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CONSEQUENTIAL IMPLICATIONS OF DEMONETIZATION ON ACCOUNTING AND FINANCE

Abstract

On 8 November 2016 midnight, the Government of India announced the demonetization of all 500 and 1000 banknotes. People have been given time up to December 30, 2016 to exchange the notes held by them. The Government claimed that the action would curtail the shadow economy and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism. This scheme has a great impact on the business, common people, accounting practices and financial institutions along with multi-diverse industrial background of India. This paper includes the meaning, historical background, reason behind this move and elucidates the consequential implications of such a move on the economy, finance and accounting.

Key Words: Demonetization, Unaccounted Money, Surgical Strike, Matching Principle, Tax Accounting, E-Accounting.

Introduction

The hope and future of a nation does not depend in itself. For the better future of a nation, the role of Government, Economic Policies and Reserve Bank of India have great contribution. Time to time the RBI and the Government make several efforts for economic growth, development and security of a nation. Demonetization is one of the significant and big step of the Government. To become the strong economy, India needs to eradicate black money, corruption, fake currency and financial crime and demonetization can play a great role in these issues.

Meaning of Demonetization

Demonetization is the act of stripping a currency unit of its status as legal tender. In other words demonetization is the withdrawal of a particular form of currency from circulation. Through demonetization the old currency is replaced by the new currency or a currency circulation is blocked. It involves either introducing new notes or coins of the same denomination or completely replacing the old denomination with the new denomination. The opposite of demonetization is remonetisation, in which a form of payment is restored as legal tender.

During the implementation of this policy, the currency unit that has lost its status as a legal tender is deposited with the banks or other authorized financial institutions and replaced with units that still have legal tender status. The Government from time to time formulates monetary policies that are meant to spur economic growth. A lot of black money circulates in the economy, and most of it is unaccounted for because the sources of income are not known to the Government. It can be money generated through illegal trade or unauthorized funding. To mop up this money out of circulation, the Government can demonetize so that the money holders are forced to deposit the cash with the banks or lose their wealth.

Demonetization can also be referred to as the process of moving people from a cash-based system to a cash-less system (Digital System).

Historical Background of Demonetization

In the world history, one can see several instances of the demonetization which was implemented in various countries of the world. Many of these countries accepted the policy of demonetization which was targeted to make the country's failing economy strong. Here is the list of countries where demonetization has taken place by the Government: Union States of America in 1969, Britain in 1971, Ghana in 1982, Nigeria in 1984, Myanmar in 1987, Congo in during 90s, Soviet union in 1991, Zaire in 1990, Australia in 1996, Zimbabwe in 2010, North Korea in 2010, Pakistan in 2015 and Venezuela in 2016.

In India, the first time demonetization occurred in the 12th January 1946. Rs. 1000 and Rs. 10000 which were in circulation were demonetized primarily to stop unaccounted money. The Government through this drive collected Rs. 134 Crore of the total Rs. 143 crore available in the market (according to RBI estimates).

The second time demonetization occurred in the 16th January 1978, during the reign of Moraji Desai, when the Wanchoo Committee appointed by the Government, decided to recall the re-introduced Rs. 1000, Rs. 5000 and Rs. 10000 entirely from cash system as the country was going through a difficult time.

The third time demonetization occurred in the 8th November 2016. “The Surgical Strike” on black money and fake currency, named “Demonetization” was announced and done by Prime Minister of India Shri Narendra Modi Ji at 8 pm. With effect from this date Shri Narendra Modi Ji banned the currency notes of 500 and 1000. These ceased to be legal tender from the midnight of 8th November 2016. People have been given up to December 30, 2016 to exchange the notes held by them. The proposal by the Government involves the elimination of these notes from circulation and a gradual replacement with a new set of notes. The RBI issued two thousand rupee notes and new notes of five hundred rupees which were placed in circulation from 10th November 2016. This demonetization move is implemented as a tool to measure the stock of black money hoarded in these high denomination currencies, and to curb terrorist activities in the country. The Government aims to bring the unaccounted money back to the formal banking sector by allowing limited exchange and unlimited deposit of old notes in bank accounts till the end of 2016.

Reasons behind Demonetization

India is swiftly increasing in terms of growth and standing in good position in terms of growth but high ranked in Global Corruption Perception Ranking. It is no secret that the evil of corruption and black money also have grown beyond the control of the system. In fact they are influencing the system and weakening the efforts in financial inclusion. Also, existence of huge number of high value currency notes has created conducive environment for hoarding black money, corruption in business and funding of terrorism by hostile countries. Therefore demonetization was on the anvil as one of the major steps to make economy free of these evils. Following are the main reasons behind the demonetization:

- ✓ To eradicate counterfeit currency
- ✓ To promote a cashless economy
- ✓ To eliminate black money in the economy
- ✓ To combat corruption
- ✓ To combat inflation

- ✓ To crack down on terrorism and naxalism
- ✓ To stop money laundering activities.

Review of Literature

(February 2017)The paper **Demonetization: Experiment Mean of Financial Inclusion**, by KajalChaudhary, Surjan Singh, NabinSubedi, KomalpreetKaur and MilandeepKour focus the impact of demonetization on Indian economy, Indian currency and common public. The Paper **Impact of Demonetization: Organized and Unorganized Sector** by Dr.S.Balamurugan and B.K.Hemalatha elucidates the impact of such a move on the availability of credit, spending, and level of activity and government finances. The Paper (December 2016) **Impact of Demonetization on Indian Economy** reveals the experience of impact of demonetization in various countries in past years, immediate impact of demonetization and their probable consequences. (December 2016) The paper **Demonetization and Complete Financial Inclusion** has taken up the issues related to demonetization and its linkage to complete financial inclusion.

Research Methodology

The present study is descriptive and conceptual in nature and secondary data are used to serve the purpose of the study. The sources of data include the facts released by RBI, Central Statistics Office India and different banks websites.

The Probable Consequences of the Demonetization on Economy and Finance

The following probable consequences of the demonetization on the economy and finance will be observed:

Black Money: The removal of these 500 and 1000 notes and replacement of the same with new 500 and 2000 rupee notes is expected to remove black money from the economy as they will be blocked since the owners will not be in a position to deposit the same in the banks.

Counterfeit Currency: Fake Indian Currency Notes network will be dismantled by the demonetization measures. Taking out 500 and 1000 rupee notes out of circulation will have a lasting impact on the syndicates producing fake Indian currency notes, thus affecting the

funding of terror networks in Jammu and Kashmir, North-eastern states and Nasalite hit states.

Hawala: The brightest spot is the end of hawala racket and rising property prices. Hawala is the way of transferring money from a different country to India in Indian denominations. Although illegal, the people in this racket make their money white through this process in different countries. To attract more people to remit through this form, they pay a premium over the existing exchange rates mostly for remitter's from African-based nations. Come 8th November, 2016, the Government scrapped all high denominations making the notes lying with the Hawala traders' null void.

Tax: Having closed the voluntary disclosure window for undisclosed money, it has been reported that the Government will keep a close watch on deposits over Rs. 2 lakh in cash. This would mean increased tax net, higher tax collection and a better tax to GDP ratio. Philips Capital in a report says that the extent of parallel economy, which was 23.2% of GDP, is now around 25-30% of GDP. As the money gets accounted and more taxes are collected, government might be tempted to reduce tax rates going forward.

Interest Rates: One of the biggest impacts of demonetization would be high value transactions, especially land and gold. This would result in lower inflation, tempting the central bank to reduce interest rates.

GST: Demonetization comes at an important as the country heads to a new tax regime with the implementation of GST. Demonetization would increase the tax net and along with GST result in reduction of black money generation.

Bank Deposits: Bank deposits will increase by a huge margin and this will increase their lending activities. This in turn will enhance the liquidity position of the banks, which can be utilized further for lending purposes.

Online Transactions and alternative modes of payment: With cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction systems, E-wallets and apps, online transactions using E-banking, usage of plastic money, etc. will definitely see substantial increase in demand.

Consequential Implications of Demonetization on Accounting

Accounting is a service activity. It is important as it provides quantitative information of financial nature, which is intended to be used in making economic and financial decisions. A well designed and well managed accounting system helps ensure proper control over finance/funds. On the basis of accounting system the Government determines the shape of its monetary and fiscal policies. Following are the consequential implications of demonetization on accounting system:

Accounting System of RBI

Management of currency is one of the central banking functions of the RBI for which it derives the necessary statutory power from section 22 of the RBI Act 1934. Along with the Government of India, the RBI is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. In consultation with the Government, RBI routinely to reduce the risk of counterfeiting or forgery of currency notes. The Balance Sheet of RBI is unique in its importance, derived not only as the source of money creation but also as a description of its relationships with the Government on the one hand and the banking and financial system on the other. In Balance Sheet of RBI, "Matching Principle" should exist between currency notes issued and actually currency note in circulation. Before demonetization through accounting system RBI found that there was imbalance equation between currency notes issued and currency notes circulation in market. There are so many reasons behind this out of which Fake/ counterfeit/ forgery currency is one of the most important reasons. Due to the fake currency circulated in market, Matching Principle was not fulfilled and equation between currency issued and currency circulation of RBI mismatched.

One of the major reasons why Prime Minister Shri Narendra Modi Ji decided to go with demonetization was the rising number of fake currency notes in India that were circulated. The decision to demonetization higher denomination currency notes of Rs. 500 and Rs. 1000 will help pull out Fake Indian Currency Notes (FICN) and correct accounting equation between currency notes issued and currency notes in circulation will be matched. This will help to show true Position of currency notes in Balance Sheet of RBI. RBI data showed that as of March 2016, 632926 currency notes were counterfeit-known as an FICN (Fake Indian

Currency Note). As a proportion of NIC(Noyes in Circulation), the 1000 rupee and 500 rupee notes were the highest.

Transparency in Accounting System of an Individual and Business Houses

Before demonetization the accounting system of an individual and business houses were not shows the correct information of their incomes. In other words a person or a firm earn money from economic activities but not shown in their books of accounts. These types of practices created Black Money/Unaccounted Money in the market. Unaccounted Money created a parallel economy in India. There are two concept of unaccounted money, first to earn income from legal activities but not accounted in the books of accounts and also not reported to the Government so as to avoid paying taxes on it and second money earned from illegal market or activities and also not accounted or reported to the Government. Unaccounted Money is basically a term that refers to money/ funds earned by individual or business houses, from legal or illegal activities, which they have not declared for tax purpose but officially they are supposed to pay tax on it. Unaccounted money does not contribute anything to the economic growth of an economy. After demonetization a lot of money which is outside the system or unaccounted will be come back into the financial system because every individual or a business houses show their unaccounted income/money in books of accounts otherwise automatically it will flush out from the market. Within 3 days of that striking decision: 35000 Crore Rs. Deposited in banks and approximate 1500 Crore Rs. black money/unaccounted money were destroyed. This step of Government will compel individual or business houses to record and maintain all transactions in their books of account. These practices of individual or business houses will take transparency in accounting system as a whole.

Tax Accounting

On 8th Nov 2016, India's Prime Minister announced demonetization of Rs 500 and Rs 1000 currency notes. This news came as a surprise to many of us! However, if we carefully think through the sequence of measures undertaken by the Government such as opening of bank accounts, linking with Aadhar numbers, introducing the tax amnesty program, announcing a warning for defaulters and so on, we will see a pattern that makes us believe this was well planned.

Now, what does this mean for individual and business houses? It signals that the Government and the tax department are very serious about those individuals and business houses that do not show their correct books of accounts because of tax evasion. When unaccounted money will be disclosed in the books of accounts, proper and correct tax accounting practices comes in practices and more tax will be collected by the Government.

It is reasonable to assume that a large amount of income tax evasion happens on account of non-salaried classes, as those getting salaries have their taxes deducted at source. The income tax department classifies ITR filings on the basis of type of tax payers. At present there are nine such categories, where ITR 1 and 2 represent individuals or Hindu Undivided Family (HUFs) earnings from salaries, interest, house income etc. These categories account for close to half of ITR filings in the country. To be sure, there could still be an increase in tax collection if such elements have been forced to declare their ill-gotten wealth (result of under-reported incomes in earlier tax-returns) kept in cash to tax authorities. Demonetization is one of the important step of the Government to keep proper tax accounting system and increase tax collection from those person and business houses who keep unaccounted money. Union Finance Minister Arun Jaitely said that “The impact of demonetization on tax revenue and collection is already visible. There has been a 26.2% increase in central indirect tax collection till November 30th and increase direct tax collection extent of 14.4%, till 19th December against a growth rate of only 8.3% previous year”. India’s tax to GDP ratio is 16.6%, according to economic survey 2015-16. This is lower than the average for emerging markets, which is around 21% with deposits going away from unproductive assets and getting channelized into banks post the demonetization of INR, the tax to GDP ratio is set to rise.

National Accounting System

National Accounts or National Account System (NAS) are the implementation of complete and consistent accounting techniques for measuring the economic activity of a nation. These include detailed underlying measures that rely on double-entry accounting. National accounts broadly present output, expenditure, and income activities of the economic actors (households, corporations, government) in an economy, including their relations with other countries' economies, and their wealth (net worth). Due to unbalancing equation between currency notes issued and currency notes in circulation, improper accounting system and tax evasion by individual and business houses, national accounts were not showing correct, true and fair position of national wealth and income. After demonetization correct equation

between currency notes issued and currency notes in circulation will be generated, proper accounting system will be developed by individuals and business houses, lot of unaccounted money will be come back into the financial system and tax revenue will be increases, through these implications the overall national accounts will be shown true and fair position of the nation, correct national wealth, financial position and economic growth of a nation.

E-Accounting System

After demonetization, cash transactions facing a reduction, alternative forms of payment will see a surge in demand. Digital transaction system, E-wallets and apps, online transactions using E banking, usage of plastic money (Debit and credit Card), etc. Will definitely see substantial increase in demand. When these types of practices will increases in market then, automatically all the transactions will come into accounting system. Gradually all individuals and business houses will be move towards transactions through banking and online system E-Accounting System can be developed and obviously E-Accounting System may be a by-product of demonetization. New-age payments like PayTM, Instamojo Payment Gateway, PayUMoney and Mobikwik, online banking and e-commerce platforms will see an increased demand in the near future as people will show willingness to move away from cash. Yes definitely, it will take long time to developed E-Accounting System but it can be said that demonetization is significant step towards this change.

Conclusion

No doubt demonetization has generated lots of debates and discussions among economists, media personnel and politicians. In short-term Demonetization has some negative macroeconomic impact, but more importantly, demonetization is expected to have a positive impact over the medium to long term. In order to capitalize its medium and long term benefits, a number of complementary measures are required to be adopted. The Government has adopted some measures to control unaccounted money/black money and improve transparency in the financial/economic transactions even before the commencement of demonetization. The Government's drive towards promotion of use of digital technology in money transactions will help to track the transactions and reduce the tax evasion, which may help the government to get more tax revenue even by lowering the tax rate. In particular, there is expected to be greater formalization of the accounting system for an individual or

nation as a whole with the increased use of digital payments, balancing between currency notes issued and in circulation and unaccounted money comes in accounting system.

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