.11.1111. If actual output is 850 units, abnormal loss is 50 units and its basic valuation is 50 x 11.1111=Rs.555.56. Normal loss changes the denominator; abnormal loss is identified separately.

Change the situation

If normal-loss scrap is worthRs.1 perunit, reduce the process cost allocated to expected good output byRs.100: 9,900/900=Rs.11.00. The valuation changes because scrap recovers part of process cost.

COMMON MISTAKE - WHY IT FAILS

Choose a costing method by the production/service pattern. Job, batch, process, contract and service costing address different cost objects; equivalent units require separate completion percentages where material and conversion progress differ.

Build the connections

Idea	Why it matters
1	Job costing accumulates distinct-job costs.
2	Batch costing groups similar units.
3	Process costing follows continuous production stages.
4	Service costing uses a suitable service unit.

Idea	Why it matters
1	Contract costing needs contract-specific analysis.
2	Departmental costing tracks departmental responsibility.
3	Composite costing combines appropriate methods.
4	Method and costing technique are different dimensions.

Idea	Why it matters
1	A job cost sheet records relevant inputs.
2	Material requisitions support material charging.
3	Time records support labour charging.
4	Overhead application needs a rational basis.

Idea	Why it matters
1	Normal loss reflects expected process loss.
2	Scrap value can reduce net process cost.
3	Abnormal loss differs from normal loss.
4	Abnormal gain reflects output above expected yield.

Idea	Why it matters
1	Equivalent units express partial completion.
2	Material and conversion may progress differently.
3	Weighted-average andFIFOprocess methods differ.
4	Opening work-in-progress affects calculation.

Idea	Why it matters
1	Joint costs differ from separable costs.
2	By-products need suitable accounting treatment.
3	Service units can be simple or composite.
4	Cost per unit requires a meaningful denominator.

Idea	Why it matters
1	Case expected good output is 900 units.
2	Case basic abnormal loss is 50 units.
3	Without scrap its value isRs.555.56.
4	With stated scrap the expected-unit cost isRs.11.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Expected good output	Input units-normal-loss units	Treat actual abnormal loss/gain separately.
Expected-unit cost	(Process cost-normal-loss scrap value)/expected good output	Use the method and cost assumptions stated.
Equivalent units	Physical WIP units xcompletion proportion	Calculate separately for material and conversion where necessary.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Introduction
Costing is the process of determining the expenditure incurred in producing a product or providing a service.
Correct costing is crucial for any business organisation as it has a direct bearing on all its sales and marketing strategies.
Basic principles of costing do not change with the system of costing adopted.
Costing methods are broadly classified into two categories

Two principal production patterns

Job costing	Process costing
Separate identifiable orders	Continuous or repetitive processing
Accumulate by job	Accumulate by process and period

Concept / condition / application
Some methods make part use of job costing and part use of processing costing.
Under these broad categories, Unit or output Costing, Job Costing, Batch costing, Contract costing, Process costing and Service costing are amongst the widely used methods of costing, in the industry.
Unit And Single-Output Costing

This method of costing

Finding out the cost of the total output

Concept / condition / application
Cost per unit = total cost / the number of units produced

Example: A company produces television sets of only one type. During one month, its total production was 3000 sets. The total cost incurred by the company was Rs. 3 crore = cost of one television set is Rs. 3 crore/ 3000 = Rs.10000

Concept / condition / application
Suitable: Assembly department in a factory producing a mechanical article as also in industries like brick-making, mining, sugar, cement etc.

When using this method of costing, it may not be necessary to maintain separate cost accounts as the required information can be derived from the financial records maintained under financial accounting.

Concept / condition / application
This method has some limitations and can be used in the following cases:
Where a firm is producing a single article on large scale by continuous manufacture.
Where the units produced are identical. Where the products are homogenous. Where a firm is producing two or more grades of one product.
Cost Sheet
The cost sheet, maintained under the single-output/ unit cost, is a periodic statement.

Concept / condition / application
It is a document which records the detailed cost of a cost centre or cost unit.
It contains information on expenditure incurred on material, labour and direct expenses.
The administration expenses actually incurred are also included in the total cost.
Indirect expenses, payable at periodical intervals, are included in the cost sheet on the basis of estimates.
Selling and distribution expenses may or may not be included in cost sheets, depending upon the management decision.

Concept / condition / application
Not recorded: Taxes/interest/dividends paid, provisions and write offs, cash discounts, profit or loss on sale of assets, etc.
Job Costing
Job costing system is required by the industries where each unit or batch of output of a product is different form the other units or batches.

Concept / condition / application
This is in contrast to process costing system, which is used in industries where production units are similar and the production takes place on a continuous basis.
When the production is not on a continuous basis and each job is different from the other

Concept / condition / application
Also known as Job Order Costing
Applications of Job Costing
Companies manufacturing products or rendering services against specific orders or jobs use this system of costing.
Examples are: Engineering and construction companies, ship- building/furniture making, machine manufacturing companies, repair shops, automobile garages and such other industries where jobs or orders can be segregated.
The aim of job costing is to record all the costs incurred for completing a job so that it may be appropriately priced.

Concept / condition / application
Features of Job Costing

Execution of a job order involves meticulous planning of resources to control the costs. Execution of a specific job, as per the specifications of the customer, is more difficult compared to production under continuous process, where the systems and procedures

Concept / condition / application
are stable and standardised. The job execution may not be just arranging for materials and labour but may also involve design and innovation.
The main features of job costing system can be summarised as under:
It is costing of a specific order for production or rendering of services as per the requirements of the customer.
It involves recording all the costs incurred for completing a job so that it may be appropriately priced.
Estimation of costs is difficult as very little data may be available due to uniqueness of the job.

Concept / condition / application
At the end of the job, the materials left may be difficult to value due to uncertainties about their use in other jobs.
Job Cost Cards/Sheets
A job cost card is used for each job, which is the object of costing, to record the costs of materials, labour and overheads pertaining to that particular job.

Concept / condition / application
Job card basically provides a record to the management for their decision making and controlling the cost.
The job cost card also records the time spent by operators on each job.

Concept / condition / application
Any breaks or idle time taken by the operators is also recorded in the job cost card.

The main advantages of a job cost card are as under:

It gives clear and relevant information to the management to enable them to take appropriate decisions It is an effective tool for cost control It helps in reducing the idle time of labour involved in the job Job card information can be used to check the accuracy of job account It acts as a link between the production control and costing departments

Concept / condition / application
Following is a specimen of a simple costing card/sheet, only for the purpose of

illustrating its concept:

Job cost card/sheet (specimen)

Customer _____

Name of Job _____

Job No _____

Date of start _____

Date of completion _____

Worked figure / record

Materials costs			Labour costs			Manufacturing overheads			
Date	Requisition No.	Amount	Date	Hours	Rate	Amount	Hours	Rate	Amount

Job cost-sheet summary

Cost component	Amount field
Direct materials	Rs.__
Direct labour	Rs.__
Direct / manufacturing overheads	Rs.__
Allocated fixed / non-manufacturing overheads	Rs.__ as appropriate to purpose
Total	Sum the stated included components; distinguish direct expenses and overheads under the chosen classification.

Concept / condition / application
Collecting Direct Costs
The job costing collects the following direct costs pertaining to a job:

Direct material costs

Direct labour costs

Direct overhead costs or production overheads

Direct material costs

On receipt of a production order, the production department submits a requisition note to the stores to issue the requisite materials. Surplus, excess or incorrect materials are returned by the production department to the stores with materials return note. The job cost sheet records all these issues and returns of materials.

Direct labour costs

Each day, the time spent by various types of labour on a particular job, is recorded. Labour summaries or wages analysis sheets are prepared for each week or any other suitable accounting period. This analysis also includes the amounts on account of overtime, idle time, shift- differential etc. Direct labour costs are posted on the respective job cost-sheets.

Direct overhead costs or production overheads Direct overhead costs for a job are recorded for all the cost centres through which the job passes in the course of its completion. The amount of direct overhead costs for each job order is summarised in an analysis sheet and is posted in the relevant cost cards/sheet of that job

Concept / condition / application
Allocation of Fixed/Non-Manufacturing Overheads

Concept / condition / application
This is done on the basis of a pre-decided percentage of the total Fixed/Non- manufacturing overhead costs.
The criteria for this percentage could be the time taken, labour input, complexity of job or any other suitable parameter. Normally, these overheads are added only after completion of the job.
Job Account
For each job, a Job account is maintained so that the cost of that job is known readily.

Concept / condition / application
The Job Account is different from the job cost sheet.
Job account contains only the monetary information, while the job cost sheet records other information also.
As in the case of job sheet, depending upon the nature of the job and the requirements of the organisation, the format of the Job account is devised and used.

An illustrative format of a job account may be as under:

Cost-analysis record fields

Field	Record content
Date	Transaction date
Particulars	Description
Materials	Material amount
Labour	Labour amount
Indirect overheads	Overhead amount
Total	Sum of included cost elements
Analysis of total cost	Further classification/allocation explanation

Concept / condition / application
Contract Costing
Contract costing is a form of job costing applied to relatively large jobs which take a considerable time to complete (normally, more than one year).
Like in job costing, in contract costing also, each contract is treated as a cost unit and its costs are separately ascertained.
Examples where contract costing is suitable include shipbuilding, engineering projects, construction contracts, infrastructure projects etc.

Concept / condition / application

In some industries and government contracting, contract costing is the primary task of the accounting department.

Concept / condition / application

Proper contract costing is crucial to earn adequate profits, and so is usually staffed with experienced accountants.

Features of Contract Costing

Under Contract Costing, a separate contract account is maintained for each contract.

All the direct costs related to execution of contract, are allocated to the contract.

The overheads for a contract are allocated in the same way as under the job costing. A contract usually involves a lower amount of overheads but these require appropriate allocation.

Concept / condition / application

Work-in-progress is an important aspect in contract costing.

Distinction Between Job and Contract Costing

The work is usually carried out at a site different from contractor’s workplace, in a contract. In execution of a job, the job is usually carried out at the contractor’s workplace.

A contract and a job are differentiated on the basis of size and time taken also. Contracts are usually larger and take longer time compared to jobs.

In a contract, most of the costs are of direct nature, unlike in a job.

Concept / condition / application

In costing a contract, each contract is treated as a cost unit while in job costing, there can be more than one cost units.

Types of Contracts

Fixed price: Under this type of contracts, the price is not dependent on any factor like materials, labour, time etc. but is a fixed total amount.

Cost plus: Under this type of contracts, the contract price is based on the costs actually incurred, plus a percentage profit or fixed profit. This is used in those contracts whose exact cost cannot be correctly estimated at the time of starting a work. In this type of contracts, the customer may use the services of an auditor to examine the contractor’s contract costs, and may not sallow some of them.

Time and material: This is similar to the cost plus arrangement, except that the contractor includes a profit into its billings, rather than being given a specific profit. In this arrangement also, the customer may verify all the costs in detail.

Concept / condition / application
Progress Payments and Retention Money
When a contractor undertakes to execute a large contract for a customer, the two parties agree on the terms of reimbursement to the contractor. As a contract involves considerable period of time, large amount of contractor's working capital may get stuck up if there is no periodic payment by the customer. Thus, it is always suggested to have a system of progress payments. Normally, this progressive payment is based, at least in part, on the costs incurred by the contractor in execution of the contract. Therefore, the contractor must keep a track of the costs associated with the execution of that contract to justify its billings to the customer.
The progress billing is normally decided by the experts, such as architects, engineers, and surveyors etc.
Based on this certificate, the proportionate billing is done by the contractor.
Retention money is normally an integral part of every contract. The customer keeps some amount of money, out of the progressive bill payments, with himself as retention money/security deposit, to ensure that the work is carried out as per the plan agreed to in the contract and that there are no defects in the end work.

Concept / condition / application
The amount is used to compensate the customer for any shortcomings in

execution of contract by the contractor.

Concept / condition / application
The retention money is given back to the contractor by the customer after
examining the quality of the work after the contract is fully executed.

Retention money is aimed at providing inspiration to the contractor to provide quality work.

Concept / condition / application
Escalation Clause
As a contract is spread over a long period of time, the contractor runs the risk of price escalation of input costs. Therefore, an escalation clause is normally included in the contracts to safeguard the contractor against any likely changes in the prices of material and labour.
This clause provides that in case prices of materials, labour etc. specified in the contract, change beyond a specified limit over the prices prevailing at the time of signing the contract, during the execution of the contract, the contract price will be suitably adjusted.
This clause may be useful in safeguarding the interest of the customer also in case of decline in the prices of material, labour etc. which is highly unlikely in present inflationary environment.

Historical formulation: Profit on Incomplete Contracts

CLARIFICATION / 1 NOVEMBER 2026

Apply the relevant revenue standard. AS 7 remains relevant within its AS framework;IAS 11 was superseded byIFRS 15 from 2018. Ind AS 115 has its own performance-obligation and over-time/point-in-time recognition requirements. Do not assume all contract profit waits until goods are sold or follows a single cost-percentage shortcut.

Concept / condition / application
As a contract is spread over a long period, the contract work may not be complete during an accounting period.
Financial accounting normally recognises profit when the goods are sold. But, it may not be fair to adopt this principle in case of contracts, because it will result in low or no profit during the accounting periods in which the contract is continuing and abnormal profit in the accounting period in which the contract is finished.
It is therefore, necessary to determine the profit relating to a contract for each accounting period during which the contract is under execution.
AS 7 and Ind AS 115 also recognise this principle and provide guidelines in this respect.
While precise calculation of profit on an incomplete contract is difficult due the uncertainties involved during the time remaining for completion of the contract, the broad principle applied can be as under:

Concept / condition / application
Profit to date = (Cost of work completed/ Total estimated contract cost) *

Estimated contract profit.

Concept / condition / application
For arriving at the cost of work completed, a contract account is maintained.

Illustration

In a factory, refining the groundnut oil, total production of refined oil during the month was 1000 ton. The unrefined oil used in the production was 1020 ton. This loss of 20

ton was considered to be a normal process loss. If the total cost during the month, including the cost of unrefined oil used was Rs. 10 crore, what is the cost of one ton of refined oil, assuming that no scrap is generated?

Solution:

Concept / condition / application
The total cost during the month = Rs. 10 crore
Quantity of unrefined oil consumed = 1020 ton
Quantity of refined oil produced = 1000 ton
Value of scrap = 0
Cost of one ton of refined oil = 10, 00,00,000/ (1020 – 20) = Rs. 1,00,000 per ton

Concept / condition / application
Abnormal Loss:
The normal losses are estimated assuming that the production will take place under normal circumstances. However, in practice, the actual losses may be more due to abnormal conditions such as power failures, machine or plant breakdowns, inferior quality of materials, carelessness of workers, accidents etc.
Such losses are in excess of the estimated normal losses. The difference between the actual losses and the expected normal losses is called Abnormal Loss.

Worked figure / record

Value of Abnormal Loss = (Total Cost - Scrap Value of Normal Loss)/ (Input Units – Normal Loss of Units) × Units of abnormal loss

Concept / condition / application
Abnormal Gain
If the actual process loss is less than the estimated normal loss, it is called Abnormal Gain.
Due to the increased efficiency of workers, favourable process conditions or expected loss not materializing.
Abnormal gain does not mean that the output is more than the input. It only means that the extent of reduction in output quantity, compared to input quantity, which was estimated by us before starting production, was higher

than that actually achieved. Therefore, the abnormal gain is equal to

normal loss minus the actual loss.

Concept / condition / application
Calculation: Gain is not used to reduce the cost of units of production, but is taken into the Profit and Loss A/c.

Historical formulation: Work-In-Progress and Equivalent Units

CLARIFICATION / 1 NOVEMBER 2026

Equivalent units require the relevant completion percentage for each cost element. Material and conversion completion can differ; opening WIP and the chosenFIFO/weighted-average method matter.

Concept / condition / application
In process industries, as the production is continuous, there is always some Work-in-Progress at any particular point of time.
units which are not yet finished are known as Work-in-Progress.
Also, all these unfinished units may have different stages of completion. Some may be 90% complete while some may be only 10% complete.
In such a situation, it becomes difficult to assign cost to one unit because though the total cost incurred during the day is known, all units cannot be assigned the same cost.

This issue is addressed through the concept of “Equivalent units”.

Concept / condition / application
If 60 units are at the stage of 50% completion, we treat them equivalent to 30 fully finished units.
If 10 units are at the stage of 80% completion, we treat them equivalent to 8 fully finished units, and so on.

Worked figure / record

Formula

“Equivalent units” of work in progress = Actual no. of units in progress x Percentage of work completed

Concept / condition / application
Inter-Process Profit
Sometimes, production of a product in process industries, may involve more than one process.
All these processes are internal, the organisation may not be interested in knowing the cost involved in each stage as marketing decisions are based on the cost of the finished goods only.
However, sometimes the management may be interested in knowing the cost involved in each stage and the notional profit involved in it.
The notional profit at each processing stage may be based on current market price or at cost plus an agreed percentage.

Concept / condition / application
This may be useful in taking a make or buy decision regarding intermediate products.
Joint- Products

Concept / condition / application
If we examine the working of a petroleum refinery, we will see that while the input is crude oil, the finished goods produced include petrol, diesel, LPG, kerosene and aviation fuel, apart from some minor products called by products) like coal tar, lubricating oils etc.
There are many such process industries where more than one products of significant proportion and value are simultaneously produced.
Such products are called joint products.

Concept / condition / application
As per the definition of CIMA, London, joint products are “two or more products separated in processing, each having a sufficiently high saleable value to merit recognition as a main product.”
By-Products
When the quantity and sales value of a product, compulsorily produced in a process, is much lower compared to the main products, manufactured in the process, that product is classified as “by-product”. These are the products incidental to the production of the main products.
Taking the same example of petroleum refinery, as above, products like coal tar, lubricating oils are also produced in the refining process of the crude oil.
But the value and quantity of these products is very small in comparison

Concept / condition / application
To the value of joint products which are petrol, diesel and LPG.
By-products usually do not influence the decision regarding manufacture of main products.
A by-product is different from scrap/waste which is a material of insignificant value.
Accounting for Joint Products
Split point : In the production process, joint products are identifiable only after a stage of common raw material processing is achieved.

Concept / condition / application
After the split point a joint product may or may not require further processing.
After the split point, the processing cost of each product is separate and is allocated to that product only
Batch Costing
The cost accumulation system may not, always, be classified into job costing and process costing.
If the products have some common characteristics and also some individual characteristics, we may have to use a combination of both the systems.

Concept / condition / application
For example; a company manufacturing tables manufactures same type of tables except that some tables are given extra polishing.
In such a case, the costs of common processes through which all the tables pass are calculated by applying the job costing system, while the cost of extra work done on some items is calculated by applying the process costing system in which a product goes to another process centre after completion of previous process.
Features and Applications
Important features of batch costing system that costing is done not for an individual unit but for a batch of identical units.
The cost of one unit = Batch cost / number of units in the batch.

Illustration

A furniture manufacturer has received order for supplying 100 identical wooden chairs. The company estimates the requirements of materials at Rs. 1,00,000, labour at Rs. 50,000, and manufacturing overheads at Rs. 20,000. As per company's policy, the fixed/non- manufacturing overheads are allocated at 20% of material cost. What will be cost of one table, applying the batch costing system?

Answer

Concept / condition / application
The total variable cost of the batch of 100 tables is 1,00,000 + 50,000 + 20,000 = Rs. 1,70,000.
The fixed cost allocated to the batch is 20% of Rs. 1,00,000 = Rs. 20,000. Total cost for the batch is Rs. 1,90,000.
So, cost of one table is 1,90,000/100 = Rs. 1,900.
Batch costing is useful in industries like pharmaceuticals, readymade garments, toys, tyres and tubes etc.
Service Costing

Concept / condition / application
Service Costing is also known as operating costing. Service costing is a method of costing used by the organisations which provide service rather than produce commodities.
It is used for establishing costs of services rendered. CIMA London, defines Service Costing as "that form of operation costing which applies where standardized services are rendered either by an undertaking or by a service cost renter with in an undertaking".
Service costing is used in service organizations like transport companies, utility companies like electricity and water supply, hotels, hospitals, education institutions etc.
An example of internal services is canteen services.

Concept / condition / application
When services are provided to outside parties, these are termed as external. For example, hospitals, transport companies, water and electricity supply companies.

Concept / condition / application
Application of Service Costing
Service costing provides the basis for pricing the services rendered. It helps service sector organisations like hospitals, hotels, transport companies, utility companies etc. Service costing helps an organisation in not only pricing its services but also in tracking and controlling the costs by benchmarking them against standard costs of the industry.
Unit Costing And Multiple Costing
Unit Costing is used to where the production consists of units which are identical and are normally mass produced.
Examples are mining, brick making, cement production etc

Concept / condition / application
Multiple Costing refers to the costing method used in cases where a large variety of articles are produced.
The difference may be in regard to material required and/or the process involved in manufacturing.
In such cases, one costing method may not be sufficient.
Therefore, more than one method of costing may be used to compute the cost of each unit separately.

Apply your understanding: original practice

1. Why divide by 900 rather than 1,000 in the case?

Answer and reason
Expected good output is 1,000 less 100 normal-loss units. Its cost absorbs the expected loss under the stated method.

2. What is abnormal loss if actual output is 850?

Answer and reason
50 units: expected good output 900 minus actual 850.

3. What is the equivalent output for 200 units 50% converted?

Answer and reason
100 conversion-equivalent units. Material equivalent units need their own completion assumption.

4. Which method suits bespoke furniture orders?

Answer and reason
Job costing normally fits separately identifiable customer jobs; batch or process patterns would need different analysis.

5. Can all joint costs automatically decide whether to process further?

Answer and reason
No. Further-processing decisions compare incremental revenue with relevant separable costs; allocated joint costs may not change.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Job costing accumulates distinct-job costs.	15. Abnormal loss differs from normal loss.
02. Batch costing groups similar units.	16. Abnormal gain reflects output above expected yield.
03. Process costing follows continuous production stages.	17. Equivalent units express partial completion.
04. Service costing uses a suitable service unit.	18. Material and conversion may progress differently.
05. Contract costing needs contract-specific analysis.	19. Weighted-average andFIFOprocess methods differ.
06. Departmental costing tracks departmental responsibility.	20. Opening work-in-progress affects calculation.
07. Composite costing combines appropriate methods.	21. Joint costs differ from separable costs.
08. Method and costing technique are different dimensions.	22. By-products need suitable accounting treatment.
09. A job cost sheet records relevant inputs.	23. Service units can be simple or composite.
10. Material requisitions support material charging.	24. Cost per unit requires a meaningful denominator.
11. Time records support labour charging.	25. Case expected good output is 900 units.
12. Overhead application needs a rational basis.	26. Case basic abnormal loss is 50 units.
13. Normal loss reflects expected process loss.	27. Without scrap its value isRs.555.56.
14. Scrap value can reduce net process cost.	28. With stated scrap the expected-unit cost isRs.11.

MODULE D / D 05

Standard Costing

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

Standard output requires 100 kg of material atRs.5/kg, givingRs.500 standard cost. Actual usage is 110 kg atRs.6/kg, givingRs.660 actual cost. With favourable-positive convention, total cost variance=500-660=-Rs.160(adverse). Price variance=110 x(5-6)=-Rs.110; usage variance=5 x(100-110)=-Rs.50. They reconcile to-Rs.160.

Change the situation

If actual price returns toRs.5 but usage stays 110 kg, price variance is zero and theRs.50 adverse usage variance remains. A cheaper input can also increase wastage; investigate causes together.

COMMON MISTAKE - WHY IT FAILS

Always state the sign convention and flex the standard quantity/hours to actual output. A favourable price variance does not prove a good buying decision if quality or usage deteriorates.

Build the connections

Idea	Why it matters
1	A standard is a predetermined performance benchmark.
2	Basic standards differ from current attainable standards.
3	Ideal standards assume unusually demanding conditions.
4	Standards need suitable review.

Idea	Why it matters
1	Variance compares actual and standard outcomes.
2	State favourable/adverse sign convention.
3	Use standard allowance for actual output.
4	Do not compare unmatched output volumes.

Idea	Why it matters
1	Material cost variance can split price and usage.

Idea	Why it matters
2	Price variance uses an explicit quantity basis.
3	Usage variance reflects consumption against allowance.
4	Mix and yield can explain usage differences.

Idea	Why it matters
1	Labour cost can split rate and efficiency.
2	Rate variance needs a stated actual-hours basis.
3	Efficiency compares standard and actual hours.
4	Idle-time treatment needs its own convention.

Idea	Why it matters
1	Variable overhead varies with the selected activity.
2	Fixed-overhead volume differs from spending effects.
3	Budget capacity and actual activity differ.
4	Sales variances need a defined profit/revenue basis.

Idea	Why it matters
1	Variances are signals, not final explanations.
2	Material quality can affect usage and labour.
3	Responsibility needs controllability analysis.
4	Investigate significant and recurring deviations.

Idea	Why it matters
1	Case standard cost isRs.500.
2	Case actual cost isRs.660.
3	Case price variance isRs.110 adverse.
4	Case usage variance isRs.50 adverse.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Material cost variance	SQ xSP-AQ xAP	SQ=standard quantity for actual output;AQ=actual quantity;SP/AP=standard/actual price.
Material price variance	AQ x(SP-AP)	Quantity basis must match the purchase/usage convention.
Material usage variance	SP x(SQ-AQ)	Under matching bases, cost variance=price+usage.
Labour cost variance	SH xSR-AH xAR	SH=standard hours for actual output;AH=actual hours;SR/AR=standard/actual rate.
Labour rate variance	AH x(SR-AR)	State treatment of idle/paid/productive hours.
Labour efficiency variance	SR x(SH-AH)	Use the stated hours basis;separately analyse idle time if required.
Variable-overhead spending	AH xstandard variable rate-actual variable overhead	Illustrative hours-driver basis.
Variable-overhead efficiency	Standard variable rate x(SH-AH)	Use compatible absorbed-activity definitions.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Definition And Meaning Of Standard Costing
Standard cost of a product or service refers to the costs expected to be incurred to produce a goods or provide a service under anticipated conditions, keeping in view the prevailing market conditions.
For example: If we have to construct a residential house of 1000 sq ft carpet area with class I RCC construction, we need not calculate the cost of each construction material, labour etc. The estimate for such Construction is available with the architect/engineer, based on the detailed analysis taking into account the present market rates of all the items.

Concept / condition / application
This estimate of the cost of constructing our house, before the construction has actually started, is called the standard cost of the house.
The actual cost will be known after the house is actually constructed.

Historical formulation: Variance = Actual cost – Estimated/ Standard cost

CLARIFICATION / 1 NOVEMBER 2026

Use the stated sign convention and standard allowance for actual output. A favourable variance is not automatically beneficial if it worsens quality, usage or other costs; investigate linked causes.

Concept / condition / application
The standard cost is valid only over a period of time.
Depending of inflationary conditions, market forces of demand and supply and various other factors, a periodic updating of the standard cost may be necessary.
Significance/ Advantage Of Standard Costing
Simple and time saving technique:
Simpler in comparison to other costing techniques

Concept / condition / application
For example, difficult exercises like time and motion study to decide labour costs are not required be conducted as standard costs are already available. This results in saving time, money and manpower, while using this technique.
Eliminate the sources of inefficiencies:
As the technique of standard costing involves comparison of actual costs with the estimated costs by calculating the variance, it enables the management to locate and eliminate the sources of inefficiencies and wastages.
Delegation is simple:
The delegation of authority and fixation of responsibility for each department or individual is relatively simpler in applying this technique.

Concept / condition / application
Greater efficiency:
As the standards are already known, the operating staff tends to be more competitive to achieve the standards and show greater efficiency.
More realistic:
Prices based on standard costs are more realistic. If the selling prices are fixed on the basis of actual costs, the market may not accept these. as it is not concerned

Concept / condition / application
with the inefficiencies of any particular producer. The market prefers the product

which is available at the competitive price.

Concept / condition / application
Applications Of Standard Costing

Some of the main applications of standard costing are as under:

Concept / condition / application
In Planning: The production, sales and profit budgets are prepared based on the standard costs.
It is used for measurement of variances between standards and actuals.
It is used to identify the areas of inefficiencies so that corrective action can be initiated.
Controlling: It is effective in controlling the actual costs as the management gets timely information about variances at each cost centre.
It is also used to measure the performance of each cost centre/department.

Concept / condition / application
It can be used to motivate the workforce to contain the expenses within the set standards. It is also useful in devising an incentive system for the employees to increase productivity.
It is useful in inventory valuation.
Various Types Of Standards

Suppose, a transport company wants to find out how many kilometres a truck driver can drive in a day. It wants to set an appropriate standard for the purpose of preparing its budgets and to compare the performance of the truck drivers employed by it. The company may fix standards on the basis of performance of a few drivers who have maximum efficiency, have very little idle time, and can work

Kinds of standard

Basic	Ideal	Currently attainable
Longer-term reference base	Perfect/highly demanding conditions	Efficient but realistically achievable conditions

Concept / condition / application
Basic Standards
These are the standard which are established for use over a long period of time.
ADVANTAGE: It provides a base over a long period for comparison of actual costs with the same standard.

Concept / condition / application
DISADVATAGE: Not very useful if frequent changes take place in production methods, price levels, labour conditions and other relevant factors.
As they may not represent the current costs correctly, their use in practice is limited.

Concept / condition / application
Ideal Standards
These standards take into account the perfect performance. These standards represent the costs which are achievable under the ideal operating conditions. Hence, these are more idealistic and less realistic.
As these standards may have an adverse impact on motivation and moral of the workers, their us is also limited in practice.
Currently Attainable Standards
If frequent changes take place in production methods, price levels, labour conditions and other relevant factors of production, it is advisable to make necessary adjustments in the cost standard also to make it more realistic.

Concept / condition / application
A current attainable standard is a such an adjusted standard representing certain condition and for certain circumstances prevailing in a certain period.
These standards are fixed on the basis of scientific studies but adjusted for changes in the subjective factors in current period.
More realistic to achieve as they take into account normal idle time, wastages,

break-down of machines etc.

Concept / condition / application
These standards are neither too easy to achieve nor impossible to achieve.
Widely used in industry.
Components Of A Standard Costing System

The standard costing system involves the following components:

Concept / condition / application
Decision on the standard costs of materials, labour and overheads, for the production line
Decision on the pricing of the products and preparing the budget of sales and profit
Segregating, ascertaining and recording the actual costs and profits
Finding out the variances of various cost components
Analysing the variances and ascertaining the causes of variances

Concept / condition / application
Initiating corrective actions in areas showing variance
Standard Costs of Materials, Labour and Overheads
Starts with ascertaining the standard costs of the elements of cost i.e. materials, labour and overheads.
As the efficacy depends largely upon the correct estimate of the standard costs, we have to exercise extreme care in deciding these.
Some of the important points in setting the cost standards, are as under:

Concept / condition / application
Benchmark to be used in ascertaining the standards
Peculiar operational aspects of the organisation
Whether the standard to be applied by the organisation is basic, ideal or currently attainable standard
Proper identification of the cost centres so that the variances may be properly segregated
Standard Cost of Materials

Concept / condition / application
This relates to the quantities and prices of materials required to be used in producing a product.
Therefore, we have to set both
Materials Usage Standard and
Materials Price Standard
Materials Usage Standard: Ascertaining the standard quantities of materials to be used per unit of production.

Concept / condition / application
Also the specifications like size, grade etc.

Concept / condition / application
Based on an estimated unavoidable wastage, due allowance is made for normal wastage through evaporation, spillage, breaking of parts, generation of scrap in cutting, machining etc.
Materials Price Standard: Set for the prices of materials used per unit of production.
Due consideration is given to the efficiency of functions like purchasing and store-keeping.
While setting the price standard, we have to keep in mind factors

Concept / condition / application
Discount on purchases, Economy of bulk purchasing, Past trend of prices and Anticipated changes in market price of materials required to be used.
Standard Cost of Labour
Two factors: labour time and wage rates.
Set both the Standard Labour Time and the Labour Rate Standard.
Standard Labour Time : The labour time required per unit of production. In ascertaining this time, we have to consider the performance of a particular grade of labour required for the particular operation involved in the production process.

Concept / condition / application
Setting the standard time of labour: Standards published by the International Labour Organisation (ILO) or the industry bodies or the time and motion studies conducted by the organisation.
Past performance with adjustments for change of conditions can also form a basis for setting this standard.
Labour Rate Standard: To the wage rates estimated to be paid to different grades of labour used for performing particular types of operations in the production process.
The factors to be considered while setting the standard wage rates, include past and future trends of the labour market, agreement with the labour unions, statutory minimum wages etc.
Standard Overhead Costs

Concept / condition / application
Overhead costs may be variable costs which depend on the volume of production or, the fixed costs which do not depend on the volume of production but have to be incurred over a period of time irrespective of the production volume.
We should be able to correlate the work to be done by the service departments to the level of activity of production departments.
The standard overhead rates for each of the service departments should be ascertained and then applied to various producing departments.
Make use of past data, suitably adjusted for prevailing conditions and the anticipated future trends, for the purpose of ascertaining the costs of the service departments.

Concept / condition / application
The standard overhead rates for the producing departments may be expressed as a % of the direct labour costs or, machine hour rate etc.

Concept / condition / application
Setting Standards for Other Costs
Other costs: Administrative costs and selling and distribution costs.
For setting standards for these costs, we may use past performance data, time and motion studies standards published by industries bodies etc.
Some of these costs may have a direct relationship with the volume of production. For example, the selling and distribution costs, may largely depend on the sales volume.
Preparing Sales and Profit Budget

NEXT STEP IN PROCESS:

Concept / condition / application
We have to decide on the sales price, based on cost of production, prices of products of the competitors, consumer preference etc.
Sales = sales volume * sales price per unit of the product
The budget provides the estimates for the entire period for which the budget has been prepared.
The estimates of sales, costs and profit provide a suitable base to the management to periodically review the actual performance and compare it with the budgeted one.
Variance Analysis

Concept / condition / application
Variance in standard costing refers to the deviation of actual cost from the standard cost and provides the basis for cost control by initiating the appropriate corrective actions.
The variances indicate the extent to which the standards set have been achieved.
Variance analysis is the process of ascertaining the amount of variance and identifying the cause of variance between actual cost and standard cost.
The cost variances can be divided into the following three broad categories,

depending upon which cost element is involved:

Cost variance family

Material	Labour	Overhead
Price, usage, mix/yield where relevant	Rate, efficiency, idle-time/mix where relevant	Variable/fixed spending and activity effects where relevant

Concept / condition / application
Material Cost Variance
The cost of material is a finished product depends on two factors,
1 st : The quantity of the material consumed
2 nd: The price of the material consumed.
So, the variance of the actual cost of material consumed from the standard cost can also be arrived at by these two factors, as under:

Material price variance:

Concept / condition / application
The cost of the material in the standard cost of the product is estimated by taking the prevailing prices of the material at the time of preparing the estimated.
These estimates are for a future period and the prices may change during this period.

Illustration

Concept / condition / application
In a furniture manufacturing factory, while estimating the cost of wood and steel which go into producing one table, the cost of material as Rs. 2,000
After one week, when the review exercise was conducted, it was found that the actual cost of material in each table was Rs. 2,100 against the standard cost of Rs. 2,000.
It was found out that the quantities of wood and steel, actually consumed were the same as estimated in the standard costing.
Further analysis revealed that while the price of wood was the same as the standard cost, the price of stainless steel has increased

Worked figure / record

Wood	Stainless steel
3 cubic feet	5 kg
Rs. 500/ cf	Rs. 100/ kg
1500	500

Wood	Stainless steel
3 cubic feet	5 kg
Rs. 500/ cf	Rs. 120/ kg
1500	600

Concept / condition / application
Possible causes of Material price variance: Sometimes, the material price variance may not be the result of increase in the market rates alone.
inefficiency of the purchase department, which has not been able to locate and utilise the most cost effective sources of supply of material or, has failed to take advantage of discount on bulk purchases.
It is also possible that the inventory control department has not been efficient enough to notify the requirement of material in time resulting in emergency purchases.
A favourable variance may also require proper scrutiny as it may be a result of purchase of material of inferior quality.

Material usage variance:

Concept / condition / application
The cost of the material in the standard cost of the product is estimated by taking into account the quantities of material expected to be consumed in production of each unit.
These estimates may not materialise during the actual manufacturing process.

Illustration

Concept / condition / application
We will take the same example of the furniture manufacturing factory, taken above.
When the review exercise was conducted after one week, it was found that the actual cost of material in each table was Rs. 2,100 against the standard cost of Rs. 2,000.

Worked figure / record

Wood	Stainless steel
3 cubic feet	5 kg
Rs. 500/ cf	Rs. 100/ kg
1500	500

Wood	Stainless steel
3.2 cubic feet	5 kg
Rs. 500/ cf	Rs. 100/ kg
1600	500

CHECK THE WOOD TOTAL

At 3 cubicfeet xRs.500, the standard wood cost isRs.1,500. The older illustration shows 150 in one place; that is inconsistent with its own quantity and rate. At 3.2 cubicfeet the corresponding cost isRs.1,600.

Concept / condition / application
The analysis revealed that while the prices of both wood and steel were the same as contained in the standard cost.
The consumption of steel was as per the estimates in the standard costing. This caused a variance of Rs. 100 in the total cost of material consumed for each table.

Concept / condition / application
(It is important to note that the variance should be calculated for each material separately. As in above example, an increase in quantity of wood consumed could be nullified in money terms by a decrease in the quantity of steel consumed. The increased consumption of wood would not have been noticed if separate analysis of both materials had not been conducted).

Possible causes of Material usage variance:

Inferior quality of material purchased Theft, pilferage Increased wastage due to careless handling during manufacturing Not following the standard production procedures Changes in quality of the finished goods compared to that envisaged in standard costing

Concept / condition / application
Labour Cost Variance
Total cost of labour depends on the rate of wages for the labour and the quantity of labour used in manufacturing each unit.
So, the variance of the actual cost of labour from the standard cost, in producing one unit, can also be arrived at by these two factors, as under:

Labour rate variance:

Concept / condition / application
The variance under this head is caused due to actual wages paid per hour being different from the standard wages per hour estimated in the standard costing.

Illustration

Concept / condition / application
While preparing the estimates of standard costs, it was estimated that the labour hours required for manufacturing one table
After one week, when the review exercise was conducted, it was found that the actual cost of labour for each table was Rs. 960 against the standard cost of Rs. 900.
It was found out that while the actual labour hours for manufacturing each table were 6 hours, same as the estimates in standard costing,

Worked figure / record

Hours
6 hours
Rs. 150/ hr
900

Hours
6 hours
Rs. 160/ hr
960

The total variance in labour cost, due to this reason will be equal to the variance for one unit multiplied by the total number of units manufactured during the period

Possible causes of Labour rate variance:

Concept / condition / application
Labour rate variance is, in all likelihood, not a controllable item as it is governed by the factors beyond the control of the management of the individual companies. Sometimes, arise due to new wage agreement with the workers' union while, in the standard costing, the rates applicable earlier may have been taken.
Another possible reason of the variance could be the wrong estimate of mix of skilled and unskilled labour hours involved in manufacturing, as the rates for both are different.

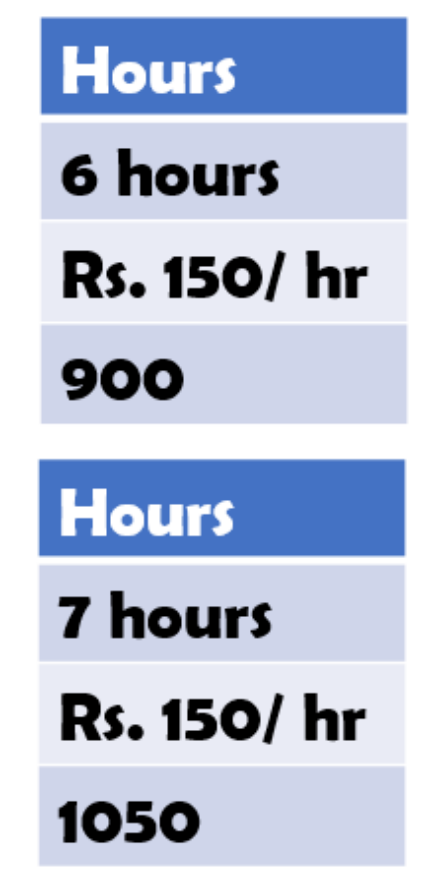
Labour time or labour efficiency variance:

Concept / condition / application
The variance under this head is caused due to actual time taken for manufacturing one unit being different from the standard hours estimated in the standard costing.

Illustration

Taking the same example as above, where the labour hours consumed in manufacturing one unit is estimated at 6 hours @ Rs. 150 per hour. When the review exercise was conducted, it was found that the actual cost of labour for each table was Rs. 1,050 against the standard cost of Rs. 900.

Worked figure / record



The total variance in labour cost, due to this reason will be equal to the variance for one unit multiplied by the total number of units manufactured during the period.

Concept / condition / application
Overheads Cost Variance

The total overhead cost variance is the difference between the actual overhead cost incurred and the standard overhead cost allowed for the actual output achieved.

Overhead cost variance consists of two parts:

Concept / condition / application
Variable overhead variance
Fixed overhead variance

Variable Overhead Variance

Concept / condition / application
This also consists of two broad categories, viz.:
Variable Overhead expenditure variance Variable Overhead volume or efficiency variance.

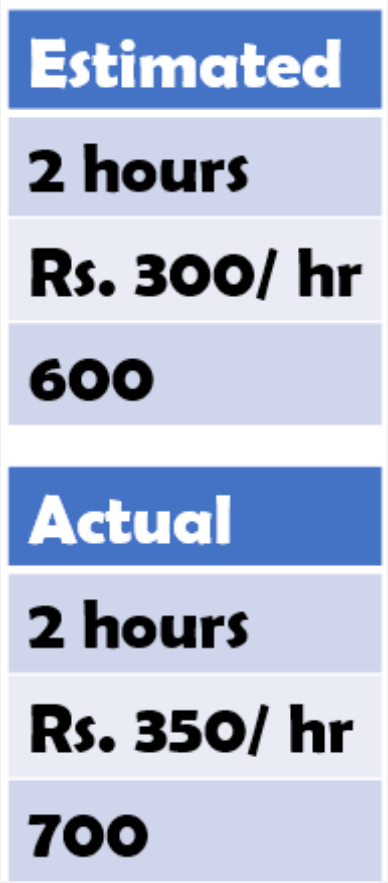
Variable Overhead expenditure variance:

This variance is due to actual variable overhead expenditure per hour being more than the budgeted (standard) variable overhead expenditure per hour, while the actual variable overhead hours, consumed in producing one table, are the same as the budgeted (standard) hours.

Illustration

Concept / condition / application
In a factory, the cost of each variable overhead hour, for producing one table
When the actual performance is reviewed,

Worked figure / record



Variable Overhead volume or efficiency variance:

This variance is due to actual variable overhead hours, consumed in producing one table, being more than the budgeted (standard) variable overhead hours, while the expenditure per hour is as per the budget estimates.

Calculated = Actual fixed overhead expenses - standard (budgeted) fixed overhead expenses.

Concept / condition / application
The overall variance figure may not be very useful to identify the area of actual cost increase as increase in one area may be nullified by decrease in expenditure in another area.
Therefore, we have to further segregate this variance into variances of various sub-areas of fixed overhead costs.
Accounting Treatment Of Variances
There is no uniform system of maintaining the cost records and making entries under a system of standard costing.
Normally, the cost variances at the end of the accounting period, may be dealt

with in any of the following ways:

Concept / condition / application
i)Transfer to costing profit and loss account
ii)Allocation of variances to finished stock, work-in-progress and cost of sales account
iii)Transfer to reserve account
Under the first method, the stock of work-in-progress, finished goods and cost of sales are maintained at standard cost and variances are charged to costing profit and loss account
while under the second method, the variances are distributed over the stocks of finished goods, work-in-progress and to cost of sales account in proportion to their respective closing values.

Concept / condition / application
Under the third method, positive variances are carried forward as deferred credits. These are adjusted against any negative variances in future accounting periods.
The first method has the advantage of easier inventory valuation, as the valuation is done at standard costs.
Also, as the variances are separately shown, the management attention and action becomes easier.
Reporting Of Variances To Management

Concept / condition / application
The basic purpose of standard costing is to identify the areas of inefficiencies, represented through variances, and take the corrective action by the management.

Concept / condition / application
The action cannot be taken by the management unless the variances are properly reported to them, timely and promptly.
While devising the system of reporting the variances to the management, we have to keep in mind that the variances can be positive (favourable) or negative (adverse).
If only the overall picture is presented to the management, the areas of concern may not be highlighted as a favourable variance may hide an adverse variance.
The top management of the company are concerned with the overall efficiency of the execution of company's plans by the middle and lower levels of management.
Therefore, the report, submitted to them, should not convey only the net result, but should clearly mention the favourable and adverse variances, separately.

Concept / condition / application
The main details should be highlighted. The following points may be considered to

make the reports effective:

The reporting should be prompt. Delays in reporting variances, specially the controllable variances, will result in delaying the corrective action by the management. The variances of each cost centre should be correctly separated. If part of a variance attributed to one cost centre is wrongly attributed to or merged with the variance of another cost centre, the report may be misleading. While analysing and reporting the uncontrollable variances, same care should be exercised as while reporting the controllable variances. The forms of reports for variances are to be selected keeping in view the preferences and needs of the management and the company.

Apply your understanding: original practice

1. Reconcile the case material cost variance.

Answer and reason
PriceRs.110 adverse+usageRs.50 adverse=Rs.160 adverse, total actual 660 less standard 500.

2. What standard quantity should be used if output doubles?

Answer and reason
Use the standard quantity allowed for the doubled actual output, assuming unchanged unit standards.

3. Is buying below standard price always good?

Answer and reason
No. Poor quality can raise waste, rework or downtime. Assess linked operational effects.

4. Why state a sign convention?

Answer and reason
Different books present actual-minus-standard or standard-minus-actual. The same economic result can have opposite algebraic signs.

5. Does a labour rate variance explain productivity?

Answer and reason
Not by itself. Rate concerns wage price; efficiency concerns hours for the actual output, with relevant idle-time and mix analysis.

Official reference: ICMAI management accounting | checked1November2026.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. A standard is a predetermined performance benchmark.	15. Efficiency compares standard and actual hours.
02. Basic standards differ from current attainable standards.	16. Idle-time treatment needs its own convention.
03. Ideal standards assume unusually demanding conditions.	17. Variable overhead varies with the selected activity.
04. Standards need suitable review.	18. Fixed-overhead volume differs from spending effects.
05. Variance compares actual and standard outcomes.	19. Budget capacity and actual activity differ.
06. State favourable/adverse sign convention.	20. Sales variances need a defined profit/revenue basis.
07. Use standard allowance for actual output.	21. Variances are signals, not final explanations.
08. Do not compare unmatched output volumes.	22. Material quality can affect usage and labour.
09. Material cost variance can split price and usage.	23. Responsibility needs controllability analysis.
10. Price variance uses an explicit quantity basis.	24. Investigate significant and recurring deviations.
11. Usage variance reflects consumption against allowance.	25. Case standard cost isRs.500.
12. Mix and yield can explain usage differences.	26. Case actual cost isRs.660.
13. Labour cost can split rate and efficiency.	27. Case price variance isRs.110 adverse.
14. Rate variance needs a stated actual-hours basis.	28. Case usage variance isRs.50 adverse.

MODULE D / D 06

Marginal Costing

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A product sells forRs.100 and has variable costRs.60 perunit. Contribution isRs.40 perunit. With fixed costRs.20,000, break-even quantity=20,000/40=500 units. At 800 units, contribution isRs.32,000 and profitRs.12,000. Contribution first covers fixed cost; only the excess is profit.

Change the situation

If variable cost rises toRs.70, the contribution becomesRs.30 and break-even quantity 666.67 units, or 667 whole units to avoid a loss under these assumptions. The original 500 unit target is no longer enough.

COMMON MISTAKE - WHY IT FAILS

A price above variable cost can help a short-run decision only under appropriate spare-capacity and relevant-cost assumptions. Capacity constraints, opportunity costs and long-term sustainability must also be considered.

Build the connections

Idea	Why it matters
1	Marginal costing distinguishes variable and fixed costs.
2	Contribution equals sales minus variable cost.
3	Contribution is not the same as profit.
4	Fixed costs must still be covered.

Idea	Why it matters
1	Unit contribution equals price less unit variable cost.
2	P/Vratio equals contribution/sales.
3	Break-even profit is zero.
4	Break-even units equal fixed cost/unit contribution.

Idea	Why it matters
1	Break-even sales equal fixed cost/P/Vratio.

Idea	Why it matters
2	A zero contribution needs special analysis.
3	Target-profit units include target profit in numerator.
4	Margin of safety measures sales above break-even.

Idea	Why it matters
1	The sales mix matters for multiple products.
2	A changing mix can change break-even.
3	CVPassumes an identified relevant range.
4	Price and unit variable cost assumptions need review.

Idea	Why it matters
1	Fixed costs can change in steps.
2	Limiting factors require contribution per scarce unit.
3	Relevant costs drive special-order decisions.
4	Opportunity costs matter at full capacity.

Idea	Why it matters
1	Sunk costs normally do not change alternatives.
2	Absorption and marginal profit can differ with inventory.
3	A shutdown decision includes avoidable fixed costs.
4	Short-run acceptance is not long-term pricing policy.

Idea	Why it matters
1	Case contribution isRs.40 perunit.
2	Case break-even is 500 units.
3	Case 800 unit profit isRs.12,000.
4	AtRs.70 variable cost whole-unit break-even is 667.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Unit contribution	Selling price-variable cost per unit	Total contribution=sales-total variable cost.
Profit	Total contribution-fixed cost	Within stated cost-behaviour assumptions.
P/Vratio	Contribution/sales	Use decimal ratio in formula calculations.
Break-even units	Fixed cost/unit contribution	Requires positive contribution;round up for indivisible units.
Break-even sales	Fixed cost/PVratio	Use a stable defined sales mix if multiple products.
Target-profit units	(Fixed cost+target profit)/unit contribution	Assumes unchanged price, cost and range.
Margin of safety	Actual/budget sales-break-even sales	Percentage uses the stated actual/budget sales denominator.
Limiting-factor ranking	Contribution per product unit/scarce-resource use per unit	Compare relevant contribution per unit of constraint.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

The following detailed material retains the chapter's teaching topics, worked records and historical formulations. Read dated clarifications alongside it. Numerical rates and historical forms are illustrations unless expressly identified as current requirements. Do not apply an old legal threshold or form without checking its period and scope.

Concept / condition / application
Meaning Of Marginal Costing
Marginal cost is the cost of producing one additional unit of product or service.

Historical formulation: According to CIMA, marginal costing is the ascertainment of marginal costs and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs.

CLARIFICATION / 1 NOVEMBER 2026

Fixed total cost is assumed constant only over the relevant range and period. Fixed cost per unit changes with output; step costs and capacity constraints need separate treatment.

Concept / condition / application
In this technique of costing, only variable costs are charged to operations, processes or products, leaving all indirect costs to be written off against profits, in the period in which they arise.
Thus, marginal costing is the accounting system in which only
Wariable costs are charged to cost units
Fixed costs are charged to the contribution or profit.
Features Of Marginal Costing

Concept / condition / application
Marginal costing is distinct from other costing techniques. Its unique features can

be summarised as under:

Concept / condition / application
Marginal costing involves both cost recording and cost reporting.
Under marginal costing, TC= VC + FC. Some costs which have features of both fixed and variable costs, are segregated as semi-variable costs.
Only the average variable cost of a unit is considered as its value.
Fixed costs are not taken into account for calculating the product cost and are charged to revenue of the period in which they are incurred.
Marginal contribution of a product or department is taken into account for calculating its profitability.

Concept / condition / application
Advantages Of Marginal Costing
Some of the main distinct advantages of Marginal Costing are as under:
Marginal costing provides a better and more rational basis for deciding the sales prices of products and services under adverse business environment/recession
The organisation need not have two separate sets of records as data required for profit planning under marginal costing is easily retrievable from the regular accounting records.
Break-even point, which is of great importance for any management, can be determined only through marginal costing.

Concept / condition / application
Marginal costs and contribution figures make easier the relative appraisal of products, territories and various segments of the business.
Marginal costing offers more effective plans for cost control compared to other techniques of costing.

Concept / condition / application
The marginal costing effectively emphases the impact of fixed costs on profits.
Marginal costing provides a very effective tool to the management to formulate marketing strategies specially under difficult market conditions.
For example: Suppose a company producing steel is not able to increase its capacity utilisation beyond 70% as the domestic market is saturated with supply from local producers. The company can export to a neighbouring country but the prevailing price of steel there is less than that in India. The management has to decide whether to export or not at lower prices.

Concept / condition / application
Marginal costing tells what the variable cost of production is, and if the export price is more than the variable cost of production, it may be a good decision to export.

This will have two benefits.

Concept / condition / application
First, the company will gain at least some “Contribution” as the export price is morethan the variable cost.
Second, the country will gain through increased deployment of labour and narrowing of trade deficit.
Limitations/Disadvantages Of Marginal Costing

Some of the main limitations/disadvantages of Marginal Costing are as under:

Concept / condition / application
Segregation of costs into fixed and variable costs is not easy as some expenses have characteristics of both and cannot be done with precision. The personal judgement of the accountant comes into play and it may not always be correct.
The assumption that the fixed costs do not vary at all and the variable costs are 100% proportional to the volume of production, is not realistic.
In practice, the fixed costs may show an increase if the volume of production increases beyond a certain level, specially if additional plant and machinery is required to be used.
Similarly, the relationship between the variable costs and the volume may not be linear, specially over a longer period of time.
Under marginal costing technique, the inventory valuation may become unrealistic as fixed costs are not included in the value of work-in-process and finished goods.

Concept / condition / application
In case of seasonally sensitive products, this may result in inflated profit during the periods of higher sales and deflated profit during the periods of lower sales.

Concept / condition / application
The assumption under marginal costing, that the sales price per unit will remain same irrespective of production and sales is not realistic. In practice, too much production and availability of a product may affect its sales value.
Cost-Volume-Profit (CVP) Analysis
This analysis involves classification of every cost as either a fixed cost or a variable cost.
A fixed cost is one that is independent of the level of sales.

Concept / condition / application
For example: insurance cost, salary of permanent staff, rent paid.
A variable cost is directly related to the level of sales.
For example: cost of materials used in the goods sold, direct labour cost, commission paid on sales.
The basic formula of CVP analysis, when profit, sales volume and costs, all are

expressed in money terms, is:

Profit = Sales Volume – Costs

Concept / condition / application
Who invented this formula may be debatable but, it is certain the first person of the mankind, who started a business, knew it.

The concept of marginal costing has refined this formula as under:

Concept / condition / application
Profit = Sales Volume – (Fixed Costs + Variable Costs) or,
P = (S × N) – [F + (V× N)]
Where, P = Profit,
S = Sales value per unit
N = Number of units sold

Concept / condition / application
F = Fixed Costs
V = Variable Cost per unit

Illustration:

A firm, manufacturing thermometers, has fixed costs of Rs. 1,00,000 and variable cost of Rs.120 per unit. Sales price is Rs.160 per unit. During the year, it sold 3000 thermometers. What is the profit of the firm during the year? Applying the CVP analysis, we calculate the profit as under:

P = (S × N) – [F + (V× N)]

Concept / condition / application
P = (160 × 3000) – [1,00,000 + (120× 3000)] =
4,80,000 – (1,00,000 + 3,60,000)
4,80,000 – 4,60,000 = Rs.20,000
Break-Even Analysis

The break-even analysis, which is a part of Cost–volume– profit (CVP) analysis, also involves finding correlation between the fixed costs, variable costs, sales revenue and profit. Whenever one unit of the product is sold, its sales value minus its variable cost provides a surplus which goes towards meeting the fixed expenses.

This sales value of one unit minus its variable cost is called “Contribution” as this is what one unit of the product contributes towards recovering the fixed expenses.

Break-even level is that activity level at which all relevant fixed costs are recovered and there is no profit or no loss. For activity level below the breakeven level, the company will make losses, while above this level it will make profit.

Illustration:

A company manufacturing LED bulbs has the following financial information:

Concept / condition / application
a)Total fixed costs Rs. 2,00,000
b)Sales price per bulb Rs. 60
c)Cost of all direct inputs like material, labour, utilities etc. Rs. 40
d)We have to calculate the Break-even level.
As the sales price of one bulb is Rs. 60 and its variable cost is Rs. 40, the contribution is Rs. 20(60-40).

Concept / condition / application
So, sale of each bulb contributes Rs. 20 towards meeting the fixed cost. We have total fixed cost Rs. 2,00,000. For meeting this cost, we have to sell 2,00,000/20 = 10,000 bulbs.
As this activity level of selling 10,000 bulbs, the fixed costs are fully met and there is no profit or loss.
The next bulb we sell, results in profit of Rs. 20 as the fixed costs have

already been met.

Concept / condition / application
The break-even point can be expressed in any of the following ways:
In number of units: Example: In the above illustration, the B-E point is 10,000 units.
In sales volume in money terms: Example: In the above illustration, the B-E point is sales volume of Rs.6,00,000.
In percentage capacity utilisation: Example: In the above illustration, if the total capacity of the plant is to manufacture 20,000 bulbs per year, the B-E point is 50%. (10,000/ 20,000 = 0.5 or, 50% of the plant capacity).
Applications Of Break-Even/Cost-Volume-Profit Analysis

Concept / condition / application
In appraising the term loan proposals, the financier expects that the operations will be substantially above the break-even level so that, term loan is repaid within a reasonable period, from the surplus generated.
If the break-even point of the project is calculated to be very high, say 75%, the margin of safety available to the project to withstand unexpected disruptions, and operate substantially above the break-even level, becomes narrow. The financers, therefore, prefer projects which have a lower break-even level.

Some of the other applications/uses of break-even/CVP analysis are as under:

The management gets a clear idea of the minimum level of activity below which it cannot afford to operate. It helps in devising an incentive scheme as the management has clear idea about impact of increased production on the profit vis-à-vis the cost of incentives. It helps in comparing the relative profitability of different products. It helps the management in deciding if the production of a particular component or product is to be outsourced. It provides a very effective tool to the management to formulate marketing strategies specially under difficult market conditions.

Concept / condition / application
Profit-Volume Ratio & Its Significance
Profit-volume ratio, known as P/V ratio is an important concept in marginal costing.
It represents the ratio of each unit’s contribution to its sales price.
It is expressed in percentage terms.
So, if C is the contribution and S is the sales price per unit,

Concept / condition / application
P/V ratio = (C/S) × 100

Illustration:

Concept / condition / application
If the unit sales price is Rs. 160 and its variable cost is Rs. 120, the P/V ratio will be:
[(160- 120)/ 160] ×100 (because the contribution of each unit is Rs. 160 - Rs. 120)
= (40/160) × 100 = 25%
Significance of P/V ratio: In a multiproduct company, the P/V ratio of different products gives a clear idea of profitability of each product.
With further analysis, this can be used by the management to decide about pushing the sales of certain products or repricing certain other products. It is also helpful in decided whether to purchase certain components from outside or continue their in-house production.

Concept / condition / application
Margin Of Safety
Every business is exposed to the uncertainties of market competition, unexpected disruptions in supply chain or production, disruptions and lock downs of the marketing channel due to strikes or pandemics etc.
Some disruption is part of the normal risk faced by the businesses in general.
But if the business declines below a level where there is a loss, such a situation cannot be sustained for a long period, As we have seen above, this level is indicated by the break-even level.
The gap between the estimated/budgeted level of operations and the break-even level indicates the cushion available to the business for sustaining its operations in times of adversity.

Concept / condition / application
This is referred to as “Margin of Safety”.
It is expressed in percentage terms. In equation form, it can be expressed as

under:

Concept / condition / application
Margin of Safety = [(Estimated sales – Break-even sales)/ Estimated sales] × 100

Illustration:

Concept / condition / application
If the estimated sales of a company during the year are Rs. 110 lakh and its break-
even sales level is Rs. 70 lakh, the margin of safety is:
[(110 – 70) /110] ×100
= (40/110) ×100 = 36.36%
Absorption Costing

Under marginal costing, only the variable cost is allocated to a product. So, the cost of a finished unit in inventory will include only the direct materials, direct labour, and variable overhead costs. It will not used.

Concept / condition / application
Therefore, the absorption costing is also called full costing or the full absorption

costing.

Concept / condition / application
Absorption costing is needed for external financial reporting and for income tax

reporting purposes while the marginal costing is mainly useful to the

Concept / condition / application
management for decision making and the outsiders may not be much interested

in it.

Illustration:

A company manufacturing LED bulbs has the following financial information:

Concept / condition / application
Fixed overhead costs: Rs. 1,50,000
Cost of all direct inputs like material, labour, utilities etc. per bulb: Rs. 40
Variable overhead costs: Rs. 60,000
Total bulbs produced in the year: 15,000
Under marginal costing, the costs allocated to each bulb are only the

Concept / condition / application
variable costs i.e. 40 + (60,000/15,000) = Rs. 44.
The fixed overhead costs are not included in the product cost.

Under absorption costing, in addition to the variable costs of Rs. 44 per bulb, the fixed overhead cost of Rs. 1,50,000 is also allocated on pro-rata basis i.e. 1,50,000/15,000 = Rs. 10 per bulb.

Concept / condition / application
So, the total cost of each bulb under the absorption costing is Rs. 54 per bulb.
Effect on stock valuation
Costs allocated to each unit of the product, under the absorption costing will be more than that under the marginal costing.
Higher valuation of finished goods
If there is no change in the inventory of the finished goods, during the year, it will make no difference in the valuation of stocks whether we use marginal costing or the absorption costing.

Concept / condition / application
Effect on profit
If inventories increase during a period, higher profit will be shown under the absorption costing than marginal costing.
When inventories decrease, less profits are shown
The difference in the profit is due to difference in accounting for fixed overhead costs for valuation of finished goods.
When the entire stock, produced during the year is sold, there is no change in the inventory of finished goods, and so, the profit revealed by both the methods will be same.

Concept / condition / application
But when sales and production are not same, difference in profit will be shown in the profit and loss account.
Difference Between Absorption Costing and Marginal Costing

Worked record / comparison

BASIS FOR COMPARISON	MARGINAL COSTING	ABSORPTION COSTING
Meaning	A decision making technique for ascertaining the total cost of production is known as Marginal Costing.	Apportionment of total costs to the cost center in order to determine the total cost of production is known as Absorption Costing.
Cost Recognition	The variable cost is considered as product cost while fixed cost is considered as period costs.	Both fixed and variable cost is considered as product cost.

Worked record / comparison

Classification of Overheads	Fixed and Variable	Production, Administration and Selling & Distribution
Profitability	Profitability is measured by Profit Volume Ratio.	Due to the inclusion of fixed cost, profitability gets affected.
Cost per unit	Variances in the opening and closing stock does not influence the cost per unit of output.	Variances in the opening and closing stock affects the cost per unit.
Highlights	Contribution per unit	Net Profit per unit
Cost data	Presented to outline total contribution of each product.	Presented in conventional way.

Apply your understanding: original practice

1. Why isRs.40 contribution notRs.40 profit on every unit?

Answer and reason
It must first cover total fixed costs. Profit begins only after those are covered.

2. Compute target units forRs.10,000 profit in the case.

Answer and reason
(20,000+10,000)/40=750 units, under unchanged price, cost and fixed-cost assumptions.

3. What is margin of safety at 800 units?

Answer and reason
800-500=300 units, or 37.5% of actual sales volume under the stated single-product assumptions.

4. With one scarce machine hour, should you maximise unit contribution?

Answer and reason
Compare contribution per unit of scarce resource, not merely contribution per product unit.

5. Why round 666.67 break-even units upward?

Answer and reason
Whole units must be sold.667 units are needed to reach non-negative profit under the given assumptions.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. Marginal costing distinguishes variable and fixed costs.	15. CVPassumes an identified relevant range.
02. Contribution equals sales minus variable cost.	16. Price and unit variable cost assumptions need review.
03. Contribution is not the same as profit.	17. Fixed costs can change in steps.
04. Fixed costs must still be covered.	18. Limiting factors require contribution per scarce unit.
05. Unit contribution equals price less unit variable cost.	19. Relevant costs drive special-order decisions.
06. P/Vratio equals contribution/sales.	20. Opportunity costs matter at full capacity.
07. Break-even profit is zero.	21. Sunk costs normally do not change alternatives.
08. Break-even units equal fixed cost/unit contribution.	22. Absorption and marginal profit can differ with inventory.
09. Break-even sales equal fixed cost/P/Vratio.	23. A shutdown decision includes avoidable fixed costs.
10. A zero contribution needs special analysis.	24. Short-run acceptance is not long-term pricing policy.
11. Target-profit units include target profit in numerator.	25. Case contribution isRs.40 perunit.
12. Margin of safety measures sales above break-even.	26. Case break-even is 500 units.
13. The sales mix matters for multiple products.	27. Case 800 unit profit isRs.12,000.
14. A changing mix can change break-even.	28. AtRs.70 variable cost whole-unit break-even is 667.

MODULE D / D 07

Budgets and Budgetary Control

Understand the problem before choosing the entry, formula or rule.

Identify the facts → Explain the method → Change one assumption → Check and interpret

Worked situation: follow the reason

A flexible budget allows fixed costRs.10,000 plusRs.20 perunit. At 1,000 units the budget isRs.30,000. Actual production is 1,200 units and costRs.35,000. Flexed allowance=10,000+20 x 1,200=Rs.34,000, so the relevant overspend isRs.1,000. Comparing only withRs.30,000 would confuse higher activity with poor cost control.

Change the situation

If activity falls to 800 units, the flexed budget isRs.26,000, notRs.30,000. Fixed cost staysRs.10,000 within this relevant range; the variable portion changes.

COMMON MISTAKE - WHY IT FAILS

A budget is a quantified plan, not a guarantee. Cash budgets differ from profit budgets because credit periods, capital expenditure, loans and non-cash charges affect them differently.

Build the connections

Idea	Why it matters
1	A budget quantifies a plan for a period.
2	Budgetary control compares results with that plan.
3	Responsibility should match controllability.
4	Coordination links departmental plans.

Idea	Why it matters
1	A principal budget factor constrains activity.
2	A sales budget can drive production planning.
3	Production needs inventory-policy adjustments.
4	Material and labour budgets support operations.

Idea	Why it matters
1	Overhead budgets need cost-behaviour analysis.

Idea	Why it matters
2	Capital budgets concern long-term outlays.
3	Cash budgets show dated receipts and payments.
4	Profit is not the same as cash.

Idea	Why it matters
1	A master budget integrates functional budgets.
2	A fixed budget uses one activity level.
3	A flexible budget adjusts to actual activity.
4	Flexing separates volume from spending effects.

Idea	Why it matters
1	Fixed total cost assumes a relevant range.
2	Variable total cost follows its activity driver.
3	Rolling budgets update the planning horizon.
4	Zero-based budgeting requires justification.

Idea	Why it matters
1	Incremental budgeting starts from an existing base.
2	Participation can improve information and ownership.
3	Budget slack can distort targets.
4	Variances require explanation and action.

Idea	Why it matters
1	Case 1,000 unit budget isRs.30,000.
2	Case 1,200 unit flexed budget isRs.34,000.
3	Case overspend against flexed budget isRs.1,000.
4	Case 800 unit flexed budget isRs.26,000.

Choose the formula: read its assumptions

Measure	Formula / relationship	Meaning and conditions
Flexible allowance	Fixed cost+variable rate xactual activity	Valid within the stated relevant range.
Matched spending difference	Actual cost-flexible allowance	Positive is overspend under this convention.
Production requirement	Budget sales+desired closing finished goods-opening finished goods	Match units and applicable inventory policy.
Closing cash	Opening cash+cash receipts-cash payments	Include actual cash timing, not merely accounting profit.

Detailed study and worked records

READ THE FRAMEWORK AND DATE

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Concept / condition / application
Budgetary Control
Concept Of Budget and Budgeting
A number of definitions are available to describe a budget. From these various

definitions, the following prominent points, about budgets, are highlighted:

Concept / condition / application
It is a financial plan serving as an estimate of and a control over future operations
It contains estimate of future costs
It is a systematic plan for the utilisation of manpower, material or other resources
It is a plan expressed in money terms/physical units
It is prepared and approved prior to the budget period (usually a year). and may show income, expenditure and the capital to be employed

Concept / condition / application
The complete process of designing, implementing and operating budgets is called Budgeting.
Types Of Budgets
Budgets may be classified into various categories depending upon the base adopted to

prepare it. Budgets may be classified on the basis of:

Concept / condition / application
The scope of their coverage or the functions covered by them. Examples: Sales budget, Production budget, Overheads budget, cash budget, Production Cost budget, Capital expenditure budget, etc. These are called Functional Budgets.

Historical formulation: the capacity or efficiency to which they are related. Based on this, a budget may be Fixed or Flexible budget.

CLARIFICATION / 1 NOVEMBER 2026

Flex a budget to the relevant actual activity before interpreting spending differences. Higher output can increase allowed variable cost without showing poor control.

Concept / condition / application
The conditions on which they are based. Based on this, a budget may be Basic or Current budget.
The periods which they cover. Based on this, a budget may be a Long period or a Short period budget.
Preparation and Monitoring Of Budgets

The highlights about the characteristics and preparation and monitoring of various

types of budgets are given below:

Concept / condition / application
Functional budgets

Budgets are prepared for each of the various interrelated activities in the organisation. These budgets are then consolidated to show the combined budget for all the activities. This consolidated budget is called the “Master Budget”. Approved budgets for individual functions are called “functional budgets”. The main functional budgets are:

Sales Budget:

Concept / condition / application
Forms the basis for preparing other functional budgets.
estimate of total sales, expressed in money terms as also in terms of quantity.
The sales during the budget period (normally one year), are estimated taking into account various internal and external factors.
Internal Factors: Present production capacity of the company, expansion plans, development of new products, pricing policy etc.
The external Factors: Competition in the market, growth of economy, Consumer preference, Government policies, etc.

Production Budget:

Concept / condition / application
It contains the estimated production quantities of various products during the budget period.
This is an offshoot of the sales budget and depends on the decision taken by the management regarding the sales estimates of various products.

Production Cost Budget:

Concept / condition / application
As per the components of cost of products, this budget may be a combination of three budgets, viz., Materials, Labour and Overhead costs budgets.

Cash Budget:

Concept / condition / application
This budget contains the detailed estimates of cash inflows (receipts) and cash outflows (payments) periodically.
For this, the budget period is further sub-divided on quarterly, monthly or even weekly basis.

Capital Expenditure Budget:

Concept / condition / application
The Capital expenditure budget details the plan of the proposed expenditure on fixed assets to enhance the capacity and efficiency of production process of the organisation.
Capital expenditure is a continuous process in any organisation and is planned through a long-term budget.
Capital forecasts should be made for a number of years. As the capital budget affects the cash budget also, normally, a short-term forecast to cover the general budget period is also prepared along with the long term capital expenditure plan.

Master budget:

Concept / condition / application
The Master budget is prepared by consolidating various functional budgets like the sales budget, production budget, production cost budget, purchase budget etc.
It is not a simple consolidation but a coordinated consolidation of various functional budgets.
This is the budget which is finally approved, adopted and employed by the organisation.
The Master budget is very important for successful financial planning and control in the organisation.
Fixed and Flexible Budgets

The characteristics of a fixed budget are;

Concept / condition / application
It does not change with the level of activity actually attained. In practice, however, a fixed budget is revised if the business conditions undergo a basic change or if, due to any reasons, actual operations are widely different from the planned ones.
It is designed for a specific planned output level.
It is not adjusted to the actual level of activity at periodic reviews which compare the budgeted and actual costs.
Normally, fixed budgets are established for a shorter period of time during which the actual output and the budgeted output are not anticipated to differ much from each other

The characteristics of a flexible budget are;

Concept / condition / application
It recognises different cost behaviour patterns.
It is designed to change as volume of output changes.
It is prepared in such a manner that it gives the budgeted cost for any level of activity.
It recognises the difference between fixed, semi-fixed and variable costs and changes with the actual activity level attained.
Basic and Current budgets

Basic budgets:

Concept / condition / application
Basic budget is prepared for use over a long period of time without any change.
This is attainable only under standard conditions as current conditions are not take into consideration for preparing this budget.

Current budgets:

Concept / condition / application
Current budget is prepared for use over a relatively shorter period of time and takes into account the current conditions. without any change.
As the target laid down in the current budget take into account the current conditions, it is considered to be more useful than the basic budget.
Long-term or Short-term budget

Long-term budget:

Concept / condition / application
A budget which is prepared for a period longer than a year is, normally considered to be a long-term budget.
As the period is long, the precise details of various items are not included in this budget. It is more helpful in business forecasting and forward planning.
For example, a Capital expenditure budget contains planning for a period beyond one year. Similarly, a research and developments budget involve strategic planning over a longer period.

Short-term Budget:

Concept / condition / application
A budget which is prepared for a period of up to one year is, normally considered to be a short-term budget. It emphasises on the micro aspects of the business rather than the long term strategic planning of the organisation.
A short-term budget is not in contradiction to the long-term budget but is fits into it.
Budgetary Control System

The CIMA, London, defines Budgetary control as “the establishment of budgets, relating the responsibilities of executive to the requirements of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objectives of that policy or to provide a firm basis for its revision”.

This definition implies that a budgetary control system involves:

Concept / condition / application
Preparing and approval of budgets
Comparing actual attainments with the budgeted figures
Secure control over performance and costs in different parts of a business by taking corrective action and remedial measures or revision of the budgets, if considered appropriate.

While budgeting involves planning for a future period, budgetary control involves continuous comparison of actual results with the budgets and taking appropriate remedial action promptly.

Budgetary control is a logical extension of the budgets. The budget involves fixing of targets, in the form of specific tasks, and the budgetary control involves collection of

Concept / condition / application
information regarding actual performance, its comparison with the targets and reporting these comparisons to the management for their action.

In short, budgetary control means laying down in monetary and quantitative

Concept / condition / application
terms, what exactly is expected to be done over the budget period and then to
monitor the actual results so that they do not diverge from the planned ones.
The main advantages of a budgetary control system are as under:
It enhances the probability of achieving the planned objectives of the organisation expressed through the budget.
It leads to optimum utilisation of limited resourced available to the organisation.

Concept / condition / application
It leads to better coordination amongst various functionaries of the organisation.
It encourages the culture of proactive thinking and actions as the targets are known to the functionaries.
It leads to delegation of authority while inculcating the culture of accountability.
It makes performance evaluation of various functionaries more transparent.
The main shortcomings/limitations of a budgetary control system are as under:

Concept / condition / application
The comparison of actual achievement with the budgeted figure may, sometimes, lead to conflicts specially when the budgeted figure is estimated on unrealistic presumptions and is far from reality.
The budgeted figures are for a future period (normally one year). The business conditions may change too fast to keep these figures relevant. For example, the Covid pandemic has caused an unprecedented business turmoil over a short period of time and this has upset the budget estimates of many organisations.
The personal/human aspect is often neglected in formation of budgets and their monitoring. The monitory and quantitative aspects of the business often prevail at the cost of personal/human considerations.
Like any other control, the budgetary controls are also not liked by many persons. They consider these as blocks in the way of their creativity and innovative skills.
Implementation Of Budgetary Control System

Concept / condition / application
The Budgetary Control System of a business organisation depends on its size, nature of business, objectives and its peculiar control needs.
No two organisations can be expected to have the same structure of their Budgetary Control Systems. Still, there are a few common things amongst the Budgetary Control Systems of various organisations.

The following are the usual components of a Budgetary Control System.

Concept / condition / application
Organisation Chart:

This chart shows the functional responsibilities of each functional executive, the delegation of authority to him and his relative position with other functional heads.

Concept / condition / application
Budget Centre
A budget centre means a section of the organisation with clearly defined functions.
The functions are as per the budget.
This centre is monitored for the purpose of budgetary control.

Concept / condition / application
The actual performance of a budget centre is recorded under the budgetary control and the variance from the budgeted figure is reported to the management.

Concept / condition / application
Budget Manual:
Setting out instructions and guidelines relating to the preparation and use of budgets, is known as the budget manual.
Pertain to forms and records, responsibilities of persons, the procedures to be followed and the time schedules to be followed etc.
The intention behind the budget manual is to lay down in unambiguous terms the procedures to be followed by the executive so that, there is no confusion or resentment regarding these, in future.
Budget Committee:

Concept / condition / application
These budget centres or functionaries are inter-related and budget for each cannot be set in isolation. They have to consult each other before finalising the budget.
For example; The sales promotion department may plan a budget for promoting new products but it may turn out that the production department will not be ready to produce these in near future.
Unless there is co-ordination between the two departments, a realistic budget for the organisation will not be finalised.
The budget committee consists of the representatives of various departments of the organisation. This committee co-ordinates in preparing and finalising the budget.
Budget Controller:

Concept / condition / application
The function of the budget controller is to bring together and co-ordinate the various functions involve in preparation of the budget.
He mainly carries out the function of compiling various types of information for the purposes of preparation of realistic budgets and proper reporting.
Budget Reports:
The budget reports contain the comparison of actual performance with the budgeted one.
These reports are submitted periodically and regularly to the management.

Concept / condition / application
The budget reports are submitted irrespective of whether the variance is positive or negative.
Zero Base Budgeting

Concept / condition / application
Zero base budgeting is budgeting from the beginning without any reference to any base.
For example: A company, which has achieved a sales level of Rs. 50 Crore, may budget for a 10% increase in sales for the next year. In this process a base of Rs. 50 Crore has been used to form the budget.
In Zero base budgeting, the process starts from the scratch and the potential of the company is judged without any constraint of the past data.

Concept / condition / application
It is based on the premise that every rupee of expenditure requires justification.
This is a deviation from the traditional budgeting approach where an expenditure of previous year is automatically incorporated in new budget proposals and only the quantum of increment is subjected to discussion.
Programme Budgeting
A budget prepared for a specific activity or program is called a Programme Budget.
Includes the estimates/targets related to the functions pertaining only to that specific activity or programme.

Concept / condition / application
For example: a management institute, conducting a special programme for middle-level executives of large companies, prepares a budget of revenue and expenditure of conducting only that programme, rather than having a budget covering all the programme of the Institute.
Another example of programme budgeting are specific programmes like safety drive, conducted by a Government body. By looking at a Programme Budget, it can be easily found out, in considerable detail, what precisely will be carried out, at what cost and with what expected results.
Performance Budgeting
According to National Institute of Bank Management, Mumbai, performance budgeting technique is the process of analysing, identifying, simplifying and crystallising specific performance objectives of a job, to be achieved over a period, in the frame work of the organisational objectives, and the objectives of the job.
The performance budgeting is characterised by its specific stress on the performance of every unit of the organisation. direction towards the business objectives of the organisation.

Concept / condition / application
It reflects both the input of resources and the output of services for each unit of an organization.
It is widely used in Government agencies to show the link between allocation of funds and the outcome of services provided by the government agency.
The performance budgeting lays stress on the achievement of specific goals, by a unit of the organisation, over a specific period of time.

Concept / condition / application
Preparation of periodic performance reports is an essential part of this.
These performance reports compare budget and actual performance and the corrective steps are taken if so needed

Concept / condition / application
The performance budgeting has certain limitations. These include difficulty in correctly segregating programmes and activities, lack of standard methods of evaluation of different schemes, the results being unmeasurable etc.

Apply your understanding: original practice

1. Why is the case adverse spending differenceRs.1,000 rather thanRs.5,000?

Answer and reason
Actual activity was 1,200 units. The matched flexible allowance isRs.34,000;actual costRs.35,000 exceeds it byRs.1,000.

2. Does a cash budget include depreciation as a payment?

Answer and reason
Not as depreciation itself. It is non-cash;actual asset purchases and related cash payments are considered separately.

3. What happens to this fixed cost at 800 units?

Answer and reason
It remainsRs.10,000 within the stated relevant range. The variable part becomesRs.16,000.

4. Why identify the principal budget factor?

Answer and reason
A binding constraint, such as demand or capacity, limits feasible plans and coordinates other budgets.

5. Does a favourable variance always show excellent management?

Answer and reason
No. It may reflect deferred maintenance, lower activity, poor standards or damaging cuts. Investigate cause and future effects.

Quick Revision: 28 essential recall facts

FOUNDATIONS /01-14	APPLICATION /15-28
01. A budget quantifies a plan for a period.	15. A flexible budget adjusts to actual activity.
02. Budgetary control compares results with that plan.	16. Flexing separates volume from spending effects.
03. Responsibility should match controllability.	17. Fixed total cost assumes a relevant range.
04. Coordination links departmental plans.	18. Variable total cost follows its activity driver.
05. A principal budget factor constrains activity.	19. Rolling budgets update the planning horizon.
06. A sales budget can drive production planning.	20. Zero-based budgeting requires justification.
07. Production needs inventory-policy adjustments.	21. Incremental budgeting starts from an existing base.
08. Material and labour budgets support operations.	22. Participation can improve information and ownership.
09. Overhead budgets need cost-behaviour analysis.	23. Budget slack can distort targets.
10. Capital budgets concern long-term outlays.	24. Variances require explanation and action.
11. Cash budgets show dated receipts and payments.	25. Case 1,000 unit budget isRs.30,000.
12. Profit is not the same as cash.	26. Case 1,200 unit flexed budget isRs.34,000.
13. A master budget integrates functional budgets.	27. Case overspend against flexed budget isRs.1,000.
14. A fixed budget uses one activity level.	28. Case 800 unit flexed budget isRs.26,000.

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