**CORPORATE FINANCIAL ACCOUNTING**

**UNIT -1: Conceptual Framework of Accounting:** Accounting as an information system, Users and their information needs, concepts and conventions, Elements of financial statements: Recognition and measurement Qualitative characteristics of Financial Statements, Accounting Standards: Historical developments, Needs International Accounting Standards, accounting Standards in India: Objectives, Process of Standard setting

**UNIT – 2 : Statutory Financial Statements:** Preparation of Company Final Accounts, Managerial Remuneration, Disposal of Company Profits, Accounting Reports , Accountants Report in Prospectus , Half yearly Financial Report of Listed Companies

UNIT – 3: **Funds Flow Statement:** Meaning and importance, Elements of funds flow statement, uses, funds flow reporting, cash flow reporting, meaning and importance, Elements of cash flow statement, uses, cash flow reporting, accounting standards for cash flow statement

**UNIT – 4 : Financial statement Analysis :** Need , process , tools cross sectional techniques , time series analysis , Financial ratio analysis and interpretation, trends of financial ratios, predictability of insolvency on the aspects of financial ratios, financial ratios for budgeting, limitations of financial ratios

**UNIT – 5: Corporate Social reporting**: Social Income Statement, social Balance Sheet, value Added Statement, importance, preparation, interpretation of VA, limitations, corporate disclosures, and modern trends in published Accounts.

# UNIT I: CONCEPTUAL FRAMEWORK OF ACCOUNTING

**Structure**



## 1.0 INTRODUCTION

Accounting is known as the language of business. This designation is applied to accounting because it is the method of communicating business information. The basic function of any language is to serve as a means of communication. Accounting duly serves this function. The task of learning accounting is essentially the same as the task of learning a new language. But the rapid change in business organization has contributed to increase the complexities in this language. Like other languages, it is undergoing continuous change in an attempt to discover better means of communications. To enable the accounting language to convey the same meaning to all stakeholders, it should be made standard. To make it a standard language certain accounting principles, concepts and standards have been developed over a period of time. This lesson based upon the different dimensions of accounting, accounting concepts, accounting principles and the accounting standards.

## 1.1 UNIT OBJECTIVES

After reading this lesson, you will be able to:

- Know the Evolution of Accounting
- Understand the Definition of Accounting
- Comprehend the Scope and Function of Accounting
- Ascertain the Users of Accounting Information
- Know the Specialized Accounting Fields
- Understand the Accounting Concepts and Conventions
- Realize the Need for Accounting Standards

## 1.2 ACCOUNTING AS AN INFORMATION SYSTEM

**Evolution of Accounting:**

Accounting is as old as money itself. It has evolved, as have medicine, law and most other fields of human activity in response to the social and economic needs of society. People in all civilizations have maintained various types of records of business activities. The oldest known are clay tablet records of the payment of wages in Babylonia around 600 B.C. accounting was practiced in India twenty-four centuries ago as is clear from kautilya's book 'arthshastra' which clearly indicates the existence and need of proper accounting and audit. For the most part, early accounting dealt only with limited aspects of the financial operations of private or governmental enterprises. Complete accounting system for an enterprise which came to be called as "double entry system" was developed in Italy in the 15th century. The first known description of the system was published there in 1494 by a Franciscan monk by the name ***Luca Pacioli.***

Accounting is practiced by every one of us in our day to day life. An individual, who is working with an organization, earns his salary every month. From this salary amount, he goes on spending money, on various household items, such as clothing, medicines, grocery, milk, tuition fees etc... Many people maintain diaries wherein all these expenses are recorded every day. At the end of a month, such a person can summarize these expenses and prepare a statement to ascertain the amount he is left with. The amount so available will be his savings at the end of that particular month.

Everyone knows that "man must cut his coat according to his cloth ". If a man carelessly spends money, he will be left with no money sooner or later. This is also true of a businessman. A businessman receives money from sale of goods or for rendering services and spends money for payment of purchases, salaries to staff, rent electricity etc... He cannot remember what he received & what he spent at the end of month or a particular period. Therefore, it is necessary for him to record these happenings (incomes & expenses) in a systematic way. This will enable him to know whether he has made any profit or incurred any loss during a particular period.

**Definition & Features of accounting:**

The most commonly accepted definitions of accounting are as under:-

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

- **Accounting is an art:** Art is that part of knowledge which enables us to attain our objective & shows the way in which we may reach our objective in the best possible manner. It is an art because it helps us in attaining our objective of ascertaining the financial results by showing the best way of recording , classifying & summarizing the business transactions .
- **Recording:** Accounting not only records the transactions of financial nature but also records them in an orderly manner. The method of recording is adjusted according to the nature and size of the business. Thus, cash transactions, credit transactions, purchase & sale of fixed assets etc… are recorded in different ways.
- **Classifying business transactions:** The classification or grouping is done by opening different accounts in a separate book called ledger. For example, all transactions relating to purchases are shown on one page from the different books of account, cash book, and credit purchases from purchase book.
- **Summarizing:** This is the art of presenting the classified data in the ledger, in an understandable and useful manner to the management or other interested parties. This involves preparation of
    - Trial Balance
    - Trading & Profit and Loss Account &
    - Balance Sheet
- **Records transactions in terms of money:** Accounting records the transactions by expressing them in terms of money. This makes the transactions more meaningful. Thus, if the business has 06 machines, 10 tonnes of raw materials, 20 tables, 10 fans etc... It is not possible to add them together or know which one is more valuable unless they are expressed in terms of money.

- **Records transactions of financial character:** Accounting records only those events and transactions which are of financial character. Poor lighting & ventilation, relationship between workers and management, though they affect the earning capacity of the business cannot be recorded in financial books. These events cannot be expressed in terms of money.
- **Interprets the financial data:** Accounting involves recording, classifying & summarizing the financial events & finally preparation of final accounts. The interpretation of final accounts helps in making meaningful judgments about financial condition, profitability etc.., which in turn help the management and other interested parties to take important decisions.

**Accounting as an Information System:**

Accounting as a “Language of business” communicates the financial results of an enterprise to various interested parties by means of financial statements which have to exhibit a “true and fair” view of its state of affairs. Like any other language, accounting has its own complicated set of rules. However, these rules have to be used with a reasonable degree of flexibility in response to specific circumstances of an enterprise and also in line with the changes in the economic environment, social needs, legal requirements and technological developments.

**BOOK KEEPING, ACCOUNTING & ACCOUNTANCY:-**

According to G.A Lee, the accounting system has two stages

- The making of routine records , in prescribed form and according to set rules , of all events which affect the financial state of the organization &
- The summarization from time to time of the information contained in the records , its presentation in a significant form to interested parties and its interpretation as an aid to decision making by these parties .

The first stage is called Book- keeping & the second stage is called Accounting. Book-keeping is mainly concerned with recording of financial data whereas the accounting involves not only recording but also balancing of accounts , interpreting the balances , ascertaining the business results by preparing Profit & loss account & Balance Sheet .

The term Accountancy refers to a systematized knowledge of accounting and is regarded as an academic subject like economics, statistics etc... It explains “why to do” & “how to do” of various aspects of accounting. In other words, while accounting refers to the actual process of preparing & presenting the accounts; Accountancy tells us why and how to prepare the books of account and how to summarize the accounting information & communicate it to the interested parties.

**Is Accounting a 'Science' or an 'Art'?**

Any organized knowledge based on certain basic principles is a 'science'. Accounting is also a science. It is an organized knowledge based on scientific principles which have been developed as result of study and experience. Of course, accounting cannot be termed as a "perfect science" like Physics or Chemistry where experiments can be carried and perfect conclusions can be drawn. It is a social science depending much on human behavior and other social and economic factors. Thus, perfect conclusions cannot be drawn. Some people, therefore, though not very correctly, do not take accounting as a science.

Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art. The American Institute of Certified Public Accountants also defines accounting as "the art of recording, classifying and summarizing the financial transactions". Accounting helps in achieving our desired objective of maintaining proper accounts, i.e., to know the profitability and the financial position of the business, by maintaining proper accounts.

**SYSTEMS OF BOOK KEEPING:-**

Book keeping is the art of recording transactions in a proper set of books. There are two systems of bookkeeping –

- Double Entry System
- Single Entry System

**Double Entry System:-**

***1. Meaning-*** Double entry system is based on the principle that "every debit must have a corresponding credit". According to dual aspect concept, each business transaction has two effects; receiving of a benefit & giving of a benefit. Thus each transaction involves two accounts. Under this system, one account will be debited and the other will be credited. The debit aspect is recorded or posted to the debit side of an account while the credit aspect is posted to the credit side of another account. It shows that each and every transaction is recorded at different places in the ledger in two accounts.

***2. Principles of Double Entry System: -*** The following are the main principles of double entry system –

- For every transaction two parties must be interested.

- Every business transaction has two aspects, one receiving of benefit and other 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.

- The two fold effect of a business transaction is recorded by debiting one account and crediting the other account at the same time.

***3. Advantages of double entry system:-***

- Both the aspects of transactions are recorded simultaneously. They are equal in amount. Hence, this system ensures arithmetical accuracy of accounts.

- Under the system, all business transactions are recorded perfectly, completely and systematically. Therefore, chances of errors and frauds are reduced.

- Under this system, it is easy to find out results of the business for any period and also state of financial position on any day. Thus, under this system, the trader knows at any time-

I. amount receivable from each customer

II. Amount payable to each supplier

III. Expenses and income under each head

IV. Amount spent on various assets

- The system enables the accountant, to prepare the annual accounts, profit & loss account and balance sheet.

- This system can be implemented by any organization.

**Single Entry System:-**

Under double entry system of book keeping, both the aspects of each and every transaction are recorded. This is known as dual aspect analysis. Under the single entry system, only one aspect of the transaction, personal is recorded and the other aspect is ignored. For example goods sold on credit to a customer. Here only customer’s account is opened and debited but goods account is not to be opened. Under this system, only the accounts which are absolutely necessary are maintained. Other accounts, nominal & real accounts are not opened except cash. The accounts maintained under this system are incomplete and unsystematic and therefore not reliable .The system is followed by small business firms.

## 1.3 PARTIES INTERESTED IN ACCOUNTING INFORMATION

Following are the parties interested to know the accounting information:

- **Owners:** They have contributed capital to the business and hence are interested in knowing the profits earned by the business & its financial position as on a particular date.
- **Managers:** Managers are responsible for carrying on day to day business. The accounting information will help them in planning, decision making & controlling business.
- **Employees:** Employees are interested in knowing profits made by the business from year to year so that they can put forward their claims for higher wages & other benefits from the employees.
- **Lenders:** Banks & other financial institutions that have financed business activities would like to know how efficiently the funds lent by them are utilized. They would also like to know the profitability & financial soundness of the business to satisfy them that their money will be safe & repayments will be made in time.
- **Creditors:** They are the suppliers of goods & services to the business on credit. They are interested in knowing the creditworthiness of the business to determine the limits up to which credit can be granted.
- **Government:** Government departments collect income tax, sales tax, excise duty etc... from the business houses. These departments are interested in studying the financial statements of the business enterprises. Government is also interested to keep a close watch especially on big business houses & large industrial undertakings as to how they are conducting their business.
- **Prospective Investor:** A person who wants to become a partner in the business or purchase shares of a limited company would like to know how sales & profitable would be his investment.

**ADVANTAGES OF ACCOUNTING:-**

- **Systematic Record:** The financial transactions are recorded systematically in different books of account. The books of account will serve as historical records.
- **Controlling & protecting business properties**: Accounting helps to ensure that there is no unauthorized use or disposal of any asset or properties belonging to the business, as proper records are maintained. The information about cash on hand , bank balance, closing stock of goods , amounts due from customers and amounts due to suppliers is available at any time  This will enable the management to make use of these assets in the best possible way .

- **Helps to Know Profit or Loss made:** Accounting records help the management to prepare profit and loss account for any particular period and balance sheet as on that date. These statements will show profit or loss made by the business and the financial position of it.
- **Rendering information to users:** Various interested parties such as owners, lenders, creditors, government agencies and so on get the necessary information about the business.
- **Facilitates rational decision making:** By comparing its own business results with that of the earlier years or with those of its competitors, useful conclusions can be drawn & suitable decisions can be taken to improve the performance.

**LIMITATIONS OF ACCOUNTING:**

The various concepts & conventions on which the principles of accounting are based, to a large extent are responsible for the limitations of accounting. The limitations are stated below:

- Accounting records only business transactions which can be measured in terms of money. Thus quality of product & human resources, locational advantages, licenses possessed etc... do not find any place in books of account.
- Assets are brought into at historical costs, cost at which they were acquired and they do not reflect current market values. Therefore, for an outsider who wishes to evaluate the business, Balance sheet is not much useful if it is not supplemented by other information.
- Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgments of the accountant or management. Valuation of inventory, provision for doubtful debts, and assumption about useful life of an asset may differ from one business to another.

## 1.4 SPECIALIZED ACCOUNTING FIELDS

As in many other areas of human activity, a number of specialized fields in accounting also have evolved besides financial accounting. Management accounting and cost accounting are the result of rapid technological advances and accelerated economic growth. The most important among them are explained below:

- **Tax Accounting:**

Tax accounting covers the preparation of tax returns and the consideration of the tax implications of proposed business transactions or alternative courses of action. Accountants specializing in this branch of accounting are familiar with the tax laws affecting their employer or clients and are up to date on administrative regulations and court decisions on tax cases.

- **International Accounting:**

This accounting is concerned with the special problems associated with the international trade of multinational business organizations. Accountants specializing in this area must be familiar with the influences that custom, law and taxation of various countries bring to bear on international operations and accounting principles.

- **Social Responsibility Accounting:**

  This branch is the newest field of accounting and is the most difficult to describe concisely. It owes its birth to increasing social awareness which has been particularly noticeable over the last three decades or so. Social responsibility accounting is so called because it not only measures the economic effects of business decisions but also their social effects, which have previously been considered to be immeasurable. Social responsibilities of business can no longer remain as a passive chapter in the text books of commerce but are increasingly coming under greater scrutiny. Social workers and people's welfare organizations are drawing the attention of all concerned towards the social effects of business decisions. The management is being held responsible not only for the efficient conduct of business as reflected by increased profitability but also for what it contributes to social well-being and progress.

- **Inflation Accounting:**

Inflation has now become a world-wide phenomenon. The consequences of inflation are dire in case of developing and underdeveloped countries. At this juncture when financial statements or reports are based on historical costs, they would fail to reflect the effect of changes in purchasing power or the financial position and profitability of the firm. Thus, the utility of the accounting records, not taking care of price level changes is seriously lost. This imposes a demand on the accountants for adjusting financial accounting for inflation to know the real financial position and profitability of a concern. Thus emerged a future branch of accounting called inflation accounting or accounting for price level changes. It is a system of accounting which regularly records all items in financial statements at their current values.

- **Human Resources Accounting:**

Human resources accounting is yet another new field of accounting which seeks to report and emphasize the importance of human resources in a company's earning process and total assets. It is based on the general agreement that the only real long lasting asset which an organization possesses is the quality and caliber of the people working in it. This system of accounting is concerned with, "the process of identifying and measuring data about human resources and communicating this information to interested parties".

## 1.5 RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines. In many cases they overlap accounting. The Accountant should have a working knowledge of the related disciplines so that he can understand such overlapping areas and apply the knowledge of other disciplines in his own work wherever possible, or he can take the expert advice.

a. **Accounting and Economics:** Economics is viewed as a science of rational decision-making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole. Accounting is viewed as a system, which provides data to the users to permit informed judgment and decisions. Some non-accounting data are also relevant for decision-making. Still, accounting provides a major database.

   Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting. However; there exists a wide gulf between economists' and accountants' concepts of income and capital. Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision-making techniques which may owe to the economic theorems for origin but these are moulded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability.

b. **Accounting and Statistics:** The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought. In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behavior or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalizations or the average of relationships, statistical methods have to be applied in accounting data.

Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Accounting records generally take a short-term view of events and are confined to a year while statistical analysis is more useful if a longer view is taken for the purpose. However, statistical methods do use past accounting records maintained on a consistent basis. Accounting records are based on historical costs of fixed assets, while the current assets are valued at the current values. The new methods of inflation accounting are an attempt to correct this situation. The correction of values is made on the basis of the current purchasing power of money or the current value of the concerned assets revalued from the data of purchase till the day of recording, charging depreciation on the current value, so that the present value of the asset is in line with the current value of money. All this would require the use of price indices or the price deflators, which are based on statistical calculations of price changes. The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. Several accounting and financial calculations are based on statistical formulae. Statistical methods are helpful in developing accounting data and in their interpretation.

For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Now-a-days multiple discriminate analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

c. **Accounting and Mathematics:** Double Entry book-keeping can be converted in algebraic form; in fact the first known book on this subject was part of a treatise on algebra. The fundamental accounting equation will be discussed in detail under 'Dual Aspect Concept' of this chapter. Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation, finding out installments in hire-purchase and installments payment transactions, calculating amount to be set aside for repayment of loan and replacement of assets and calculating lease rentals, mathematical techniques are frequently used. Accounting data are also presented in ratio form.

With the advent of the computer, mathematics is becoming a vital part of accounting. Understanding mathematics has become must to grasp the decision models framed by statisticians, econometricians and the O.R.experts.Presently graphs and charts are being extensively used for communicating accounting information. In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting communications system.

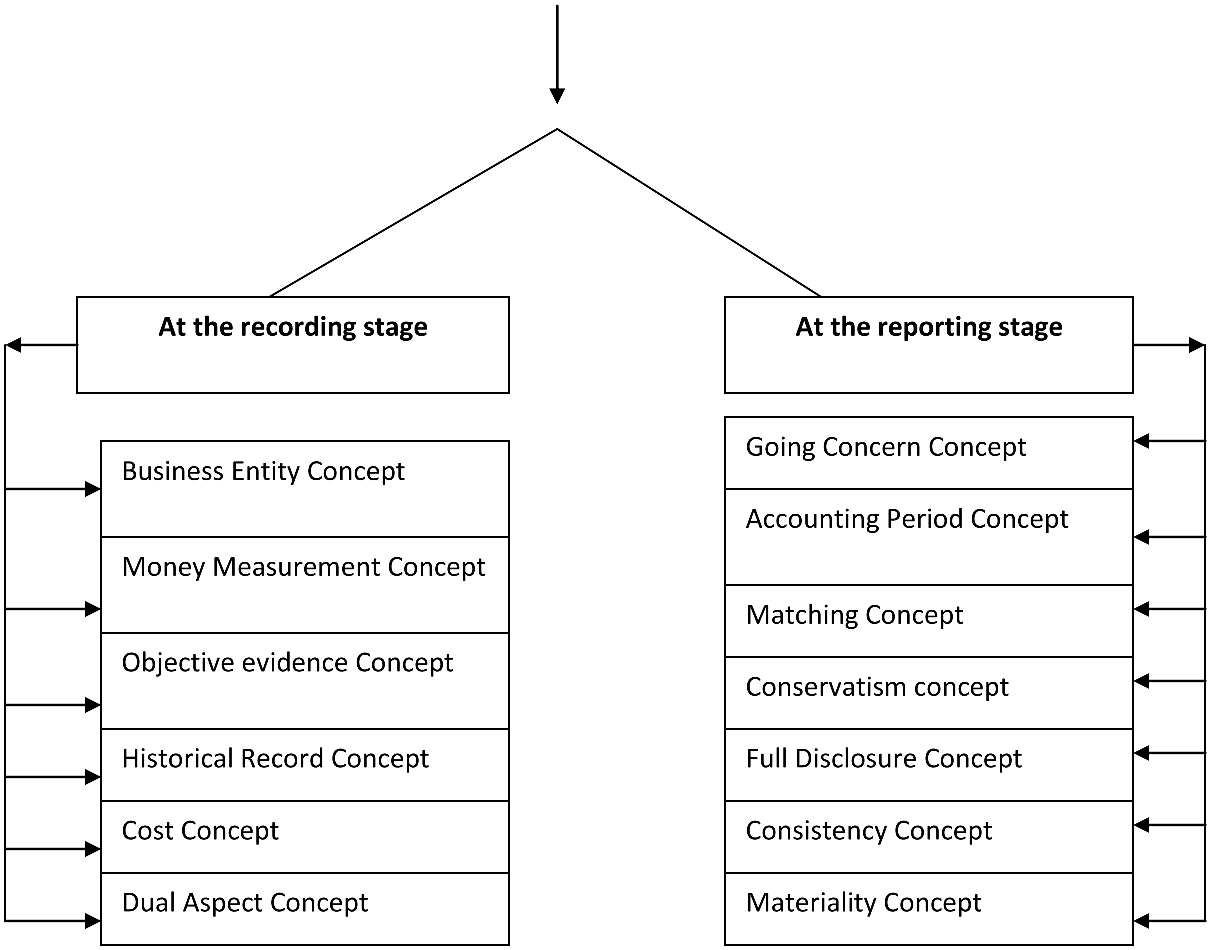
d. **Accounting and Law:** An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a partnership business is controlled by Partnership Act. A company is created by the Companies Act and also controlled by Companies Act. Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements. Banking, insurance and electric supply undertakings also have to produce financial statements as prescribed by the respective legislations controlling such entities. However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

e. **Accounting and Management:** Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision-making. Although management relies on other data sources, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management; he understands the data requirements. So the accounting system can be molded to serve the management purpose.

## 1.6 BASIC CONCEPTS OF ACCOUNTING

As we know that accounting is an art of recording business transactions in a systematic way. For recording transactions certain basic rules are laid down. These are based on experience, reason, usage and necessity. These are fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are the broad working rules for all accounting activities developed and accepted by the accounting profession.

**ACCOUNTING CONCEPTS**




**A. Concepts at the recording Stage:**

- **Business Entity Concept:** A business is always separate from its owner. The affairs of business must not be mixed up with the private affairs of the owners or other persons associated with it. This concept is applicable to all forms of business. Thus in sole proprietary or partnership business , amounts brought in by the proprietor and partners or their personal withdrawals are shown separately as capital and drawings respectively .This concept is applicable to all forms of business .Thus , in sole proprietary or partnership business , amounts brought in or personal withdrawals are shown separately as capital and drawings respectively .
- **Money Measurement Concept:** In accounting, all transactions are expressed & interpreted in terms of money. Money is the common unit of measurement. Fixed assets like furniture, land, buildings, plant etc... are expressed in terms of money and in terms of area, numbers. The only drawback of this concept is that transactions which cannot be measured in terms of money do not find a place in

business records. Thus, quality of product, management and industrial relations cannot be expressed anywhere in the accounts. Secondly, the value of money goes on decreasing due to inflationary trends in the economy from time to time and therefore, accounting data may not reveal true & fair view of the business affairs.

- **Objective evidence Concept:** According to this concept, all accounting transactions should be evidenced & supported by objective documentary evidence. Thus, purchase invoices, sales invoices, cash memos, vouchers, cheque book, pass book, etc from this documentary evidence. The entries passed in the books of account can be verified by owners, auditors & others by reference to these documents.
- **Historical record concept:** Accounting involves recording of business transactions which have taken place. A trader purchases a business premises for Rs, 5, 00,000 /- . The mount due is paid to vendor & business acquires that place. Now these transactions can be recorded in the books. The business transactions are recorded as and when they take place; date wise. This leads to preparation of historical records of all transactions. The future transactions can hardly be identified & measured accurately.
- **Cost Concept:** Business transactions which can be measured in terms of money can only be recorded. An amount spent for acquiring a particular asset will be its cost. A trader buys an imported machine from Germany. He pays Rs. 5, 00,000 /- to the suppliers. He has to incur further sum of Rs. 7, 00,000 /- for payment of import duty and clearing charges. Now, in this case, total cost of the machine will be Rs. 12, 00,000 /- . Thus, according to cost concept, an asset is recorded at the price at which it is acquired.
- **Dual Aspect Concept:** Every business transaction has a dual effect, one receiving of a benefit and the other giving of a benefit. For example, when a firm acquires an asset (receiving of a benefit) it must have to pay cash (giving of a benefit). Therefore, two accounts are to be opened in the books of account, one for receiving the benefit and the other for giving the benefit. Thus, there will be a double entry for every transaction. For each and every debit, there must be a corresponding credit and vice versa. This is nothing but the principles of double entry system of accounting which is known as dual aspect concern.

Let us look at another accounting implication of the dual aspect concept. The initial amount required to start a business is contributed by the owner. If additional funds are required, bank loans are taken. As per the dual aspect concept, all these receipts create corresponding obligations for their repayment. In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal. This equality is called Balance Sheet Equation or Accounting Equation.

**LIABILITIES = ASSET, *or*CAPITAL + LIABILITIES = ASSETS, *or* ASSETS – LIABILITIES = CAPITAL**

**B. Concepts at Reporting Stage :**

- **Going Concern Concept:** This concept is also known as a continuing concept or concept of continuity of a business unit. It is presumed that a business unit has an indefinite life or existence, unless there is specific information or clear and strong evidence to the contrary. The whole process of preparing profit and loss account and balance sheet is the result of this concept.
- **Accounting Period Concept:** Though the "going concern" concept stresses the continuing nature of the business enterprise. It is customary to divide its life into periods known as accounting period. An accounting period is the interval of time at the end of which the income statement and financial position statement (Balance sheet) are prepared to know the results and resources of the business. This period is normally one year, 12 months ending on a particular date, says 30th June, 31st December or 31st march. This is also necessary to comply with legal requirements, filling of income tax and sales tax returns every year, holding of annual general meeting of shareholders of a limited company etc.
- **Matching Concept:** This concept is based on the accounting period concept. The expenses which are actually incurred during a specific accounting period , in order to earn the revenue for the said period must be matched against the revenues which are realized for that period .Therefore , as per this concept adjustments are made for all outstanding expenses , prepaid expenses , accrued income , income received in advance etc .
- **Conservatism concept:** It is a policy of caution or playing safe and has its origin as a safeguard against possible losses in a world of uncertainty. The accountant wants to play safe particularly in the determination of incomes or profit or loss and in the process of valuation, which he is associated with in the accounting literature. He does not consider any gain or income until the same has been realized or converted into money but he does consider all future expected losses and contingencies. Following are the example of application of conservatism :
    - Making provision for doubtful debts and discount on debtors
    - Valuing stock in trade at cost or market price , whichever is less
    - Making provision against fluctuations in the prices of investments
- **Full disclosure concept:** This implies that accounts must be honestly prepared and all material information must be disclosed therein. The Indian companies act makes ample provisions for the disclosure of essential information in accounts. The contents of Balance sheet & profit and loss accounts are prescribed by law.

These are designed to make disclosure of all material facts compulsory. The practice of appending notes relating to various facts or items which do not find place in accounting statements is in pursuance of the convention of full disclosure of material facts.

- **Consistency concept:** The comparison of one accounting period with the other is possible, only when the convention of consistency is followed. It means that the accounting practices and methods remain unchanged from one accounting period to another. For example, a company may adopt straight line method, written down method or any other method of providing depreciation on fixed assets. It is expected that keeping in mind the consistency concept, the company would consistently follow the same method of depreciation which is chosen. Any change from one method to another would result in inconsistency. Similarly, if stock is valued at cost or market price, whichever is less, this principle should be followed every year.
- **Materiality Concept:** This accounting concept means that effect of all significance or material transactions must be disclosed or reported in conformity with the generally accepted accounting principles. Items that are material in amount and significance must be disclosed. As per the American Accounting Association "an item should be regarded as material if there is a reason to believe that knowledge of it would influence the decision of an informal investor". Indian companies act prescribes that a separate disclosure of items of expenses and income should be made. If it exceeds 1 % of the total revenue or Rs. 5,000 /- whichever is greater.

**Qualitative Characteristics of Financial Statement:**

- **Relevance:** This means selecting the information most likely to aid the users in their economic decisions.
- **Understandability:** which implies not only that the selected information must be intelligible but also that the users of financial reporting can understand it.
- **Verifiability:** This implies that the accounting results may be corroborated by independent measures using the same method of measurement.
- **Neutrality:** This implies that the accounting information is directed towards the common needs of users rather than the particular needs of specific user.
- **Timeliness:** This implies as early communication of information to avoid delays in economic decision-making.
- **Comparability:** This implies that differences should not be the result of different financial accounting treatments.
- **Completeness:** This implies that all the information that reasonably fulfills the requirements of the other qualitative objective should be reported.

Besides qualitative characteristics there are some quantitative characteristics of financial reporting are also mentioned as under:

- To provide reliable information about economic resources and obligations of business enterprise in order to (i) evaluate its strengths and weaknesses (ii) show its financing and investment (iii) evaluate its ability to meet its commitments and (iv) show its resource base for growth.
- To provide reliable information about changes in net resources resulting from a business enterprise's profit directed activities in order to (i) show to investor expected dividend return (ii) show the operation's ability to pay creditors and suppliers, provide jobs for employees, lay taxes and generate funds for expansion (iii) provide management with information for planning and control (iv) show its long term profitability.
- To provide financial information useful for estimating the earning potentials of the firm.
- To provide other information about changes in economic resources and obligations.
- To disclose other information relevant to statement user's needs.

## 1.7 ACCOUNTING STANDARDS AND INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE:

International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations called as founder-members signed the agreement and constitution for its formation. The Committee has its headquarters at London.

The objective of the Committee was "to formulate and publish inthe public interest standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance". The formulation of such standards will bring uniformity in terminology, approach and presentation of results. This will not only help in a correct understanding and exchange of economic and financial information but also in facilitating a smooth flow of international investment.

Between 1973 and 2000, the IASC issued several Accounting Standards, known as International Accounting Standards (IASs). Since 2001, the IASC was renamed as the International Accounting Standards Board (IASB). The IASB has now taken over the work of IASC. The IASB has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on whichthere was no previous IAS. Besides this, the IASB has replaced some IASs with new IFRSs. Thus, now the IASs issued by the IASC and IFRS issued by the IASB all come within the preview of IASB.

The list of 41 IASs issued7 by the IASC Between 2000-2003 and 8IFRSs issued by the IASB is given below:

**International Financial Reporting Standards (IFRS)**

| | |
|---|---|
| **IFRS 1** | First-time Adoption of International Financial ReportingStandards |
| **IFRS 2** | Share-based Payment |
| **IFRS 3** | Business Combinations |
| **IFRS 4** | Insurance Contracts |
| **IFRS 5** | Non-current Assets held for Sale and Discontinued Operations |
| **IFRS 6** | Exploration for and Evaluation of Mineral Assets |
| **IFRS 7** | Financial Instrument: Disclosures |
| **IFRS 8** | Operating Segments |

**International Accounting Standards (IAS)**

**IAS 1** Presentation of Financial Statements.

**IAS 2** Inventories

**IAS 3** Consolidated Financial Statements. (Originally issued in 1976, effective 1 Jan. 1977.**Superseded** in 1989by **IAS 27** and **IAS 28**)

**IAS 4** Depreciation Accounting. (Withdrawn in 1999 Replaced by **IAS 16, 22 and 38,** all of which were issued or revised in 1998)

**IAS 5** Information to be Disclosed in Financial Statements.(Originally issued in Oct. 1976, effective 1 January1997. **Superseded by IAS 1** in 1997)

**IAS 6** Accounting Responses to Changing Prices. (**Superseded by IAS 15**, which was withdrawn in December 2003)

**IAS 7**Cash Flow Statements.

**IAS 8** Accounting Policies, Changes in Accounting Estimates and Errors.

**IAS 9** Accounting for Research and Development Activities (**Superseded by IAS 38** effective 1 July 1999)

**IAS 10** Events after the Balance Sheet Date.

**IAS 11** Construction Contracts.

**IAS 12** Income Taxes.

**IAS 13** Presentation of Current Assets and Current Liabilities. (**Superseded by IAS 1**)

**IAS 14** Segment Reporting.

**IAS 15** Information Reflecting the Effects of Changing Prices. (Withdrawn in December 2003)

**IAS 16** Properties, Plant and Equipment.

**IAS 17** Leases.

**IAS 18** Revenue.

**IAS 19** Employee Benefits.

**IAS 20** Accounting for Government Grants and Disclosure of Government Assistance.

**IAS 21** The Effects of Changes in Foreign Exchange Rates.

**IAS 22** Business Combinations. (**Superseded by IFRS 3** effective 31 March 2004)

**IAS 23** Borrowing Costs.

**IAS 24** Related Party Disclosures.

**IAS 25** Accounting for Investments. (**Superseded by IAS 39 and IAS 40** effective 2001)

**IAS 26** Accounting and Reporting by Retirement Benefit Plans.

**IAS 27** Consolidated and Separate Financial Statements.

**IAS 28** Investments in Associates.

**IAS 29** Financial Reporting in Hyperinflationary Economies.

**IAS 30** Disclosures in the Financial Statements of Banks and Similar Financial Institutions. (**Superseded by IFRS 7**effective 2007)

**IAS 31** Interests in Joint Ventures.

**IAS 32** Financial Instruments: Presentation. (Disclosure provisions. **Superseded by IFRS 7** effective 2007)

**IAS 33** Earnings Per Share.

**IAS 34** Interim Financial Reporting.

**IAS 35** Discontinuing Operations. (**Superseded by IFRS 5**effective 2005)

**IAS 36** Impairment of Assets.

**IAS 37** Provisions, Contingent Liabilities and Contingent Assets.

**IAS 38** Intangible Assets.

**IAS 39** Financial Instruments: Recognition and Measurement.

**IAS 40** Investment Properties.

**IAS 41** Agriculture.

The International Accounting Standards Committee (IASC) announced in January, 1975 the following standards regarding disclosure of fundamental accounting assumptions and policies.

**Fundamental Accounting Assumptions:**

Fundamental Accounting Assumptions refer to those accounting standards whose acceptance and use are assumed in the preparation of financial statements. The IASC recognized the following as fundamental accounting assumptions.

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

***Consistency:*** It is assumed that accounting policies are constant from one period to another.

***Accrual***: Revenue and costs are accrued, i.e., recognized as they are earned or incurred (and not as money is received or paid), and recorded in the financial statements of the periods to which they relate (the considerations affecting the process of matching costs with revenues under the accrual assumptions are not dealt with in this statement).

In case any of the above fundamental accounting assumptions isnot followed, that fact should be disclosed in the financial statements together with reasons.

**Accounting Policies:**

Accounting policies include the principles, bases, conventions, rulesand procedures adopted by management in preparing financial statements. There are different policies in use even in relation to the same subject. The management should select a policy which properly represents the financial position as well as the results of operations of the enterprise.

The following considerations should govern the selection andapplication of the appropriate accounting policies and preparation of financial statements by the management.

***Prudence***: Uncertainties inevitably surround many transactions. This should be recognized by exercising prudence in preparing financial statements. Prudence does not, however, justify the creation of secret or hidden reserves.

***Substance over form***: Transactions and other events should beaccounted for and presented in accordance with their substance andfinancial reality and not merely with their legal form.

***Materiality:*** Financial statements should disclose all items which are material enough to affect evaluation or decisions.

## 1.8 ACCOUNTING STANDARDS IN INDIA

International Accounting

Standards Committee

↓

Institute of Chartered

Accountants of India (ICAI)

↓

Standing Committees

Non-standing Committees

| | | | |
|---|---|---|---|
| Expert Advisory Committee | Accounting Standards Board | Research Committee | Auditing Practices Committee |

Accounting Standard Board (ASB), constituted by ICAI on 21.04.1977, prepares Accounting Standards (AS) and presents to ICAI for consideration and issuance under the authority of the council of ICAI.

Clarification issued by ICAI regarding the authority attached to the documents AS:

AS establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards. AS become mandatory on the dates specified either in the respective documents or by notification issued by the council.

What constitutes “true and fair view” has not been defined either in the Companies Act 1956 or in any other statute. The pronouncements of the Institute like AS seek to describe.The accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view.

| Sl. No. | Nature of Pronouncements of Institute | Prepared by | Subjects covered |
|---|---|---|---|
| 1. | Accounting Standards (AS) | Accounting Standard Board (ASB) | Accounts |
| 2. | Statements on Standard Auditing Practices (SAP) | Auditing Practices Committee (APC) | Auditing |
| 3. | Statements | Research Committee | Accounting Auditing |

| | | | |
|---|---|---|---|
| | | (RC) | |
| 4. | Guidance Notes (GN) | RC, ASB, APC, Technical Committees | Accounting, Auditing, Taxes other Technical Areas, ethics etc. |
| 5. | Opinions | Expert Advisory Committees | Accounting,Auditing, code of conduct and Professional Ethics, Taxes etc. |

***Notes:***

i. AS& Statements are mandatory.

ii. GN and opinions are recommendatory.

iii. All documents except OPINIONS are issued under the authority of ICAI.

iv. Where certain matters are covered both by a "statement" and by an "Accounting Standards", "Statement" shall prevail till "Accounting Standard" becomes mandatory. Once "Accounting Standards" becomes mandatory, concerned "Statement" shall automatically stand withdrawn.

**Functions of Accounting Standards Board:**

- To harmonize diverse accounting policies and practices prevailing in India by formulating Accounting Standards to be established by ICAI.
- To give due consideration to the applicable laws, customs, usage and business environment of India.
- To integrate, to the extent possible, international Accounting Standards, in the light of the auditing practices prevailing in India.

- To give classifications on issue in Accounting Standards by issuing guidance notes.
- To propagate AS and to persuade concerned parties to adopt AS in the preparation and presentation of financial statements.

**Scope of Accounting Standards:**

1. Accounting Standards should be prepared in conformity with the provisions of the applicable laws, customs, usages and business environment of our country.
2. If due to subsequent amendments in the law, a particular Accounting Standard is found to be not in conformity with such law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.
3. The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in our country.
4. The ICAI will determine the extent of disclosure to be made in financial statements and the related auditor's reports. Such disclosure may be by way of appropriate notes explaining the treatment of particular items.
5. The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Standard will be made clear by the Institute from time to time.
6. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the Institute. However, no standard will have retroactive application, unless otherwise stated.
7. The Institute will use its best endeavors to persuade the Government, appropriate authorities, industrial and business community to adopt these Standards in order to achieve uniformity in the presentation of financial statements.
8. In carrying out the task of formulation of Accounting Standards, the intention is to concentrate on basic matters. The Endeavour would be to confine Accounting

Standards to essentials and not to make them so complex that they cannot be applied effectively and on a nation-wide basis.

9. In the years to come, it is to be expected that Accounting Standards will undergo revision and a greater degree of sophistication may then be appropriate.

**PROCEDURES FOR ISSUING ACCOUNTING STANDARDS**

DETERMINITION OF BROAD

AREAS BY ASB

FORMATION OF

STUDY GROUPS

HOLD DIALOGUES WITHGOVT, PSU's, INDUSTRY ETC.

ISSUE OF EXPOSURE DRAFT

RECEIVE COMMENTS ON

EXPOSURE DRAFT

FINALISE AND PRESENT

FINAL DRAFT TO COUNCIL

COUNCIL ISSUES ACCOUNTING STANDARDS

NOTE: Council can modify the final draft of AS in consultations with ASB.

**Procedure for Issuing Accounting Standards:**

The Institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices at present in use in India, constituted an Accounting Standards Board (ASB) on 21st April, 1977 for issue of accounting standards.The main function of ASB is to formulate accounting standards taking into consideration the applicable laws, customs, usages and business environment, so that such standards may be established by the Council of the Institute in India. ASB issues guidance notes on the Accounting Standards and give clarifications on issues arising there from. ASB will also review the Accounting Standards at periodical intervals. The procedure for issue of accounting standards is:

1. ASB shall determine the broad areas in which Accounting Standards need to be formulated and the priority in regard to the selection thereof.
2. In the preparation of Accounting Standards, ASB will be assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision will be made for wide participation by the members of the Institute and others.
3. ASB will also hold a dialogue with the representatives of the Government, Public Sector Undertakings, Industry and other organizations for ascertaining their views.
4. On the basis of the work of the Study Groups and the dialogue with the organizations, an exposure draft of the proposed standard will be prepared and issued for comments by members of the Institute and the public at large.
5. After taking into consideration the comments received, the draft of the proposed Standard will be finalized by ASB and submitted to the Council of the Institute.
6. The Council of the Institute will consider the final draft of the proposed Standard, and if found necessary, modify the same in consultation with ASB. The Accounting Standard on the relevant subject will then be issued under the authority of the Council.

The draft of the proposed standard will include the following basic points:

- A statement of concept and fundamental accounting principles relating to the standard.
- Definitions of the terms used in the standard.
- The manner in which the accounting principles have been applied for formulating the standard.
- The presentation and disclosure requirements in complying with the standard.
- Class of enterprises to which the standard will apply.

- Date from which the standard will effective.
- After taking into consideration the comments received, the draft of the proposed standard will be finalized by ASB and submitted to the council of the Institute.
- The council of the Institute will consider the final draft of the proposed standard, and if found necessary modify the same in consultation with ASB. The Accounting Standard on the relevant subject will then be issued under the authority of the council.

Accounting standards which seek to suggest rules and criteria of accounting measurements have to keep the above in view. On the one hand, the rules and criteria cannot be rigid and on the other they cannot permit irrational and totally expedient accounting measurements. Formulation of proper accounting standards is a vital step in developing accounting as a business language.

In India there are thirty two accounting standards. These accounting standards are prepared by the Accounting Standard Board constituted by the ICAI and issued by the ICAI. The term accounting Standard is defined as a written statement issued from time to time by institutions of accounting profession or institutions in which it has sufficient involvement and institutions which are established expressly for this purpose. Accounting standards mainly deal with financial measurements and disclosures for a fair presentation of financial statements. In this respect Accounting Standards can be thought of as a system of measurement and disclosure

**Benefits of Accounting Standards:**

Accounting Standards improve the reliability and credibility of financial statements. Standards reduce or eliminate the confusing variation in accounting treatments. Facilitates comparison of financial statement between companies over a period of time. Standards help in promoting a better understanding of financial statements.

**Types of Accounting Standards:**

AS may be classified by their subject matter and by how they are enforced.

Disclosure Standards – Specify minimum uniform rules for external reporting.

Presentation Standards - Specify the form and type of accounting information to be presented

Content Standards – Specify the accounting information which is to be published.

**Accounting Standards in India:**

| AS No. | Title of Standard | Effective Dates |
|---|---|---|
| 1 | Disclosure of Accounting Policies | 1st April 1991 |
| 2 | Valuation of Inventories | 1st April 1999 |
| 3 | Cash Flow Statement | 1st April 2001 |
| 4 | Contingencies and events occurring after Balance Sheet Date | 1st April 1996 |
| 5 | Net Profit or loss for the period, Prior period items, Changes in Accounting Policies | 1st April 1996 |
| 6 | Depreciation Accounting | 1st April 1995 |
| 7 | Construction Contracts | 1st April 2003 |
| 8 | | |
| 9 | Revenue Recognition | 1st April 1991 |
| 10 | Accounting for Fixed Assets | 1st April 1991 |
| 11 | Effect of Changes in Foreign Exchange Rates | 1st April 1995 |
| 12 | Accounting for Government Grants | 1st April 1994 |
| 13 | Accounting for Investments | 1st April 1995 |
| 14 | Accounting for Amalgamations | 1st April 1995 |
| 15 | Accounting for Retirement benefits in the financial statement of Employers | 1st April 1995 |
| 16 | Borrowing Cost | 1st April 2000 |
| 17 | Segment Reporting | 1st April 2001 |
| 18 | Related Party Disclosure | 1st April 2001 |
| 19 | Leases | 1st April 2001 |

| | | |
|---|---|---|
| 20 | Earnings per Share | 1st April 2001 |
| 21 | Consolidated Financial Statement | 1st April 2001 |
| 22 | Accounting for taxes on Income | 1st April 2001 |
| 23 | Accounting for Investments in Associates in Consolidated Financial Statements | 1st April 2002 |
| 24 | Discounting Operations | 1st April 2004 |
| 25 | Interim Financial Reporting | 1st April 2002 |
| 26 | Intangible Assets | 1st April 2003 |
| 27 | Financial Reporting of Interests in Joint Ventures | 1st April 2002 |
| 28 | Impairment of Assets | 1st April 2004 |
| 29 | Provisions, Contingent Liabilities and Contingent Assets | 1st April 2004 |
| 30 | Financial Instruments:Recognition and Measurement | 1st April 2011 |
| 31 | Financial Instruments: Presentation | 1st April 2011 |
| 32 | Financial Instruments: Disclosures | 1st April 2011 |

**Compliance with the Accounting Standards**:

While discharging their attest functions, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations.

In the initial years, the Standards will be recommendatory in character and the Institute will give wide publicity among the users and educate members about the utility of Accounting Standards and once awareness about these requirements is ensured, steps will be taken, in course of time, to enforce compliance with the accounting standards. The adoption of Accounting Standards and disclosure of the extent to which they have not been observed will, over the years, have an important effect, with consequential improvement in the quality of presentation of financial statements.

**IFRS Convergence in India:**

The need for harmonization of financial reporting is being increasinglyfelt all over the world to raise confidence among investors generally ininformation they are using to make their decision and assess their risk.This requires each nation to design and maintain National AccountingStandards in way that they largely comply with the requirements ofInternational Financial Reporting Standards. In line with the global trend,the Institute of Chartered Accountants of India, has proposed a plan forconvergence of the Indian Accounting Standards with the InternationalFinancial Reporting Standards.The Institute of Chartered Accountants of India (ICAI), has also sofar formulated 35 Indian Accounting Standards (IND ASs) convergedwith IFRS which are in line with corresponding IAS/IFRS, adoptableunder the conditions prevailing in the country. All these IND ASs samehave also been notified by Ministry of Corporate Affairs on 25 February, 2011 on the recommendation of National Advisory Committee onAccounting Standards (NACAS).

A list of Indian Accounting Standards (IND ASs) corresponding to IAS/IFRS and as developed and finalized by the Institute of Chartered Accountants of India approved by the National Advisory Committee on Accounting Standards and notified by the Ministry of Corporate Affairs is as under**:**

**Ind AS 1:** Presentation of financial statements

**Ind AS 2:** Inventories

**Ind AS 7:** Statement of cash flows

**Ind AS 8:** Accounting policies, changes in accounting estimates anderrors

**Ind AS 10:** Events after the reporting period

**Ind AS 11:** Construction contracts

**Ind AS 12:** Income tax

**Ind AS 16:** Property, plant and equipment

**Ind AS 17:** Leases

**Ind AS 18:** Revenue

**Ind AS 19**: Employee benefits

**Ind AS 20:** Accounting for government grants and disclosures of government assistance

**Ind AS 21:** The effects of changes in foreign exchange rates

**Ind AS 23:** Borrowing costs

**Ind AS 24:** Related party disclosures

**Ind AS 27:** consolidated and separate financial statements

**Ind AS 28:** Investment in associates

**Ind AS 29:** Financial reporting in hyperinflationary economics

**Ind AS 31:** Interests in joint ventures

**Ind AS 32:** Financial instruments: presentation

**Ind AS 33:** Earning per share

**Ind AS 34:** Interim financial reporting

**Ind AS 36:** Impairment of assets

**Ind AS 37:** Provisions, contingent liabilities and contingent assets

**Ind AS 38:** Intangible assets

**Ind AS 39:** Financial instruments: recognition and measurements

**Ind AS 40:** Investment property

**Ind AS 101:** First-time adoption of Indian Accounting Standards

**Ind AS 102:** Share-based payment

**Ind AS 103:** Business combinations

**Ind AS 104:** Insurance contracts

**Ind AS 105:** Non-current assets held for sale and discontinued operations

**Ind AS 106:** Exploration for and evaluation of mineral resources

**Ind AS 107:** Financial instruments: disclosures

**Ind AS 108:** Operating segments

The Ministry of Corporate Affairs has already confirmed that there will be two separate sets of Accounting Standards. One set to comprise the Indian Accounting Standards (Ind ASs) conversed with International Financial Reporting Standards which shall be applicable to specified class of companies as may be notified by the Government. However, before such notification and implementation, it may be necessary to amend the concerned Acts such as the Companies Act, Income Tax Act, the Insurance Act and SEBI Act etc.

## 1.9 SUMMARY

- Accounting records only those transactions and events in terms of money which are of a financial character.
- International Accounting Standards Committee (IASC) came into existence on 29th June, 1973.
- Accounting policies include the principles, bases, conventions, rules and procedures adopted by management in preparingfinancial statements.
- Responsibility for the preparation of financial statements and forthe adequate disclosure is that of the management of theenterprise.
- The need for harmonization of financial reporting is beingincreasingly felt all over the world to raise confidence amonginvestors generally in information they are using to make theirdecision and assess their risk.

## 1.10 KEY TERMS

- **Accounting:** language of business.
- **Financial Accounting:** concerned with the recording of transactions for a business enterprise and the periodic preparation of various reports from such records
- **Accounting Principle:** the body of doctrines commonly associated with the theory and procedure of accounting.
- **Accounting Concept:** accounting postulates i.e. Necessary assumptions or conditions upon which accounting is based.
- **Accounting Conventions:** convention signifies the customs or traditions which serve as a guide to the preparation of accounting statements.
- **Accounting Standard:** standards to be observed in the presentation of financial statements.
- **Fundamental accounting assumptions:** Whose acceptanceand use are assumed in the preparation of financial statements.
- **Financial statement:** An organized collection of data accordingto logical and consistent accounting procedures.

- **Income statement:** Explains what has happened to a businessas a result of operations between two balance sheet dates.
- **Balance sheet**: It is a statement of financial position of a business at a specified moment of time.

## 1.11 QUESTIONS AND EXERCISES

1. Why is accounting called the language of business?
2. What are the functions of accounting?
3. Accounting as a social science can be viewed as an information system. Examine.
4. Give an account of the various branches of accounting.
5. ‘Accounting is a service function’. Discuss the statement in the context of a modern manufacturing business.
6. What are accounting concepts and conventions? Is there any difference between them?
7. What is the significance of dual aspect concept?
8. Write a short note on accounting standards.
9. Explain the procedure of setting AS in India by ASB.
10. What is the position in India regarding the formulation and enforcement of accounting standards?
11. Give an overview of the basic accounting concepts andconventions.
12. Write a note on Accounting Standards and InternationalAccounting Standards Committee.

*********

# UNIT-2 STATUTORY FINANCIAL STATEMENTS

**Structure**



## 2.0 INTRODUCTION:

Annual reports of companies have emerged as common medium of financial reporting. However other Medias are also being used e.g., prospects interim reporting and public relation offers of companies. Any of these can serve the purpose of financial reporting of a company. But despite the presences of all these medium annual reports of companies are still regarded most significant source of information about affairs of the companies. T.A. Lee and D. P. Tweedie in their research paper “Accounting Information: an investigation of private shareholder usage” in 1975 (pp. 280-291) have mentioned.

## 2.1 UNIT OBJECTIVES

After reading this lesson, you will be able to:

- Understand financial reports of company.
- Understand preparation of company final accounts.
- Realize the Need for mandatory disclosure by the Company.
- Enumerate the statutory register to be kept by the company.
- Calculate managerial remuneration.
- Enumerate the legal provisions relating to the nature of particulars to be shown in the profit and loss account.
- Specify the legal requirements affecting presentation and preparation of company balance sheet.

## 2.2 STATUTORY REPORTS

**Requirement of Annual Reports:**

Annual report is considered most important of the sources of information on account of following reasons:

- Annual report is relatively more and easily accessible than any other source of information.
- Annual report contains audited information, which creates confidence among the public.
- Annual report includes besides financial statements, some more detailed information such as historical summary, data, important business results, company's plans and policies which are not available in other sources of information.
- Annual reports represents most commonly available source of information on past performance.

**INDIAN CORPORATE ANNUAL REPORT**

Indian Corporations formed under Company Law, 1956 are legally required to provide to their shareholders and debenture holders information regarding financial results of an accounting period. This annual report which can be conveniently into several section as follows:

a) Directors Report.

b) Profit and Loss Account.

c) Balance Sheets.

d) Notes and schedules related with financial statements.

e) Ten years record of operating results minimum 5 years records.

f) Details about employees.

There are some other Indian companies, which are providing more information in addition to the above. Such additional disclosures are related with Human resource Accounting inflation accounting and social corporate reporting. With the mandating of AS-3 in India regarding cash flow statements now Indian companies are required to present cash flow statement as per requirements of AS-3 revised by ASB of ICAI.

**SUGGESTIONS FOR IMPROVEMENT IN FINANCIAL REPORTING:**

**a) Improvement in Director's Report**: It has been found in most of the director's significant events, their causes, results and implications particularly financial in coming period. Director's report should avoid promotional comments, subjectively and should be frank in exposition. Director report should be more informative as has a great bearing on credibility of the annual report as a whole.

**b) Statement of objectives and strategies:** It is suggested the preparation of a separate statement of objectives of the company and its board strategies may be prepared to help the various external users groups in predicting the future earning power of the company.

**c) Segment Reporting:** Diversified companies should provide segment information to help the users particularly investors in making better assessment of earning capacity and general financial position of the business as a whole. It is also suggested to provide information on foreign operations if any, such as sales, operating expenses, Net profit and other items of balance sheet besides the only information of foreign sales.

**d) Effects of Inflation:** Effect of inflation on financial statement has become a number one problem throughout the whole globe. Accounting researchers are still busy in doing research on various models of inflation accounting and could not develop a single inflation accounting model, which could get worldwide acceptance. However financial reporting should incorporate information reflecting effects of inflation on the financial statements. Management may opt any single model for the purpose.

**e) Disclosures on Human resources:** It has been observed by going through various annual reports particularly in India only disclosures are being made on Human resource information. It is desirable to provide information on human resource accounting with the help of various models to improve the utility of financial reports for the users. It has been found only few companies in public sector are using Lev and Schwartz model for valuation of human resources. Human resources accounting information has a great potential not only for the management but also important for investor in investment valuation.

**f) Information on Social Desirability**: Annual reports should incorporate social responsibility information so as to help to evaluate accountability of business enterprises towards different sections of the society. A business corporation is not only responsible only to the shareholders but also to the shareholders who are also the users of financial reports. Various social accounting models have been developed by accounting researchers. Management can select one model for providing social information and can provide opportunity to stake holders to determine social desirability of reporting entity.

**g) Interim Reporting**: Companies while doing financial reporting must keep in mind that reporting has not remain only annual feature but investors and other users are interested in getting financial information throughout an accounting year. Investment decisions are made by the investors throughout the year and not necessarily at the end of accounting period only. Quarterly or half yearly interim information should be reported to the investors.

**h) Simplification of Financial Reports**: Financial reports should be more simplified to make it more easily understandable by common investors. It can be done by better-organized data. Presentation of the financial information can be made simple with the help of graphs and diagrams and tables.

**i) Highlighting Government Policies:** Corporate financial reporting should highlight policies of the governments and developments being taken in place in economy. Any changes in government policy do affect the earning potentials of the company. Information in this regard will help the investors while making investment decisions.

**j) Use of Accounting Ratios:** Ratio Analysis is most popular tool of financial analysis and has got worldwide recognition. Various accounting ratios along with principal ratio i.e., ROI can be calculated and presented to analyze liquidity, profitability, solvency and activity of the reporting enterprise. Incorporation of various accounting ratios will improve the quality of financial reporting.

**k) Information on Cash Flow Data:** Investors and creditors prefer cash flow data that net profit disclosed by the reporting entity because investors are not only interested in mere declaration of dividends but in the payments of dividend. Creditors are also interested in liquidity of the enterprise than the profitability. In India AS 3 has been made mandatory to present cash flow statement in a prescribed format. Only cash flow data helps the investors in making their investment decisions.

It is advised that while taking investment decisions investor must assess risk also. Another important risk is regarded as market risk. Which is related fluctuations e.g., in interest rates, foreign currency rates, or commodity prices that are beyond the control of management. Although market risk affects all the firms, most extant studies investigating interest rate risk focus on financial institutions for three primary reasons. First, interest rate risk is economically significant for financial institutions because of the close link between interest rate risk and operating risk. Second financial institutions are major participants in the derivatives market, a focus of some risk studies. Third disclosures required primarily by financial institution regulators provide empirical proxies for risk that researchers can study.

**Legal formalities and provisions for the preparation of final accounts:**

In order to understand the preparation of final statement of companies, it is necessary to follow some of the provisions and following few sections:

- Statutory contents of the final statement that is balance sheet, profit and loss account and directors reports.
- Accounting treatment of the various new accounts and adjustments which are not found in final accounts of sole trading concern or partnership firms.
- Calculation of managerial remuneration according to the basis of some legal provisions.
- The meaning of divisible profits and accounting treatment of dividend in final accounts of companies.
- Guidelines in the issue of bonus shares and accounting treatment of it in final accounts.
- **Solved examination problems by giving new ideas of examination standards.**

## 2.3 PREPARATION & PRESENTATION OF FINAL ACCOUNTS

Under section 210 of the Companies Act, 1956 it has been made compulsory to present the balance sheet and profit and loss account at every annual general meeting of the company. It should be placed within one year but not exceed 15 months.

According to Section 211 of the Companies Act, 1956, the profit and loss account should exhibits a true and fair view of profit or loss of the company and the balance sheet should exhibits a true and fair view of the state of affairs of the company for the financial year and comply with the requirements of Part-II Schedule 4 of the Companies Act.

The disclosure of interest of the subsidiary company under section 212 of the Companies Act, if the company is holding company. The following documents relating to subsidiary companies shall be attached to its balance sheet –

- A copy of the Profit and Loss Account of each subsidiary company.
- A copy of the Balance Sheet of each subsidiary company.
- A copy of the director's report of each subsidiary company.
- A copy of the auditor's report of each subsidiary company.
- A statement of the holding Company which shows the interest of the subsidiaries.

Under Section 213 of the Companies Act audited and directors report shall be attached to the balance sheet of the company.

Under Section 215 of the Companies Act, authorization of balance sheet and Profit and Loss Account shall be given which is duly signed by manager, managing directors, secretary on behalf of board of directors of the company.

**Filing of Accounts –** Under Section 220 of the Companies Act, every company should submit the accounts and statements within 30 days of the annual general meeting of the company with the registrar in three copies of balance sheet and Profit and Loss Account and three copies of all documents which are equal to be attached with the balance sheet.

**BALANCE SHEET**

**Contents of Balance Sheet –** The form of balance sheet as laid down in schedule 4, Part I of the Companies Act. According to Section 210 of the Companies Act, a company is required to prepare a balance sheet at the end of each trading period. Section 211 requires the balance sheet to be set up in the prescribed form. This provision is not applicable to banking, insurance, electricity and the other companies governed by special Acts. The Central Government has also the power to exempt any class of companies from compliance with the requirements of the prescribed form if it deems to be in public interest. The object of prescribing the form is to elicit proper information from the company so as to give a 'true and fair' view of the state of the company's affairs. As a matter of fact both window dressing and creating secret reserves will be considered against the provisions of Section 211. Schedule VI, Part I gives the prescribed form of company's balance sheet. Notes and instructions regarding various items have been given in brackets below each item. It may be noted that if information required to be given under any of the items or sub-items in the prescribed form cannot be conveniently given on account of lack of space, it may be given in a separate schedule or schedules. Such schedules will be annexed to and form part of the balance sheet. Schedule VI, Part I permits presentation of balance sheet both in horizontal as well as vertical forms. The forms with necessary notes, explanations, etc. are given below:

## SCHEDULE VI: PART I

(See Section 211)

*Horizontal Form of Balance Sheet*

Balance Sheet of.....(Here enter the name of the company) as on.....(Here enter the date at which the balance sheet is made out)

| *Figures for the previous year* ₹ | *Liabilities* | *Figures for the current year* ₹ | *Figures for the previous year* ₹ | *Assets* | *Figures for the current year* ₹ |
|---|---|---|---|---|---|
| | **Share Capital:**<br>Authorised.....Share of ₹ ..each.<br>Issued: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class).....shares of ₹ ..each.<br>Subscribed: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class).Shares of ₹....each...₹ called up.<br>(Of the above shares..., shares are allotted as fully paid up pursuant to a contract without payments being received in cash. Of the above shares..., shares are allotted as fully paid up by way of bonus shares.)<br>[Specify the source from which bonus shares are issued, *e.g.*, capitalisation of profits or Reserves or from Share Premium Account.]<br>*Less:* Calls unpaid;<br>(*i*) By Directors<br>(*ii*) By Others<br>*Add:* Forfeited shares:<br>(amount originally paid up)<br>(Any capital profit on reissue of forfeited shares should be transferred to Capital Reserves).<br>**Notes:**<br>1. Term of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversions. | | | **Fixed Assets:**<br>Distinguishing as far as possible between expenditure upon<br>(*a*) good will<br>(*b*) land<br>(*c*) buildings<br>(*d*) leaseholds<br>(*e*) railway sidings<br>(*f*) plant and machinery<br>(*g*) furniture and fittings<br>(*h*) development of property<br>(*i*) patents, trade marks and designs<br>(*j*) livestock, and<br>(*k*) vehicles, etc.<br>(Under each head the original cost and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year is to be stated. Depreciation written off or provided shall be allotted under the different assets heads and deducted in arriving at the value of Fixed Assets. [Also see note (11) on page 1.215.<br>In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books is to be given. For the purpose of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, amount of sale proceeds shall be shown as deduction. | |

*(Contd.)*

| *Figures for the previous year* ₹ | *Liabilities* | *Figures for the current year* ₹ | *Figures for the previous year* ₹ | *Assets* | *Figures for the current year* ₹ |
|---|---|---|---|---|---|
| | 2. Particulars of any option on unissued Share Capital are to be specified.<br>3. Particulars of the different classes of preference shares are to be given.<br>These particulars are to be given along with Share Capital.<br>In the case of subsidiary companies, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries shall be separately stated in respect of Subscribed Share Capital. (The auditor is not required to certify the correctness of such share-holdings as certified by the management.)<br>**Reserves and Surplus:**<br>(1) Capital Reserves<br>(2) Capital Redemption Reserves<br>(3) Securities Premium Account (showing detail of its utilisation in the manner provided in Section 78 in the year of utilisation).<br>(4) Other Reserves specifying the nature of each Reserve and the amount in respect thereof.<br>*Less:* Debit balance in profit and loss account (if any).<br>(The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any).<br>(5) Surplus *i.e.*, balance in profits and loss account after providing for proposed allocation, namely Dividend, Bonus or Reserves.<br>(6) Proposed additions to Reserves.<br>(7) Sinking Funds.<br>(Additions and deductions since last balance sheet to be shown, under each of the specified heads. The word "fund" in relation to any "Reserve" should be used only where such under Reserve is specifically represented by earmarked investments.) | | | Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance-sheet) subsequent to the reduction or revaluation shall show the reduced figures with the date of the reduction in place of the original cost.<br>Each balance-sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction made.<br>Similarly, where sums have been added by writing up the assets every balance-sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original costs. Each balance-sheet for the first five years subsequent to the date of the writing up shall also show the amount of increase made).<br>**Investments:**<br>Showing nature of investments and mode of valuation, for example, cost or market value, and distinguishing between:<br>(1) Investments in Government of Trust Securities.<br>(2) Investments in Shares, Debentures or Bonds.<br>(Showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing similarly details of investments in shares, debentures or bonds of subsidiary companies.<br>(3) Immovable properties.<br>(4) Investments in the capital of partnership firms.<br>(5) Balance of unutilised moneys raised by issue.*<br>**Notes:**<br>(*i*) Aggregate amount of company's quoted Investments and also the market value thereof shall be shown.<br>(*ii*) Aggregate amount of company's unquoted investments shall also be shown. | |

(*Contd.*)

* Notification issued by Deptt. of Company Affairs, Ministry of Finance, GOI dated 13.9.1996.

| *Figures for the previous year* ₹ | *Liabilities* | *Figures for the current year* ₹ | *Figures for the previous year* ₹ | *Assets* | *Figures for the current year* ₹ |
|---|---|---|---|---|---|
| | (Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head Unsecured Loans)<br>(Where Loans have been guaranteed by manager, and/or directors, a mention thereof shall also be made together with the aggregate amount of such loans under each head. This does not apply to Fixed Deposits.)<br>**Current Liabilities and Provisions:**<br>*A*. Current Liabilities<br>(1) Acceptances.<br>(2) Sundry Creditors.<br>(*i*) Total outstanding dues of micro enterprices and small enterprises (substituted w.e.f. 16.11.2007)<br>(*ii*) Total outstanding dues of creditors other than (micro enterprises and small enterprises (substituted w.e.f. 16.11.2007)<br>(3) Subsidiary Companies.<br>(4) Advance Payments and unexpired discounts for the portion for which value has still to be given, *e.g.*, in the case of companies like Newspaper, Fire Insurance, Theatres, Clubs, Steamship companies, Banking etc.<br>(5) Unclaimed Dividends.<br>(6) Other Liabilities (if any)<br>(7) Interest accrued but not due on loans. | | | (Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated. Debts due from other companies under the same management within the meaning of sub-section (1*B*) of Section 370 to be disclosed with the names of the companies.<br>The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.<br>The Provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such Provision, if already created, should be shown at every closing under "Reserves and Surplus" (in the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts.")<br>(7*A*) Cash balance on hand.<br>(7*B*) Bank Balances:<br>(*a*) with Scheduled Banks. (*b*) with others.<br>[With regard to bank balances particulars to be given separately of:<br>(*a*) the balance lying with Scheduled Banks on current accounts, call accounts and deposit accounts.<br>(*b*) the names of the bankers other than Scheduled Banks and the balances lying with each such banker on current account, call account and deposit account and the maximum amount outstanding at any time during the year with each such banker; and<br>(*c*) the nature of the interest, if any, of any director or his relative in each of the banks (other than Scheduled Banks referred to in (*b*) above] | |

(*Contd*)

| Figures for the previous year ₹ | Liabilities | Figures for the current year ₹ | Figures for the previous year ₹ | Assets | Figures for the current year ₹ |
|---|---|---|---|---|---|
| | *B*. Provisions<br>(8) Provision for Taxation.<br>(9) Proposed Dividends.<br>(10) For Contingencies.<br>(11) For Provident Fund Scheme.<br>(12) For Insurance, Pension and Similar Staff Benefit Schemes.<br>(13) Other provisions.<br>A foot-note to the balance sheet may be added to show separately<br>(1) Claims against the company not acknowledged as debts.<br>(2) Uncalled liability on shares partly paid.<br>(3) Arrears of fixed cumulative dividends.<br>(The period for which the dividends are in arrears or if there is more than one class of shares, the dividends on each such class that are in arrear, shall be stated. The amount shall be stated before deduction of Income-tax, except that in the case of tax-free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated).<br>(4) Estimated amount of contracts remaining to be executed on capital account and not provided for<br>(5) Other moneys for which the company is contingently liable.<br>(The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount or each such contingent liability, if material, shall also be specified). | | | (*d*) All unutilised moneys out of the issue must be separately disclosed in the balance sheet of the company indicating the form in which such unutilised funds have been invested.*<br>(*B*) LOANS AND ADVANCES:<br>(8) (*a*) Advances and loans to subsidiaries.<br>(*b*) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner.<br>(9) Bills of Exchange.<br>(10) Advances recoverable in cash or in kind or for value to be received, *e.g.*, Rates, Taxes, Insurance, etc.<br>(11) Balances with Customs, Port Trust, etc. (where payable on demand).<br>[Instructions regarding Sundry Debtors apply to "Loans and Advances" also. The amounts due from other companies under the same management within the meaning of sub-section (1*B*) of Section 370 should also be given with the names of the companies; the maximum amount due from every one of these at any time during the year must be shown].<br>**Miscellaneous Expenditure**<br>(to the extent not written off or adjusted).<br>(1) Preliminary expenses.<br>(2) Expenses including commission or brokerage or underwriting or subscription of shares or debentures.<br>(3) Discount allowed on the issue of shares or debentures.<br>(4) Interest paid out of capital during construction (also stating the rate of interest).<br>(5) Development expenditure not adjusted.<br>(6) Other sums (specifying nature).<br>**Profit and Loss Account**<br>(Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any) | |

* Inserted by Notification No. GSR 423 (E) dated 13.9.1992.

**Notes:**

i) Paise can also be given in addition to rupees, if desired.

ii) Dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of a period which closed on or before the date of the balance sheet.

iii) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report.

iv) Particulars of any redeemed debentures which the company has power to issue should be given.

v) Where any of the company's debentures are held by a nominee or a trustee for the company the nominal amount of the debenture and the amount at which they are stated in the books of the company shall be stated.

vi) A statement of investments (whether shown under "Investment" or under "Current Assets" as Stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance sheet, showing the names of the bodies corporate (including separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given in the statement.

vii) If, in the opinion of the Board, any of the current assets, loans and advance do not have value on realisation in the ordinary course of business, at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

viii) Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts of the immediately preceding financial year for all items shown in the balance sheet shall also be given in the balance sheet. The requirements in this behalf shall, in case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.

ix) Current accounts with Directors and Manager, whether they are credit or debit, shall be shown separately.

x) The information required to be given under any of the items or sub-items in the Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and forming part of the balance sheet. This is recommended when items are numerous.

xi) Where the original cost (of fixed assets) and additions and deductions thereto, relate to any fixed assets which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such assets there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset (being in either cases the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed assets.

**VERTICAL FORM OF BALANCE SHEET**

**Name of the Company.......**

**Balance Sheet as at........**

| | **Schedule No.** | **Figures as at the end of the current financial year** | **Figures as at the end of the previous financial year** |
|---|---|---|---|
| **I. Sources of Funds** | | | |
| (1) Shareholders' Funds | | | |
| (a) Capital | -- | -- | -- |
| (b) Reserves and Surplus | ... | ... | ... |

| | | | |
|---|---|---|---|
| (2) Loan Funds | | | |
| (a) Secured Loans | ... | … | ... |
| (b) Unsecured Loans | ... | ... | ... |
| Total | ... | ... | ... |
| **II. Application of Funds** | | | |
| (1) Fixed Assets | | | |
| (a) Gross Block | ... | ... | ... |
| (b) Less Depreciation | ... | ... | ... |
| (c) Net Block | ... | ... | ... |
| (d) Capital Work-in-Progress | ... | ... | ... |
| (2) Investments | ... | ... | ... |
| (3) Current Assets Loans and Advances | | | |
| (a) Inventories | ... | ... | … |
| (b) Sundry Debtors | ... | ... | ... |
| (c) Cash and Bank Balances | ... | ... | ... |
| (d) Other Current Assets | ... | ... | ... |
| (e) Loans and Advances | ... | ... | ... |
| Less: Current Liabilities and Provisions | ... | ... | ... |
| (a) Liabilities | ... | ... | ... |
| (b) Provisions | ... | ... | ... |
| Net Current Assets | | | |
| (4) (a) Miscellaneous expenditure to the | | | |
| extent not written off or adjusted | | ... | ... |
| (b) Profit and Loss Account | ... | ... | .. |
| **Total** | ... | ... | ... |

**Notes:**

i) Details under each of the above items shall be given in separate Schedules. The Schedules shall incorporate all the information required to be given under Part IA of Schedule VI read with Notes containing General Instruction for preparation of balance sheet.
ii) The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
iii) The figures in the Balance Sheet may be rounded off as per Government Notification dated 01.08.2002.
iv) A footnote to the balance sheet may be added to show contingent liabilities separately.

**Schedule VI: Part III**

***Interpretation***

**I.**

1. For the purpose of Parts I and II of this schedule, unless the context otherwise requires:
   a. the expression “provision” shall, subject to sub-clause (2) of this clause, means any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;
   b. the expression “reserve” shall not subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;
   c. the expression “capital reserve” shall not include any amount regarded as free for distribution through the profit and loss account: and the expression “revenue reserve” shall mean any reserve other than a capital reserve; and in this sub-clause the expression “liability” shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.
2. Where
   a. any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this act; or
   b. any amount retained by way of providing for any known liability: In excess of the amount which in the opinion of the directors is

reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

**II.** For the purposes aforesaid, the expression "quoted investment" means an investment in respect of which there has been granted a quotation or permission to deal on recognized stock exchange, and the expression "unquoted investment" shall be constructed accordingly.

**Illustration:** The following are the balances of Johri Albhushan Bhander Co. Ltd. as on 31st March 2008:

| Debit | Rs. | Credit | Rs. |
|---|---|---|---|
| Premises | 30,72,000 | Share capital | 40,00,000 |
| Plant | 33,00,000 | 12% Debentures | 30,00,000 |
| Stock | 7,50,000 | P&L A/c | 2,62,500 |
| Debtors | 8,70,000 | Bills payable | 3,70,000 |
| Goodwill | 2,50,000 | Creditors | 4,00,000 |
| Cash and Bank | 4,06,500 | Sales | 41,50,000 |
| Calls in Arrear | 75,000 | General reserve | 2,50,000 |
| Interim Dividend paid | 3,92,500 | Bad Debt. provision | |
| | | on 1.4.97 | 35,000 |
| Purchases | 18,50,000 | | |
| Preliminary Expenses | 50,000 | | |
| Wages | 9,79,800 | | |
| General Expenses | 68,350 | | |
| Salaries | 2,02,250 | | |
| Bad debts | 21,100 | | |
| Debentures Interest paid | 1,80,000 | | |
| | **1,24,67,500** | | **1,24,67,500** |

Information:

(a) Depreciate Plant by 15%

(b) Write off ` 5,000 from Preliminary Expenses

(c) Half-year's Debenture Interest due

(d) Credit 5% Provision on Debtors for Doubtful Debts

(e) Provide for Income Tax @ 50%

(f) Stock on 31st March, 2008 was ` 9,50,000

(g) A claim of ` 25,000 for workmen's compensation is being disputed by the company.

Prepare Final Accounts of the company.

**Solution**

**M/s Johri Albhushan Bhander Co. Ltd.**

**PROFIT AND LOSS ACCOUNT**

**for the year ending 31st March, 2008**

Dr. Cr.

| **Particulars** | **Rs.** | **Particulars** | **Rs.** |
|---|---|---|---|
| To Opening Stock | 7,50,000 | By Sales | 41,50,000 |
| To Purchases | 18,50,000 | By Closing Stock | 9,50,000 |
| To Wages | 9,79,800 | | |
| To Gross Profit c/d | 15,20,200 | | |
| | **51,00,000** | | **51,00,000** |
| To Salaries | 2,02,250 | By Gross Profit b/d | 15,20,200 |
| To Deb. Interest paid1,80,000 | | | |
| Add: Outstanding 1,80,000 | 3,60,000 | | |
| To General expenses | 68,350 | | |

| | | | |
|---|---|---|---|
| To Provision for Doubtful debts: | | | |
| Bad debts 21,100 | | | |
| Add: New provision 43,500 | | | |
| 64,600 | | | |
| Less: Old provision 35,000 | 29,600 | | |
| To Depreciation: Plant | 4,95,000 | | |
| To Preliminary expenes. written off | 5,000 | | |
| To Provision for tax | 1,80,000 | | |
| To Net profit for the year | 1,80,000 | | |
| | **15,20,200** | | **15,20,200** |

**PROFIT & LOSS APPROPRIATION ACCOUNT**

**for the year ending 31st March, 2008**

| Particulars | Rs. | Particulars | Rs. |
|---|---|---|---|
| To Interim dividends paid | 3,92,500 | By Balance b/d | 2,62,500 |
| To Balance c/d | 50,000 | By P&L A/c (Profit for the year) | 1,80,000 |
| | **4,42,500** | | **4,42,500** |

**M/s Johri Albhushan Bhander Co. Ltd.**

**BALANCE SHEET**

**as on 31.3.2008**

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| ***Shares Capital*** | | ***Fixed Assets*** | |
| Authorised .......... | | Goodwill | 2,50,000 |
| Issued & Subscribed | | Premises | 30,72,000 |
| 4,00,000 Shares of | | Plant 33,00,000 | |
| ` 10 each 40,00,000 | | Less: Depreciation 4,95,000 | 28,05,000 |

| | | | | |
|---|---|---|---|---|
| Less: Calls in Arrear 75,000 | 39,25,000 | ***Current Assets*** | | |
| ***Reserves & Surplus:*** | | ***Loans & Advances:*** | | |
| General Reserve | 2,50,000 | Stock | | 9,50,000 |
| P&L A/c | 50,000 | Debtors | 8,70,000 | |
| ***Secured Loans:*** | | Less: Provision for Bad | | |
| 12% Debentures | 30,00,000 | Debt | 43,500 | 8,26,500 |
| Interest Outstanding | 1,80,000 | Cash at Bank | | 4,06,500 |
| ***Current Liabilities & Provisions:*** | | ***Miscellaneous*** | | |
| Bills Payable | 3,70,000 | ***Expenses & Losses***: | | |
| Creditors | 4,00,000 | Preliminary Expenses | 50,000 | |
| Provisions for Taxation | 1,80,000 | Less: Written off | 5,000 | 45,000 |
| | **83,55,000** | | **83,55,000** | |

## 2.4 REVISED SCHEDULE VI

Ministry of Corporate Affairs, Government of India has recently replaced the existing Schedule VI by a revised Schedule VI which is effective from 01.04.2011 i.e. Financial Year 2011-12 onwards. Accordingly the revised Schedule VI is based on existing Accounting Standards and not on Ind AS and is, therefore, applicable on all companies. It is expected that as and when date of implementation of Ind AS is notified a separate set of Schedule VI would be issued in respect of companies preparing their financial statements as per Ind AS. Of course, the applicability the Ind As, it was earlier settled to be implemented in a phase manner starting from 01.04.2011 has been deferred; the instant decision for Schedule VI can be treated as a step towards conversions to IFRS to some extent with regard to presentation of Financial Statements. The revised Schedule VI giving the format of Balance Sheet and Profit & Loss Account is given below:

The revised Schedule VI as notified by Government of India through its gazette dated 20 February, 2011 is effective from 01-04-2011 i.e., from FY 2011-2012 onward. The revised Schedule VI formal is applicable to companies-covered under IGAAP and Ind-As (Converged IFRS). The existing Schedule VI has been totally revamped. The revised Schedule VI fairly to an extent is drafted in an IFRS-complaint manner. Below is the revised Schedule VI which is effective from 1 April 2011.

**General Instructions for Preparation of Balance Sheet:**

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

All other assets shall be classified as non-current.

2. A liability shall be classified as current when it satisfies any of the following criteria:
    a. it is expected to be settled in the company's normal operating cycle;
    b. it is held primarily for the purpose of being traded;
    c. it is due to be settled within twelve months after the reporting date; or
3. A company shall disclose the following in the notes to accounts:

**A. Share Capital**

for each class of share capital (different classes of preference shares to be treated separately):

**Part I Form of Balance Sheet**

**Name of the Company.........**

**Balance sheet as at.............**

(Rupees in ......)

| **Particulars** | **Note No.** | **Figures as at** | **Figures as at** |
|---|---|---|---|
| **(1)** | **(2 )** | **(3 )** | **(4)** |

**I. EQUITY AND LIABILITIES**

1. Shareholders' funds
    a. Share capital

b. Reserves and surplus
c. Money received against share

2. Share application money pending
3. Non-current liabilities
    a. Long-term borrowings
    b. Deferred tax liabilities (Net)
    c. Other Long term liabilities
    d. Long-term provisions
4. Current liabilities
    a. Short-term borrowings
    b. Trade payables
    c. Other current liabilities
    d. Short-term provisions

**Total**

---

## II. ASSETS

***Non-current assets***

1. A. Fixed assets
    a. Tangible assets
    b. Intangible assets
    c. Capital work-in-progress
    d. Intangible assets under

   B. Non-current investments

   C. Deferred tax assets (net)

   D. Long-term loans and advances

   E. Other non-current assets
2. Current assets
    a. Current investments
    b. Inventories
    c. Trade receivables
    d. Cash and cash equivalents
    e. Short-term loans and advances
    f. Other current assets

**Total**

---

**A. Share Capital**

a) the number and amount of shares authorized;

b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
c) par value per share;
d) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
    - Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
    - Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
    - Aggregate number and class of shares bought back.
e) Calls unpaid (showing aggregate value of calls unpaid by directors and officers)
f) Forfeited shares (amount originally paid up)

**B. Reserves and Surplus**

i. Reserves and Surplus shall be classified as:
    a. Capital Reserves;
    b. Capital Redemption Reserve;
    c. Securities Premium Reserve;
    d. Debenture Redemption Reserve;
    e. Revaluation Reserve;
    f. Share Options Outstanding Account;
    g. Other Reserves - (specify the nature and purpose of each reserve and the amount in respect thereof);
    h. Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

ii. Debit balance of statement of profit and loss shall be shown as a negative figure under the head ‘Surplus’. Similarly, the balance of “Reserves and Surplus’, after adjusting negative balance of surplus, if any, shall be shown under the head ‘Reserves and Surplus’ even if the resulting figure is in the negative.

**C. Long-Term Borrowings**

i. Long-term borrowings shall be classified as:
    a. Bonds/debentures.
    b. Term loans
        i. from banks.
        ii. from other parties.
    c. Deferred payment liabilities.
    d. Deposits.
    e. Loans and advances from related parties.
    f. Long term maturities of finance lease obligations
    g. Other loans and advances (specify nature).

ii. Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

**D. Other Long Term Liabilities**

Other Long term Liabilities shall be classified as:

a. Trade payables
b. Others

**E. Long-term provisions**

The amounts shall be classified as:

a. Provision for employee benefits.
b. Others (specify nature).

**F. Short-term borrowings**

i. Short-term borrowings shall be classified as:
   a. Loans repayable on demand
      i. from banks.
      ii. from other parties.
   b. Loans and advances from related parties.
   c. Deposit
   d. Other loans and advances (specify nature).

**G. Other current liabilities**

The amounts shall be classified as:

a. Current maturities of long-term debt;
b. Current maturities of finance lease obligations;
c. Interest accrued but not due on borrowings;
d. Interest accrued and due on borrowings;
e. Income received in advance;
f. Unpaid dividends
g. Application money received for allotment of securities and due for refund and interest accrued thereon.
h. Unpaid matured deposits and interest accrued thereon
i. Unpaid matured debentures and interest accrued thereon
j. Other payables (specify nature);

**H. Short-term provisions**

The amounts shall be classified as:

**I. Tangible assets**

Classification shall be given as:

a. Land.
b. Buildings.
c. Plant and Equipment.
d. Furniture and Fixtures.
e. Vehicles.
f. Office equipment.
g. Others (specify nature).

**J. Intangible assets**

i. Classification shall be given as:
    a. Goodwill.
    b. Brands /trademarks.
    c. Computer software.
    d. Mastheads and publishing titles.
    e. Mining rights.
    f. Copyrights, and patents and other intellectual property rights, services and operating rights.
    g. Recipes, formulae, models, designs and prototypes.
    h. Licenses and franchise.
    i. Others (specify nature).

**K. Non-current investments**

i. Non-current investments shall be classified as trade investments and other investments and further classified as:
    a. Investment property;
    b. Investments in Equity Instruments;
    c. Investments in preference shares
    d. Investments in Government or trust securities;
    e. Investments in debentures or bonds;
    f. reinvestments in Mutual Funds;
    g. Investments in partnership firms
    h. Other non-current investments (specify nature)

ii. Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

**L. Long-term loans and advances**

Long-term loans and advances shall be classified as:

a. Capital Advances;
b. Security Deposits;
c. Loans and advances to related parties (giving details thereof);
d. Other loans and advances (specify nature).

**M. Other non-current assets**

Other non-current assets shall be classified as:

i. Long Term Trade Receivables (including trade receivables on deferred credit terms);
ii. Others (specify nature)
iii. Long term Trade Receivables, shall be sub-classified as:
    a. Secured, considered good;
    b. Unsecured considered good;
    c. Doubtful
    d. Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

**N. Current Investments**

i. Current investments shall be classified as:
    a. Investments in Equity Instruments;
    b. Investment in Preference Shares
    c. Investments in government or trust securities;
    d. Investments in debentures or bonds;
    e. Investments in Mutual Funds;
    f. Investments in partnership firms
    g. Other investments (specify nature).

**O. Inventories**

i. Inventories shall be classified as:
    a. Raw materials;
    b. Work-in-progress;
    c. Finished goods;
    d. Stock-in-trade (in respect of goods acquired for trading);
    e. Stores and spares;
    f. Loose tools;
    g. Others (specify nature).
ii. Goods-in-transit shall be disclosed under the relevant subhead of inventories,
iii. Mode of valuation shall be stated.

**P. Trade Receivables**

i. Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated,
ii. Trade receivables shall be sub-classified as:
    a. Secured, considered good;
    b. Unsecured considered good;
    c. Doubtful.

iii. Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

**Q. Cash and cash equivalents**

i. Cash and cash equivalents shall be classified as:
   a. Balances with banks;
   b. Cheques, drafts on hand;
   c. Cash on hand;
   d. Others (specify nature).

**R. Short-term loans and advances**

i. Short-term loans and advances shall be classified as:
   a. Loans and advances to related parties (giving details thereof);
   b. Others (specify nature).

ii. The above shall also be sub-classified as:
   a. Secured, considered good;
   b. Unsecured, considered good;
   c. Doubtful.

iii. Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

**S. Contingent liabilities and commitments (to the extent not provided for)**

i. Contingent liabilities shall be classified as:
   a. Claims against the company not acknowledged as debt;
   b. Guarantees;
   c. Other money for which the company is contingently liable

ii. Commitments shall be classified as:
   a. Estimated amount of contracts remaining to be executed on capital account and not provided for;
   b. Uncalled liability on shares and other investments partly paid
   c. Other commitments (specify nature).

## PART II - Form of STATEMENT OF PROFIT AND LOSS

**Name of the Company.......................**

**Profit and loss statement for the year ended...........**

| Particulars | Note No. | | Figures for the current Reporting period | | Figures for the previous Reporting period |
|---|---|---|---|---|---|
| I. Revenue from operations | | | xxx | | xxx |
| II. Other income | | | xxx | | xxx |
| III. Total revenue (I+II) | | | xxx | | xxx |

| | | | | | |
|---|---|---|---|---|---|
| IV. Expenses:<br>Cost of materials consumed<br>Purchases of Stock-in-Trade<br>Changes in inventories of finished goods work-in-progress<br>and Stock-in-Trade<br><br>Employee benefits expenses<br>Finance costs<br>Depreciation and amortization expenses<br>Other expenses | | | xxx<br>xxx<br>xxx | | xxx<br>xxx<br>xxx |
| Total expenses | | | xxx | | xxx |
| V. Profit before exceptional and extraordinary items and tax (III-IV) | | | | | |
| VI. Exceptional items | | | xxx | | xxx |
| VII. Profit before extraordinary items and tax (V - VI) | | | xxx | | xxx |
| VIII. Extraordinary items | | | xxx | | xxx |
| IX. Profit before tax (VII-VIII) | | | xxx | | xxx |
| X. Tax expenses:<br>(1) Current tax<br>(2) Deferred tax | | <br>xxx<br>xxx | | <br>xxx<br>xxx | |
| XI. Profit (Loss) for the period from continuing operations (VII-VIII) | | | xxx | | xxx |
| XII. Profit/(loss) from discontinuing operations | | | xxx | | xxx |
| XIII. Tax expense of discontinuing operations | | | xxx | | xxx |
| XIV. Profit/(loss) from discontinuing operations (after tax) (XII-XIII) | | | xxx | | xxx |
| XV. Profit (Loss) for the period (XI + XIV) | | | xxx | | xxx |
| XVI. Earning per equity share:<br>(1) Basic<br>(2) Diluted | | | <br>xxx<br>xxx | | <br>xxx<br>xxx |

*Note: See accompanying notes to the financial statements*

**General Instructions for Preparation of Statement of Profit and Loss:**

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of Section 210 of the Act, in like manner as they apply to a statement of profit and loss.
2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from
    a. sale of products;
    b. sale of services;
    c. other operating revenues; Less:
    d. Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from

a. Interest; and
b. Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

a. Interest expense;
b. Other borrowing costs;
c. Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

a. Interest Income (in case of a company other than a finance company);
b. Dividend Income;
c. Net gain/loss on sale of investments
d. Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

i. Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
ii. Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;
iii. Details of items of exceptional and extraordinary nature;

iv. Prior period items;
   a. In the case of manufacturing companies,-(1) Raw materials under broad heads. (2) Goods purchased under broad heads.
   b. In the case of trading companies, purchases in respect of goods traded in by the company under broad heads,
   c. In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

v. Expenditure incurred on each of the following items, separately for each item:-
   a. Consumption of stores and spare parts,
   b. Power and fuel,
   c. Rent,
   d. Repairs to buildings,
   e. Repairs to machinery,
   f. Insurance,
   g. Rates and taxes, excluding, taxes on income,
   h. Miscellaneous expenses,

**Contents of the P/L A/C –** According to paragraph 3 of the Part II schedule 4 the P/L A/c of a company must set up the various items relating to income and expenditure of the company arranged under the most convenience head.

a) Turn Over – It is the aggregate amount for which sales are affected by the company.

- Commission paid to selling agents.

- Brokerage on discount on sales.

b) In case of manufacturing companies the value of raw material consumed work-in-progress.

- In case of trading companies, opening stocks, closing stock, purchases.

- In case of companies rendering supply services.

a) Work in progress, opening and closing figures

b) Provision for depreciation, renewals of fixed assets.

c) Interest on debentures and fixed loans.

d) Income tax.

e) Repayment of loans (reserves, provisions)

f) Expenditure incurred on consumption on stores and spare parts

- Power and fuel
- Rent
- Repairs to buildings and machineries
- Salaries, bonus, wages.
- Insurance
- Workmen's welfare expenses
- Rate and taxes
- Miscellaneous expenses

Further information in Profit and Loss A/c – The P/L A/c shall also content detail information showing payments made during the financial year to the directors or manager in the following manner :-

- Managerial remuneration under Section 198 of the Act.
- Other allowances and commission including guarantee commission.
- Pension, gratuities.
- Payment from provident fund.
- Other payment in connection with retirement from office.
- Auditors fees, income tax and license fee, provision for taxation and other provisions.

P/L A/c (Credit)

- Interest received, commission received (Brokerage, under-writing commission, dividend received, premium received, miscellaneous receives)

**Directors Report –** Under Section 197 it has been required that directors shall make out a report and attached the same with the every balance sheet. These reports contents the following –

i) State the affairs of the company.

ii) The amount if any which the board proposes to carry any reserves in such balance sheet.

iii) The amount if any which the board recommends should be paid by way of dividend.

iv) Material changes and commitments if any, affecting the financial position of the company which is occurred between the financial year to which the balance sheet relates.

v) The report of the board of directors must deal with any changes which have occurred during the year with the respect of the nature of the business of the company.

## 2.5 MANAGERIAL REMUNERATION

The company loss lays down some restrictions on the calculation of managerial remuneration to be provided by a public company for or a private company or other subsidiaries. Following are the details of the restriction regarding remuneration.

**A. Remuneration of Directors –** Provisions relating to remuneration of directors including managing directors laid down under Section 309 a) Fee for attending each meeting of the board should not exceed Rs.250/-, b) a whole time directors or a managing directors may be paid remuneration either by way of monthly remuneration or at a specified percentage of the net profit of the company like I) 5 % of the net profit for on such directors, ii) 10 % of the net profit for all of them put together, if there are more than one directors.

**B.** In case of **part-time directors** the commission is not more than 1 % of the profit of the company.

**C. Remuneration to Manager** – Provisions relating to remuneration of a manager at content into Section 387 of the companies Act. They are summarized as under:

- A manager may get his remuneration by way of monthly payment or by way of a specific percentage of the Net Profit.

- Net profit is calculated with reference to Section 349 and 350.

- The total remuneration cannot exceed 5 % of the net profit except with the approval of the central government.

**Overall managerial remuneration** According to Section 198 of the Companies Act, the total managerial remuneration payable by a public company or a private company which is subsidiary of a public company in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year. Net profits for this purpose are to be calculated in the manner laid down in Section 349 and 350 of the Companies Act, explained later in the chapter. Of course,this amount is exclusive of the fees payable to the Directors for attending board's meeting or a committee thereof. It may be noted that such fee is payable only to part-time directors. The limit for such fee has been fixed as under w.e.f. 24.7.2003.13

| | |
|---|---|
| (a) Companies with a paid up share capital and free reserves of Rs.10 crores and above or turnover of ` 50 crores andabove | Not to exceed Rs. 20,000 per meeting |
| (b) Other companies | Not to exceed Rs.10,000 per meeting |

Within the above maximum limit of 11%, a company may pay monthly remuneration to its managing or whole-time director in accordance with the provision of Section 309 or to its manager in accordance to the provisions of Section 386 of the Companies Act. Incase of no profits or inadequacy of profits in any year, the company may pay remuneration as per the provisions of Schedule XIII, explained later in the chapter.

Managerial remuneration includes the following:

(i) Any expenditure incurred by the company in providing any rent free accommodation or any other benefit or amenity in respect of accommodation free of charge to any of its managerial personnel referred above.
(ii) Any expenditure incurred by the company in providing another benefit or amenity free of charge or at a concessional rate to any of the aforesaid persons.
(iii) Any expenditure incurred by the company in respect of any obligation or service which, but for such expenditure by the company, would have been incurred by any of the persons aforesaid.
(iv) Any expenditure incurred by the company to effect an insurance on the life of or to provide any pension, annuity or gratuity for any of the aforesaid persons, his spouse or child.

**Remuneration payable to different categories of managerial personnel:** Remuneration payable to different categories of managerial personnel is as follows:

**(i) Manager:** Manager means a person who has got the control of the whole or substantially the whole of the affairs of a company. There can be only one manager in a company and such manager cannot be paid more than 5% of the net profits of the company by way of managerial remuneration.
**(ii) Managing director**: Managing director means a director who has substantial powers of management. A company cannot have both a managing director as well as a manager. Of course, it can have more than one managing director. A managing director can be paid by way of managerial remuneration a sum not exceeding 5% of the net profits of the company. In case a company has more

than one managing director, the total managerial remuneration payable to all the managing directors will not exceed 10% of the net profits of the company.

**(iii)Whole-time director:** A whole-time director is a director who devotes his whole time attention to the company. A company may have one or more whole-time directors with or without managing director. A whole-time director cannot be paid more than 5% of the net profit of the company by way of managerial remuneration. In case a company has more than one whole-time director, the total remuneration payable to the whole-time directors (including managing directors, if any) should not exceed 10% of the net profits of the company.

**(iv)Director:** A director is one who directs, guides or manages the affairs of a company. According to the Companies Act, the term director includes any person occupying the position of director by whatever name called. Minimum number of directors in case of a private company is two while it is three in case of a public company.

The managerial remuneration payable to all the part-time directors is not to exceed 3% of the net profits of the company if the company does not have a manager or a managing or a whole-time director. In case a company has a manager or a managing director or a whole time director, the total remuneration payable to directors (part-time) shall not exceed 1% of the net profits of the company. Of course, this does not include the sitting fee payable to these directors.

The maximum managerial remuneration payable to different categories of managerial personnel, as stated above, can be presented in the form of the following chart:

| ***Category of managerial personnel*** | ***Max. % of annual net profit*** |
|---|---|
| (i) Overall limit for total remuneration to all managerial personnel | 11% |
| (ii) Managing Director (for one) | 5% |
| (iii) Managing Directors (more than one-for all together) | 10% |
| (iv) Whole-time Director (for one) | 5% |
| (v) Whole-time Directors (more than one-for all together) | 10% |
| (vi) Manager (there cannot be more than one Manager) | 5% |
| (vii) Managing Director or Managing Directors or Manager with one or more Whole-time Director/Directors (for all together) | 10% |
| (viii) Directors (for all) when there is no Manager or Managing Director or Whole-time Director | 3% |
| (ix) Directors (for all) when there is a Manager or a Managing Director or a Whole-time Director | 1% |

**Administrative ceiling regarding managerial remuneration:** Section 637AA of the Companies Act empowers the Central Government to adopt an administrative ceiling regarding managerial remuneration payable to a particular person within the overall ceiling fixed by the Companies Act. Such ceiling is to be fixed by the Central Government taking into consideration the financial position of the company, the professional qualifications and experience of the individual concerned, the remuneration drawn by him from any other company, public policy relating to removal of disparities in incomes, etc.

The Central Government has reviewed from time to time the entire question of managerial remuneration in the context of socio-economic objective of State policy and the need for establishing a correlation in managerial remuneration at comparable levels of responsibility in Government, public sector undertakings and public limited companies. As a result of these reviews, the Central Government has been fixing the maximum limit of managerial remuneration payable to Managing, Whole-time or Part-time Director or a Manager of public limited company or its subsidiaries. The first limits were fixed on 11.11.1969, these were later on revised on 9.11.1978 and further on 1.4.1983.

The Companies (Amendment) Act, 1988, introduced a new Schedule XIII fixing the ceilings of remuneration payable to a managing or whole-time director or a manager of a public company or its subsidiary. The ceilings were revised w.e.f. 14th July, 1993 and later w.e.f. 1.2.1994. With a view to give still greater freedom to companies regarding managerial appointment and remuneration, the Central Government once again amended the Schedule XIII w.e.f. 2.3.2000 and recently w.e.f. 16.1.2002. The revised ceilings are applicable to a person appointed as a Managing Director, Whole-time Director or a Manager of a Company as defined in the Companies Act.

The provisions of the schedule are being summariased below:

1. **Remuneration payable by companies having profits**: Subject to the provisions of Sections 198 and 309,a company having profits in a financial year may pay any remuneration by way of salary, dearness allowance, perquisites, commission and other allowances which shall not exceed 5% of its net profits for one such managerial person and if there is more than one such managerial person, 10% for all of them together.
2. **Remuneration payable by companies having no profits or inadequate profits:** Notwithstanding anything contained in this part, where in any financial year, during the currency of tenure of the managerial person, by way of salary, dearness allowance, perquisites and any other allowances:
   a) *not exceeding the ceiling limit of Rs. 24,00,000 per annum or Rs. 2,00,000 per month calculated on the following scale:*

| ***Where the effective capital of Company is*** | ***Monthly remuneration payable shall not exceed (Rs.)*** |
|---|---|
| (i) less than rupees 1 crore | 75,000 |
| (ii) rupees 1 crore or more but less than rupees 5 crores | 1,00,000 |
| (iii) rupees 5 crores or more but less than rupees 25 crores | 1,25,000 |
| (iv) rupees 25 crores or more but less than rupees 50 crores | 1,50,000 |
| (v) rupees 50 crores or more but less than rupees 100 crores | 1,75,000 |
| (vi) rupees 100 crores or more | 2,00,000 |

Provided that the ceiling limits specified under this subparagraph shall apply, if—

(i) payment of remuneration is approved by a resolution passed by the Remuneration Committee;

(ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures orinterest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person.

*(b) not exceeding the ceiling limit of Rs. 48,00,000 per annum or Rs. 4,00,000 per month calculated on the following scale:*

| ***Where the effective capital of Company is*** | ***Monthly remuneration payable shall not exceed (Rs.)*** |
|---|---|
| (i) less than rupees 1 crore | 1,50,000 |
| (ii) rupees 1 crore or more but less than rupees 5 crores | 2,00,000 |
| (iii) rupees 5 crores or more but less than rupees 25 crores | 2,50,000 |
| (iv) rupees 25 crores or more but less than rupees 50 crores | 3,00,000 |
| (v) rupees 50 crores or more but less than rupees 100 crores | 3,50,000 |
| (vi) rupees 100 crores or more | 4,00,000 |

i) Provided that the ceiling limits specified under this subparagraph shall apply, if: payment of remuneration is approved by a resolution passed by the Remuneration Committee;

ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person;

iii) a special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years;
iv) a statement with the prescribed information as required under the Companies Act along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders.

(c) Exceeding the ceiling limit of Rs. 48,00,000 per annum or Rs. 4,00,000 per month calculated on the following scale:

| ***Where the effective capital of Company is*** | ***Monthly remuneration payable shall not exceed (Rs.)*** |
|---|---|
| (i) less than rupees 1 crore | 1,50,000 |
| (ii) rupees 1 crore or more but less than rupees 5 crores | 2,00,000 |
| (iii) rupees 5 crores or more but less than rupees 25 crores | 2,50,000 |
| (iv) rupees 25 crores or more but less than rupees 50 crores | 3,00,000 |
| (v) rupees 50 crores or more but less than rupees 100 crores | 3,50,000 |
| (vi) rupees 100 crores or more | 4,00,000 |

Provided that the ceiling limits specified under this subparagraph shall apply, if:

i) payment of remuneration is approved by a resolution passed by the Remuneration Committee;
ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person;
iii) a special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years;
iv) a statement along with the prescribed information as required under the Companies Act, along a notice calling the general meeting referred to in clause (iii) is given to the shareholders.

**Computation of net profits for managerial remuneration:** Net profit for the calculation of managerial remuneration is to be computed in accordance with the provision of Sections 349 and 350.Section 349 provides for the addition of the following items to the normal profits: Bounties and subsidies received from any Government, or any public authority constituted or authorized in this behalf by any Government, unless they are exempted, or as the Central Government otherwise directs. It prohibits the giving of credit for the following items:

(i) profits by way of premium on shares or debentures of the company, which are issued or sold by the company;
(ii) profits on sale of forfeited shares;
(iii) profits of a capital nature including profits from the sale of undertaking or any of the undertakings of the company or any part thereof;
(iv) Profits from sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertaking of the company, unless the business of the company consists, whether wholly or partly, of buying or selling any such property or assets.

Provided that where the amount for which any fixed asset is sold exceeds the written down value thereof, referred to in Section 350, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written down value. Further Section 349 provides for the deduction of the following items from the profits of the company:

(i) all working charges;
(ii) directors' remuneration;
(iii) bonus or commission paid or payable to any member of the company's staff or to any engineer, technician or person employed or engaged by the company, whether on a whole time or on a part-time basis;
(iv) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits. The super profits tax under Section 4 of the Super Profits Tax Act, 1963and the surtax under Section 4 of the Companies (Profits)Surtax Act, 1964, were notified to be taxes in the nature of tax on excess or abnormal profits within the meaning of this clause;
(v) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;
(vi) interest on debentures issued by the company;
(vii) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;
(viii) interest on unsecured loans and advances;
(ix) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;
(x) Outgoings inclusive of contributions made under Section293 (1)(e). This includes contributions made to charitable and other funds;
(xi) depreciation to the extent provided in Section 350;
(xii) the excess of expenditures over income which has arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this act, in so far as such excess has not been deducted in

any subsequent year preceding the year in respect of which the net profits have to be ascertained;

(xiii) any compensation or damages to be paid by virtue of any legal liability, including a liability arising from breach of contract;

(xiv) any sum paid by way of insurance against the risk of meeting any liability, such as is referred to in clause (xiii);

(xv) Debts considered bad and written off or adjusted during the accounting year.

Section 349, however, does not permit the deduction of the following items from the profits of the company:

a) income-tax and super-tax payable by the company under the Indian Income-tax Act, 1922 or any other tax on the income not covered under (iv) and (v) above;
b) any compensation, damages or payment made voluntarily, that is to say, otherwise than by virtue of a liability such as is referred to in clause (xiii);
c) loss of a capital nature including loss on sale of undertaking or any of the undertakings of the company or any part thereof not including any excess of written down value over its sale proceeds or scrap value of any asset sold, discarded, demolished or destroyed. Such excess has to be written off to profit and loss account.

**Provisions of Section350** The amount of depreciation to be deducted in pursuance of clause (iv) of Section 349 above shall be the amount calculated with reference to the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of this act or immediately thereafter and at the end of each subsequent financial year, at the rate specified in Schedule XIV.

Provided that if any asset is sold, discarded, demolished or destroyed for any reason before depreciation of such assets has been provided for in full, the excess, if any, of the written-down value of such asset over its sale proceeds or, as the case may be, its scrap value, shall be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.

According to Schedule XIV in case an asset is purchased during the year, the depreciation thereon has to be calculated pro rata basis, from the date of purchase at the rate specified in the Companies Act for the purposes of Section 350. However, for purposes of Income-tax, the company has to charge depreciation as per the rates given in the Income Tax Act.

***Note:*** *In calculating net profit for overall maximum managerial remuneration limit and remuneration payable to directors (including managing and whole-time directors)directors' remuneration is not deducted from gross profits. However, fees payable to directors for* *attending Board's meeting are to be deducted. But for calculating remuneration payable to a manager, directors' remuneration shall also be deducted from gross profits as given in Section 349.*

**Calculation of commission etc. in certain cases (Section 199):**

In case, an officer or employee of a company (other than the managerial personnel referred above) is entitled to get remuneration by way of percentage on the net profits of the company, such profits shall also be calculated in the manner laid down in Sections 349 and 350 discussed in this chapter.

**Prohibition of tax-free payment (Section 200):** A company is not allowed to make any tax-tree payment of remuneration to its officers or employees. The intention underlying this provision is to prevent creation of a class of persons who are immune from any future increase in taxation.

***Illustration***

A manager is entitled to a commission at a certain percentage of net profit (such commission to be charged in arriving at the net profit).

The commission is to be allowed on the following rates:

| | |
|---|---|
| First Rs. 10,000 of the net profit | Nil |
| Next Rs.20,000 " " " " | @ 10% |
| Next Rs.30,000 " " " " | @ 15% |
| Next Rs.60,000 " " " " | @ 20% |
| Balance " " " " | @ 30% |

The net profit before charging the manager's commission is Rs.1,45,000. Compute the amount of manager's commission.

***Solution:***

**Calculation of Commission Payable to Manager**

| ***Profit*** | ***Commission (Rs.)*** | ***Total Net Profit considered (Rs.)*** |
|---|---|---|
| First Rs. 10,000 net profit | Nil | 10,000 |
| Next Rs. 20,000 @ 10% | 2,000 | 22,000 |

| | | |
|---|---|---|
| Next Rs.30,000 @ 15% | 4,500 | 34,500 |
| Next Rs. 60,000 @ 20% | 12,000 | 72,000 |
| | ***18,500 (i)*** | ***1,38,500*** |
| Balance Net Profit: | | |
| Total Profit | | 1,45,000 |
| **Less:** Profit on which commission provided (as above) | | 1,38,500 |
| | | ***6,500*** |
| Commission = 6500 × 30/130 | | **1,500 (ii)** |
| **Total Commission payable (i) + (ii)** | | **20,000** |

**Illustration**

The manager of M/s Slow and Steady Ltd. is entitled to get a salary of Rs. 2,500 per month plus 1 per cent commission on the net profits of the company after such salary and commission. The following is the Profit and Loss account of the company for the year ended 30 June, 2008.

| ***Particulars*** | ***(Rs.)*** | ***Particulars*** | ***(Rs.)*** |
|---|---|---|---|

| | | | |
|---|---|---|---|
| To Salaries, wages and bonus | 1,92,500 | By Gross profit b/d | 9,00,000 |
| To General expenses | 74,000 | By Subsidy from Govt. | 60,000 |
| To Depreciation | 82,000 | By Profit on sale of assets | |
| To Expenditure on scientific | | (Cost price ` 2,50,000and | |
| research (cost of an apparatus) | 14,000 | written-down value ` 1,80,000) | 1,00,000 |
| To Manager's salary | 30,000 | | |
| To Commission to Manager | | | |
| (on account) | 6,000 | | |
| To Prov. for bad and doubtful debts | 17,500 | | |
| To Provision for income-tax | 2,40,000 | | |
| To Proposed dividend | 1,00,000 | | |
| To Balance c/d | 3,04,000 | | |

Depreciation as per income-tax rules amounts to Rs.81,000.Calculate the remuneration payable to the Manager.

**Solution**

**Calculation of Remuneration Payable to Manager**

| ***Particulars*** | ***(Rs.)*** | ***(Rs.)*** |
|---|---|---|
| Profit as per Profit & Loss A/c | | 3,04,000 |
| ***Add:*** Inadmissible deductions: | | |
| Depreciation | 82,000 | |
| Expenditure on Scientific Research (Capital expenditure) | 14,000 | |
| Salary & Commission paid to Manager | 36,000 | |
| Reserve for bad and doubtful debts | 17,500 | |
| Provision for Income-tax | 2,40,000 | |
| Proposed dividend | 1,00,000 | 4,89,500 |

| | | |
|---|---|---|
| | | 7,93,500 |
| Less: Depreciation as per Income-tax Rules | 81,000 | |
| Capital profit on sale of assets, (1,80,000 + 1,00,000 – 2,50,000) | 30,000 | 1,11,000 |
| Net Profit for calculation of managerial remuneration | | 6,82,500 |
| Net profit as calculated above | | 6,82,500 |
| Less: Salary to Manager | | 30,000 |
| | | 6,52,500 |

The **amount of Commission** would therefore be = 6,52,500 × 1/101 **= Rs.6,460**.

However, the manager has already been paid commission to the extent of Rs.6,000.

Balance to be payable therefore comes to: Rs.460.

As per Section 387 of the Companies Act, 1956, the manager is entitled to a maximum remuneration of = 6,82,000 ` 5/105 = Rs. 32,500.

Since maximum remuneration payable to the manager is Rs.32, 500under Section 387, it has been assumed that the approval of the Central Government has been obtained for the excess payment.

## 2.6 DIVISIBLE PROFITS & DIVIDENDS

The profits of the company which are available for the distribution of dividend to the shareholders that is known as divisible profit. In normal course profits are distributed as dividends only when they are left after the meeting of all the expenses like depreciation on fixed assets, taxation, transfers a reasonable amount of reserve, past losses etc.

There are some legal provisions Under **Section 205** of the Companies Act on the ascertainment of divisible profits. These provisions are summarized as follows:-

- Dividend should be declared only out of current year's profit after providing for depreciation and other losses.

- Dividend out of the profits of any previous financial year can be declared which falls after the commencement of the company.

- Dividend can be declared out of the aggregate of profits.

- Dividend can be declared after the subsidies provided by the central government or state government.

**OTHER PROVISIONS RELATING TO DIVISIBLE PROFITS –**

- Dividend must be paid in cash.

- Dividend is payable out of profits only.

- Capital profits – The profit which is earned not by the way of trading transactions of the business but by other means which are not usually available for distribution of dividend.

The following types of capital profits are not at all available for dividend: -

- Share premium account.

- Profits remaining after the reissue of the forfeited share.

- Capital redemption reserve account.

- Profits prior to incorporation.

- Profits on the redemptions of the debentures.

- Premium on issue of debentures.

- Profits acquisition of building.

- Profits on sale of fixed asset.

Capital profit can be used for:

- Paying fully paid bonus years.

- Writing of fictitious assets (discount on issue of shares, preliminary expenses, goodwill and debentures).

- **Dividend profits –** Dividend is the write to claim of the shareholder of the company. This write is available only when dividend is declared at the general meeting of the company. The dividend once declared becomes a debts and a shareholder is entitled to sue at loco for recovery of the same. From the accounting point of view of the following points are to be noted:

- Dividend is calculated at the recommended rate on the paid up capital.

- No dividend is paid on calls on advance.

- No dividend is paid proportionately from the date of issue of shares.

TAX – These are debts at source 23 % on all dividend declared by the company.

- It is a dividend paid by the directors at any time between two annual general meeting. (Interim dividend)

- Final dividend – Final dividend is that type of dividend which is declared after the annual general meeting is held.

**POWER OF SHARE HOLDER –**

- Shareholder considers the annual accounts and balance sheet.

- They have the capacity to examine the director's reports.

- Power to pass resolutions at the annual general meeting.

- They can declared dividend at the annual general meeting.

- There are powers to elect the directors and appointment of casual directors.

- There is power to appoint auditors.

- There is power to purchase shares which is not exceeding 5 % of the paid up capital of the company.

**WHEN THE PERSONS CAN NOT BE APPOINTING AS DIRECTORS AND WHO ARE THEY?**

The following persons cannot be appointing as directors:

- A person found by court to be of unsound mind.

- Undischarge insolvent.

- A person who has applied to be adjudged and insolvent and whose application is pending.

- A person who has been convicted of an offence.

- A person has failed to pay calls for six months.

- A person who has been disqualified by the court under section 203.

**UNDER WHICH CIRCUMSTANCES A DIRECTOR AUTOMATICALLY CEASES TO BE A DIRECTOR?**

- He fails to acquit qualification shares within two months.
- He is found by the court to be of unsound mind.
- He applies to the court to be adjudged an involvement.
- He is adjudged an insolvent.
- He is convicted of an offence and is sentenced to imprisonment for not less than 6 months.
- If he fails to pay calls within 6 months.
- He or any firm of which he is a partner or a private company of which he is director receives a loan.
- He fails to disclose his interest in any contract with the company.
- He is debarred by the court from being a director.
- He occupies an office of profit unless excused.

**POWERS OF THE BOARD OF DIRECTORS –**

The following powers must be exercised only by the board of directors at its meeting.

- Power to make calls.
- Power to issue debentures.
- Power to borrow moneys otherwise than on debentures.
- Power to invest company's funds.
- Power to make loan.

ISSUE OF SHARES – Public company may issue share on the basis of prospectus. From the point of accounting entries the following points should be noted:

a) The prospectus mentions the number of shares issues by the company, the public may be apply for more than the total number of shares issued. The excess shares may be rejected or may be adjusted proportionately at the time of allotment.

b) Prospectus also mentioned the minimum subscription – Minimum subscription may be defined as that a number of shares which will enable the company get enough cash for proper working. This minimum subscription has to be estimated by the directors under the companies act according to the requirements of cash and determine the minimum number of shares which will be subscribed by the public in order to enable the company to function.

While determining the minimum subscription the directors will have to be estimated for each of the following separately.

- Purchase price of any property purchased.
- Any preliminary expenses payable by the company.
- The repayment of any money borrowed by the company for above two purposes.
- Requirements of working capital.
- Any other expenditure.

c. In case of the prospectus shows that the application is being made a stock exchange or more than one stock exchange for the permission.

d. It is up to the directors to ask for the whole of the amount on shares along with the application or the share money may be paid on installments like application money, allotment, first call and final call but the application money must not be less than 5 % of the nominal value of shares.

e. Money is received along with the application must be deposited in a schedule bank and must be kept to be deposited until the company obtains the certificate of commencement of business.

**Shareholders Equity and Liability**

**SHAREHOLDERS' EQUITIES:**

In case of corporate organizations equity represents the interest of shareholders in the company. So t consists of share capital, retained earnings and the reserves.

**Share Capital:**

The capital of a company is divided into a number of units called shares of the company. So shares are the smallest denomination of the capital of a company. Since the capital of a company consists of shares it is known as share capital. Basically there are two types of share capital based on the types of shares which can be issued by a company.

**i) Preference Share capital:** This capital consists of preference shares. Preference shares are the shares which have a preferential right to a fixed dividend and to the repayment of capital at the time of liquidation. Like long term loans and debentures the preference shares are redeemable after a certain period of time. According to the companies Amendment Act 1988 no preference share can be irredeemable. If article permits the preference shareholders may have some additional based on the type of preference share.

Cumulative Right – Cumulative preference shares are those where the shareholders are entitled to receive their arrears of dividend when the company has sufficient profit and directors decide to distribute them in way of dividend. No such right is availed for non-cumulative preference shares. Unless he article otherwise provide all the preference shares would be cumulative.

Participating Right – Participating preference shares have the right to participate in the surplus profits remaining after the distribution of dividend on equity shares. The preference shares which don't have such rights are known as non-participating shares.

Conversion Right- As per Articles of the company the preference shareholders have the right to convert their preference shares into equity shares after a certain period of time.

The preference shareholders also get the right to receive premium on redemption of their shares and they can participate in the surplus remaining after the equity shares are redeemed in case of winding up of a company. The preference shareholders don't have any voting rights except when dividend is outstanding for more than two years in case of Cumulative Preference shares and for more than three years in case of non-cumulative preference shares. But Preference shareholders have the right to vote on any resolution for winding up of the company or for the reduction or repayment of share capital.

**ii) Equity share Capital:** Equity share capital consists of ordinary shares which have no fixed right. They are normally risk bearing shares. Equity share holders get dividend and capital after the claims of preference shareholders are met. These shareholders also are not entitled to a fixed rate of dividend as in case of preference shares. In simple words these shareholders have a residual claim in the company. Equity shareholders are the ultimate decision makers in a company as they have right to vote on any resolution placed before the company. The voting rights to the shareholders are granted on the basis of their shareholdings.

There are three ways of raising share capital

(i) Public Offer

(ii) Private Placement

(iii) Right Issue

Issue of share Capital:

When a public company desires to raise capital from public, the invitation should be made through prospectus.

The company cannot allot more than the number of shares offered through prospectus.

No allotment of shares can be made if the minimum subscription mentioned in the prospectus is not received from the public and the company has to refund the money received from public in form of application money. As per SEBI guidelines minimum subscription has been fixed at 90% of the issued amount. Such subscription should be received within 60 days the close of the issue.

The amount payable on application is fixed by the directors but the amount can't be less than 25% of the issue price as per SEBI guidelines.

The amount received with share application has to be kept in a scheduled bank till the minimum subscription is raised and the certificate of commencement is obtained in case of a new company.

If the shares are listed on a stock exchange approval of stock exchange is to be sought before the shares are allotted.

If the number of shares applied is more than number of shares offered then board of directors have to decide certain criterion for allotment but as per SEBI guidelines 35% of shares offered should be allotted to small investors.

The director can call the remaining amount only after the shares have been allotted and the names of the members are entered in the register of members.

**Disclosure of share Capital in the financial statements:**

**i) Authorized Capital –** It is the maximum amount of share capital that a company can issue as specified in the memorandum of association. The company is registered with this amount of capital. The authorized capital specified can also be changed with the approval of shareholders.

**ii) Issued Capital** – It is the part of the authorized capital which has been offered or issued by a company to the public. This includes shares issued for cash and for consideration other than cash like shares allotted to vendors and promoters. It sets the limit of the capital available for subscription.

**iii) Subscribed Capital** – It refers to that part of issued capital which has actually been subscribed by the public and subsequently allotted to them.

**iv) Called up Capital –** It is that portion of the subscribed capital which the shareholders are called upon to pay on the shares allotted to them. A company does not want the entire amount of shares subscribed at once, hence calls up in parts when it needs funds. The part of the entire amount which is not called by company is known uncalled capital.

**v) Paid up Capital –** It is the part of called up capital which has been received by a company from the shareholders. This is the actual capital of the company which is included in the total of balance sheet. Paid up capital becomes equal with called up capital if none of the shareholders is at default.

Normally as a practice the paid up share capital appears in the balance sheet and the details of capital is given in a schedule.

**Illustration:**

ABC Ltd incorporated in the year 2012 with an authorized capital of rupees one crore divided into 10 lakh shares of Rs 10 each. In December 2012 the company issued 5 lakh shares for which Rs 5 is payable in application, Rs 3 on allotment and Rs 2 on call. Four out of five lakh shares issued is subscribed by public. In February 2013 the company made the allotment and received allotment money. In December 2012 the company made the call of Rs 2 per share and received the call money for 3.8 lakh shares. Show the presentation of capital in the balance sheet of the company on 31st March 2013.

**Solution:**

**M/s ABC Limited**

**Balance Sheet as on 31st March 2013**

Sources of Fund      Amount (Rs)

Authorised Capital

10,00,000@10 each          100,00,000

Issued capital

5,00,000@ 10 each 50,00,000

Subscribed Capital

4,00,000@ 10 each 40,00,000

Called Up Capital

4,00,000@ 10 each 40,00,000

Paid up capital

3,80,000@10 each  38,00,000

**Retained Earnings:** It represent the cumulative net income after dividend of the firm since its beginning. In other words it is the profit ploughed back in the business or the internal equity of a firm.

**Reserves:** A reserve may be defined as a portion of profit transferred to a separate account without affecting the normal course of financial activities of a business during the year. Reserves are set aside for strengthening the overall financial position of the business and to meet the future unforeseen contingencies. It also can be utilized for the future development, extension and improvement (restructuring) of the business.

**Classification of reserve:**

Reserves can be broadly classified into two types - Revenue reserve and Capital reserve.

**i) Revenue reserve -** Reserves created out of revenue profit of a business is called revenue reserve. Generally the term 'reserve and surplus' represent the profit retained by the entity and are known as revenue reserve. These reserves can be distributed among the shareholders as dividends. Revenue reserves may be general or specific in nature. General reserves are created to add strength to the financial position of a company.

**ii) Capital Reserve –** Capital reserves are created out of capital profits exclusive of trading profits. These reserves are created out of

a) Pre-incorporation profits

b) Profit realized from sale of fixed assets

c) Profit realized from reissue of forfeited of shares

d) Profits from acquisition of business

e) Premiums on shares and debentures

These reserves cannot be distributed as dividend to shareholders but may be used for

i) Issue of bonus shares

ii) Writing up of fictitious assets like good will

iii) Payment of premium on redemption of debentures and preference shares

Similarly the reserves may be classified as Disclosed and Undisclosed reserve. Disclosed reserve may be revenue reserve or capital reserve. Undisclosed reserves are the reserves which are kept secret to the public as their existence cannot be figured out from the balance sheet. These reserves are created by disclosing the assets at lower figures than actual or by disclosing the liabilities at enhanced figures than actual. Secret reserves are maintained by financial institutions and companies involved in power and water supply. Sometimes the secret reserves are also statutory. Generally commercial business houses with few exceptions are not allowed for secret reserves because of the risk of misuse.

**LIABILITIES:**

According to FASB, "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or services."

According to ICAI, liability is "the financial obligation of an enterprise other than owners' funds".

**Characteristics of Liability:**

- **Obligations on the part of enterprise** – Liabilities are obligations on the part of an enterprise arising out of contracts and other agreements or from governmental actions that are enforceable at law.

- **Occurrence of past transaction or event** – The Obligation must arise out of some past transaction or event. For example acquisition of goods and services obligates an enterprise to pay or sacrifice some assets in future.

- **Future Sacrifice of Assets** – The essence of a liability is a duty or requirement to sacrifice assets in the future. A liability requires an enterprise to transfer asset, provide services or otherwise expand assets to satisfy a responsibility it has incurred or that has been imposed on it.

**Classification of Liabilities:** Liabilities are classified either on the basis of time or security as given below.

**Current Liabilities:** Obligations that are expected to be paid within the operating cycle of the business or within one accounting period (one year of balance sheet date). The current obligations are normally met from current assets. Current liabilities may be definite or estimated liabilities. If the current obligation can be ascertained precisely like trade creditors and bills payable then they are classified as definite current liabilities. The obligations which fall in current year but the amount can't be determined accurately at present are known as estimated liabilities. Examples of estimated liabilities are income tax, product warranties. Provisions on current assets are also treated as estimated liabilities.

**Long Term Liabilities**: Liabilities that are neither due in the operating cycle nor in the accounting period are classified as long term liabilities. Few examples are debentures, Long term Bank Loans etc.

**Secured Liabilities:** Liabilities that are accompanied by security or hypothecation of borrower's assets are known as secured liabilities. In case of default by the borrower, the lender can dispose of the asset to realize his amount. Secured liabilities may be fully secured or partly secured. If the entire amount of liability is covered by security it is known as fully secured and if a portion of liability is covered then that is classified as partly secured liabilities.

**Unsecured Liabilities:** The liabilities which are not backed by any security are known as unsecured liabilities. These liabilities are normally availed on the basis of the credit worthiness of the borrower. These liabilities though not backed by securities are always backed by legal claims.

**Contingent Liabilities:** Another type of liability which doesn't fall in the preview of above classification is known as contingent liability. According to accounting standard 29, a contingent Liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of some future uncertain events not wholly within the control of the business. The standard provides that "an enterprise should not recognize a contingent liability". But the contingent liability should be disclosed in the corporate report if its chance of occurrence is not remote.

**Provisions:**

A provision is a liability. According to accounting standard 29, "a provision is a liability which can be measured only by using a substantial degree of estimation". So provision is

I) A liability

II) Expenditure will be incurred to meet the liability

III) Quantum of such expenditure is not certain

The difference between liability and provision is that in case of former the amount is known while in case of latter the amount is not certain. A provision is different from accruals as accruals are liabilities to pay for goods or services that have been received from suppliers and employees. Quite often it is necessary to estimate the amount and timing of accruals. Yet the uncertainty element associated with accruals is far less than in case of provisions.

The provision should be recognized in the books of accounts if the following three conditions are satisfied:

i) An enterprise has a present obligation because of some past event

ii) It will lead to outflow of resources

iii) A reliable estimate can be made of the amount of obligation.

## 2.7 RECENT TRENDS IN CORPORATE REPORTING

### 1. ANNUAL REPORT:-

An annual report is a document produced annually by companies designed to portray a true & fair view of the company's annual performance, with audited financial statements prepared in accordance with company law & other regulatory requirements & also containing other non-financial information.

The companies Act 1956 require companies to publish their annual report & accounts.

It should include

- A Balance Sheet
- A Profit & loss Account
- A Cash flow Statement
- A Director's Report

### 2. STAKEHOLDERS IN THE ANNUAL REPORT –

- Shareholders (the owners of the business)

- Potential Shareholders
- Managers & Employees
- Creditors & Potential Creditors
- Suppliers – Especially if the supply goods on credit
- Employees & their trade Unions
- The Government for tax purposes

**3. FUNCTIONS OF THE ANNUAL REPORT –**

- The stewardship & Accounting Function
- Reporting to Shareholders
- The decision making Function
- To provide information about performance & changes in the financial position of an enterprise that is useful to a wide range of users in making economic decisions
- Providing users, especially shareholders with financial information so that they can make decisions such as buying or selling shares
- The Public relations function: The annual report is an opportunity to publicize the corporate image

**4. A TRUE & FAIR VIEW:-**

- Directors are responsible for the preparation of the accounts which must give true & fair view.
- A true & fair view is one where accounts reflect what has happened & do not mislead the readers.
- The accounts must be prepared in accordance with relevant AS.

**5. INFORMATION TO BE INCLUDED:-**

- The rules governing the content of the annual report are derived from –

Statute law – the companies Act

Accounting Standards

Stock Exchange rules

Codes of best practice in Corporate Governance

**6. COMPANIES ACT 1956:-**

- Directors have stewardship of limited companies.
- Directors are required to publish accounts which show a true & fair view of the company's financial position
- Accounts must be sent to-

    -- All Shareholders'

    -- All Debenture holders'

    -- The Registrar of companies

    -- This must be done within 10 months of the Year –end for a private company & within 7 months of the year end in the case of a public company.

**7. CONTENTS: THE AUDITED INFORMATION:-**

**1. MAIN STATEMENTS:**

- Profit & loss Account
- Balance Sheet
- Cash Flow Statement

**2. SUBSIDIARY STATEMENTS:**

- Statement of total recognized gains & losses
- Note on historical cost profit & losses
- Reconciliation of movement in shareholders' funds

**3. EXPLANATORY MATERIAL:**

- Accounting policies
- Notes to the accounts
- Principal subsidiaries

**8. CONTENTS: NON –AUDITED INFORMATION:-**

**1. NARRATIVE ITEMS**

- Chairman's Statement
- Director's Report

- Operating & Financial review
- Review of Operation's
- Statement of Corporate Governance
- Auditor's Report
- Statement's of Director's Responsibilities for the Financial Statements
- Shareholder's information

**2. NON-NARRATIVE ITEMS**

- Highlights
- Historical Summary
- Shareholder Analysis

**9. BALANCE SHEET:-**

1. A Balance Sheet is a statement of the resources owned & controlled by a business at a single point in time.
2. It gives a snapshot of assets & liabilities & capital at a point of time
3. It provides information about the companies' funds & how they are used in the business.

**10. PROFIT & LOSS ACCOUNT:-**

- The profit & loss Account is a statement which shows total business revenues less expenses.
- The P & L account quantifies & explains the gains or losses of the company over the period of time bounded by two balance sheets.
- It provides a summary of the year's trading activities –

  -- Revenue from sales (Turnover)

  -- Business costs

  -- Profit or loss

  -- How the profit was used

**11. CASH FLOW STATEMENT:-**

- This is a statement which shows the flow of cash into & out of the business.
- It is not the same as a profit & loss account.
- The cash flow statement only records movements of cash & for example; Does not include credit sales or purchases until such time as cash actually flows.
- This statement became mandatory because of some high profile business failures of the 1980's / 1990's – these were profitable but were short of cash to pay their debts.
- The cash flow statement should not be confused with a cash flow forecast. The former is historical whereas the latter is a forecast about the future.

**12. STATEMENT OF TOTAL RECOGNISED GAINS & LOSSES:-**

- STRGL is a financial statement which attempts to highlight all shareholders gains & losses and not just those from trading.
- It is a summary of all the profits & losses made during the year.
- It is necessary because not all gains & losses are shown on the P & L account.
- Example: Revaluation of fixed assets is not classed as revenue from trading operations & so it will not show up on the P & L account. It does show up as an addition to revaluation reserves on the Balance Sheet.

**13. NOTES TO THE ACCOUNTS:-**

- Provides a more detailed analysis of some of the entries in the accounts including
- Disclosure of accounting policies used (depreciation) & any changes to these policies
- An explanation for any deviation from accounting standards
- Sources of turnover from different geographical areas
- Details of fixed assets, investments, sharecapital, debentures & reserves
- Director's emoluments (how much the Director's earned)
- Earnings per share

**14. ACCOUNTING POLICIES:-**

1. Companies must describe the accounting policies, they use in preparing financial statements.

2. Companies have a choice of accounting policies in many areas such as foreign currencies, goodwill, pensions, sales & stocks.

3. As different accounting policies will result in different figures, it is necessary to state the policy that was used so that readers of the accounts can make an informed judgments about performance

4. It is also important to state the effect of changes in accounting policies-restating prior year numbers where this is materially significant.

**15. CHAIRMAN'S STATEMENT:-**

1. An overview of the trading year

2. A personalize overview of the company's performance over the past year

3. Usually covers strategy, financial performance & future prospects

**16. DIRECTOR'S REPORT:-**

The principal objective is to supplement the financial information with other information consider necessary for a full appreciation of the companies activities. It includes:-

- A description of the principal activities of the company
- A fair review of the current & future prospects of the business
- Information on the sale, purchase or valuation of assets
- Recommended dividends
- Employee's Statistics
- Names of Director's &their interests
- Details of political or charitable donations

**17. OPERATING & FINANCIAL REVIEW:**

- This is a statement in the annual report which provides a formalized, structured explanation of financial performance
- The operating review covers items such as operating results, profit & dividend

- The financial review discusses items such as capital structure & treasury policy

**18. OTHER FEATURES:-**

1. Highlights:-

- An "At a Glance" summary of selected figures & ratios

2. Historical Summary

- Five years of selected data from the Balance Sheet and Profit & loss account
- Tables and graphs to illustrate trend and comparison of turnover,Profit, dividends and EPS

2. Shareholder's Analysis

- Detailed analysis of
- The shareholder's for example by size of shareholding

**19. AUDITOR'S REPORT:-**

- Auditors are independent accountants who are registered to carry out this work
- They also have to certify that the accounts are drawn up in accordance with the requirements of the companies act
- Auditors must make a brief a report to confirm that the accounts give a true & fair view of firm's financial position

**Financial Statement of Companies;-**

**Introduction:** In case of companies the maintenance of proper books of accounts and preparation of final companies are compulsory as per the requirements of Section 209 and Section 210 0f the Companies Act 1956.

**Preparation of Final Accounts:** The preparation of final accounts final accounts of a company is governed by Section 210 of the Companies Act. The important provisions are:

- At every AGM of the company the BOD should lay before the company:

1. the Balance Sheet at the end of the accounting period, and
2. a profit and loss account for the period.

 The Balance Sheet should be in the form as per Part I of Schedule VI and that of P&L A/C should comply with the requirements of Part II of Schedule VI of the Companies Act.

**Profit And Loss Account:**

**1. Heading:**

 Not necessary to split the Profit and loss account into three sections viz; trading, profit and loss and profit and loss appropriation account.

 To be prepared under two headings:

• P&L a/c giving details regarding the Gross Profit and Net Profit earned by the business during a particular period, and

• P&L Appropriation A/C giving details regarding the balance of profit and loss brought from the last year, the Net Profit or Loss earned (or made) during the year and appropriations made.

Note: Items appearing in P&L a/c are termed as “above the line” and those appearing in P&L A/C are termed as “below the line”

**2. Abnormal Items:** should be disclosed separately and should not be mixed up with any other item.

**3. Adjustments Relating to Previous Years:**

• be made in P&L Appropriation A/C.

• e.g.- recovery of heavy amount previously written off as bad, extra provision to be created out of the income of the previous years.

**4. Tax Adjustment:**

• Tax deducted at source:

 A company is required to deduct tax from any amount paid by it by way of salaries, dividend, interest to its employees etc.

 The P&L A/C is debited with the gross amount of salaries or interest. The tax deducted at source is shown in the liability side till it is finally paid by the company to the Govt.

 Journal Entry in respect of the above payment:

Interest on Debentures/ Salaries A/C…………Dr

To Bank A/C

To Tax Deducted at Source A/C.

- Tax is also deducted in respect of dividends and interest which the company gets on its investments.

- The P&L A/C is credited with such amount.

- Journal Entry in respect of the above receipt is:

Bank A/C……………………………..Dr

Tax Deducted At Source A/C……………Dr

To Interest/Dividends A/C.

**5. Advance Payment of Tax:** As per Section 208 of the Income Tax Act, 1961, every individual is required to pay advance tax when the advance tax payable is Rs.1500 or more in the relevant previous year. It appears as an Asset in the Company's Balance sheet. The amount so paid is adjusted against the income tax payable by the company whenever company's assessment for that year is finalized.

**6. Provision for Taxation:**

- Shown as above the line item.

- Appears as a liability till assessment in respect of that year is finalized.

**7. Dividends:**

- are the part of the profits of a company which is distributed among its shareholders.

- Interim Dividends-declared during the course of the accounting year in respect of the same accounting year.

- Final Dividend-declared by the shareholders at the AGM of the company based on the recommendation of the BODs.

- On declaration of dividend a company is required to deposit the amount of dividend payable in a separate Dividend Bank Account.

**8. Managerial Remuneration:** According to section 198 of the Companies Act 1956, the total managerial payable by a public company or a private company which is the subsidiary of public company in respect of any financial year shall not exceed 11% of the Net profits of that company for that financial year.

- Managerial Remuneration- includes remuneration payable to manager, Managing Director, whole time directors of the company.

- Net Profit-be calculated before tax but after including any bounty or subsidy from Govt.

- Capital Profit and provision for repairs, bad debts etc. should not be considered while calculating N.P for the above purpose and depreciation should be charged as per the rate.

**Illustration:**

The Balance Sheet of A Ltd. as at 31.3.1995 is as follows:

**Balance Sheet as at 31.3.1995**

| Liabilities | Rs. | Rs. | Assets | Rs. |
|---|---|---|---|---|
| Authorized Share Capital | | | Sundry Assets | 17,00,000 |
| 1, 50,000 Equity Shares | | | | |
| Of Rs. 10 each | 15, 00,000 | | | |
| Issued, Subscribed and Paid-up | | | | |
| 80,000 Equity Shares of | | | | |
| Rs. 7.50 each called-up and paid-up | | 6, 00,000 | | |
| ***Reserves and surplus*** | | | | |
| Capital Redemption Reserve | | 1, 50,000 | | |
| Plant Revaluation Reserve | | 20,000 | | |
| Securities Premium Account | | 1, 50,000 | | |
| Development Rebate Reserve | | 2, 30,000 | | |
| Investment Allowance Reserve | | 2, 50,000 | | |
| General Reserve | | 3, 00,000 | | |
| | | 17, 00,000 | | 17,00,000 |

The company wanted to issue bonus shares to its shareholders at the rate of one share for every two shares held. Necessary resolutions were passed; requisite legal requirements were complied with:

(a) You are required to give effect to the proposal by passing journal entries in the books of A Ltd.

(b) Show the amended Balance Sheet.

**Solution:**

**In the Books of A Ltd.**

| | | **Journal Entries** | **Rs.** | **Rs.** |
|---|---|---|---|---|
| (i) | Share Final Call A/c Dr. | | 2, 00,000 | |
| | | To Share Capital A/c | | 2, 00,000 |
| | | (Being the final call of Rs. 2.50 each on 80,000 equity shares made) | | |
| (ii) | Bank A/c | Dr. | 2, 00,000 | |
| | | To Share Final Call A/c | | 2, 00,000 |
| | | (Being the amount due on final call received) | | |

(iii) General Reserves Dr. 3, 00,000

Securities Premium A.c Dr. 1, 00,000

To Bonus to Shareholders A/c 4, 00,000

(Being the appropriation made as above to facilitate issue of fully paid up bonus shares at the rate of one share for every two shares held)

(iv) Bonus to Shareholders A/c Dr. 4, 00,000

To Equity Share Capital A/c 4, 00,000

(Being the issuance of 40,000 fully paid up shares of Rs. 10 each by way of bonus)

**(b) Balance Sheet (after bonus issue)**

| Liabilities | Amount(Rs.) | Assets | Amount(Rs.) |
|---|---|---|---|
| Authorised Share Capital | | Bank | 2, 00,000 |
| 1,50,000 equity shares of Rs. 10 each | 15,00,000 | Sundry Assets | 17,00,000 |
| Issued and Subscribed | | | |
| 1,20,000 Equity Shares of Rs. 10 each | | | |
| fully paid | 12,00,000 | | |
| Of the above, 40,000 equity shares are | | | |
| allotted as fully paid up by way of bonus | | | |
| shares | | | |
| ***Reserves and Surplus*** | | | |
| Capital Redemption Reserve | 1, 50,000 | | |
| Securities Premium | 50,000 | | |
| Development Rebate Reserve | 2, 30,000 | | |
| Investment Allowance Reserve | 2, 50,000 | | |
| Plant Revaluation Reserve | 20,000 | | |
| | **19, 00,000** | | **19, 00,000** |

## 2.8 ACCOUNTING REPORTS

### Accountant's Report in the Prospectus:

According to the Companies Act 1956, a Prospectus issued by a company should contain particulars as required by schedule II. Part II of schedule II also requires a Report by the accountant in the respect of the following matters.

1. **Purchase of Business:** If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly:-
    a. in the purchase of any business, or
    b. in the purchase of an interest in any business and by reason of that purchase, or anything to be done in consequence thereof, or in connection therewith; the company will become entitled to an interest as respect either the capital or profits and losses or both, in such business exceeding fifty per cent, thereof; A report made by accountants (who shall be named in the prospectus) upon :-
        i. the profits or losses of the business for each of the five financial years immediately preceding the issue of the prospectus, and
        ii. The assets and liabilities of the business at the last date to which the accounts of the business were made up, being a date not more than one hundred and twenty days before the date of the issue of the prospectus.
2. **Acquisition of Business:**
    i. If-
        a. the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and
        b. by reason of that acquisition or anything to be done in consequence thereof or in connection therewith, that body corporate will become a subsidiary of the company.

A report made by accountant (who shall be named in the prospectus) upon:-

a. the profits or losses of the other body corporate for each of the five financial years immediately preceding the issue of the prospectus; and
b. the assets and liabilities of the other body corporate at the last day to which its accounts were made up. .

ii. The said report shall-
    a. indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with for holders of other shares, if the company had at all material times held the shares to be acquired; and
    b. where the other body corporate as subsidiaries deal with the profits or losses and the assets and liabilities of the body corporate and its

subsidiaries in the manner provided by sub-clause (ii) above in relation to the company and its subsidiaries.

**Half - yearly Financial Report of Listed Companies:**

SEBI vide its circular 5, 2010 has amended clause 41 of the listing agreement. The amended clause required listed companies should disclose, on stand alone or consolidated basis, their quarterly (audited or un-audited with limited review), financial results within 45 days of the end of every quarter. Audited annual results on stand-alone as well as consolidated basis, should be disclosed within 60 days from the end of the financial year for those entities which opt to submit their annual audited results in lieu of the last quarter unaudited financial results with limited review.

## 2.9 SUMMARY

- A company's statutory records should always be kept updated. The significance of these records should not be underestimated. They serve as definite evidence that the company legally exists and so do its members.
- The importance of preparing a company's final accounts accurately and on time is very critical for minimizing its tax liability and ensuring that the revenue is right.
- Managerial remuneration includes remuneration that is payable to the managing director, manager, part-time directors and whole time directors. It does not include the remuneration paid to technical advisors and secretaries.
- Bonus is an extra dividend to the equity shareholders in a joint stock company from surplus profits.
- Balance sheet is a financial statement that encapsulates the assets, liabilities and shareholders' equity of a company, at ascertains point in time. These components of a balance sheet give investors a view of what belongs to the company and what it owes, as well as the amount invested by shareholders.

## 2.10 KEY TERMS:

- **Appropriation**: Distribution of profits.
- **Balance Sheet:** Statement of assets and liabilities depicting the financial position as at the end of the financial year.
- **Below the Line**: Part of the Profits and Loss Account which shows the appropriation of profits.
- **Contingent Liability:** Liability which depends upon the happening of a certain event.

- **Gross Block:** Gross value of fixed assets before depreciation.
- **Preliminary Expenses:** Expenses incurred in connection with the formation and registration of a company.
- **Premium on shares:** Amount realized in. excess of the face value of shares of a company.
- **Turnover:** Total value sale of goods or supply of services,
- **Underwriting Commission:** Commission payable to underwriters of shares and debentures in lien of their undertaking to subscribe to the issue in the event of under-subscription by the public.
- **Bonus:** An extra dividend to the equity shareholders in a joint stock company from surplus profits.
- **Bonus shares:** Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

## 2.11 QUESTIONS AND EXERCISES

1. According to Section 209, what should every company's booksof account contain?
2. Who are responsible for keeping the books of account?
3. Name the different Statutory Books or Statutory Ledgers.
4. What does a register of debenture holders contain?
5. According to Section 217, what details should the Board ofDirectors report contain?
6. What are divisible profits?
7. What does the bonus mean?
8. According to Section 210 of the Companies Act, when is a company required to prepare a balance sheet?
9. What are the special features of the Profit and Loss Account of a Company?
10. What do you understand by Appropriation of Profits? What are the items relevant in that connection?
11. Enumerate four items each of current assets and current liabilities, how are current assets and current liabilities shown in the vertical form of Balance Sheet?
12. What are the particulars required to be given with regard to the fixed assets while preparing Balance Sheet of a Company?
13. State the nature of particulars and information to be given in Company Final Accounts with regard to :
    - Sundry Debtors.
    - Share Capital
    - Reserves and Surplus.

14. What should be the contents of a statutory report, according to Section 165 of the Companies Act?
15. List the requirements of a Profit and Loss Account.
16. What are the statutory provisions regarding divisible profits?
17. Discuss the rules regarding declaration and payment of dividends.

*******

# UNIT 3: FUNDS FLOW STATEMENT

**Structure**



## 3.0 INTRODUCTION

At the end of each accounting period, preparation and presentation of financial statements are undertaken with an objective of providing as much information as possible for the public. The balance sheet presents a snapshot picture of the financial position at a given point of time and the income statement shows a summary of revenues and expenses during the accounting period. Though these are significant statements especially in terms of the principal goals of the enterprise, yet there is a need for one more statement which will indicate the changes and movement of funds between two balance sheet dates which are not clearly mirrored in the balance sheet and income statement. That statement is called as funds flow statement. The analysis which studies the flow and movement of funds is called as funds flow analysis.

## 1.1 UNIT OBJECTIVES

After reading this lesson, you will be able to:

- Understand the concept of funds and flow.
- Evaluate the changes in working capital in an organization.
- Ascertain the sources and uses of funds from a given financial statement.
- Prepare fund flow statement.
- Understand the concepts of cash and cash flow.
- Understand the cash flow analysis.
- Prepare cash flow statement.

## 3.2 CONCEPT OF FUNDS

How are funds defined? Perhaps the most ambiguous aspect of funds flow statement understands what is meant by funds. Unfortunately there is no general agreement as to precisely how funds should be defined. To a lay man the concept of funds means `cash'. According to a few, `funds' means `net current monetary assets' arrived at by considering current assets (cash + marketable securities + short term receivables) minus short term obligations. A third view, which is the most acceptable one, is that concept of funds means `working capital' and in this lesson the term `funds' is used in the sense of Working capital.

**Working Capital Concept of Funds:**

The excess of an enterprise's total current assets over its total current liabilities at some point of time may be termed as its net current assets or working capital. To illustrate this, let us assume that on the balance sheet date the total current assets of an enterprise are rs.3, 00,000 and its total current liabilities are rs.2, 00,000. Its working capital on that date will be rs.3, 00,000 – rs.2, 00,000 = rs.1, 00,000. It follows from the above, that any increase in total current assets or any decrease in total current liabilities will result in a change in working capital.

**Flow of Funds:**

The term `flow' means change and therefore, the term `flow of funds' means `change in funds' or `change in working capital'. According to manmohan and goyal, "the flow of funds" refers to movement of funds described in terms of the flow in and out of the working capital area. In short, any increase or decrease in working capital means `flow of funds'. Many transactions which take place in a business enterprise may increase its working capital, may decrease it or may not affect any change in it. Let us consider the following examples.

- **Purchased Machinery For Rs.3,00,000:**

The effect of this transaction is that working capital decreases by 3,00,000 as cash balance is reduced. This change (decrease) in working capital is called as application of funds. Here the accounts involved are current assets (cash a/c) and fixed asset (machinery a/c).

- **Issue Of Share Capital Of Rs.10,00,000:**

This transaction will increase the working capital as cash balance increases. This change (increase) in working capital is called as source of funds. Here the two accounts involved are current assets (cash a/c) and long-term liability (share capital a/c).

- **Sold Plant For Rs.3,00,000:**

This transaction will have the effect of increasing the working capital by rs.3,00,000 as the cash balance increases by rs.3,00,000. It is a source of funds. Here the accounts involved are current assets (cash a/c) and fixed assets (plant a/c).

- **Redeemed Debentures Worth Rs.1,00,000:**

This transaction has the effect of reducing the working capital, as the redemption of debentures results in reduction in cash balance. Hence this is an example of application of funds. The two accounts affected by this transaction are current assets (cash a/c) and long-term liability (debenture a/c).

- **Purchased Inventory Worth Rs.10, 000:**

This transaction results in decrease in cash by rs.10,000 and increase in stock by rs.10,000 thereby keeping the total current assets at the same figure. Hence there will be no change in the working capital (there is no flow of funds in this transaction). Both the accounts affected are current assets.

- **Notes Payable Drawn By Creditors Accepted For Rs.30,000:**

The effect of this transaction on working capital is nil as it results in increase in notes payable (a current liability) and decreases the creditors (another current liability). Since there is no change in total current liabilities there is no flow of funds.

- **Building Purchased For Rs.30,00,000 And Payment Is Made By Shares:**

This transaction will not have any impact on working capital as it does not result in any change either in the current asset or in the current liability. Hence there is no flow of funds. The two accounts affected are fixed assets (building a/c) and long term liabilities (capital a/c).

From the above series of examples, we arrive at the following rules on flow of funds:

I. ***There Will Be Flow Of Funds Only When There Is A Cross-Transaction I.E., Only When The Transaction Involves:***

- Current Assets And Fixed Assets .Ex-Purchase Of Machinery For Cash (Application Of Funds) Or Sale Of Plant For Cash (Source Of Funds).
- Current Assets And Capital, Ex-Issue Of Shares (Source Of Funds).
- Current Assets And Long Term Liabilities, Ex-Redemption Of Debentures In Cash (Application Of Funds).
- Current Liabilities And Long-Term Liabilities, Ex-Creditors Paid Off In Debentures Or Shares (Source Of Funds).
- Current Liabilities And Fixed Assets, Ex-Building Transferred To Creditors In Satisfaction Of Their Claims (Source Of Funds).

**There Will Be No Flow of Funds When There Is No Cross Transaction i.e When The Transaction Involves:**

- Current Assets and Current Assets, Ex-Inventory Purchased For Cash.
- Current Liabilities and Current Liabilities, Ex-Notes Payable Issued To Creditors.
- Current Assets and Current Liabilities, Ex-Payments Made To Creditors.
- Fixed Assets And Long Term Liabilities, Ex-Building Purchased And Payment Made In Shares Or Debentures.

a) **Sources and Application Of Funds:** the following are the main sources of funds:
    - **Funds from Operations:** the operations of the business generate revenue and entail expenses. Revenues augment working capital and expenses other than depreciation and other amortizations. The following adjustments will be required in the figures of net profit for finding out the real funds from operations:

**Funds from Operations**

| | | | | |
|---|---|---|---|---|
| Net profit for the year | | x | x | x |
| Add*: depreciation of fixed assets | x | x | x | |
| Preliminary expenses, goodwill, etc. | | | | |
| Written off | x | x | x | |
| Loss on sale of fixed assets | | x | x | x |
| Transfers to reserve | x | x | x | |
| Less: profit on sale or revaluation | x | x | x | |
| Dividends received, etc. | X | x | x | |
| Funds from operations | x | x | x | |

*****these items are added as they do not result in outflow of funds. In case of `net loss' for the year these items will be deducted.

- **Issue of Share Capital:** an issue of share capital results in an inflow of funds.
- **Long-Term Borrowings:** when a long-term loan is taken, there is an increase in working capital because of cash inflow. A short term loan, however, does not increase the working capital because a short-term loan increases the current assets (cash) and the current liability (short term loan) by the same amount, leaving the size of working capital unchanged.
- **Sale of Non-Current Assets:** when a fixed asset or a long-term investment or any other non-current asset is sold, there will be inflow represented by cash or short-term receivables.

**b) Uses of Funds:** the following are the main uses of funds:

- **Payment of Dividend:** the transaction results in decrease in working capital owing to outflow of cash.
- **Repayment of Long-Term Liability:** The repayment of long-term loan involves cash outflow and hence it is used for working capital. The repayment of a current liability does not affect the amount of working capital because it entails an equal reduction in current liabilities and current assets.
- **Purchase of Non-Current Assets:** when a firm purchases fixed assets or other non-current assets, and if it pays cash or incurs a short-term debt, its working capital decreases. Hence it is a use of funds.

**Importance and Utility of Funds Flow Analysis:**

Funds flow analysis provides an insight into the movement of funds and helps in understanding the change in the structure of assets, liabilities and owners' equity. This analysis helps financial managers to find answers to questions like:

i. How far capital investment has been supported by long term financing?
ii. How far short-term sources of financing have been used to support capital investment?
iii. How much funds have been generated from the operations of a business?
iv. To what extent the enterprise has relied on external sources of financing?
v. What major commitments of funds have been made during the year?
vi. Where did profits go?
vii. Why were dividends not larger?
viii. How was it possible to distribute dividends in excess of current earnings or in the presence of a net loss during the current period?
ix. Why are the current assets down although the income is up?
x. Has the liquidity position of the firm improved?
xi. What accounted for an increase in net current assets despite a net loss for the period?
xii. How was the increase in working capital financed?

## 3.3 PREPARATION OF FUNDS FLOW STATEMENT

Two statements are involved in funds flow analysis:

I. Statement or Schedule of Changes in Working Capital.
II. Statement of Funds Flow.

### I. Statement of Changes In Working Capital:

This statement when prepared shows whether the working capital has increased or decreased during two balance sheet dates. But this does not give the reasons for increase or decrease in working capital. This statement is prepared by comparing the current assets and the current liabilities of two periods. It may be shown in the following form

**Schedule of Changes In Working Capital (Proforma)**

| Items | As on | As on | Change | |
|---|---|---|---|---|
| | | | **Increase** | **Decrease** |
| Current Assets | | | | |

Cash Balances

Bank Balances

Marketable Securities

Stock In Trade

Pre-Paid Expenses

Current Liabilities

Bank Overdraft

Outstanding Expenses

Accounts Payable

Provision for Tax

Dividend

Increase / Decrease In Working Capital

Any increase in current assets will result in increase in working capital and any decrease in current assets will result in decrease in working capital. Any increase in current liability will result in decrease in working capital and any decrease in current liability will result in increase in working capital.

**a) Funds Flow Statement:**

Funds flow statement is also called as statement of changes in financial position or statement of sources and applications of funds or where got, where gone statement. The purpose of the funds flow statement is to provide information about the enterprise's investing and financing activities. The activities that the funds flow statement describes can be classified into two categories:

- Activities that generate funds, called sources, and
- Activities that involve spending of funds, called uses.

When the funds generated are more than funds used, we get an increase in working capital and when funds generated are lesser than the funds used, we get decrease in working capital. The increase or decrease in working capital disclosed by the schedule of changes in working capital should tally with the increase or decrease disclosed by the funds flow statement.

The funds flow statement may be prepared either in the form of a statement or in `t' shape form. When prepared in the form of statement it would appear as follows:

**Funds Flow Statement**

| | | | | |
|---|---|---|---|---|
| ***Sources of Funds*** | | | | |
| Issues of shares | x | x | x | |
| Issue of debentures | x | x | x | |
| Long term borrowings | | x | x | x |
| Sale of fixed assets | x | x | x | |
| *operating profit | | | | |
| (funds from operations) | x | x | x | |
| Total sources | | x | x | x |
| ***Application of Funds*** | | | | |
| Redemption of redeemable | | | | |
| Preference shares | | x | x | x |
| Redemption of debentures | | x | x | x |
| Payments for other long-term loans | | x | x | x |
| Purchase of fixed assets | | x | x | x |
| * operation loss (funds lost from | | x | x | x |
| Operations) | | ------------------------ | | |
| Total uses | | x | x | x |
| | | ------------------------- | | |
| Net increase / decrease in working capital | | | | |

(total sources – total uses)

When prepared in `t' shape form, the funds flow statement would appear as follows:

**Funds Flow Statement**

| **Sources of Funds** | | **Application of Funds** | |
|---|---|---|---|
| * Funds From Operation | x xx | *Funds Lost in Operations | xx x |
| Issue of Shares | x xx | Redemption Of Preference Shares | x xx |
| Issue of Debentures | x xx | Redemption of Debentures | x xx |
| Long-Term Borrowings | x xx | Payment of Other Long-Term Loans | x xx |
| Sale Of Fixed Assets | x xx | Purchase Of Fixed Assets | x xx |
| * Decrease In Working Capital | x xx | Payment Of Dividend, Tax, Etc. | x xx |
| Increase In Working Capital | | | x xx |

*Only One Figure Will Be There.

It may be seen from the proforma that in the funds flow statement preparation, current assets and current liabilities are ignored. Attention is given only to change in fixed assets and fixed liabilities.

In this connection an important point about provision for taxation and proposed dividend is worth mentioning. These two may either be treated as current liability or long-term liability. When treated as current liabilities they will be taken to `schedule of changes in working capital' and thereafter no adjustment is required anywhere. If they are treated as long-term liabilities there is no place for them in the schedule of changes in working capital. The amount of tax provided and dividend proposed during the current year will be added to net profits to find the funds from operations. The amount of actual tax and dividend paid will be shown as application of funds in the funds flow statement. In this lesson, we have taken them as current liabilities.

**Illustration:**

The balance sheet of mathi limited for two years was as follows: Liabilities Assets

| | **2010** | **2011** | | **2010** | **2011** |
|---|---|---|---|---|---|
| Share Capital | 40,000 | 60,000 | Land & Buildings | 27,700 | 56,600 |
| Share Premium | 4,000 | 6,000 | Plant & Machinery | 17,800 | 25,650 |
| General Reserve | 3,000 | 4,500 | Furniture | 1,200 | 750 |
| Profit & Loss A/C 13,000 | 9,750 | 10,400 | Stock | 11,050 | |
| 5% Debentures 19,550 | --- | 13,000 | Debtors | 18,250 | |
| Creditors | 16,750 | 18,200 | Bank | 2,400 | 2,000 |
| Provision For Taxation | 4,900 | 5,450 | | | |
| | **784,001,** | **17,550** | **784,001 17,550** | | |

**Additional Information:**

Depreciation written off during the year was:

Plant and machinery Rs.6,400

Furniture Rs. 200

Prepare: a schedule of changes in working capital and a statement of sources and application of funds.

**Schedule of Changes in Working Capital**

| | 2010 | 2011 | Increase | Decrease |
|---|---|---|---|---|
| | **Rs.** | **Rs.** | **Rs.** | **Rs.** |
| **Current Assets:** | | | | |
| Stock | 11,050 | 13,000 | 1,950 | |
| Debtors | 18,250 | 19,550 | 1,300 | |
| Bank | 2,400 | 2,000 | | 400 |
| (a) | 31,700 | 34,550 | | |
| **Current Liabilities** | | | | |
| Creditors | 16,750 | 18,200 | | 1,450 |
| Provision for Taxation | 4,900 | 5,450 | | 550 |
| (b) | 21,650 | 23,650 | | |
| **Working capital** (a) – (b) | 10,050 | 10,900 | | |
| Increase in working Capital | 850 | | | 850 |
| | 10,900 | 10,900 | 3,250 | 3,250 |

**Calculation Of Funds From Operations**

| | | | |
|---|---|---|---|
| Profit And Loss A/C As On 31-12-2011 | | | 10,400 |
| Add: Transfer To Reserve | | | 1,500 |
| Depreciation – | Plant & Machinery | | 6,400 |
| | Furniture | | 200 |
| | | | **18,500** |
| Less: P&L A/C As On 1-1-2011 | | 9,750 | |
| Funds From Operations | | **8,750** | |

**Land & Building A/C**

| | | | |
|---|---|---|---|
| To Balance B/D | 27,700 | By Balance C/D | 56,600 |
| To Bank Purchase | 28,900 | | |
| (Balancing Figure) | -------- | | -------- |
| | 56,600 | | 56,600 |
| | -------- | | -------- |

**Plant & Machinery A/C**

| | | | |
|---|---|---|---|
| To Balance B/D | 17,800 | By Depreciation | 6,400 |
| To Bank Purchase | 14,250 | By Balance C/D | 25,650 |
| (Balancing Figure) | -------- | | -------- |
| | 32,050 | | 32,050 |
| | -------- | | -------- |

**Furniture A/C**

| | | | |
|---|---|---|---|
| To Balance B/D | 1,200 | By Depreciation | 200 |
| | | By Bank – Sale | 250 |
| | | (Balancing Figure) | |
| | | By Balance C/D | 750 |

------- ------

**Statement of Sources and Application of Funds**

| ***Sources*** | ***Rs.*** | ***Applications*** | ***Rs.*** |
|---|---|---|---|
| Funds From Operations | 8,750 | Purchase Of Land & | 28,900 |
| Share Capital | | 20,000 | Buildings |
| Share Premium | 2,000 | Purchase of Plant & | 14,250 |
| Debentures | 13,000 | Increase in Working | 850 |
| Sale Of Furniture | 250 | Capital | |
| | --------- | | -------- |
| | 44,000 | | 44,000 |
| | -------- | | -------- |

**Illustration**: Form the following Balance Sheets as on 31December, 2006 and 31 December, 2007, you are required to preparea Schedule of Changes in the Working Capital and a Funds flowStatement taking:

(a) the provision for tax and proposed dividends as non-currentliabilities;

(b) the provision for tax and proposed dividends as current liabilities.

**BALANCE SHEET**

**as on 31 December**

| **Liabilities** | **2006** ***(Rs.)*** | **2007** ***(Rs.)*** | **Assets** | **2006** ***(Rs.)*** | **2007** ***(Rs.)*** |
|---|---|---|---|---|---|
| Share Capital | 10,000 | 15,000 | Fixed Assets | 10,000 | 20,000 |
| Profit and Loss A/c | 4,000 | 6,000 | Current Assets | 13,000 | 14,500 |
| Provision for Tax | 2,000 | 3,000 | | | |
| Proposed Dividends | 1,000 | 1,500 | | | |

| | | | | |
|---|---|---|---|---|
| Sundry Creditors | 4,000 | 6,000 | | |
| Outstanding Expenses | 2,000 | 3,000 | | |
| | **23,000** | **34,500** | **23,000** | **34,500** |

***Additional Information:***

| | ***(Rs.)*** |
|---|---|
| Tax paid during 2007 | 2,500 |
| Dividends paid during 2007 | 1,000 |

**Solution:**

***i.*** *When Provision for Tax and Proposed dividends are taken asnon-current liabilities:*

**SCHEDULE OF CHANGES IN WORKING CAPITAL**

| **Particulars** | **Increase (+) (Rs.)** | **Decrease (–) (Rs.)** |
|---|---|---|
| Sundry Creditors | | 2,000 |
| Outstanding Expenses | | 1,000 |
| Current Assets | 1,500 | |
| Decrease in Working Capital | 1,500 | |
| | **3,000** | **3,000** |

**FUNDS FLOW STATEMENT**

| ***Source:*** | **(Rs.)** | **(Rs.)** |
|---|---|---|
| Increase in Share Capital | | 5,000 |
| Funds from Operations: | | |
| Net Profit | 2,000 | |

| | | |
|---|---|---|
| Add: Provision for Tax made during | | |
| the year (3,000 + 2,500 – 2,000) | 3,500 | |
| Add: Proposed Dividends | 1,500 | 7,000 |
| **Total Sources** | | **12,000** |
| ***Applications:*** | | |
| Fixed assets purchased | | 10,000 |
| Tax paid | | 2,500 |
| Dividends paid | | 1,000 |
| **Total Applications** | | **13,500** |
| Net Decrease in Working Capital | | 1,500 |

*ii. When Provision for Tax and Proposed Dividends are taken asCurrent Liabilities:*

**SCHEDULE OF CHANGES IN WORKING CAPITAL**

| Particulars | Increase (+) (Rs.) | Decrease(–) (Rs.) |
|---|---|---|
| Sundry Creditors | | 2,000 |
| Outstanding Expenses | | 1,000 |
| Current Assets | 1,500 | |
| Provision for Tax | | 1,000 |
| Proposed Dividends | | 500 |
| Decrease in Working Capital | 3,000 | |
| | **4,500** | **4,500** |

**FUNDS FLOW STATEMENT**

| Particulars | (Rs.) |
|---|---|
| ***Sources:*** | |
| Increase in Share Capital | 5,000 |
| Funds from Operations | 2,000 |
| **Total Sources** | **7,000** |
| ***Applications:*** | |
| Purchase of Fixed Assets | 10,000 |
| Decrease in Working Capital | **3,000** |

**Illustration:**From the following balance sheets of X Ltd. on 31December, 2005 and 2006, you are required to prepare:

(a) A schedule of changes in working capital,

(b) A funds flow statement.

| Liabilities | 2005 (Rs.) | 2006 (Rs.) | Assets | 2005 (Rs.) | 2006 (Rs.) |
|---|---|---|---|---|---|
| Share Capital | 1,00,000 | 1,00,000 | Goodwill | 12,000 | 12,000 |
| General Reserve | 14,000 | 18,000 | Building | 40,000 | 36,000 |
| Profit and Loss A/c | 16,000 | 13,000 | Plant | 37,000 | 36,000 |
| Sundry Creditors | 8,000 | 5,400 | Investments | 10,000 | 11,000 |
| Bills Payable | 1,200 | 800 | Stock | 30,000 | 23,400 |
| Provision for Taxation | 16,000 | 18,000 | BillsReceivable | 2,000 | 3,200 |
| Provision for Doubtful | | | Debtors | 18,000 | 19,000 |
| Debts | 400 | 600 | Cash/Bank | 6,600 | 15,200 |
| | **1, 55,600** | **1, 55,800** | | **1, 55,600** | **1, 55,800** |

The following additional information has also been given:

(i) Depreciation charged on Plant was Rs. 4,000 and on Building Rs.4,000.

(ii) Provision for taxation of Rs.19,000 was made during the year2006.

(iii) Interim dividend of Rs. 8,000 was paid during the year 2006.

**Solution:**

**SCHEDULE OF CHANGES IN WORKING CAPITAL**

| **Particular** | **2005 (Rs.)** | **2006 (Rs.)** | **Increase (+) (Rs.)** | **Decrease (–) (Rs.)** |
|---|---|---|---|---|
| ***Current Assets:*** | | | | |
| Cash at Bank | 6,600 | 15,200 | 8,600 | |
| Debtors | 18,000 | 19,000 | 1,000 | |
| Bills receivable | 2,000 | 3,200 | 1,200 | |
| Stock | 30,000 | 23,400 | | 6,600 |
| ***Current Liabilities:*** | | | | |
| Provision for doubtful debts | 400 | 600 | | 200 |
| Bills payable | 1,200 | 800 | 400 | |
| Sundry creditors | 8,000 | 5,400 | 2,600 | |
| **Total** | | | **13,800** | **6,800** |
| **Net Increase in working capital** | | | | **7,000.** |

**FUNDS FLOW STATEMENT**

| **Particulars** | **(Rs.)** |
|---|---|
| ***Source:*** | |
| Funds from Operations (See Note 1) | 36,000 |
| **Total Sources** | **36,000** |
| ***Applications:*** | |
| Purchase of plant (See Note 2) | 3,000 |

| | |
|---|---|
| Tax paid (See Note 3) | 17,000 |
| Investments purchased (See Note 4) | 1,000 |
| Interim dividend paid | 8,000 |
| **Total Applications** | **29,000** |
| **Net Increase in Working Capital** | **7,000** |
| | **36,000** |

**Working Notes:**

***1. Funds from operations:***

| Particulars | (Rs.) | (Rs.) |
|---|---|---|
| Profit and loss A/c balance on 31 December, 2006 | | 13,000 |
| ***Add:*** Items which do not decrease funds from operations | | |
| Transfer to general reserve | 4,000 | |
| Provision for tax | 19,000 | |
| Depreciation: | | |
| Plant | 4,000 | |
| Building | 4,000 | |
| Interim dividend paid | 8,000 | 39,000 |
| | | **52,000** |
| ***Less:*** Profit and Loss Account balance on 31 December, 2006 | | 16,000 |
| Funds from operations for the year | | **36,000** |

**2. Purchase of Plant:** This has been found out by preparing the PlantAccount.

**PLANT ACCOUNT**

| Particulars | (Rs.) | Particulars | (Rs.) |
|---|---|---|---|

| | | | |
|---|---|---|---|
| To Balance b/d | 37,000 | By Depreciation | 4,000 |
| To Bank (Purchase of plant balancing figure) | 3,000 | By Balance c/d | 36,000 |
| | 40,000 | | 40,000 |

**3. Tax paid** during the year has been found out by preparing a provisionfor tax account.

**PROVISION FOR TAX ACCOUNT**

| **Particulars** | **(Rs.)** | **Particulars** | **(Rs.)** |
|---|---|---|---|
| To Bank (being tax paid—bal. figure) | 17,000 | By Balance b/d | 16,000 |
| To Balance c/d | 18,000 | By P. & L. A/c | 19,000 |
| | 35,000 | | 35,000 |

**4. 'Investments'** have been taken as a fixed asset presuming thatthey are long-term investments.

## 1.4 CASH FLOW STATEMENT

**Meaning of Concepts of Cash, Cash Flow Analysis:**

While explaining the concept of `fund' it was mentioned that in a narrower sense the term `fund' is also used to denote cash.The term `cash' in the context of cash flow analysis stands for cash and bank balances. Cash flow refers to the actual movement of cash in and out of an organization. When cash flows into the organization it is called cash inflow or positive cash flow. In the same way when cash flows out of the organization, it is called cash outflow or negative cash flows. Cash flow analysis is an analysis based on the movement of cash and bank balances. Under cash flow analysis, all movements of cash would be considered.

**Cash Flow Statement:**

A cash flow statement is a statement depicting changes in cash position from one period to another i.e. The result of cash flow analysis is given in the cash flow statement. For example if the cash balance of a concern as per its balance sheet as on 31st march 2004 is rs.90,000 and the cash balance as per its balance sheet as on 31st march 2005 is rs.1,20,000, there has been an inflow of cash of rs.30,000 in the year 2004-05 as compared to the year 2003-04. The cash flow statement explains the reasons for such inflows or outflows of cash as the case may be.

Normally the following are principal sources of inflows of cash:

- Issue of shares and debentures for cash
- Sale of fixed assets and investments for cash
- Borrowings from banks and other financial institution
- Cash from operations outflows of cash generally include:
- Redemption of shares and debentures by cash
- Purchase of fixed assets and investments by cash
- Repayment of loans
- Cash lost in operations

**PREPARATION OF CASH FLOW STATEMENT:**

The Cash Flow Statement can be prepared on the same pattern on which a Funds Flow Statement is prepared. The change in the cash position from one period to another is computed by taking into account' Sources' and 'Applications' of cash.

**Sources of Cash:**

Sources of Cash can be both internal as well as external:

***Internal sources*** Cash from operations is the main internal source. The Net Profit shown by the Profit and Loss Account will have to be adjusted for non-cash items finding out cash from operations. Some of these items are as follows:

(i) Depreciation. Depreciation does not result in outflow of cash and, therefore, net profit will have to be increased by the amount of depreciation or development rebate charged, in order to find out the real cash generated from operations.

(ii) Amortization of intangible assets. Goodwill, preliminary expenses, etc., when written off against profits, reduce the net profits without affecting the cash balance. The amounts written off should, therefore, be added back to profits to find out the cash from operations.

(iii) Loss on sale of fixed assets. It does not result in outflow of cash and, therefore, should be added back to profits.

(iv) Gains from sale of fixed assets. Since sale of fixed assets is taken as a separate source of cash, it should be deducted from net profits.

(v) Creation of reserves. If profit for the year has been arrived at after charging transfers to reserves, such transfers should be added back to profits. In case operations show a net loss, such net loss after making adjustments for non-cash items will be shown as an application of cash.

Thus, cash from operations is computed on the pattern of computation of 'Funds' from operations, as explained in the earlier chapter. However, to find out of real cash from operations, adjustments will have to be made for 'changes' in current assets and current liabilities arising on account of operations, viz., trade debtors, trade creditors, bills receivable, bills payable, etc.

**Adjustments for Changes in Current Assets and Current Liabilities:**

The cash from operations has been computed on the same pattern on which funds from operations are computed. As a matter of fact, the fund from operations is equivalent to cash from operations. This is because of the presumption that all are cash transactions and all goods have been sold. However, there may be credit purchases, credit sales, outstanding and prepaid expenses, etc. In such a case, adjustments will have to be made for each of these items in order to find out cash from operations. This has-been explained in the followings:

**(i) Effects of Credit Sales**: In business, there are both cash sales and credit sales. In case, the total sales are Rs. 30,000 out of which the credit sales are Rs. 10,000, it means sales have contributed only to the extent of ` 20,000 in providing cash from operations. Thus, while computing cash from operations, it will be necessary that suitable adjustments for outstanding debtors are also made.

**(ii) Effect of Credit Purchases:** Whatever have been stated regardingcredit sales is also applicable to credit purchases. The only difference will be that decrease in creditors from one period to another will result in decrease of cash from operations because it means more cash payments have been made to the creditors which will result in outflow of cash. On the other hand, increase in creditors from one period to another will result in increase of cash from operations because less payment has been made to the creditors for goods supplied which will result in increase of cash balance at the disposal of the business.

**(iii)Effect of Opening and Closing Stocks:** The amount of opening stock is charged to the debit side of the Profit and Loss Account. It thus reduces the net profit without reducing the cash from operations. Similarly, the amount of closing stock is put on the credit side of the Profit and Loss Account. It thus increases the amount of net Profit without increasing the cash from operations.

**(iv)Effect of Outstanding Expenses:** Incomes received in Advance,etc. The effect of these items on cash from operations is similar to the effect of creditors. This means any increase in these items will result in increase in cash from operations while any decrease means decrease in cash from operations. This is because net profit from operations is computed after charging to it all expenses whether paid or outstanding. In case certain expenses have not been paid, this will result in decrease of net profit without a corresponding decrease in cash from operations. Similarly, income received in advance is not taken into account while calculating profit from operations, since it relates to the next year. It, therefore, means cash from operations will be higher than the actual net profit as shown by the Profit and Loss Account.

**(v) Effect of Prepaid Expenses and Outstanding Income:** The effect of prepaid expenses and outstanding income of cash from operations is similar to the effect of debtors. While computing net profit from operations, the expenses only for the accounting year are charged to the Profit and Loss Account. Expenses paid in advance are not charged to the Profit and Loss Account. Thus, pre-payment of expenses does not decrease net profit for the year but it decreases cash from operations. Similarly, income earned during a year is credited to the Profit and Loss Account whether it has been received or not. Thus an income, which has not been received but which has become due, increase the net profit for the year without increasing cash from operations.

**External sources:**

The external sources of cash are:

**(i) Issue of new shares:** In case shares have been issued for cash, the net cash received (i.e., after deducting expenses on issue of shares or discount on issue of shares) will be taken as a source of cash.

**(ii) Raising long-term loans:** Long-term loans such as issue of debentures, loans from Industrial Finance Corporation, State Financial Corporation, IDBI, etc., are sources of cash. They should be shown separately.

**(iii) Purchase of plant and machinery on deferred payments:** In case plant and machinery has been purchased on a deferred payment system, it should be shown as a separate source of cash to the extent of deferred credit. However, the cost of machinery purchased will be shown as an application of cash.

**(iv) Short-term borrowings (cash credit from banks):** Short-term borrowing, etc., from banks increase cash available and they have to be shown separately under this head.

**(v) Sale of fixed assets, investments, etc.** It result in generation of cash and therefore, is a source of cash.

Decrease in various current assets and increase in various current liabilities may be taken as external sources of cash, if they are not adjusted while computing cash from operations.

**Applications of Cash:**

Applications of cash may take any of the following forms:

(i) **Purchase of fixed assets** Cash may be utilized for additional fixed assets or renewals or replacement of existing fixed assets.

(ii) **Payment of long-term loans** The payment of long-term loans such as loans from financial institutions or debentures results in decrease in cash. It is, therefore, an application of cash.

(iii) **Decrease in deferred payment liabilities** Payments for plant and machinery purchased on deferred payment basis has to be made as per the agreement. It is, therefore, an application of cash.

(iv) **Loss on account of operations** Loss suffered on account of business operations will result in outflow of cash.

(v) **Payment of tax:** Payment of tax will result in decrease of cash and hence it is an application of cash.

(vi) **Payment of dividend**: This decreases the cash available for business and hence it is an application of cash.

(vii) **Decrease in unsecured loans, deposits, etc.** The decrease in these liabilities denotes that they have been paid off to that extent. It results, therefore, in outflow of cash.

Increase in various current assets or decrease in various current liabilities may be shown as applications of cash, if changes, in these items have not been adjusted while finding out cash from operations. The following is the format of a cash flow statement:

**Cash Flow Statement for the Year Ending Say 31st March 2012**

| Balance as on | 1-4-2011 | Balance as on | 1-4-2011 |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Cash in hand | x xx | bank overdraft (if any) | xx x |
| Cash at bank | x xx | | |
| Add: cash inflows: | | cash outflows: | |
| Here the items mentioned | | here the items mentioned | |
| As sources of cash inflows | | as outflows of cash above | |
| Above will be recorded | | will be recorded | |
| Balance as on 31-3-2012 | | balance as on 31-3-2012 | |
| Bank overdraft (if any) | x xx | cash in hand | xx x |
| Cash at bank | x xx | | |
| | x xx | | x xx |

The accounting standard (AS) 3 issued by the institute of chartered accountants of India requires the companies to prepare cash flow statement and present them as part of their annual reports.

**Calculation of Cash from Operations**: The important step in the preparation of cash flow statement is the calculation of cash from operations. It is calculated as follows:

The first step in the calculation of cash from operations is the calculation of funds from operations (which is already explained in the lesson on funds flow analysis). To the funds from operations the decrease in current assets and increase in current liabilities will be added (except cash, bank and bank o.d.). From the added total, increase in current assets and decrease in current liabilities will be deducted (except cash, bank and bank o.d.). The resultant figure is cash from operations (refer illustration 3).

**Pro-forma of Cash from Operations Statement**

| | | |
|---|---|---|
| Funds from operations or funds lost from operations | | x xxx |
| Add: Decrease in current assets | x xxx | |

| | | |
|---|---|---|
| Increase in current liabilities | x xxx | x xxx |
| Less: Increase in current assets<br>Decrease in current liabilities | x xx<br>x xx | x xxx |
| Cash from operations or cash lost from operations | | x xxx |

As in the case of fund flow analysis here also we assume provision for taxation and proposed dividend as current liabilities.

## 3.5 UTILITY OF CASH FLOW ANALYSIS

Cash flow analysis yields the following advantages:

- It is very helpful in understanding the cash position of the firm. This would enable the management to plan and coordinate the financial operations properly.
- Since it provides information about cash which would be available from operations the management would be in a position to plan repayment of loans, replacement of assets, etc.
- It throws light on the factors contributing to the reduction of cash balance inspite of increase in income and vice versa.
- A comparison of the cash flow statement with the cash budget for the same period helps in comparing and controlling cash inflows and cash outflows.

However cash flow analysis is not without limitations. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments. Further cash flow statement cannot replace the income statement or funds flow statement. Each of them has a separate function to perform.

## 3.6 CASH FLOW ANALYSIS VS. FUNDS FLOW ANALYSIS

- A cash flow statement is concerned only with the changes in cash position while funds flow analysis is concerned with changes in working capital position between two balance sheet dates.
- Cash flow analysis is a tool of short-term financial analysis while the funds flow analysis is comparatively a long-term one.
- Cash is part of working capital and therefore an improvement in cash position results in improvement in the funds position but not vice versa. In other words "inflow of cash" results in "inflow of funds" but inflow of funds may not necessarily result in "inflow of cash".
- In funds flow analysis, the changes in various current assets and current liabilities are shown in a separate statement called schedule of changes in working capital in order to ascertain the net increase or decrease in working capital. But in cash flow analysis, such changes are adjusted to funds from operations in order to ascertain cash from operations.

**Limitations of Cash Flow Analysis:**

Cash flow analysis is a useful tool of financial analysis. However, it has its own limitations. These limitations are as under:

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

In spite of these limitations it can be said that cash flow statement is a useful supplementary instrument. It discloses the volume as well as the speed at which the cash flows in the different segments of the business. This helps the management in knowing the amount of capital tied up in a particular segment of the business.

**Illustration:**

From the following balances calculate cash from operations:

| | December 31st | |
|---|---|---|
| | **2010(Rs.)** | **2011(Rs.)** |

| | | |
|---|---|---|
| Profit and loss a/c balance | 75,000 | 1,55,000 |
| Debtors | 45,000 | 42,000 |
| Creditors | 20,000 | 26,000 |
| Bills receivable | 12,000 | 15,000 |
| Cash in hand | 2,500 | 3,000 |
| Prepaid expenses | 1,600 | 1,400 |
| Bills payable | 18,000 | 16,000 |
| Cash at bank | 8,000 | 10,000 |
| Outstanding expenses | 1,200 | 1,600 |
| Income received in advance | 250 | 300 |
| Outstanding income | 800 | 900 |

***Additional Information:***

- depreciation written off during the year Rs.10,000
- Transfer to general reserve Rs.10,000.

**Calculation of Funds from Operations**

| | ***(Rs.)*** |
|---|---|
| Profit & Loss A/C As On 31St December 2011 | 1,55,000 |
| Add: Depreciation | 10,000 |
| Transfer To General Reserve | 10,000 |
| | 1,75,000 |
| Less: P & L A/C As On 1St January 2011 | 75,000 |
| Funds From Operations | 1,00,000 |

**Calculation of Cash from Operations**

| | |
|---|---|
| Funds from operations | 1,00,000 |
| **Add:** ***Decrease in Current Assets*** | |
| Decrease in debtors | 3,000 |
| Decrease in prepaid expenses | 200 |
| ***Increase in Current Liabilities*** | |
| Increase in creditors | 6,000 |
| Increase in outstanding expenses | 400 |
| Increase in income received in advance | 50 |
| | **1,09,650** |
| **Less:** ***Increase In Current Assets*** | |
| Increase in bills receivables | 3,000 |
| Increase in outstanding income | 100 |
| ***Decrease in Current Liabilities*** | |
| Decrease in bills payable | 2,000 |
| **Cash from operations** | **1,04,550** |

***Note:*** decrease in current assets means current assets are converted into cash and increase in current liabilities results in further generation of cash. Hence they are added. Increase in current assets and decrease in current liabilities result in outflow of cash. Hence they are deducted.

## 3.7 ACCOUNTING STANDARD FOR CASH FLOW STATEMENT

### AS 3 (Revised): Cash Flow Statement

The following are the salient features of the Revised Accounting Standard (AS) 3, Cash Flow Statements, issued by the Council of the Institute of Chartered Accountants of India in March 1997. This Standard supersedes AS 3, Changes in Financial Position, issued in June, 1981.This accounting standard (AS) has become mandatory w.e.f.accounting periods beginning from 1.4.2001 for the following enterprises.

(a) Enterprises whose debt or equity securities are listed or going to be listed on a recognized stock exchange.

(b) All other commercial, industrial and business reporting enterprises whose turnover for the accounting period exceeds Rs. 50 crores.

**Objectives**

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Statement deals with the provisions of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

**Scope:**

1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.
2. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

**Benefits of Cash Flow Information**

1. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, 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. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises.
2. It also enhances the comparability of the reporting of operating performance by different enterprise because it eliminates the effects of using different accounting treatments for the same transactions and events.

3. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

**Definitions**

The following terms are used in this Statement with the meanings specified:

1. Cash comprises cash on hand and demand deposits with banks.
2. Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
3. Cash flows are inflows and outflows of cash and cash equivalents.
4. Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
5. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
6. Financing activities are activities that result in changes in the size and composition of the owner's capital (including preference share capital in the case of a company) and borrowings of the enterprise.

**Presentation of a Cash Flow Statement**

The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

**Operating activities:** Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, the generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

(a) Cash receipts from the sale of goods and the rendering of services;
(b) Cash receipts from royalties, fees, commissions, and other revenue;
(c) Cash payments to suppliers for goods and services;
(d) Cash payments to and on behalf of employees;
(e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
(g) Cash receipts and payments relating to futures contracts, forward contracts, option contracts, and swap contracts when the contracts are held for dealing or trading purposes.

**Investing activities:** Examples of cash flows arising from investing activities are:

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

**Financing activities:** Examples of cash flows arising from financing activities are:

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

**Reporting Cash Flows from Operating Activities**

1. An enterprise should report cash flows from operating activities using either:
    a. the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or
    b. the indirect method, whereby net 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 payments, and items of income or expense associated with investing or financing cash flows.

2. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:
   a. from the accounting records of the enterprise; or
   b. by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
      i. changes during the period in inventories and operating receivables and payables;
      ii. other non-cash items; and
      iii. Other items for which the cash effects are investing or financing cash flows.
3. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:
   a. changes during the period in inventories and operating receivables and payables;
   b. non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and
   c. all other items for which the cash effects are investing or financing cash flows.
4. Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

**Reporting Cash Flows from Investing and Financing Activities**

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

**Reporting Cash Flows on a Net Basis**

1. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:
   a. Cash receipts and payments on behalf of customer's when the cash flows reflect the activities of the customer rather than those of the enterprise.

   Examples of cash receipts and payments referred above are as follows:

   i. the acceptance and repayment of demand deposits by a bank;

ii. funds held for customers by an investment enterprise; and
iii. Rents collected on behalf of, and paid over to, the owners of properties.

b. Cash receipts and payments for items in which the turnovers quick, the amounts are large, and the maturities are short.

Examples of cash receipts and payments referred above are advances made for, and the repayments of:

i. principal amounts relating to credit card customers;
ii. the purchase and sale of investments; and
iii. Other short-term borrowings, for example, those which have a maturity period of three months or less.

2. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:
   a. cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
   b. the placement of deposits with and withdrawal of deposits from other financial enterprises; and
   c. Cash advances and loans made to customers and the repayment of those advances and loans.

**Foreign Currency Cash Flows:** Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

**Extraordinary Items:** The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

**Interest and Dividends:** Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

**Taxes on Income**: Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

**Investments in Subsidiaries, Associates, and Joint Ventures:** When accounting for an investment in an associate or a subsidiary or a joint venture; an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture; for example, cash flows relating to dividends and advances.

**Acquisitions and Disposals of Subsidiaries and Other Business Units**

1. The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.
2. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
    a. the total purchase or disposal consideration; and
    b. the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

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

**Disclosure:**

**Components of cash and cash equivalents:** An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

**Other disclosures**: An enterprise should disclose together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

**Illustration:** From the following information prepare a Cash Flow Statement relating to (a) Direct Method (b) Indirect Method. Working notes would form a part of your answer.

**BALANCE SHEET**

**as on 31.12.2006**

***(Rs. in '000)***

| | 2006 | 2005 |
|---|---|---|
| **Assets** | | |
| Cash on hand and balances with banks | 200 | 25 |
| Short-term investments | 670 | 135 |
| Sundry debtors | 1,700 | 1,200 |
| Interest receivable | 100 | – |
| Inventories | 900 | 1,950 |
| Long-term investments | 2,500 | 2,500 |
| Fixed assets at cost 2,180 1,910 | | |
| Less: Accumulated depreciation (1,450) (1.060) | | |
| Fixed assets (net) | 730 | 850 |
| ***Total Assets*** | **6,800** | **6,660** |
| **Liabilities** | | |
| Sundry creditors | 150 | 1,890 |
| Interest payable | 230 | 100 |
| Income taxes payable | 400 | 1,000 |
| Long-term debt | 1,110 | 1,040 |
| ***Total liabilities*** | **1,890** | **4,030** |
| **Shareholders' funds** | | |
| Share capital | 1,500 | 1,250 |
| Reserves | 3,410 | 1,380 |
| **Total shareholders' funds** | **4,910** | **2,630** |

| | | |
|---|---|---|
| Total Liabilities and shareholders’ funds | **6,800** | **6,660** |

## (2) **STATEMENT OF PROFIT AND LOSS**

### for the period ended 31.12.2006

***(Rs. in ’000)***

| | |
|---|---|
| Sales | 30,650 |
| Cost of sales | (26,000) |
| Gross profit | 4,650 |
| Administrative and selling expenses | (910) |
| Interest expense | (400) |
| Interest income | 300 |
| Dividend income | 200 |
| Foreign exchange loss | (40) |
| Net profit before taxation and extraordinary item | 3,350 |
| Extraordinary item— | |
| Insurance proceeds from earthquake disaster settlement | 180 |
| Net profit after extraordinary item | 3,530 |
| Income tax | (300) |
| Net Profit | 3,230 |

***Additional Information:*** (Figures are in Rs. ’000).

(a) An amount of 250 was raised from the issue of share capital and a further 250 was raised from long-term borrowings.

(b) Interest expense was 400 of which 170 was paid during the period.100 relating to interest expense of the prior period was also paid during the period.

(c) Dividends paid were 1,200.

(d) Tax deducted at source on dividends received (included in the tax expense of 300 for the year) amounted to 40.

(e) During the period, the enterprise acquired fixed assets for 350.The payment was made in cash.

(f) Plant with original cost of 80 and accumulated depreciation of 60was sold for 20.

(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

**Solution:**

**CASH FLOW STATEMENT**

***(Direct Method)***

(Rs. in ’000)

| | 2006 | |
|---|---|---|
| ***Cash flows from operating activities*** | | |
| Cash receipts from customers | 30,150 | |
| Cash paid to suppliers and employees | (27,600) | |
| Cash generated from operations | 2,550 | |
| Income taxes paid | (860) | |
| Cash flow before extraordinary item | 1,690 | |
| Proceeds from earthquake disaster settlement | 180 | |
| ***Net cash from operating activities*** | | ***1,870*** |
| ***Cash flows from investing activities*** | | |
| Purchase of fixed assets | (350) | |
| Proceeds from sale of equipment | 20 | |
| Interest received | 200 | |
| Dividend received | 160 | |
| ***Net cash from investing activities*** | | ***30*** |
| ***Cash flows from financing activities*** | | |
| Proceeds from issuance of share capital | 250 | |
| Proceeds from long-term borrowings | 250 | |
| Repayments of long-term borrowings | (180) | |
| Interest paid | (270) | |
| Dividend paid | (1,200) | |
| ***Net cash used in financing activities*** | | ***(1,150)*** |
| Net increase in cash and cash equivalents | | 750 |
| Cash and cash equivalents at beginning of period (Note 1) | | 160 |
| Cash and cash equivalents at end of period (Note 1) | | 910 |

**Working Notes:**

1. Cash and cash equivalents Cash and cash equivalents consistof cash on hand and balances with banks, and investments inmoney-market instruments. Cash and cash equivalents includedin the cash flow statement comprise the following balance sheetamounts.

| | **2006** | **2005** |
|---|---|---|
| Cash on hand and balances with banks | 200 | 25 |
| Short-term investments | 670 | 135 |
| Cash and cash equivalents | 870 | 160 |
| Effect of exchange rate changes | 40 | – |
| Cash and cash equivalents as restated | 910 | 160 |

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely permissible to the company because of currency exchange restrictions. The company has undrawn borrowing facilities of 2,000 of which700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

**CASH FLOW STATEMENT**

**(Indirect Method)**

***(Rs. in ’000)***

| | | 2006 |
|---|---|---|
| ***Cash flows from operating activities*** | | |
| Net profit before taxation, and extraordinary item | | **3,350** |
| Adjustments for: | | |
| Depreciation | 450 | |
| Foreign exchange loss | 40 | |
| Interest income | (300) | |
| Dividend income | (200) | |
| Interest expense | 400 | |
| Operating profit before working capital changes | 3,740 | |
| Increase in sundry debtors | (500) | |
| Decrease in inventories | 1,050 | |
| Decrease in sundry creditors | (1,740) | |
| Cash generated from operations | 2,550 | |
| Income taxes paid | (860) | |
| Cash flows before extraordinary item | 1,690 | |
| Proceeds from earthquake disaster settlement | 180 | |
| ***Net cash from operating activities*** | | **1,870** |
| ***Cash flows from investing activities*** | | |
| Purchase of fixed assets | (350) | |
| Proceeds from sale of equipment | 20 | |
| Interest received | 200 | |
| Dividends received | 160 | |
| ***Net cash from investing activities*** | | ***30*** |

| | | |
|---|---|---|
| ***Cash flows from financing activities*** | | |
| Proceeds from issuance of share capital | 250 | |
| Proceeds from long-term borrowings | 250 | |
| Repayment of long-term borrowings | (180) | |
| Interest paid | (270) | |
| Dividends paid | (1,200) | |
| ***Net cash used in financing activities*** | | ***(1,150)*** |
| Net increase in cash and cash equivalents | | |
| Cash and cash equivalents at beginning of period(Note 1) | | 750 |
| Cash and cash equivalents at end of period(Note 1) | | 160 |
| | | **910** |

**Alternative Presentation (Indirect Method)**

As an alternative, in an indirect method cash flow statement, operatingprofit before working capital changes is sometimes presented as follows:

| | |
|---|---|
| Revenues excluding investment income | 30,650 |
| Operating expenses excluding depreciation | (26,910) |
| Operating profit before working capital changes | 3,740 |

***Working Notes:***

**(Figures are in Rs. '000)**

1. Cash receipts from customers

| | |
|---|---|
| Sales | 30,650 |
| **Add:** Sundry debtors at the beginning of the year | 1,200 |
| | 31,850 |
| **Less:** Sundry debtors at the end of the year | 1,700 |
| | **30,150** |

2. Cash paid to suppliers and employees

| | | | |
|---|---|---|---|
| Cost of sales | | | 26,000 |
| Administrative & selling expenses | | | 910 |
| | | | 26,910 |
| Add: Sundry creditors at the beginning of the year | 1,890 | | |
| Inventories at the end of the year | 900 | 2,790 | |
| | | | 29,700 |
| Less: Sundry creditors at the end of the year | 150 | | |
| Inventories at the beginning of the year | 1,950 | | 2100 |
| | | | **27,600** |

3. Income taxes paid (including tax deducted at source from dividends received)

| | |
|---|---|
| Income tax expense for the year | |
| (including tax deducted at source from dividends received) | 300 |
| Add: Income tax liability at the beginning of the year | 1,000 |
| | 1,300 |
| Less: Income tax liability at the end of the year | 400 |
| | 900 |

Out of 900, tax deducted at source on dividends received(amounting to 40), is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities.

4. Repayment of long-term borrowings

| | |
|---|---|
| Long-term debt at the beginning of the year | 1,040 |
| **Add:** Long-term borrowings made doing the year | 250 |
| | 1,290 |
| Less: Long-term borrowings at the end of the year | 1,110 |
| | 180 |

5. Interest paid

| | |
|---|---|
| Interest expense for the year | 400 |
| **Add:** Interest payable at the beginning of the year | 100 |
| | 500 |
| Less: Interest payable at the end of the year | 230 |
| | 270 |

## 3.8 SUMMARY

- The Funds Flow Statement is widely used by the financial analysts, credit granting institution and financial managers in performance of their jobs. It has become a useful tool in their analytical kit. This is because the financial statements, i.e.,' Income Statement' and the 'Balance Sheet' have a limited role to perform.
- The term 'Funds' has a variety of meanings. There are people who take it synonymous to cash and to them there is no difference between a Funds Flow Statement and a Cash Flow Statement. While others include marketable securities besides cash in the definition of the term 'Funds'.
- Funds flow statement helps the financial analyst in having a more detailed analysis and understanding of changes in the distribution of resources between two balance sheet dates. In case such study is required regarding the future working capital position of the company, a projected funds flow statement can be prepared.
- A Cash Flow Statement is a statement depicting change in cash position from one period to another. For example, if the cash balance of a business is shown by its Balance Sheet on 31December, 2007 at ` 20,000 while the cash balance as per its Balance Sheet on 31 December, 2008 is 30,000, there has been an inflow of cash of Rs. 10,000 in the year 2008 as compared to the year 2008.
- Cash from operations is the main internal source. The Net Profit shown by the Profit and Loss Account will have to be adjusted for non-cash items finding out cash from operations.
- A Cash Flow Analysis is concerned only with the change in cash position while a Fund Flow Analysis is concerned with change in working capital position, between two balance sheet dates. Cash is only one of the constituents of working capital besides several other constituents such as inventories, accounts receivable, prepaid expenses.

- A Cash Flow Statement is useful for short-term planning. A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts maturing in the near future, expenses of the business, etc.
- The balance sheet is merely a static statement. It is a statement of assets and liabilities as on a particular date. It does not sharply focus those major financial transactions which have been behind the balance sheet changes. One has to draw inferences from the Balance Sheet about major financial transactions only after comparing the Balance Sheets of two periods.

## 3.9 KEY TERMS

- **Working Capital:** working capital is that part of capital used for the purposes of day-to-day operations of a business.
- **Fund:** fund refers to the long term capital used for financing current assets. It can be ascertained by finding the difference between current assets and current liabilities.
- **Flow of funds:** flow refers to transactions which change the size of fund in an organization. The flow transactions are divided into uses and sources. While the former refers to those transactions which reduce the funds, the latter increases the size of fund.
- **Cash:** cash refers to cash and bank balances.
- **Cash Flow:** cash flow refers to the actual movement of cash in and out of an organization.
- **Current assets:** Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.
- **Current liabilities:** Liabilities payable within a year either out of the existing current assets or by creation of other current liabilities.
- **Cash flow statement:** A statement depicting change in cash position from one period to another

## 3.10 QUESTIONS AND EXERCISE

1. What do you mean by working capital concept of funds?
2. Explain the significance of funds flow analysis and cash flow analysis.
3. Distinguish between schedule of changes in working capital and funds flow statement.
4. Distinguish between cash flow analysis and funds flow analysis.
5. What is a 'Funds Flow Statement'? Examine its managerial uses.

6. "A Funds Flow Statement is a better substitute for an Income Statement." Discuss.
7. Explain the various concepts of funds in the context of Funds Flow Analysis.
8. What do you understand by Funds Flow Statements? How are they prepared? What are their uses?
9. What are the chief advantages of Funds Flow Statement? Also describe its limitations.
10. Write short notes on:
    a. Application of Funds
    b. Importance of Funds Flow Statement.
    c. Non-fund Items
11. Explain the meaning of a Cash Flow Statement. Discuss its utility.
12. Explain the technique of preparing a Cash Flow Statement with imaginary figures.
13. What is a Cash Flow Statement? Discuss briefly the major classification of cash flows as per AS 3.
14. Define cash and cash equivalent as suggested in Accounting Standard 3 to be used for preparing a cash flow statement.

## 3.11 PRACTICAL PROBLEMS

**1.** Shyam and company has the following information for the year ending 31st march 2012:sales Rs.5,000, depreciation Rs. 450, other operating expenses Rs.4,100.

You are required to:

- Estimate The Amount Of Funds Generated During The Year.
- If The Amount Of Depreciation Increases To Rs.9,000 What Would Be Its Effect On Funds Generated During The Year.
- Under What Circumstances Can The Funds From Operation Be Zero?

**2.** From the following balance sheets of damodar ltd. As on 31st december 2010 and 2011 you are required to prepare:

- A Schedule Of Changes In Working Capital
- A Funds Flow Statement.

| Liabilities | 2010(Rs.) | 2011(Rs.) | Assets | 2010(Rs.) | 2011(Rs.) |
|---|---|---|---|---|---|
| Share capital | 1,00,000 | 1,00,000 | Goodwill | 12,000 | 12,000 |
| General reserve | 14,000 | 18,000 | Building | 40,000 | 36,000 |
| Creditors | 8,000 | 5,400 | Plant | 37,000 | 36,000 |
| Bills payable | 1,200 | 800 | Investments | 10,000 | 11,000 |
| Provision for | | | Stock | 30,000 | 23,400 |
| taxation | 16,000 | 18,000 | Bills receivable | 2,000 | 3,200 |
| Provision for | | | Debtors | 18,000 | 19,000 |
| doubtful debts | 400 | 600 | Cash at bank | 6,600 | 15,200 |
| Profit & loss a/c | 16,000 | 13,000 | | | |
| | **1,55,600** | **1,55,800** | | **1,55,600** | **1,55,800** |

***Additional information:***

- Depreciation charged on plant was rs.4,000 and on building Rs.4,000.
- Provision for taxation Rs.19,000.
- Interim dividend of Rs.8,000 Was paid during the year 2011.

**3.** Alfa Ltd. supplies you the following Balance Sheets on 31 December:

| Liabilities | 2004 (Rs.) | 2005 (Rs.) | Assets | 2004 (Rs.) | 2005 (Rs.) |
|---|---|---|---|---|---|
| Share capital | 70,000 | 74,000 | Bank balance | 9,000 | 7,800 |
| Bonds | 12,000 | 6,000 | Receivable | 14,900 | 17,700 |
| Accounts payable | 10,360 | 11,840 | Inventories | 49,200 | 42,700 |
| Provision for | | | Land | 20,000 | 30,000 |
| doubtful debts | 700 | 800 | Goodwill | 10,000 | 5,000 |
| Reserves and surplus | 10,040 | 10,560 | | | |
| | **1,03,100** | **1,03,200** | | **1,03,100** | **1,03,200** |

***Additional information:***

(i) Dividends amounting to Rs. 3,500 were paid during the year 2005.
(ii) Land was purchased for Rs. 10,000.
(iii) Rs.5,500 were written off on Goodwill during the year.
(iv) Bonds of Rs. 6,000 were paid during the course of the year. You arerequired to prepare a Cash Flow Statement.

[Ans. Cash flows from: (a) Operating Activities Rs. 14,300; (b) Investment Activities Rs.10, 000; (c) Financing Activities Rs. 9,000]

**4.** Toyota Limited furnishes you the following Balance Sheets for the yearsending on 31 December 2004 and 2005. You are required to prepare aCash Flow Statement for year ended 31 December, 2005.

| **Liabilities** | **2004(Rs)** | **2005(Rs.)** | **Assets** | **2004(Rs)** | **2005(Rs.)** |
|---|---|---|---|---|---|
| Equity share capital | 10,000 | 10,000 | Goodwill | 1,200 | 1,200 |
| General reserve | 1,400 | 1,800 | Land | 4,000 | 3,600 |
| Profit and Loss A/c | 1,600 | 1,300 | Building | 3,700 | 3,600 |
| Sundry creditors | 800 | 540 | Investments | 1,000 | 1,100 |
| Outstanding exps. | 120 | 80 | Inventories | 3,000 | 2,340 |
| Prov. for taxation | 1,600 | 1,800 | Receivables | 2,000 | 2,220 |
| Prov. for bad debts | 40 | 60 | Bank balance | 660 | 1,520 |
| | **15,560** | **15,580** | | **15,560** | **15,580** |

***Additional information:***

(i) A piece of land has been sold for Rs. 400.
(ii) Depreciation amounting to Rs.700 has been charged on building.
(iii) Provision for taxation has been made for Rs. 1,900 during the year.

[**Ans.** Cash flows from: (a) Operating Activities Rs.1,160; (b) Investment Activities Rs. 300; (c) Financing Activities Rs. 660]

*********

# UNIT 4 FINANCIAL STATEMENT ANALYSIS

**Structure**



## 4.0 INTRODUCTION

Financial statement provides a summarized view of financial position and operations of a firm. Much can be learnt about a firm from careful examination of its financial statement as invaluable documents or performance reports. The focus of the financial analysis is on key figures in the financial statement and the significant relationship that exist between them. Thus analysis of financial statement involves in evaluating the relationship between components parts of financial statements to obtain a better understanding of the firms' position and performance.

## 4.1 UNIT OBJECTIVES

After reading this lesson, you will be able to:

- explain the need for analyzing financial statements;
- know different methods of analyzing the financial statements;
- understand how investors and others examine the performance of the company through ratio analysis;
- explain a few advanced financial analysis models with the help of ratio analysis; and
- Caution the users of financial statements for some of the limitations of financial statement analysis.

## 4.2 NEED FOR ANALYZING FINANCIAL STATEMENTS

The term financial statement analysis contains both analysis and interpretation. Therefore, a distinction should be made between the two terms. The term analysis is used to mean the simplification of the financial data by methodical classification of the data given in the financial statement and the other hand, interpretation means "explaining the meaning and significance of the data so simplified".

Financial statement analysis, by determining the significance and meaning of the financial statement data helps in forecasting the future earning, ability to pay interest and debt maturities and profitability of a sound dividend policy. The first task of financial analyst is to select information relevant to the decision under consideration from the total information contain in the financial statement. The second step is to arrange the information in a way to highlight significant relationship. The final step is interpretation and drawing inference and conclusion. In a brief financial analysis is the process of selection, relation and evaluation.

**Objectives:**

- Evaluation of past performance and financial position.
- Prediction of future performance.

## 4.3 TECHNIQUES OF ANALYSIS

The following tools are used to measure the operational efficiency, financial soundness of the business:

A. Horizontal Analysis
B. Vertical Analysis
C. Trend analysis
D. Ratio analysis

### A. Horizontal Analysis

An easiest way of financial statement analysis is the *horizontal analysis*. This analysis calculates the change of items both absolutely in terms of amount change and relatively through percentage change from the previous year to current year. To put it simply horizontal analysis makes a comparison of company's performance over a period of time. Hence this is also known as comparative statement. Past Performance is a good indicator but a firm never competes with its past rather with other firms operating in the industry.

**B. Vertical Analysis:**

It is the proportional expression of each item on a financial statement to the statement in total. So it facilitates in intercompany comparison in addition to horizontal analysis which facilitates in intra company comparison. To cite an example a company from vertical analysis can know its operating expenses as a proportion of sales, which can be compared with its previous figures as well as with industry norms to find out its strength and weakness. Horizontal and vertical analysis of Profit and loss account of Centurion Bank is presented below.

**Centurion Bank**

**Comparative Profit and Loss Account for the year ended 31st March 2001**

**(Horizontal Analysis)**

| | | **For the yr ended 31st March 2001** | **For the yr ended 31st March 2000** | **Change Amount** | **Change %** |
|---|---|---|---|---|---|
| | **Schedule** | | | | |
| **Income** | | | | | |
| Interest Earned | 13 | 54730 | 44280 | 10450 | 19.09373 |
| Other Income | 14 | 9809 | 8879 | 930 | 9.481089 |
| | | **64539** | **53159** | **11380** | **17.63275** |

**Expenditure**

| | | | | | |
|---|---|---|---|---|---|
| Interest Expended | 15 | 44515 | 36249 | 8266 | 18.56902 |
| Operating Expenses | 16 | 7963 | 6140 | 1823 | 22.89338 |
| Depreciation | | 6280 | 4263 | 2017 | 32.11783 |
| | | **58758** | **46652** | **12106** | **20.60315** |
| **Operating profit** | | **5781** | **6506** | **-725** | **-12.5411** |
| Provision & Contingencies | | 5079 | 3073 | 2006 | 39.49596 |
| **Net Profit for current yr** | | **702** | **3433** | **-2731** | **-389.031** |
| **Profit B/F** | | **3618** | **2454** | **1164** | **32.17247** |
| **Amount Available for appropriation** | | **4320** | **5887** | **-1567** | **-36.2731** |

**Centurion Bank**

**Comparative Profit and Loss Account for the year ended 31st March 2001**

**(Vertical Analysis)**

| | Schedule | For the yr ended 31st March 2001 | Percentage | For the yr ended 31st March 2000 | Percentage |
|---|---|---|---|---|---|
| **Income** | | | | | |
| Interest Earned | 13 | 54730 | 84.80 | 44280 | 83.30 |
| Other Income | 14 | 9809 | 15.20 | 8879 | 16.70 |
| | | **64539** | **100.00** | **53159** | **100.00** |
| **Expenditure** | | | | | |
| Interest Expended | 15 | 44515 | 68.97 | 36249 | 68.19 |
| Operating Expenses | 16 | 7963 | 12.34 | 6140 | 11.55 |
| Depreciation | | 6280 | 9.73 | 4263 | 8.02 |
| | | **58758** | **91.04** | **46652** | **87.76** |

| | | | | |
|---|---|---|---|---|
| **Operating profit** | **5781** | **8.96** | **6506** | **12.24** |
| Provision & Contingencies | 5079 | 7.87 | 3073 | 5.78 |
| **Net Profit for current yr** | **702** | **1.09** | **3433** | **6.46** |

C. **Trend analysis**:

It is an extended version of horizontal analysis which involves calculation of percentage changes in financial statement items for a number of successive years. In trend analysis one past financial is taken as the base and is assigned a value 100 and the corresponding figures of other years are expressed as a percentage of the base tear value. The trend analysis of Centurion Bank given below will make it clear.

**Centurion Bank: Trend Analysis of Selected Financial Data**

| | 31.03.2001 | 31.03.2000 | 31.03.1999 | 31.03.1998 | 31.03.1997 | 31.03.1996 |
|---|---|---|---|---|---|---|
| Total Assets | 587971 | 522434 | 310434 | 158513 | 129524 | 35532 |
| Gross Income | 64539 | 53159 | 43917 | 20404 | 11395 | 4433 |
| Gross | 12061 | 10769 | 9402 | 4744 | 2750 | 1223 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Profit | | | | | | |
| Net Profit | 702 | 3433 | 2144 | 2007 | 1624 | 964 |

**TREND ANALYSIS**

| | | | | | | |
|---|---|---|---|---|---|---|
| Total Assets | 1654.76 | 1470.32 | 873.67 | 446.11 | 364.53 | 100 |
| Gross Income | 1455.88 | 1199.17 | 990.68 | 460.28 | 257.05 | 100 |
| Gross Profit | 986.18 | 880.54 | 768.77 | 387.90 | 224.86 | 100 |
| Net Profit | 72.82 | 356.12 | 222.41 | 208.20 | 168.46 | 100 |

## 4.4 RATIOS FOR FINANCIAL STATEMENT ANALYSIS

Accounting Data in absolute terms does not provide much meaning as the analysis of data involves comparisons and relations. So it becomes fairly simple to use ratios for comparison with a competing firm and with the results of past years. If ratios are used with understanding of industry factors and general economic conditions it acts as a powerful device for identifying the company’s strength and weakness.

**Standard of comparison:**

- Rules of thumb
- Industry Standards

However the classification of the ratio is depend upon the objectives for which they are calculated. It may also depend upon the availability of the data. Analysis of the financial statement is made with a view to ascertain the effectiveness and efficiency and financial soundness of the company, as such ratios can be classified on the basis of profitability, Liquidity and turnover, financial capability, and market assessment.

**PROFITABILITY RATIOS:**

The main objective of the business concern is to earn profits. Earning profit is considered essential for the survival of the business. Lord Keynes says “profit is the engine that drives the business enterprise”. A business thus needs a profit not only for its survival but also for its expansion and diversification. The various interested groups connected with the business expect returns from the organization. For instance, the investors want an adequate return on their investments, worker wants higher wages, creditors want a higher security for their interest and loan and so on. A business can discharge its obligations to the various segments of the society only if it earns profits. Thus, profits are useful measure of the overall efficiency of the business. Profitability ratios are calculated either in relation to sales or in relations investment. The following are the various profitability ratios.

***Gross Profit Ratio:***The gross profit ratio measures the relationship of gross profit to net sales and is usually expressed as a percentage. Thus, it is calculated by dividing the gross profit by sales.

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net sales}} * 100$$

The gross profit ratio indicates the extent to which selling prices of goods per unit may decline without resulting in loss of the operation of a firm. It reflects the efficiency with which a manufactures its products. As the gross profit is calculated by deducting cost of goods sold from the net sales, the higher is the gross profit better is the result. There is no standard norm of gross profit ratio and it may vary from business to business, but the gross profit should be adequate to cover the operating expenses such as administrative expenses, office expenses, selling and distribution expenses and to provide for fixed charges, dividend and accumulation of reserves. A low gross profit ratio normally indicates high cost of goods sold due to unfavorable purchasing policies, lesser sales, lower selling prices, fierce competition, over investment in plant and machinery, etc.

***Operating Ratio:*** The operating ratio establishes the relationship between cost of goods sold and other operating expenses on one hand and the sales in other hand. In other words, it measures the cost of operation per rupee of sales. By dividing the operating costs with the net sales operating ratio is calculated. This is represented as a percentage.

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} * 100$$

Here two major elements of this ratio are operating cost and net sales. Operating cost can be found by adding operating expenses to the cost of goods. Operating expenses consist of administrative and office and selling & distribution expenses.

Operating ratio indicates the percentage of net sales that is consumed by operating cost. Apparently higher the operating ratio, the less favorable it is because it would have a small margin operating profit to cover interest, income tax, dividend and reserves. For this ratio there is no hard and fast rule and it differs from firm to firm, the nature of the business and its capital structure. However 75% to 85% may be considered to be a good ratio in case of manufacturing undertaking. In order to have better idea of the ratio, either the trend should be found by calculating operating ratio for a number of years or a comparison of the firm should be made with another in a similar business or in the same industry.

Operating ratio is considered as yardstick for measuring operating efficiency but it should be used cautiously because it may affected by the uncontrollable factors that are beyond the control of the business. Further in some firms, non-operating expenses form substantial part of the total expenses and in such cases operating ratio may give misleading results.

***Operating Profit ratio***: The operating profit ratio is calculated by dividing operating profit by sales. Operating profit calculated as follows;

$$\text{Thus, Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Sales}} * 100$$

***Expenses Ratio:*** The expenses ratio ascertains the relationship between various expenses and volume of sales. The operating ratio reveals the average total variations in expenses. In some of the cases the expenses may be increasing while in some it may be falling. Therefore the expenses ratios are calculated by dividing each of the expenses or group of expenses with net sales to analyze the cause of variation of the operating ratio. This ratio can be calculated for each individual item of expenses or group of items of particular type of expenses like cost of sales ratios, administrative expenses ratios, selling expenses ratios, material consumption ratio, etc.

$$\text{Particular Expenses Ratio} = \frac{\text{Particular Expenses}}{\text{Net sales}} * 100$$

The lower the ratio, the greater is the profitability and higher the ratio, lower is the profitability. While interpreting the ratio, one should remember that for a fixed expense like rent, the ratio will fall if the sales increase and for a variable expense, the ratio in proportion to sales shall remain nearly the same.

***Net Profit Ratio:*** The net profit ratio establishes the ratio between net profit (after tax) and sales and indicates the efficiency of the management in manufacturing, selling, administrative and other activities of the firm. This ratio gives an overall measure of the firm's profitability and is calculated as below;

$$\text{Net Profit Ratio} = \frac{\text{Net Profit after tax}}{\text{Net sales}} * 100$$

The two basic elements of the ratio are net profits and sales. Net profit will be obtained after deducting income tax and generally, non-operating incomes expenses are excluded from the net profits for calculating this ratio. Thus, incomes such as the interest on investment outside the business, profit on sale of fixed assets, etc. are excluded. The ratio is very useful because if the profit is not sufficient, the firm shall not be able to achieve a satisfactory return on its investment. This ratio also indicates the firm's capacity to face adverse economic conditions such as price competition, low demand, etc. Obviously, higher the ratio, the better is the profitability. But while interpreting the ratio, it should be kept in mind that the performance of profits must also been in relation to investment or capital of the firm and not only in relation to sales.

***Return on Assets/Return on Investment:*** This is a measure of Profitability from a given level of investment. It is one of the important measures of the performance of a company.

$$\text{Return on Assets} = \frac{\text{Net Profit after tax}}{\text{Total assets/ average total assets}} * 100$$

Return on investment depends on profit margin and assets turn over as:

$$\frac{\text{Net Profit after tax}}{\text{Aaverage total assets}} = \frac{\text{Net Profit after tax}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Average total assets}}$$

Since the ratio is used to measure the efficiency of management of assets, the non operating items and interest expenses are not considered as it has little to do with efficiency. So the profit in numerator should be "Net operating profit after tax". So ratio is normally calculated as

$$\text{Return on Assets} = \frac{\text{Net Operating Profit after tax}}{\text{Total assets/ average total assets}} * 100$$

***Return on Equity:*** The ratio measures return from shareholders' point of view. It points out how efficiently the shareholders fund is employed. The ratio is calculated as follows:

Net Profit after tax

Return on Assets = ---------------------------------- * 100

Average shareholders' Equity

The shareholders of a company expect ROE to be higher than the cost of capital so that it can add some economic value to the firm. Return on equity can be increased with the help of financial leverage, i.e., use of fixed cost fund or debt financing in the capital structure of the firm.

***Earnings per Share****:* This is one of the most commonly used measures of expressing corporate earnings. It gains importance as the return on owners' equity is not as much of interest for an individual shareholder as the earnings on a per share basis. This measure is computed by dividing the net income by the number of equity or ordinary shares outstanding. Thus, the earnings per share of equity capital would be;

Net Income for Equity Shareholders

Earnings per Share =---------------------------------------------

Number of equity shares

***Dividend per*** ... ws the cash income availa ... areholder is concerned, his/her major interest in the company is in the amount of dividend that can be earned on the investment in the shares and in the increase in the price of the shares.

Income Distributed as Dividend

Dividend per Share =---------------------------------------------

Number of equity shares

Now we will try to find out all the ratios from the financial statement of Hindustan Lever Limited.

**Hindustan Lever Limited**

**Profit and Loss Account for the year ended 31$^{st}$ March 2002**

| | 2002<br><br>(Rs Lakhs) | 2001<br><br>(Rs Lakhs) |
|---|---|---|
| Sales | 9954,85.30 | 10667,55.09 |
| Other Income | 384,54.22 | 381,79.05 |
| Total Revenue | 10339,39.52 | 11049,34.74 |
| Expenses | 8142,27.96 | 9105,97.52 |
| Profit before Tax | 2197,11.56 | 1943,37.22 |
| Tax | 479,85.00 | 402,42.00 |
| Profit after Tax | 1717,26.56 | 1540,95.22 |
| Exceptional Items | 38,41.90 | 100,36.13 |
| Net Profit | 1755,68.46 | 1641,31.35 |

**Hindustan Lever Limited**

**Balance Sheet as on 31st March 2002**

| | **2002** | **2001** |
|---|---|---|
| **Shareholders' Funds and Liabilities** | **(Rs Lakhs)** | **(Rs Lakhs)** |
| Share Capital | 220,12.44 | 220,12.44 |
| Reserves & Surplus | 3438,75.14 | 2823,56.74 |
| Secured loans | 19,61.50 | 43,04.39 |
| Unsecured loans | 38,68.26 | 40,69.47 |
| Current Liabilities & provisions | 3670,89.43 | 3501,82.28 |
| Deferred Tax liabilities | 117,38.49 | 103,13.12 |

| | | |
|---|---|---|
| **Total Funds** | **7505,45.26** | **6732,38.44** |
| **Assets** | | |
| Fixed Assets (net) | 1322,33.65 | 1320,06.02 |
| Investments | 2364,74.10 | 1635,93.12 |
| Inventories | 1278,73.62 | 1240,03.62 |
| Sundry Debtors | 367,85.04 | 424,78.47 |
| Cash and bank balances | 942,62.60 | 913,15.69 |
| Other Current Assets | 46,30.22 | 50,61.56 |
| Loans and Advances | 795,55.40 | 798,18.70 |
| Deferred Tax Assets | 387,30.63 | 349,61.26 |
| **Total Assets** | **7505,45.26** | **6732,38.44** |

Calculate the profitability ratios from the above financial information.

**Solution:**

| Formula | 2002 | 2001 |
|---|---|---|
| PAT/Sales | 171726.56/995485.3<br><br>= 17.25% | 154095.22/1066755.69<br><br>=14.45% |
| PAT/Average Total assets | 171726.56/711891.85*<br><br>= 24.12% | 154095.22/623345.69#<br><br>= 24.72% |
| NOPAT/ Average Investment | 147985.16**/711891.85<br><br>= 20.79% | 130436.79**/623345.69<br><br>= 20.93% |
| PAT/ Average Shareholders' equity | 171726.56/335128.38*<br><br>= 51.24% | 154095.22/276595.71#<br><br>= 55.71% |
| Operating Exp/sales | 813309.56/995485.3<br><br>= 81.7% | 909823.10/1066755.69<br><br>= 85.29% |
| PAT/ No of equity Shares | 175568.46/2201243793<br><br>= Rs 7.98 | 164131.35/2200922097<br><br>= Rs 7.46 |

*Average of 2001 and 2002

# Average of the figures of 2000 and 2001. Figures for 2000 collected from previous financial statement

** Calculation of Net Operating Profit:

| | | 2002 | | 2001 |
|---|---|---|---|---|
| Sales | | 995485.30 | | 1066755.69 |
| Less Operating exp | | 813309.56 | | 909823.10 |
| Operating Profit before Tax | | 182175.74 | | 156932.59 |
| Less Tax on OPBT | | | | |

| | | | | |
|---|---|---|---|---|
| Tax Reported | 47985.00 | | 40242.00 | |
| Less tax paid (36.75%) on other Income | 14131.93 | | 14030.80 | |
| Add Tax on Interest Expenses (36.75%) | 337.51 | 34190.58 | 284.60 | 26495.80 |
| NOPAT | | 147985.16 | | 130436.79 |

**LIQUIDITY RATIOS**:

Liquidity ratios are calculated to measure the short term financial soundness of the business. The ratio assesses the capacity of the company to repay its short term due and liability. Following ratios are calculated to determine the liquidity or short term solvency ratio of the company. Short term obligations are compared with short term resources for calculating the ratio.

***Current ratio/working capital ratio:*** This is one of the most important liquidity ratios. It indicates the firm's ability to pay its short term liabilities out of its current assets. It shows the firm's commitment to meet its short term current liabilities. It is calculated by dividing the current assets by current liabilities. The formula is;

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

This ratio is also known as ***working capital ratio***. The ideal current ratio is 2:1 i.e. current assets should be twice the current liability. When the current assets are twice the current liability, then payment of current liability will not affect the business operation. A higher current ratio is an indicator of idle fund, inefficient use of fund and excessive dependence on long term fund, which is costlier than the current liabilities.

***Acid-test or Quick ratio:*** This ratio is calculated by dividing the quick asset by current liabilities. It indicates the firm's abilities to pay its current liabilities out of its most liquid assets. Quick or Liquid assets are those which can be converted into cash immediately without any loss. In simple words quick assets are current assets excluding inventory and pre-paid expenses. Similarly liquid liabilities consist of all current liabilities except bank overdraft. The formula is

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current or liquid liabilities}}$$

***Absolute Liquid Ratio:*** In this ratio, absolutely liquid assets are considered which excludes Debtors, Bill receivable and Inventories as there is a doubt of its reliability in cash at a time. This ratio is calculated by following formula:

$$\text{Absolute Ratio} = \frac{\text{Cash in hand + cash at bank + short term Securities}}{\text{Current liabilities}}$$

The standard norm is 1:2 which means that Re. 1 of absolute liquid assets are sufficient to pay Rs.2 worth of current liabilities. This ratio is not normally used because a huge amount of idle cash has to be kept.

**ACTIVITY OR PERFORMANCE OR TURN-OVER RATIOS**

In addition to over all measure of liquidity it's important to measure the liquidity of each current and liability to assess the ability of the company in prompt collection or prompt payment which affects the company's liquidity. The liquidity of current items is measured through turnover ratios. As the name suggests, turnover ratio is related to sales. It is an accepted fact that sales have direct relationship with the performance of the business. Higher sales mean better performance, which really means better efficiency and productivity of the business. Higher sales also mean more production, and active participation of human resources. In this way, words turnover, performance and activity are synonymous.

***Stock or Inventory Turnover Ratio:*** This ratio established the relationship between costs of goods sold and average stock. Every business has to keep optimum quantity of stock, so that production work may be carried on smoothly.

$$\text{Stock turn over} = \frac{\text{Cost of goods sold}}{\text{Average Stock}}$$

If the average inventory kept during the year is more than ordinary requirement, the amount spent in its purchase will be unnecessarily blocked & there will also be the problem of storing it. In case the average stock is lesser than the ordinary, the production will suffer.

***Debtor Turnover Ratio****:* It is also known as receivable turnover. It establishes the relationship between credit sales and average debtors. A business concern may sell on cash as well as on credit. Following a liberal credit policy can increase the volume of sales. But the effect of a liberal credit policy may result in tying up substantial funds of a firm in the form of trade debtors. Trade debtors are expected to be converted into cash within a short period and are included in assets. Thus, the liquidity position of a concern to pay its short term obligations in time depends upon the quality of its trade debtors. By formula;

$$\text{Debtor Turnover ratio} = \frac{\text{Credit Sales}}{\text{Average debtor}}$$

***Average Collection period ratio:*** Debtor turnover is often expressed through this ratio. The ratio provides indication of the quality of debtors and company's collection efforts. It represents the average number of days taken by the firm to collect from debtors and points out the collection policy of the firm. A higher collection period implies that greater credit period is enjoyed by the customers and vice versa.

$$\text{Average Collection Period} = \frac{\text{Average trade debtor (Debtors + Bills Receivable)}}{\text{Average daily Sale}}$$

***Creditors Turnover Ratio/Account Payable Ratio:*** This ratio explains the velocity with which creditors are paid and establishes relationship between creditors & amount pay to them. In course of business operations, a firm has to make credit purchases and incur short-term liabilities. The supplier of goods, i.e. creditor is naturally interested in finding out how much time the firm is likely to take in repaying its trade creditors

$$\text{Creditors Turnover Ratio} = \frac{\text{Total Credit purchase}}{\text{Accounts Payable}}$$

***Average payment period ratio:*** It represents the average number of days taken by the firm to repay its creditors. Generally, lower the ratio, the better is the liquidity position of the firm and higher the ratio, less liquid is the position of the firm. But a higher payment period also implies greater credit period enjoyed by the firm and consequently large the benefit are reaped from credit suppliers. But much higher ratio may also imply a lesser discount facilities availed or higher prices paid for the goods purchased on credit.

$$\text{Average Payment Period} = \frac{\text{Average trade creditor (Creditors + Bills payable)}}{\text{Average daily purchase}}$$

Performance ratio also shows, whether the total capital, working capital, fixed assets and stock of the business are profitably used or not.

$$\textbf{\textit{Total Capital Turnover Ratio}} = \frac{\text{Net sales}}{\text{Capital Employed}}$$

$$\textbf{\textit{Working Capital Turnover Ratio}} = \frac{\text{Net sales or Cost Of sales}}{\text{Working Capital}}$$

$$\textbf{\textit{Fixed Assets Turnover Ratio}} = \frac{\text{Net Sales or Cost of Sales}}{\text{Fixed Assets}}$$

**Illustration:**

With the help of the financial information of Hindustan Lever Ltd find out the liquidity and performance ratio.

| Ratio | Formula | 2002 | 2001 |
|---:|---:|---:|---:|

| | | | |
|---|---|---|---|
| Current ratio | Current Assets/ Current Liabilities | 343106.88/367089.43 = 0.94 | 342678.04/350182.28 = 0.98 |
| Quick Ratio | Quick Assets/ Current Liabilities | 215233.26/367089.43 = 0.59 | 218674.42/350182.28 = 0.62 |
| Inventory Turnover | Cost of goods Sold/ Average Inventory | 813309.56/125938.62 = 6.45 times | 909823.10/121107.05 = 7.51 times |
| Inventory Holding period | Days in year / Inventory Turnover | 360/6.45 = 55.81 days | 360/7.51 = 47.94 days |
| Debtor Turnover | Sales/ Average Debtors | 995485.30/39631.76 = 25.12 times | 1066755.69/34464.72 = 30.95 times |
| Average Collection Period | Days in year / Debtor Turnover | 360/25.12 = 14.33 days | 360/30.95 = 11.63 days |

NB: Cost of goods sold is not provided in annual report. So it is calculated taking all operating expenses into consideration.

**SOLVENCY RATIOS:**

In the short-term, the solvency of the firm is measured by the ability of the firm to meet all its current maturing obligations. Similarly, the long-term solvency measures its ability to meet its long-term obligations. There are two approaches for evaluating the long-term solvency. One is in terms of evaluating the margin of safety available for lenders, represented by the owners' equity and the other is in terms of the ability of the firm to earn sufficient surpluses to meet all the long-term commitments.

***Debt-equity Ratios:*** A mix of debt and equity in the sources of finance magnifies the earnings per share of a firm. Use of debt capital is good to certain point and after that it is considered risky. The debt equity ratio measures the relationship of capital provided by creditors and capital provided by shareholders. Debt for the purpose includes both long and short term debts (Not current Liabilities). The formula for calculating the ratio is

$$\text{Debt to Equity Ratio} = \frac{\text{Short term + Long Term debt}}{\text{Shareholders Equity}}$$

This ratio means that for every rupee of shareholders funds in the company, how much is the lenders' claim. Lower the lenders' claim to the shareholders claim; lower are the demands on the firms earnings for meeting fixed commitments in terms of interest. The other aspect of this is that there is a lesser leverage in the capital structure of the company.

***Liabilities-equity Ratios:*** A variant to debt equity ratio is the liabilities equity ratio. Since current liabilities normally don't bear any cost they are excluded from debt which is considered in liabilities to equity ratio. Provisions are also considered for this ratio.

$$\text{Liabilities to Equity Ratio} = \frac{\text{Debt + Current Liabilities}}{\text{Shareholders Equity}}$$

The ratio is important for organizations which have obligations of short term in nature and they roll them over continuously.

***Interest Coverage Ratio/Times Fixed Charges Covered:*** This is a measure of protection available to creditors for payment of interest charges by the company. So the ratio of times fixed charges covered is computed usually, if the company has other fixed commitments. The ratio shows whether the company has sufficient income to cover its fixed charges requirements by a wide margin. This ratio is computed as follows:

$$\text{Times fixed charges covered} = \frac{\text{Earnings before interest and fixed charges}}{\text{Interest \& fixed charges}}$$

**Illustration:**

Calculate the different solvency ratios for Hindustan Lever Limited.

| Ratio | Formula | 2002 | 2001 |
|---|---|---|---|
| Debt Equity Ratio | St Debt+ LT Debt/ Shareholders' equity | 5829.76/365887.58 = 0.02 | 8373.86/304369.18 = 0.03 |
| Liability Equity Ratio | Debt + Current Liabilities/ Equity | 372919.19/365887.58 = 1.02 | 358556.14/304369.18 = 1.18 |
| Interest Coverage Ratio | PBIT/ Interest Expenses | 220629.96/918.40 = 240 times | 195111.64/774.42 = 252 times |

**CAPITAL MARKET RATIOS:**

These ratios relate market price to a company's performance and alsp compare the market value and book value of a firm. These ratios are quite helpful in making investment decisions.

***Price earnings ratio:*** This is the most popular measure used in investment analysis as it is a key factor in selection of stocks. P/E ratio is a growth indicator of a firm as it compares market price with the annual earnings of a share. A high P/E ratio indicates the market confidence in the future earnings growth of a company.

$$\text{Price-earnings Ratio} = \frac{\text{Stock Price}}{\text{Earnings per share}}$$

***Dividend Yield:*** It represents the percentage return on the current stock price of shareholders. Dividend Yield is calculated as:

$$\text{Dividend Yield} = \frac{\text{Dividend per Share}}{\text{Market Price of Share}}$$

***Price to book ratio:*** The ratio compares the market price of a company's share with its book value. If the ratio is more than one then it is understood that the company is overvalued by the market and vice versa. The ratio is calculated as:

$$\text{Price to book Ratio} = \frac{\text{Market Price per Share}}{\text{Book value per Share}}$$

**Illustration:**

Calculate the capital market ratios of Hindustan lever limited.

| Ratio | Formula | 2002 | 2001 |
|---|---|---|---|
| Price Earning Ratio | Stock price/ EPS | 177.50* / 7.98** | 216.80* / 7.46** |
| Dividend yield | Dividend Per share/ Stock Price | 5.50 / 177.50<br>= 3.1% | 5.00 / 216.80<br>= 2.31% |
| Price to Book Ratio | Market Price / Book Value per Share | 177.50/16.62<br>= 10.68 times | 216.80 / 13.83<br>= 15.68 times |

* Prevailing market Price of that time

** Calculated in profitability Ratios

**Interpretation of Financial Ratios:**

- The profitability ratios indicate that the company's profit margin has increased from 14.45% (2001) to 17.25% in the year 2002. This is probably due to reduction in expenses. At the same time the ROA is declined from 24.72% to 24.12% in 2002. Since ROA is a product of profit margin and asset turnover the decline point out that it is only due to assets turnover as profit margin is increasing. So the company has to keep high asset turnover to achieve a certain rate of return on assets. Same reason can be attributed to the decline in ROI. The ROE in case of Hindustan Lever limited is declined almost by 4.5% from 2001 to 2002. But ROE is higher than ROA in both the years which implies that company is using a financial leverage to earn more per rupee of shareholders' fund than per rupee of asset. But the company should try to use the leverage in an efficient manner to maintain or bring consistency in ROE.

- A look to the liquidity and efficiency ratios point out that there is no significant decline in the current ratio and the decrease is because of a greater proportionate increase in current liabilities over current assets. The quick ratio also follows the trend of current ratio. A drop in inventory turnover is observed from the ratios. It means the holding period of inventory has been increased. The debtor turnover ratio is also decreasing indicating deterioration in the management of receivables. This is also evident from the average collection period which has increased to 14.33 days from 11.63 days in its previous year. So to sum up the company's operating cycle has been increased.

| | 2002 | 2001 |
|---|---|---|
| Average Inventory Holding Period | 55.81 | 47.94 |
| Average debt Collection Period | 14.33 | 11.63 |
| Operating Cycle (Days) | 70.14 | 59.57 |

So the company needs to have a better policy for its working capital management as a longer operating cycle restricts the company from profitable use of funds.

- The debt equity ratio has decreased in 2002 from 2001 which may be a reason for lower ROE in 2002. But it is worth noting that debt equity ratio varies across industries depending on their nature. Since HLL falls under FMCG Industries, where there is a high fluctuation in demand, probably it prefers to keep lower debt equity ratio. Though relatively debt has been reduced, the absolute amount of interest expenses has been increased. The PBIT of the company has also been increased but the proportionate change in PBIT is less than the change in Interest expenses so the coverage has been reduced. Still the ratio is too high in both the years for the same company.
- The market ratios point out that the P/E ratio has fallen because of drop in the share price. The dividend yield is improved because of drop in share price and higher amount of dividend. If the capital depreciation is considered then there is negative return to shareholders. Similarly the P/B ratio is dropped because of market price. Book value shows a positive sign which imply that all the negative change in market

ratios are due to fall in market price because of depressed economic situation of that time.

## 4.5 ADVANTAGES OF FINANCIAL RATIOS

- ***Simplifies financial statements:*** Ratio Analysis simplifies the comprehension of financial statements. Ratios tell the whole story of changes in the financial condition of the business.
- ***Facilitates inter-firm comparison:*** Ratio Analysis provides data for inter-firm comparison. Ratios highlight the factors associated with successful and unsuccessful firms. They also reveal strong firms and weak firms, over-valued and undervalued firms.
- ***Makes intra-firm comparison possible:*** Ratio Analysis also makes 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.
- ***Helps in planning:*** Ratio analysis helps in planning and forecasting. Over a period of time a firm or industry develops certain norms that may indicate future success or failure. If relationship changes in firm's data over different time periods, the ratios may provide clues on trends and future problems.

Thus, "ratios can assist management in its basic function of forecasting, planning, coordination, control and communication".

## 4.6 LIMITATIONS OF ACCOUNTING RATIOS

- ***Comparative study required:*** Ratios are useful in judging the efficiency of the business only when they are compared with the past results of the business or with the results of a similar business. However, such a comparison only provides a glimpse of the past performance and forecasts for future may not be correct since several other factors like market conditions, management policies, etc., may affect the future operations.
- ***Limitations of financial statements:*** Ratios are based only on the information which has been recorded in the Financial Statements. As indicated in the preceding chapter financial statements suffer from a number of limitations, the ratios derived there from, therefore, are also subject to those limitations. For example, non-financial changes though important for the business are not revealed by the financial

statements. If the management of the company changes, it may have ultimately adverse effects on the future profitability of the company but this cannot be judged by having a glance at the financial statements of the company.

- ***Ratios alone are not adequate:*** Ratios are only indicators, they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen. For example, a high current ratio does not necessarily mean that the concern has a good liquid position in case current assets mostly comprise outdated stocks. It has been correctly observed, 'Ratios must be used for what they are-financial tools. Too often they are looked upon as ends in themselves rather than as a means to an end. "The value of a ratio should not be regarded as good or bad inter se. It may be an indication that a firm is weak or strong in a particular area but it must never be taken as proof.' Ratios may be linked to railroads. They tell the analyst, 'stop, look and listen.
- ***Window dressing:*** The term window dressing means manipulation of accounts in a way so as to conceal vital facts and present the financial statements in a way to show a better position than what it actually is. On account of such a situation, presence of a particular ratio may not be a definite indicator of good or bad management. For example, a high stock turnover ratio is generally considered to be an indication of operational efficiency of the business. But this might have been achieved by unwarranted price reductions or failure to maintain proper stock of goods.
- ***Problems of price level changes:*** Financial analysis based on accounting ratios will give misleading results if the effects of changes in price level are not taken into account. For example, two companies set up in different years, having plant and machinery of different ages, cannot be compared, on the basis of traditional accounting statements. This is because the depreciation charged on plant and machinery in case of old company would be at a much lower figure as compared to the company which has been set up recently. The financial statements of the companies should, therefore, be adjusted keeping in view the price level changes if a meaningful comparison is to be made through accounting ratios. The techniques of current purchasing power and current cost accounting are quite helpful in this respect.
- ***No fixed standards:*** No fixed standards can be laid down for ideal ratios. For example, current ratio is generally considered to be ideal if current assets are twice the current liabilities. However, in case of those concerns which have adequate

arrangements with their bankers for providing funds when they require, it may be perfectly ideal if current assets are equal to slightly more than current liabilities.

- ***Ratios are a composite of many figures:*** Ratios are a composite of many different figures. Some cover a time period, others are at an instant of time while still others are only averages. It has been said that "a man who has his head in the oven and his feet in the ice-box is on the average, comfortable". Many of the figures used in the ratio analysis are no more meaningful than the average temperature of the room in which this man sits. A balance sheet figure shows the balance of the account at one moment of one day. It certainly may not be representative of typical balance during the year.

**Illustration:** Following is the profit and Loss Account and Balance Sheet of Jai Hind Ltd. redraft them for the purpose of analysis and calculate the following ratios:
(i) Gross Profit Ratio (ii) Overall Profitability Ratio (iii) Current Ratio (iv) Debt Equity Ratio
(v) Stock Turnover Ratio (vi) Liquidity Ratio.

**Dr** **Profit and Loss Account** **Cr.**

| **Particulars** | **(Rs.)** | **Particulars** | **(Rs.)** |
|---|---|---|---|
| Opening stock of | | Sales | 10,00,000 |
| finished goods | 1,00,000 | Closing stock of | 1,50,000 |
| Opening stock of raw materials | 50,000 | raw materials | |
| Purchase of raw materials | 3,00,000 | Closing stock of | 1,00,000 |
| Direct wages | 2,00,000 | finished goods | |
| Manufacturing expenses | 1,00,000 | Profit on sale of shares | 50,000 |
| Administration expenses | 50,000 | | |
| Selling and distribution | 50,000 | | |
| expenses | 55,000 | | |
| Loss on sale of plant | 10,000 | | |
| Interest on debentures | 3,85,000 | | |
| Net profit | | | |
| | **13,00,000** | | **13,00,000** |

**Balance Sheet**

| **Liabilities** | **(Rs.)** | **Assets** | **(Rs.)** |
|---|---|---|---|
| ***Share capital:*** | | ***Fixed assets:*** | |
| Equity share capital | 1,00,000 | Stock of raw materials | 2,50,000 |
| Preference share capital | 1,00,000 | Stock of finished goods | 1,50,000 |
| Reserves | 1,00,000 | Sundry debtors | 1,00,000 |
| Debentures | 2,00,000 | Bank balance | 1,00,000 |
| Sundry creditors | 1,00,000 | Bills Payable | 50,000 |
| | 6,50,000 | | 6,50,000 |

**Solution:**

**Income Statement** ***(in Rs.)***

| | | |
|---|---|---|
| Sales | | 10,00,000 |
| **Less** Cost of sales: | | |
| Raw material consumed (Op. Stock + Purchases – Closing stock) | 2,00,000 | |
| Direct wages | 2,00,000 | |
| Manufacturing expenses | 1,00,000 | |
| **Cost of production** | **5,00,000** | |
| ***Add*** Opening stock of finished goods | 1,00,000 | |
| ***Less*** Closing stock of finished goods | 1,00,000 | |
| ***Cost of goods sold*** | | 5,00.000 |
| Gross Profit | | 5,00,000 |
| **Less** Operating expenses: | | |
| Administration expenses | 50.000 | |
| | 50,000 | 1,00,000 |

| | | |
|---|---|---|
| Selling and distribution expenses | | 4,00,000 |
| Net Operating Profit | | 50,000 |
| **Add** Non trading income: | | 4,50,000 |
| Profit on sale of shares | | |
| **Less** Non-trading expenses or losses: | | 55,000 |
| Loss on sale of plant | | 3,95,000 |
| Income before interest and tax | | 10,000 |
| **Less** Interest on debentures | | **3,85,000** |
| ***Net Profit before tax*** | | |

**Balance Sheet (Or Position Statement) (Rs.)**

| | |
|---|---|
| Bank balance | 50,000 |
| Sundry debtors | 1,00,000 |
| ***Liquid assets*** | **1,50,000** |
| Inventories: | |
| Stock of raw materials | 1,50,000 |
| Stock of finished goods | 1,00,000 |
| **Current assets** | **4,00,000** |
| Sundry creditors | 1,00,000 |
| Bills payable | 50,000 |
| **Current liabilities** | **1,50,000** |
| **Working capital** (Rs. 4,00,000 – Rs.1,50,000) | **2,50,000** |
| **Add** Fixed assets | 2,50,000 |
| **Capital employed** | **5,00,000** |
| **Less** Debentures | 2,00,000 |
| **Shareholders' net worth** | **3,00,000** |
| **Less** Preference Share Capital | 1,00,000 |
| | **2,00,000** |

| | |
|---|---|
| **Equity Shareholders' net worth** | |
| **Equity Shareholders' Net worth is represented:** | |
| Equity share capital | 1,00,000 |
| Reserves | 1,00,000 |
| | 2,00,000 |

**Ratios:**

**(i) Gross Profit ratio:**

Gross profit / Sales x100= 5, 00,000 /10, 00,000 x100 =50%

**(ii) Overall Profitability Ratio:**

Operating profit/ Capital employed x 100= 4, 00,000/5, 00,000x 100= 80%

**(iii)Current Ratio:**

Current assets/ Current liabilities= 4, 00,000/1, 50,000= 2.67

**(iv)Debt Equity Ratio:**

External equities / Internal equities =3, 50,000/3,00,000= 1.17

**(v) Stock turnover ratio:**

a. As regards of average total inventory

Cost of goods sold / Average inventory =5, 00,000/1,00,000= 5

b. As regards average inventory of finished goods:

Cost of goods sold/ Average inventory of finished goods= 5, 00,000/1,00,000= 5

c. As regards average inventory of raw materials:

Material Consumed / Average inventory of Raw Materials =2, 00,000 /1,00,000=2

**(vi)Liquid Ratio:**

Liquid Assets /Current Liabilities=1,50,000/1.50.000= 1

## 4.7 SUMMARY

Financial statement analysis is a process that investigates historical and present financial data to evaluate the performance and estimate the prospects of risks and potentials. Financial statement analysis is used by investors, creditor, security analysts, bank lending officers, managers, governmental agencies, suppliers and many other groups that depend on financial data for taking decisions that are related to the economy of a company.

Examination of financial statements primarily concentrates on the data that is given in external reports along with added information given by the management. The examination must identify the main modifications or highlights in trends, amounts and relationships. Financial statements are simply outlines of comprehensive financial information. A large number of various groups have vested interests in gaining access to internal financial statements, typically investors and creditors. At times their aims are different, but usually related. Nevertheless, it is possible to apply the fundamental tools and methodologies of financial statement analysis in an effective way by all those who are interested. Financial statement analysis is helpful to investors in finding the type of information required by them for making decisions related to their interest in a specific organization.

## 4.8 KEY TERMS:

- **Analysis:** analysis means methodical classification of the data given in the financial statements.
- **Interpretation:** interpretation means explaining the meaning and significance of the data so classified.
- **Financial Statements:** income statement and balance sheet.
- **Ratio:** the relationship of one item to another expressed in simple mathematical form is known as a ratio.
- **Ratio Analysis:** the process of computing, determining and presenting the relationship of items and groups of items in financial statements.
- **Financial Leverage:** the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the firm's earnings per share.
- **Net Worth:** proprietors' funds – intangible assets – fictitious assets.
- **Debt:** both long term and short term liabilities.
- **Operating Profit:** gross profit – operating expenses.
- **Equity:** proprietors' fund.
- **Capital Employed:** net worth + long term liabilities.
- **Current Ratio** = $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$
- **Quick Assets** = Current Assets---Inventories
- **Net Working Capital =** Current Assets ---- Current Liabilities
- **Assets Turnover Ratio** = $\dfrac{\text{Sales}}{\text{Average Total Assets}}$
- **Inventory Turnover Ratio** = $\dfrac{\text{COGS}}{}$

Average Inventories

## 4.9 QUESTIONS AND EXERCISES:

1) Who and why would anyone perform financial statement analysis?
2) List out the major components that you would concentrate while analyzing the financial statements.
3) List out the different techniques of performing financial analysis.
4) What do you think is the purpose for the Common Size Financial Statement?
5) Explain the meaning of the term `financial statements'. State their nature and limitations.
6) Explain the different types of financial analysis.
7) Explain the various tools of financial analysis.
8) Justify the need for analysis and interpretation of financial statements.
9) Collect the annual reports of any public limited company for a period of 5 years. Calculate the trend percentages and prepare a report.
10) What is meant by ratio analysis? Explain its significance in the analysis and interpretation of financial statements.
11) Explain the importance of ratio analysis in making comparisons between firms.
12) How the ratios are broadly classified? Explain how ratios are calculated under each classification.
13) What are the limitations of ratio analysis?
14) Write short notes on:
    a. Trading on Equity.
    b. Debt Equity Ratio.
    c. Misleading Ratios.
    d. Working Capital Coverage Ratio.
15) What is percentage analysis? In what manner does it help in understanding a balance sheet.
16) Discuss briefly the different techniques of analysis and interpretation of financial statements.
17) What are the different methods used for analysis of financial statements?
18) What are the various types of financial statements?
19) Explain the following with examples:
    a. Comparative financial statements

b. Common size financial statements

20) "Ratios like statistics have a set of principles and finality about them which at times may be misleading." Discuss with illustrations.

## 4.10 PRACTICAL PROBLEM

1. The Balance Sheet of X Company Ltd. as on March 31, 2005 is given below. You are required to calculate the following ratios:

- Current ratio,
- Quick ratio,
- Net Working capital ratio.

**Balance Sheet of X Company Ltd., as on 31.3.2005**

| Liabilities | Amount Rs. | Assets | Amount Rs. |
|---|---|---|---|
| Share Capital | 20,000 | Buildings | 20,000 |
| Reserves and Surplus | 16,000 | Plant and Machinery | 10,000 |
| Debentures | 10,000 | Stock | 8,000 |
| Sundry Creditors | 11,000 | Sundry Debtors | 7,000 |
| Bank Overdraft | 1,000 | Prepaid | 2,000 |
| Bills Payable | 2,000 | expenses | 12,000 |
| Provision for Taxation | 1, 000 | Securities | 2,000 |
| Outstanding Expenses | 1,000 | Bank | 1,000 |
| | | Cash | |
| **Total** | **62,000** | | **62,000** |

******

# UNIT 5: CORPORATE SOCIAL REPORTING

**Structure**



## 5.0 INTRODUCTION

Social Responsibility Accounting is the newest field of accounting and is the most difficult to describe concisely. It owes its birth to increasing social awareness which has been particularly noticeable over the last three decades or so. Social responsibility accounting is so called because it not only measures the economic effects of business decisions but also their social effects, which have previously been considered to be immeasurable. Social responsibilities of business can no longer remain as a passive chapter in the text books of commerce but are increasingly coming under greater scrutiny. Social workers and people's welfare organizations are drawing the attention of all concerned towards the social effects of business decisions. The management is being held responsible not only for the efficient conduct of business as reflected by increased profitability but also for what it contributes to social well-being and progress.

## 5.1 UNIT OBJECTIVES

After reading this lesson, you will be able to:

- Understand about social reporting.
- Know about value added statement.
- Comparison between social cost and private cost.
- Explain the different approaches for reporting social cost benefit information.
- Describe the criteria for measuring social cost benefit.
- Understand corporate disclosure regarding social reporting.

## 5.2 SOCIAL INCOME STATEMENT

**Measurement of Social Cost Benefit:** The United Nations Industrial Development Organization (UNIDO) and the Centre for Organization of Economic Co-operation and Development (COECD) have come with useful publications dealing with the problemof measuring social costs and social benefits. It may be noted, in thiscontext, that the actual cost of or revenues from the goods and/or services to the organization do not necessarily reflect the monetarymeasurement of the cost or benefit to the society. This is becausethese figures are grossly distorted on account of restrictions and controlsimposed by the Government. Hence, a different yardstick has to beused for evaluating a particular payment in terms of cost and sacrificeon the part of the society. Such payments are easily valued at opportunitycost or shadow prices to judge their real impact in terms of cost tosociety for the purpose of social cost benefit evaluation. Of course, it isalmost impossible to measure in precise monetary terms, the real costsand benefits to the society as a result of a project. However, a broadjudgment can be made about the acceptability or otherwise of a projecton social grounds by looking to the different social aspects associatedwith the project. The following are some of the indicators/criteria whichcan be used for measuring the social costs and benefits associatedwith the projects.

- **Employment potential**: The impact of the proposed project onthe employment situation is an important consideration in adeveloping country like India. A project having higher employedpotential has to be preferred over a project having a loweremployment potential.
- **Capital output ratio**: This ratio measures the expected outputin relation to the capital employed in the project. Since capital is ascarce resource, the desirability of a project can be judged onthe basis of the return which the project is expected to give oncapital employed in the project. This criterion is particularlyimportant in case of developing countries which suffer from aconstraint of capital resources. According to this criterion, a projectgiving a higher output per unit of capital employed is to be preferredover a project giving a lower output.
- **Value-added per unit of capital**: This criterion is similar tothe capital output rating. However, in case of this criterion, theestimated value added by a project is considered in place ofthe total value of the output. The term "Value Added" refers tothe cost incurred by an organization, (such as salaries, wages,interest, etc.) in converting materials into finished products. Thus,the value added by a project can be ascertained by deductingthe total value of bought-out inputs, such as raw material,components, etc. from the total value of production.This criterion is superior to the "Capital Output Ratio" since itconsiders the net contribution of the firm to the nation's economy. For example, if a firm is engaged merely in packing amanufactured product into small lots, it will have a high capitaloutput ratio but its contribution in terms of "value added" will benegligible.While evaluating different projects according to social cost benefitanalysis technique projects having high "value added" contentare to be ranked high.
- **Savings in foreign exchange**: The impact of the project on theforeign exchange reserves of the country is also good socialcriterion for accepting or rejecting a project. In a developing countrylike India, where the foreign exchange position generally remainstight, this is an important criterion, while making appraisal of aproject. For evaluating the projects according to this criterion,projects can be ranked according to the net contribution theprojects are going to make to the foreign exchange reserves ofthe country. Projects having greater potentiality in terms of foreignexchange benefits will have priority over other projects.
- **Cost benefit ratio**: According to this criterion, the projects areevaluated on the basis of total social benefits and costsassociated with the projects. Social benefits for this purposeinclude all economic and non-economic, internal and externalbenefits which the society is likely to receive on account of theproject. Similarly, the term social cost includes all costs whichthe society will have to pay whether in monetary terms or otherwisefor the project. While evaluating projects according to this criterion, the projects are ranked according to their cost benefit

ratios. Aproject having the most favorable cost benefit ratio is given thehighest preference.

## 5.3 SOCIAL ACCOUNTING

**Introduction:**

Social accounting is concerned with the measurement and disclosureof costs and benefits to the society as a result of operating activities of a business enterprise. Thus, social accounting measures social costs and social benefits as a result of business activities for communication to various groups both within and outside the business. It may be noted that social accounting is not the application of a new set of accounting principles or practices. It is the application of the same basic accounting principles for measuring and disclosing the extent, to which a business enterprise has met its social responsibility. Seidler has, therefore, defined social accountings as “modification and application of conventional accounting to the analysis and solutions of problems of a social nature.”

The objective of social accounting can be summarized as follows:

- **Measurement of net social contribution:** Social accountingaims at identifying and measuring the periodic net socialcontribution of a firm. This includes the aggregate of netbenefits to the company’s employees, to the community (i.e. local population) and to the general public.
- **Balance between firm’s strategies and social priorities:** Social accounting helps in determining whether the firm’sstrategies and policies are consistent with the legitimate individual aspirations and also with the overall priorities of thecommunity and the society.
- **Communication of information:** Social accounting aimsto make available information of a firm’s goals, policies,programmes, contribution to social goals etc. to all segmentsof the society.

**Reporting of Social Cost Benefit Information:**

As stated above, social accounting measures and reports the socialcosts and benefits on account of operating activities of a business enterprise. The different criteria used for measurement of social cost benefits have already been explained in the preceding pages. We are now explaining the different approaches for reporting social costs benefit information to the different segments of the society.

- **Social statement approach:** According to this approach, two statements are prepared (i) Social Income Statement and (ii) SocialBalance Sheet. The Social Income Statement provides informationaccording to social benefits and costs to employees, local communityand the general public. Social balance sheet portrays social investmentof capital nature (i.e. social assets) Viz. Township, roads, buildings,hospitals, schools, clubs, etc. on the assets side and the organization'sequity and social equity on the liabilities side. This approach has the advantage of giving adequate quantitative information for being used for inter-firm and intra-firm comparisons.

However, this approach is criticized on the ground that in the absence of well-accepted measurement techniques, valuation of social costs and social benefits as per this approach cannot be considered reliable. Most of the Indian companies are following this approach with some modifications. They include Minerals and Metals Trading Corporation of India Ltd. (MMTC), Oil India Ltd. (OIL), Steel Authority of India Ltd. (SAIL), Madras Refineries Ltd. (MRL) and Oil and Natural Gas Commission (ONGC) etc.

- **Operating statement approach:** According to this approach, afirm presents only the positive and negative aspects of social activities as a result of business operations. The positive aspects are broadly termed as "social benefits" while negative aspects are termed as "social costs." The difference between social benefits and social costs represent the net social contribution by the firm.

**Illustration:** From the following information of Steel India Ltd. For the year ended 31st March, 2008, prepare their Social Balance Sheet as on that date:

(i) A specialist has valued their human assets at ` 828 lakhs.

(ii) Their investments were classified as:

***(Rs. in lakhs)***

| | **Residential** | **Hospital** | **School** | **Welfare** |
|---|---|---|---|---|
| **Buildings** | 17.00 | 1.00 | 1.40 | 0.80 |
| **Equipment** | 2.80 | 1.00 | 1.00 | Nil |

(i) Water, electricity and gas supply systems totalledRs.1 lakh.

(ii) Their Net owned funds were Rs. 26 lakhs.

**Solution:**

**Steel India Ltd.**

**BALANCE SHEET as on 31.03.2008**

***(Rs.in lakhs)***

| ***Liabilities*** | ***Rs.*** | ***Asset*** | ***Rs.*** |
|---|---|---|---|
| Organization Equity | 26.00 | Social Capital Investment: | |
| | | (a) Buildings | |
| Social Equity<br>(Contribution by staff) | 828.00 | *(i) Residential 17.00*<br>*(ii) Hospital 1.00*<br>*(iii) School 1.40*<br>*(iv) Welfare 0.80* | 20.20 |
| | | (b) Equipment<br>*(i) Residential 2.80*<br>*(ii) Hospital 1.00*<br>*(iii) School 1.00* | 4.80 |
| | | (c) Water Electricity and Gas supply systems | 1.00 |
| | 854.00 | Human assets (as valued by the specialist) | 828.00 |
| | | | 854.00 |

**Illustration**: From the following information taken from the books of F Ltd. relating to staff and community benefits, prepare a statement classifying the various items under the appropriate heads, required under Corporate Social Reporting.

| | (***Rs.)*** |
|---|---|
| Environment Improvements | 21,10,000 |
| Medical facilities | 45,00.000 |
| Training Programmes | 10,25,000 |
| Generation of Job Opportunities | 60,75,000 |
| Municipal Taxes | 10,70,000 |
| Increase in cost of living in the vicinity due to a thermal power station | 16,55,000 |
| Concessional transport, water supply | 11,25,000 |
| Extra work put in by staff and officers for drought relief | 18,50,000 |
| Leave encashment and leave travel benefits | 52,00,000 |

| | |
|---|---|
| Educational facilities for children of staff members | 21,60,000 |
| Subsidised canteen facilities | 14,40,000 |
| Generation of business | 25,00,000 |

**Solution:**

**F Ltd.**

**STATEMENT RELATING TO STAFF AND COMMUNITY BENEFITS**

| | ***Rs.*** |
|---|---|
| **I. Social Benefits and Cost to Staff** | |
| ***A. Social Benefits to Staff*** | |
| 1. Medical facilities | 45,00,000 |
| 2. Training programmes | 10,25,000 |
| 3. Concessional transport, water supply | 11,25,000 |
| 4. Leave encashment and leave travel benefits | 52,00,000 |
| 5. Educational facilities for children of staff members | 21,60,000 |
| 6. Subsidised canteen facilities | 14,40,000 |
| **Total** | **1,54,50,000** |
| ***B. Social Costs to Staff*** | |
| Extra work put in by staff and officers for drought relief | 18,50,000 |
| ***Net Social Benefits to Staff (A) – (B)*** | ***1,36,00,000*** |
| **II. Social Benefits and Cost to Community** | |
| ***A. Social Benefits to Community*** | |
| 1. Environmental improvements | 20,10,000 |
| 2. Generation of job opportunities | 60,75,000 |
| 3. Municipal taxes | 10,70,000 |
| 4. Generation of business | 25,00,000 |

| | |
|---|---|
| ***Total*** | ***1,16,55,000*** |
| ***B. Social Costs to Community*** | |
| Increase in cost of living in the vicinity due to a thermal power station | 16,55,000 |
| ***Net Social Benefits to Community (A) – (B)*** | ***1,00,00,000*** |

- **Narrative approach:** This is simplest and easiest method for reporting social costs and social benefits information. In case of this approach, disclosure regarding social costs and social benefits is made in a narrative and not in a quantitative form. According to this approach, the firm generally highlights the positive aspects of its social activities. This approach is not informative since it does not provide quantitative information. Moreover, inter-firm and intra-firm comparisons are also not possible.
- **Goal-oriented approach**: This approach is based on the listed objectives of a firm. According to this approach, the firm prepares a list of its social and economic goals or objectives. At the end of the accounting year, the firm prepares its annual report giving the description of the goals both economic and social and the firm's performance in respect of these goals. Wherever possible, the goals, and the achievements are presented in the form of charts and graphs.

  The presentation of information about social costs and benefits in the above manner helps in ascertaining the direction in which the firm is moving in achieving its social goals. The actual social goals can be compared with the predetermined social goals and the performance of the firm can be evaluated.

- **Pictorial approach**: According to this approach, social activities undertaken by an enterprise are presented in the form of pictures. The annual reports contain photographs of school, hospital, club, Public Park established and/or maintained by the firm. This is the simplest method of presenting social information and hence followed by many companies in our country.

**Social Cost Benefit Analysis in India**

There is no legal obligation on companies in India to provide details of social costs and social benefits while preparing their financial statements. However, some companies in private and public sectors are giving by means of supplementary information the details of social costs and benefits as a result of their operations. Some of these companies are as follows:

1. Tata Iron and Steel Co.

2. Projects and Equipment Corporation of India Ltd.

3. Bharat Heavy Electricals Ltd.

4. Indian Petrochemicals Corporation Ltd.

5. Cement Corporation of India.

6. Bharat Petroleum Corporation India Ltd.

7. Neyveli Lignite Corporation Ltd.

8. Oil India Ltd.

9. Cochin Refineries Ltd.

10. The Minerals & Metals Trading Corporation of India Ltd.

11. Indian Rare Earths Ltd.

12. Madras Refineries Ltd.

13. Oil & Natural Gas Corporation.

## 5.4 VALUE ADDED STATEMENT

**Value Added:**

Value Added is the wealth created by a Firm, through the combined effort of (1) Capital (2) Management and (3) Employees. This wealth concept arises due to the input- output exchange between a Firm and components of its external environment.

Value Added = Sale Value of Outputs **Less:** Cost of Bought in goods and services.

**Gross Value Added (GVA)**

Retained Profits= Sales Revenue - Materials Cost - Wages Cost - Expenses Cost -

Managerial Remuneration - Depreciation Expenses - Interest paid - Taxes paid - Dividends paid.

**Transposing the same, we have the following equation –**

Sales Revenue - Materials Cost - Expenses Cost = Retained Profits + Wages paid + Managerial

Remuneration + Interest, paid + Taxes paid + Dividends paid + Depreciation Expense.

**Net Value Added (NAV)**

Net Value Added = Gross Value Added — Depreciation

**Utility of GVA reporting than NVA reporting:**

- Realistic meaning of Retained profits: There is no cash outflow from a firm to the extent of depreciation charged. Hence, GVA reporting, which includes depreciation as part of retained profits, properly reflects the amount retained for business purposes.
- Objectivity: Depreciation charged in the accounts depends on the firm's policy and also on the estimates of the asset's useful life, scrap value, etc. Since the cost of bought in materials and services are deducted to compute GVA, it is derived in an objective manner than NVA.
- Macro level analysis: At the macro level, Gross Domestic Product (GDP) is commonly used as indicator of economic trends. GVA reporting will make aggregation of data easier for macro level analysis.

**Advantages of NVA over GVA:**

- Matching: NVA reporting properly deducts depreciation, which represents a write off of the capital cost of the asset due to wear and tear. This results in proper matching of the period's revenues with costs.
- Asset Life Disparity: Under GVA, cost of tools, jigs, etc. having a life of one year would be deducted whereas depreciation on assets having a longer useful life will not be deducted. NVA recognizes both types of assets and properly records depreciation on the assets utilized. Calculation of Wealth: Wealth or Surplus created by an entity will be overstated if no allowance is made towards wear and tear or loss of value of fixed assets used by the entity.
- Impact on Productivity Bonus: When a Productivity Bonus is paid to employees based on Value Added, NVA is more appropriate since it recognizes the effect of mechanization, etc. by charging depreciation.

**(a) Proprietary Theory; (b) Entity Theory; and (c) Enterprise Theory.**

a) **Proprietary Theory:** This theory is based on the principle that the proprietor is the center of interest. This theory propounds that all assets belong to the Proprietor and all liabilities are the Proprietor's obligations. This theory holds good only for a Sole Proprietorship or a Partnership.

b) **Entity Theory:** This theory is suitable for corporate form of business enterprises. The theory suggests that the Net Income of the Reporting Entity is generally expressed in terms of the Net Change in the Stockholders' Equity. It represents the residual change in equity position after deducting all outsiders' claims. The Reporting Entity is considered as a separate economic unit operating only for the benefit of its Equity Shareholders.

c) **Enterprise Theory:** In this theory, the Reporting Entity is a Social Institution, operating for the benefit of many interested groups like Shareholders, Bondholders, Management, Employees, etc. The Value Added isan important concept in this theory. When the income is defined as the reward of a larger group of people than just shareholders, the concept and its understanding is better.

## 5.5 RELEVANCE OF VALUE ADDED STATEMENTS IN CORPORATE FINANCIAL REPORTING

- **Company Ranking:** The Value Added is a very good index to measure the size and importance of company. It also overcomes the distortion in ranking caused by the use of inflated sales.
- Systems Concept: The Value Added Statement reflects the Company's objectives and responsibilities in abetter fashion. It establishes the fact that the business entity is part of a larger system interacting with other components in the environment.
- **Employee Incentives:** The Value Added Statement paves way for introduction of productivity linked bonus schemes for the employees. Calculation also becomes easier.
- **Macro level analysis:** The Value Added Statement links the Company's financial accounts to the national income by indicating the Company's Contribution to National Income.
- **Ratio Analysis:** The Value Added Statement helps in ratio analysis. The Value Added to Payroll, Taxes to Value Added and Value Added to Sales ratios are used as predictive tools for analysis of different firms. It also provides for adjustments in respect of inflation, to facilitate comparison between periods.
- **Concepts:** The Value Added Statement is based on fundamental concepts that are accepted in financial statements like the going concern concept, matching concept, consistency and substance over form, etc.

- **Performance Measure:** Value Added is a better measure of performance of business entity than the profit. It explains the input-output relationship. Once the value added is ascertained, it is possible to establish linkage with value to be used —
    - For the work force – for Wages, Salaries
    - For the Government – for Corporation Tax and related expenses
    - For the Financiers – for Interest on loans and
    - For the Business – for retention for Dividends on Share Capital
- Budgeting: Value Application is a pre-condition for value generation. So insufficiency of value added can be understood beforehand. This may be good test for Business Budgeting than Financial Reporting.

**What information can we gather from Value Added Statements?**

- Wealth Creation: The Value Added Statement specifies the wealth accumulated by the Company. It states in monetary terms the wealth accumulated by the Company.
- Beneficiaries/participants of wealth: The Value Added Statement states the application of Value Added to shareholders, bondholders, employees, etc. This identifies the participants/beneficiaries of the wealth generated by the Company and their interest in the Company in terms of value and percentage.
- Value Added based ratios: The following ratios can be computed – Value Added to Sales, Value Added to payroll, Taxes to Value Added, etc. This facilitates comparison of ratios between periods as well as comparison between Companies.
- Value Added Interpretation: Value Added facilitates interpretation of operating results or contribution of various Companies. The real wealth of Companies can be understood only from the Value Added Statement, as the comparison of Sales Turnover may not give a real picture. Many Companies can have the same turnover also.

**Disadvantages of Value Added Reporting:**

- Risk: Employees, Government and Fund Providers are interested only in getting their share of Value Added. The entire business risk is borne only by the Shareholders. The residual profits after meeting the obligations of the outside groups should be shown as the Value Added accruing to the shareholders.
- Non-uniformity: Value Added Statements are non-standardized in areas like inclusion or exclusion of Depreciation, Taxation on Profits, etc. This can however be overcome by defining an Accounting Standard on Value Added.

## 5.6 CORPORATE DISCLOSURES

**Environmental Disclosures:**

In recent years, the public concern about adverse impact on environment due to business activities is growing. As a result, companies have started disclosing qualitative and quantitative information about showing their role is improvement and maintenance of environment. However, the mode of recording and presentation of such information for different corporations in different countries has not been uniform. The International Accounting Standards Committee is now, therefore, working to form the global environmental accounting standard to bring uniformly in the environmental accounting protection throughout the world.

The following are some of the environmental issues which are pertinent to business enterprise:

a. Environmental protection policy and programme adopted by the enterprise.
b. Improvements effected since the introduction of environmental policy in different key areas over the period at least 5 years, whichever is shorter.
c. Environmental emission targets set by the enterprise for data and progress achieved so far.
d. The extent to which environmental protection measures have been taken due to government legislation.
e. Legal proceedings taken against the company for material violation of environmental laws.
f. Financial implications of short-term and long-term environmental protection measures.

**Corporate Environmental Reporting in India**

In view of the public concern about environment and the ambiguity in the accounting treatment of environmental costs and liabilities, the corporate undertakings world over, in their own way, have started disclosing both qualitative and financial information about the role played by them in the improvement and maintenance of environment. In India, the corporate sector is making environmental disclosure both on account of statutory requirements and also on their own as discussed below:

**a. Statutory disclosure:** The legal provisions as to environmental disclosure in Annual Accounts are minimal. Section 217(I)(e) of the Companies Act, 1956, provides that the Directors' Report shall include the particulars as to "Conservation of energy, technology absorption, foreign exchange earnings and outgo in such manner as may be prescribed," Consequently, the Government of India has prescribed the following information to be given by 21industrial groups:“Every company shall, in the report of its Board of Directors, disclose particulars with respect to the following matters, namely:

- **Conservation of energy:**
  (a) Energy conservation measures taken;
  (b) Additional investments and proposals, if any, being implemented for reduction of consumption of energy;
  (c) Impact of the measures of (a) and (b) above for reduction of energy consumption and consequent impact on the cost of production of goods; and
  (d) Total energy consumption and energy consumption per unit of production as per Form A in respect of industries specified in the Schedule thereto…”

b. **Voluntary disclosure.** Many corporate enterprises in India, on their own are giving information in their Annual Reports on the role played by them in environmental protection. Such information shows their concern about their social responsibility and their inclination to protect the interest of both the present and future generation. Some of the companies which are making such disclosures are: Asian Paints Limited, Chloride Industries Limited,GoodlessNerolac Paints Limited, MarutiUdyog Limited, SteelAuthority of India Limited, Hindustan Lever Limited, etc.

**Commitment to Environment**

**Energy Management**

Conserving energy through innovative thinking and efficient process. Our efforts focused on energy conservation as well as use of renewable energy have resulted in a reduction of our energy consumption by 61% since 1996. It has also led to a 58% reduction of emission of greenhouse gases. We have taken several initiatives including process redesign, fuelsubstitution, rationalizing equipment and productivity improvement. We have deployed new technologies to optimize electrical energy inputs and heat recover while plugging atmospheric energy losses. This has reduced the global warming potential as well as saved energy.

Our Energy Management and conservation efforts are based on the 5R principle-Reduce, Reuse, and Recycle, Recover and Renew. Our focus on energy reduction is beneficial both from an environmental viewpoint and also from the point of view of cost saving for the company.

**Sustainable Agricultural Initiatives:**

Ensuring long-term access to raw materials and reducing effects of modern farming. We aim to meet the needs of the present without compromising on the ability of the future generations to meet their own needs. Our Sustainable Agriculture projects in our tea plantations in Assam and South India work with the objective of ensuring continued supply of tea with higher productivity, better quality and with environmental and social benefits for all involved.

As part of the project, 2000 MT of vermi-compost made fromagricultural waste is produced in our plantations. Experiments are under way to study the scope of use of bio-fertilizers with an aim to reduce inorganic fertilizers by 50%. We have also published booklets on Good Agricultural Practices for the benefit of the Tea Industry and the environment at large. Sustainable Agriculture that ensures economic growth, environmental protection and social progress is a key element of our plantation operations.

## 5.7 CORPORATE GOVERNANCE DISCLOSURES

**Corporate Governance:**

***Concept of Corporate Governance:***

The good governance is the expectation of a stakeholder in every walkof life. This expectation has lately come to be recognized as a right inthe corporate world also. Corporate Governance is, therefore, the newbuzzword in corporate jargon. Its concept has emerged over the lasttwo decades. It requires, by corporations, timely and accuratedisclosures on all material matters relating to them, viz., financialposition, performance, ownership and governance of the corporationetc.The objective of corporate governance is compliance with corporatelaws and rules on the legislative side and proper accountability to thestakeholder, legally and morally. Corporate governance is a compulsionof long-term corporate existence. Its importance and significance hasgreatly increased in the present era of liberalization, privatization andglobalization. The concept of corporate governance has been well speltout by Sir Adrian Cadbury, in the following words: “Corporate Governanceis considered with holding the balance between economic and socialgoals and between individual and community goals. The governanceframework is there to encourage the efficient use of resources andequally to require accountability for the stewardship of those resources.The aim is to align as nearly as possible the interests of individuals,corporations and society”.Thus, corporate governance aims at enhancement of the longtermshareholder value while at the same time, protecting the interestsof other stakeholders’ viz., the suppliers, customers, creditors, bankers,employees, government and the society at large. Good corporategovernance is essential not only for gaining credibility and trust but alsoas a strategy for survival, consolidation and growth. The mainconstituents of corporate governance are the Shareholders, the Boardof Directors, and the Management.The need and importance of corporate governance can best beconveyed from the following statement of Benjamin Franklin:

*"A little neglect may breed great mischief – for the want of a nail, the show was lost; for the want of a shoe, the horse was lost; for the want of a horse, the rider was lost; and for the want of a rider, the battle was lost".*

**Emergence of Corporate Governance**

The concept of corporate governance gained prominence in academicand professional literature towards the end of 20th century, particularlyin the year 1980 and onwards. In UK, many corporations collapsed inthe late 1980s and the early 1990s. Notable cases were BCCI, PollyPeck and pension funds of the Maxwell Communication Group. Theimpact of the failures of these corporations was quite severe on thesociety as a whole resulting in boost of the debate on corporategovernance. The resultant focus on the issue of corporate governanceculminated in the Cadbury Report on the financial aspects of thecorporate governance in 1992, the Green Bury Report on Directors'Remuneration in 1995, the Preliminary and Final Hampel Report onCorporate Governance in 1997 and 1998. The stock exchange listingrules were also amended in UK w.e.f. July 1993 in compliance with theCadbury Committees' Report.

In the U.S., the intensive debate on the corporate governancesystem was initiated in the 1980s during a period of widespreadcorporate restructuring and takeovers. Tread Way Commission Reportwas published in the U.S. in October 1987. The report was essentiallyin respect of fraudulent financial reporting. The Securities and ExchangeCommission of the U.S. updated the listing requirements for thecorporation in 1988 following the above reporting. Later on, the collapseof Enron, large scale misreporting of World Dotcom, Quest and actionagainst a leading auditing company KPMG, and the resultant publicannoyance, all made the U.S. Government to take appropriate legislativemeasures. Consequently, the Sarbanes-Oxley Act was passed by theU.S. Congress in June 2002. This is, by far, the most sweeping reformof corporate governance in USA since the great depression of thirties.The most outstanding aspect of Act is the better regulation of auditorsand restrictions on what they can and cannot do.In India, the history of corporate governance dates back to the year1998 with the setting of corporate governance code developed by theConfederation of Indian Industries (CII). The initiative got momentum byconstitution of the Corporate Governance Committee by SEBI underthe chairmanship of Shri Kumar Mangalam Birla. The recommendationsof the Committee were accepted by the SEBI vide press release dated21.02.2000, as a result of which Clause 49 on corporate governancewas incorporated in the Listing Agreements of the stock exchanges.Simultaneously, the Central Government came forward with theCompanies (Amendment) Act, 2000, which introduced many provisionsrelating to corporate governance, viz., additional grounds ofdisqualification of directors in certain cases, setting up of auditcommittees, directors' responsibility statement as a part of Directors'Report etc.

The Enron debacle of 2001, the scam involving the fall of corporategiants in the U.S. like World Com, Quest, Global Crossing and theenactment of stringent Sarbanes-Oxley Act in the U.S., referred earlier,were some important factors which led the Indian Government to wakeup and appoint in the year 2002, the Naresh Chandra Committee. TheCommittee was asked to examine and recommend drasticamendments to the law involving Auditor-Client relationships and therole of the individual auditors. The committee, in its report, made severalrecommendations regarding auditor-company relationship,independence of auditors, disqualification for audit assignments,prohibition of non-audit services by the auditors, rotation of audit firms,disclosures by auditors, appointment and remuneration of auditors etc.In 2002, SEBI itself constituted a Committee under the chairmanship ofNarayan Murthy, Chairman of Infosys Technologies Limited, to reviewthe performance of corporate governance in India and make appropriaterecommendations. The Committee submitted its report to the SEBI on8th February, 2003. In the meantime, the government accepted manyof the recommendations of Naresh Chandra Committee andconsequently introduced Companies (Amendment) Bill, 2003 inParliament in May 2003.

The Clause 49 of the listing agreement providing for CorporateGovernance in February 2000 has been amended several times. It was amended twice in 2000, thrice in the year 2001 and now further w.e.f.26August 2003 on the basis of the recommendations of the Committee appointed by SEBI under the chairmanship of Shri N.R. Narayana murthy.The provisions of the revised clause 49 are as under:

**I. Board of Directors**

**A. Composition of board**

(i) The board of directors of the company shall have an optimumcombination of executive and non-executive directors with notless than fifty per cent of the board of directors comprising ofnon-executive directors. The number of independent directorswould depend on whether the Chairman is executive or nonexecutive.In case of a non-executive chairman, at least one-thirdof board should comprise of independent directors and in caseof an executive chairman, at least half of board should compriseof independent directors.“Provided that where the non-executive Chairman is a promoterof the company or is related to any promoter or person occupyingmanagement positions at the Board level or at one level belowthe Board, at least one-half of the Board of the company shallconsist of independent directors.”

***Explanation (i)*** For the purpose of this clause, the expression‘independent director’ shall mean non-executive director of thecompany who

(a) Apart from receiving director's remuneration, does not haveany material pecuniary relationships or transactions with thecompany, its promoters, its senior management or its holdingcompany, its subsidiaries and associated companies;

(b) Is not related to promoters or management at the board levelor at one level below the board;

(c) Has not been an executive of the company in the immediatelypreceding three financial years;

(d) Is not a partner or an executive of the statutory audit firm orthe internal audit firm that is associated with the company,and has not been a partner or an executive of any such firmfor the last three years. This will also apply to legal firm(s)and consulting firm(s) that have a material association withthe entity.

(e) Is not a supplier, service provider or customer of thecompany. This should include lessor-lessee typerelationships also; and

(f) Is not a substantial shareholder of the company, i.e. owningtwo per cent or more of the block of voting shares.

(g) Is not less than 21 years of age.

***Explanation (ii)*** Institutional directors on the boards ofcompanies shall be considered as independent directors whetherthe institution is an investing institution or a lending institution.

**B. Non-executive directors' compensation and disclosures**

(i) All compensation paid to non-executive directors shall be fixedby the board of directors and shall be approved by shareholdersin general meeting. Limits shall be set for the maximum numberof stock options that can be granted to non-executive directors inany financial year and in aggregate. The stock options granted tothe non-executive directors shall vest after a period of the leastone year from the date such non-executive directors have retiredfrom the Board of the Company.

(ii) The considerations as regards compensation paid to anindependent director shall be the same as those applied to a nonexecutivedirector.

(iii) The company shall publish its compensation philosophy andstatement of entitled compensation in respect of non-executivedirectors in its annual report. Alternatively, this may be put up onthe company's website and reference drawn thereto in the annualreport. Company shall disclose on an annual basis, details ofshares held by non-executive directors, including on an “ifconverted”basis.

(iv) Nonexecutive directors shall be required to disclose their stockholding (both own or held by/for other persons on a beneficialbasis) in the listed company in which they are proposed to beappointed as directors, prior to their appointment. These detailsshould accompany their notice of appointment.

**C. Independent director**

(i) Independent Director shall however periodically review legalcompliance reports prepared by the company as well as stepstaken by the company to cure any taint. In the event of anyproceedings against an independent director in connection withthe affairs of the company, defense shall not be permitted on theground that the independent director was unaware of thisresponsibility.

(ii) The considerations as regards remuneration paid to anindependent director shall be the same as those applied to a nonexecutivedirector.

**D. Board procedure**

(i) The board meeting shall be held at least four times a year, with amaximum time gap of four months between any two meetings.The minimum information to be made available to the board isgiven in Annexure-1A.

(ii) A director shall not be a member in more than ten committees oract as Chairman of more than five committees across allcompanies in which he is a director. Furthermore it should be amandatory annual requirement for every director to inform thecompany about the committee positions he occupies in othercompanies and notify changes as and when they take place.

***Explanation:*** For the purpose of considering the limit of thecommittees on which a director can serve, all public limitedcompanies, whether listed or not, shall be included and all othercompanies (i.e. private limited companies, foreign companies andcompanies under Section 25 of the Companies Act, etc) shall beexcluded.

(iii) Further only the three committees viz. The Audit Committee, theShareholders’ Grievance Committee and the RemunerationCommittee shall be considered for this purpose.

**E. Code of conduct**

(i) It shall be obligatory for the Board of a company to lay down thecode of conduct for all Board members and senior managementof a company. This code of conduct shall be posted on the websiteof the company.

(ii) All Board members and senior management personnel shall affirmcompliance with the code on an annual basis. The annual reportof the company shall contain a declaration to this effect signedby the Chief Executive Officer (CEO) and Chief Operating Officer(COO).

***Explanation:*** For this purpose, the term “senior management”shall mean personnel of the company who are members of itsmanagement/operating council (i.e. core management teamexcluding Board of Directors). Normally, this would comprise allmembers of management one level below the executive directors.

**F. Term of office of non-executive directors**

Person shall be eligible for the office of nonexecutive director solong as the term of office did not exceed nine years in three termsof three years each, running continuously.

**II. Audit Committee**

**A. Qualified and independent audit committee**

A qualified and independent audit committee shall be set up and shallcomply with the following:

(i) The audit committee shall have minimum three members. All themembers of audit committee shall be nonexecutive directors, withthe majority of them being independent.

(ii) All members of audit committee shall be financially literate and atleast one member shall have accounting or related financialmanagement expertise.

***Explanation (i)*** The term “financially literate” means the abilityto read and understand basic financial statements i.e. balancesheet, profit and loss account, and statement of cash flows.

***Explanation (ii)*** A member will be considered to haveaccounting or related financial management expertise if he orshe possesses experience in finance or accounting, or requisiteprofessional certification in accounting, or any other comparableexperience background which results in the individual’s financialsophistication, including being or having been a chief executiveofficer, chief financial officer, or other senior officer with financialoversight responsibilities.

(iii) The Chairman of the Committee shall be an independent director;

(iv) The Chairman shall be present at annual general meeting toanswer shareholder queries;

(v) The audit committee should invite such of the executives, as itconsiders appropriate (and particularly the head of the financefunction) to be present at the meetings of the committee, but onoccasions it may also meet without the presence of anyexecutives of the company. The finance director, head of internalaudit and when required, a representative of the external auditorshall be present as invitees for the meetings of the auditcommittee;

(vi) The Company Secretary shall act as the secretary to thecommittee.

**B. Meeting of audit committee**

The audit committee shall meet at least thrice a year. One meetingshall be held before finalization of annual accounts and one every sixmonths. The quorum shall be either two members or one third of themembers of the audit committee, whichever is higher, and minimum oftwo independent directors.

**C. Powers of audit committee**

The audit committee shall have powers which should include thefollowing:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if itconsiders necessary.

**D. Role of audit committee**

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and thedisclosure of its financial information to ensure that the financialstatement is correct, sufficient and credible.
2. Recommending the appointment and removal of external auditor,fixation of audit fee and also approval for payment for any otherservices.
3. Reviewing with management, the annual financial statementsbefore submission to the board, focusing primarily on;
   (a) Any changes in accounting policies and practices.
   (b) Major accounting entries based on exercise of judgment bymanagement.
   (c) Qualifications in draft audit report.
   (d) Significant adjustments arising out of audit.
   (e) The going concern assumption.
   (f) Compliance with accounting standards.

(g) Compliance with stock exchange and legal requirementsconcerning financial statements

(h) Any related party transactions

4. Reviewing with the management, external and internal auditors,and the adequacy of internal control systems.
5. Reviewing the adequacy of internal audit function, including thestructure of the internal audit department, staffing and seniorityof the official heading the department, reporting structure coverageand frequency of internal audit.
6. Discussion with internal auditors any significant findings and followup there on.
7. Reviewing the findings of any internal investigations by the internalauditors into matters where there is suspected fraud or irregularityor a failure of internal control systems of a material nature andreporting the matter to the board.
8. Discussion with external auditors, before the audit commences,about nature and scope of audit as well as post-audit discussionto ascertain any area of concern.
9. Reviewing the company's financial and risk management policies.
10. To look into the reasons for substantial defaults in the payment tothe depositors, debenture holders, shareholders (in case of nonpaymentof declared dividends) and creditors.

***Explanation (i)*** The term "related party transactions" shall havethe same meaning as contained in the Accounting Standard 18,Related Party Transactions, issued by The Institute of CharteredAccountants of India.

***Explanation (ii)*** If the company has set up an audit committeepursuant to provision of the Companies Act, the company agreesthat the said audit committee shall have such additional functions/features as is contained in the Listing Agreement.

**E. Review of information by audit committee**

The Audit Committee shall mandatorily review the following information:

1. Financial statements and draft audit report, including quarterly/half-yearly financial information;
2. Management discussion and analysis of financial condition andresults of operations;
3. Reports relating to compliance with laws and to risk management;
4. Management letters/letters of internal control weaknesses issuedby statutory/internal auditors; and
5. Records of related party transactions;
6. The appointment, removal and terms of remuneration of the chiefinternal auditor shall be subject to review by the Audit Committee.

**III. Audit Reports and Audit Qualifications**

**Disclosure of accounting treatment:**

In case it has followed a treatment different from that prescribed in anAccounting Standards, management shall justify why they believe suchalternative treatment is more representative of the underlined businesstransactions. Management shall also clearly explain the alternativeaccounting treatment in the footnote of financial statements.

## IV. Whistle Blower Policy

**Internal policy on access to audit committees**

(i) Personnel who observe an unethical or improper practice (notnecessarily a violation of law) shall be able to approach the auditcommittee without necessarily informing their supervisors.

(ii) Companies shall take measures to ensure that this right of accessis communicated to all employees through means of internalcirculars, etc. The employment and other personnel policies ofthe company shall contain provisions protecting “whistle blowers”from unfair termination and other unfair prejudicial employmentpractices.

(iii) Company shall annually affirm that it has not denied any personnelaccess to the audit committee of the company (in respect ofmatters involving alleged misconduct) and that it has providedprotection to “whistle blowers” from unfair termination and otherunfair or prejudicial employment practices.

(iv) Such affirmation shall form a part of the Board report onCorporate Government that is required to be prepared andsubmitted together with the annual report.

(v) The appointment, removal and terms of remuneration of the chiefinternal auditor shall be subject to review by the Audit Committee.

## V. Subsidiary companies

(i) The company agrees that provisions relating to the compositionof the Board of Directors of the holding company shall be madeapplicable to the composition of the Board of Directors ofsubsidiary companies.

(ii) At least one independent director on the Board of Directors of theholding company shall be a director on the Board of Directors ofthe subsidiary company.

(iii) The Audit Committee of the holding company shall also reviewthe financial statements, in particular the investments made bythe subsidiary company.

(iv) The minutes of the Board meetings of the subsidiary companyshall be placed for review at the Board meeting of the holdingcompany.

(v) The Board report of the holding company should state that theyhave reviewed the affairs of the subsidiary company also.

## VI. Disclosure of contingent liabilities

The company agrees that management shall provide a clear descriptionin plain English of each material contingent liability and its risks, whichshall be accompanied by the auditor's clearly worded comments onthe management's view. This section shall be highlighted in thesignificant accounting policies and notes on accounts, as well as, inthe auditor'' report, wherever necessary.

## VII. Disclosures

### A. Basis of related party transactions

(i) A statement of all transactions with related parties including their basis shall be placed before the Audit Committee for formal approval/ratification. If any transaction is not on an arm's length basis, management shall provide an explanation to the Audit Committee justifying the same.

### B. Board disclosures – risk management

(i) It shall put in place procedures to inform Board members aboutthe risk assessment and minimization procedures. Theseprocedures shall be periodically reviewed to ensure that executivemanagement controls risk through means of a properly definedframework.

(ii) Management shall place a report certified by the complianceofficer of the company, before the entire Board of Directors everyquarter documenting the business risks faced by the company,measures to address and minimize such risks, and any limitationsto the risk taking capacity of the corporation. This document shallbe formally approved by the Board.

### C. Proceeds from initial public offerings (IPOs)

(i) When money is raised through an Initial Public Offering (IPO) itshall disclose to the Audit Committee, the uses/applications offunds by major category (capital expenditure, sales and marketing,working capital, etc), on a quarterly basis as a part of their quarterlydeclaration of financial results. Further, on an annual basis, thecompany shall prepare a statement of funds utilized for purposesother than those stated in the offer document/prospectus. Thisstatement shall be certified by the independent auditors of thecompany. The audit committee shall make appropriaterecommendations to the Board to take up steps in this matter.

### D. Remuneration of directors

(i) All pecuniary relationship or transactions of the nonexecutivedirector’s vis-à-vis the company shall be disclosed in the AnnualReport.

(ii) Further the following disclosures on the remuneration of directorsshall be made in the section on the corporate governance of theannual report.

a. All elements of remuneration package of all the directorsi.e. salary, benefits, bonuses, stock options, pensionetc.
b. Details of fixed component and performance linkedincentives, along with the performance criteria.
c. Service contracts, notice period, severance fees.
d. Stock option details, if any—and whether issued at adiscount as well as the period over which accrued andover which exercisable.

**E. Management**

(i) As part of the directors’ report or as an addition there to, aManagement Discussion and Analysis Report should form partof the annual report to the shareholders. This ManagementDiscussion and Analysis should include discussion on thefollowing matters within the limits set by the company’scompetitive position:

a. Industry structure and developments.
b. Opportunities and threats.
c. Segment-wise or product-wise performance.
d. Outlook
e. Risks and concerns.
f. Internal control systems and their adequacy.
g. Discussion on financial performance with respect tooperational performance.
h. Material developments in human resources/industrialrelations front, including number of people employed.

Management shall make disclosures to the board relating to all materialfinancial and commercial transactions, where they have personalinterest, that may have a potential conflict with the interest of the companyat large (for e.g. dealing in company shares, commercial dealings withbodies, which have shareholding of management and their relativesetc.).

**F. Shareholders**

(i) In case of the appointment of a new director or re-appointment ofa director the shareholders must be provided with the followinginformation:

a. A brief resume of the director;
b. Nature of his expertise in specific functional areas; and
c. Names of companies in which the person also holds the directorship and the membership of Committees of theboard.

(ii) Information like quarterly results, presentation made by companiesto analysts shall be put on company's website, or shall be sent insuch a form so as to enable the stock exchange on which thecompany is listed to put it on its own website.

(iii) A board committee under the chairmanship of a nonexecutivedirector shall be formed to specifically look into the re-dressal ofshareholder and investors complaints like, transfer of shares, non-receiptof balance sheet, non-receipt of declared dividends etc.This Committee shall be designated as 'Shareholders/InvestorsGrievance Committee'.

(iv) To expedite the process of share transfers, the board of thecompany shall delegate the power of share transfer to an officeror a committee or to the registrar and share transfer agents. Thedelegated authority shall attend to share transfer formalities atleast once in a fortnight.

**VIII.CEO/CFO Certification**

(i) CEO (either the Executive Chairman or the Managing Director)and the CFO (whole-time Finance Director or other persondischarging this function) of the company shall certify that, to thebest of their knowledge and belief:

a. They have reviewed the balance sheet and profit and lossaccount and all its schedules and notes on accounts, aswell as the cash flow statements and the Directors' Report;
b. These statements do not contain any materially untruestatement or omit any material fact nor do they containstatements that might be misleading;
c. These statements together present a true and fair view ofthe company, and are in compliance with the existingaccounting standards and/or applicable laws/regulations;
d. They are responsible for establishing and maintaining internalcontrols and have evaluated the effectiveness of internalcontrol systems of the company; and they have alsodisclosed to the auditors and the Audit Committee,deficiencies in the design or operation of internal controls, ifany, and what they have done or propose to do to rectifythese;
e. They have also disclosed to the auditors as well as the AuditCommittee, instances of significant fraud, if any, that involvesmanagement or employees having a significant role in thecompany's internal systems; and
f. They have indicated to the auditors, the Audit Committeeand in the notes on accounts, whether or not there weresignificant changes in internal control and/or of accountingpolicies during the year.

**IX. Report on Corporate Governance**

(i) There shall be a separate section on Corporate Governance inthe annual reports of company, with a detailed compliance reporton Corporate Governance. Non-compliance of any mandatoryrequirement i.e. which is part of the listing agreement with reasonsthereof and the extent to which the non-mandatory requirementshave been adopted should be specifically highlighted. Thesuggested list of items to be included in this report is given inAnnexure-1B and list of non-mandatory requirements is given inAnnexure-1C.

(ii) The companies shall submit a quarterly compliance report to thestock exchanges within 15 days from the close of quarter as perthe format given below. The report shall be submitted either bythe Compliance Officer or the Chief Executive Officer of thecompany after obtaining due approvals.

**X. Compliance**

The company shall obtain a certificate from either the auditors orpracticing company secretaries regarding compliance of conditions ofcorporate governance as stipulated in this clause and annex thecertificate with the directors' report, which is sent annually to all theshareholders of the company. The same certificate shall also be sentto the Stock Exchanges along with the annual returns filed by thecompany.

***Schedule of implementation***

1. The provisions of the revised clause 49 shall be implemented asper the schedule of implementation given below:
    a. By all entities seeking listing for the first time, at the time oflisting.
    b. By all companies which were required to comply with therequirement of the erstwhile clause 49 i.e. all listed entitieshaving a paid up share capital of Rs.3 crores and above ornet worth of Rs.25 crores or more at any time in the historyof the entity. These entities shall be required to comply withthe requirement of this clause on or before March 31, 2004.
2. The non-mandatory requirement given in Annexure-1C shall beimplemented as per the discretion of the company. However, thedisclosures of the adoption/non-adoption of the non-mandatoryrequirements shall be made in the section on corporategovernance of the Annual Report.

**Annexure 1A**

Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.

3. Quarterly results for the company and its operating divisions orbusiness segments.
4. Minutes of meetings of audit committee and other committees ofthe board.
5. The information on recruitment and remuneration of senior officersjust below the board level, including appointment or removal ofChief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty noticeswhich are materially important.
7. Fatal or serious accidents, dangerous occurrences, any materialeffluent or pollution problems.
8. Any material default in financial obligations to and by the company,or substantial non-payment for goods sold by the company.
9. Any issue, which involves possible public or product liability claimsof substantial nature, including any judgment or order which,may have passed strictures on the conduct of the company ortaken an adverse view regarding another enterprise that can havenegative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill,brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Anysignificant development in Human Resources/Industrial Relationsfront like signing of wage agreement, implementation of VoluntaryRetirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets,which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the stepstaken by management to limit the risks of adverse exchange ratemovement, if material.
15. Non-compliance of any regulatory, statutory nature or listingrequirements and shareholders service such as non-payment ofdividend, delay in share transfer etc.

## Annexure 1B

Suggested list of items to be included in the report on corporateGovernment in the Annual Report of Companies

1. A brief statement of company's philosophy on code ofgovernance.
2. Board of Directors:
    a. Composition and category of directors, for example,promoter, executive, nonexecutive, independentnonexecutive, nominee director, which institutionrepresented as lender or as equity investor.
    b. Attendance of each director at the BoD meetings and thelast AGM.

c. Number of other BoDs or Board Committees in which he/she is a member or Chairperson
d. Number of BoD meetings held, dates on which held.

3. Audit Committee:
   a. Brief description of terms of reference
   b. Composition, name of members and Chairperson
   c. Meetings and attendance during the year
4. Remuneration Committee:
   a. Brief description of terms of reference
   b. Composition, name of members and Chairperson
   c. Attendance during the year
   d. Remuneration policy
   e. Details of remuneration to all the directors, as per format inmain report.
5. Shareholders Committee:
   a. Name of nonexecutive director heading the committee
   b. Name and designation of compliance officer
   c. Number of shareholder's complaints received so far
   d. Number not solved to the satisfaction of shareholders
   e. Number of pending complaints

6. General Body Meetings:
   a. Location and time, where last three AGMs held.
   b. Whether any special resolutions passed in the previous 3AGMs
   c. Whether any special resolution passed last year throughpostal ballot – details of voting pattern
   d. Person who conducted the postal ballot exercise
   e. Whether any special resolution is proposed to be conductedthrough postal ballot
   f. Procedure for postal ballot
7. Disclosures:
   a. Disclosures on materially significant related partytransactions that may have potential conflict with theinterests of company at large.
   b. Disclosure of accounting treatment, if different, from thatprescribed in accounting standards with explanation.
   c. Details of non-compliance by the company, penalties,and structures imposed on the company by Stock Exchange orSEBI or any statutory authority, on any matter related tocapital markets, during the last three years.
   d. Whistle Blower policy and affirmation that no personnel havebeen denied access to the audit committee.

8. Means of Communication:
    a. Half-yearly report sent to each household of shareholders.
    b. Quarterly results
    c. Newspapers wherein results normally published
    d. Any website, where displayed
    e. Whether it also displays official news releases; and
    f. The presentations made to institutional investors or to theanalysts.
    g. Whether Management Discussion & Analysis (MD&A) is apart of annual report or not.
9. General Shareholder Information:
    a. AGM: Date, time and venue
    b. Financial Calendar
    c. Date of Book closure
    d. Divided Payment Date
    e. Listing on Stock Exchanges
    f. Stock Code
    g. Market Price Data: High, Low during each month in lastfinancial year
    h. Performance in comparison to board-based indices suchas BSE Sensex, CRISIL index etc.
    i. Register and Transfer Agents
    j. Share Transfer System
    k. Distribution of shareholding
    l. Dematerialization of shares and liquidity
    m. Outstanding GDRs/ADRs/Warrants or any Convertibleinstruments, conversion date and likely impact on equity
    n. Plant Locations
    o. Address for correspondence

**Annexure 1C**

Non-Mandatory Requirements

1. Chairman of the Board:
   A nonexecutive Chairman should be entitled to maintain aChairman’s office at the company’s expense and also allowedreimbursement of expenses incurred in performance of his duties.
2. Remuneration Committee:
    a. The board should set up a remuneration committee todetermine on their behalf and on behalf of the shareholderswith agreed terms of reference, the company’s policy onspecific remuneration packages for executive directorsincluding pension rights and any compensation payment.

b. To avoid conflicts of interest, the remuneration committee,which would determine the remuneration packages of theexecutive directors should comprise of at least threedirectors, all of whom should be nonexecutive directors, thechairman of committee being an independent director.
c. All the members of the remuneration committee should bepresent at the meeting.
d. The Chairman of the remuneration committee should bepresent at the Annual General Meeting, to answer theshareholder queries. However, it would be up to theChairman to decide who should answer the queries.

3. Shareholder Rights

The half-yearly declaration of financial performance includingsummary of the significant events in last six-months, should besent to each household of shareholders.

4. Postal Ballot

Currently, though there is requirement for holding the generalmeeting of shareholders, in actual practice only a small fractionof the shareholders of that company do or can really participatetherein. This virtually makes the concept of corporate democracyillusory. It is imperative that this situation which has lasted toolong needs an early correction. In this context, for shareholderswho are unable to attend the meetings, there should be arequirement which will enable them to vote by postal ballot forkey decisions. Some of the critical matters which should bedecided by postal ballot are given below:

a. Matters relating to alteration in the memorandum ofassociation of the company like changes in name, objects,address of registered office etc;
b. Sale of whole or substantially the whole of the undertaking;
    (i) Sale of investments in the companies, where theshareholding or the voting rights of the companyexceeds 25%;
    (ii) Making a further issue of shares through preferentialallotment or private placement basis;
    (iii) Corporate restructuring;
    (iv) Entering a new business area not germane to theexisting business of the company;
    (v) Variation in rights attached to class of securities;
    (vi) Matters relating to change in management.

5. Audit Qualifications

Company may move towards a regime of unqualified financialstatements.

6. Training of Board Members

Company shall train its Board members in the business modelof the company as well as the risk profile of the businessparameters of the company, their responsibilities as directors,and the best ways to discharge them.

7. Mechanism for Evaluating nonexecutive Board Members

The performance evaluation of nonexecutive directors should bedone by a peer group comprising the entire Board of Directorsexcluding the director being evaluated; and Peer Group evaluationshould be the mechanism to determine whether to extend/continuethe terms of appointment of nonexecutive directors.

## 5.8 MODERN TRENDS IN PUBLISHED ACCOUNTS

### 5.8.1 BRAND ACCOUNTING

The profitability of a business enterprise depends to a great extent onthe marketability of its products or services. Brands or trade namesunder which the products or services of the company are marketedplay a major role in maintaining and improving the marketability of suchproducts or services. It is, therefore, argued by some accountants thatthe published financial statements should disclose the value of suchbrands or trade names and also their impact on the sales and profitachieved during the accounting period.

***Development of Brand Accounting Concept***

Brand accounting is basically concerned with this aspect. In other words,it provides a basis for the valuation of brands and their reflection in thefinancial statements of an enterprise. The concept of 'Brand Accounting'is quite new and the accounting profession has yet to evolve a scientificand realistic basis for the valuation of brands and their disclosure in thefinancial statements.

The pioneers in the field of Brand Accounting are two largecompanies of United Kingdom: (i) Grand Metropolitan PLC, and (ii) RankHovis McDougall PLC. The Grand Metropolitan PLC capitalised the valueof the acquired brands and disclosed them at this figure in balancesheet. The company Chairman's statement in the annual report for 1988stated as follows:

"During the year, your Board decided to give recognition in thebalance sheet to the cost of significant brands acquired since January1, 1985. This move has the full support of the company's auditors. It willreflect to some extent the worth of our intangible assets, althoughhomegrown brands acquired before 1985 and licences and agreements are still excluded."

The Rank Hovis McDougall PLC treated both acquired brands anddeveloped brands alike. They capitalized them at their 'Current use value'to the company and showed the figures in their balance sheet. Thecompany Chairman's statement in the annual report for 1988 stated asfollows:

"In order to recognize the great importance of our brands, we havetaken the opportunity this year to include them in the Balance Sheet.The figure of £ 678 million has been shows as an intangible asset. Iwould emphasize that this (treatment) only recognizes the value ofbrands as they are currently used by the Groups and does not takeaccount of their future prospects or, indeed, their worth in the openmarket."

**Accounting Treatment**

There is no specific international accounting standard available regardingthe accounting treatment to be given to brands. However, brands likegoodwill are intangible assets and do not have a physical identity. Hence,it will be advisable to follow the provisions of AS 26.

**Accounting for Goodwill:** The application of this standard ismandatory for all companies operating in United Kingdom. The standardrestricts capitalization only to acquired brands and not capitalization ofbrands created by the companies themselves. The capitalized value ofthe brands can be shown as 'Intangible Assets' and the correspondingvalue as revaluation reserve in the company's Balance Sheet. It maybe noted here that the Grand Metropolitan PLC by capitalizing only theacquired brands fell in line with SSAP-22, but Rank Hovis McDougallPLC by capitalizing both acquired as well as created brands violatedthe provisions of SSAP-22.

According to AS 26: "Intangible Assets", issued by ICAI, an intangibleasset should be recognized if and only if:

(i) (a) It is probable that the future economic benefits that areattributable to the asset will flow to the enterprise, and

(b) The cost of the asset can be measured reliably.

(ii) An intangible asset should be recognized at cost only.
(iii) Internally generated goodwill should not be recognized asan asset.
(iv) Internally generated brands, mastheads, published titles,customer lists and similar in substance should not berecognized as intangible assets.

Thus, according to AS 26 brands or goodwill purchased can berecognized subject to conditions (i) and (ii) above. However brands orgoodwill internally generated should not be recognized as assets in thefirm's books.

## 5.8.2 LEAN ACCOUNTING

**Introduction:**

Lean Accounting is the most recent concept in the accounting literature.In September 2005, a Lean Accounting Summit in Detroit co-sponsoredby Association for Manufacturing Excellence (AME) was held. Thesummit had on its agenda to codify the principles, practices and toolsof lean accounting developed over the last 10 years. It may be notedthat lean accounting involves lean thinking, i.e., eliminating all forms ofwaste in the accounting process to provide quality goods or service tothe customer at the lowest price. Thus:

a. Lean accounting focuses measuring and understanding the valuecreated for the customer and uses this information to enhancecustomer relationships, product design, product pricing and leanimprovements.
b. To be lean accountant one must relentlessly seek to view hisorganization through the eyes of his customers.

However, it has been found that everybody working seriously toimplement lean thinking in his organization ultimately bumps up againstthe accounting system prevalent in the organization. This is because ithas been found that in most “customer focused” companies, theiremployees in their narrow interest optimize functional performance. Asa result there is wide waste in the enterprise and large number ofunhappy customers.

**Limitations of Traditional Accounting:**

The traditional accounting systems are largely and actively anti-leanbecause of their following limitations:

**(i) Non-value work:**They are large, complex, wasteful processesrequiring huge amounts of non-value work.

**(ii) High-inventory Levels:** They provide measurements and reportslike labor efficiency and overhead absorption that motivate largebatch production and high inventory levels.

**(iii)Misleading reports:** They have no good way to identify thefinancial impact of the lean improvements taking place throughoutthe company. On the contrary, the financial reports will often showthat bad things are happening when very good lean change isbeing made.

**(iv)Lack of understanding:** Very few people in the companyunderstand the reports that emanate from the accountingsystems. However, they are used to make important and farreachingdecisions.

**(v) Misleading costs:** They use standard product costs which aremisleading when making decisions related to quoting, profitability,sourcing, make/buy, product rationalization, and so forth.

### *Meaning of Lean Accounting*

Lean accounting may be defined as applying lean methods to theaccounting processes. It may be noted that some accounting processesmay involve waste which cannot be avoided while others may involvewaste that can be eliminated. The waste of a later type is to be eliminatedin the same way as is done in case of other production processes.Thus, lean accounting is the accounting technique that aims atcontinuously eliminating waste from the transaction processes, reportsand accounting methods throughout the organization. This all helps insimplifying accounting, quick decision making and reducing cost.

### *Objectives of Lean Accounting*

The objectives of lean accounting can be summarized as under:

**(i) Providing appropriate information:**Lean accounting aims atproviding accurate, timely and understandable information to allsegments of an organization. It results in motivating leantransformation throughout the organization helping in quickdecision-making, leading to increased customer value, growth,profitability and cash flows.

**(ii) Elimination of waste:** Lean accounting uses lean tools toeliminate waste from the accounting processes besides increasedcomprehensive financial control.

**(iii)Compliance with “GAAP”:** Lean accounting fully complies withthe Generally Accepted Accounting Principles (GAAP), externalreporting regulations and internal reporting requirements.

**(iv)Encourages lean culture**: Lean accounting supports the leanculture by motivating investment in people, providing informationthat is relevant and empowering continuous improvement at everylevel of the organization.

### Steps of Lean Accounting:

The following steps may be taken for introduction of lean accounting inan organization:

**(i) Defining value:** This means identifying the expectation of thecustomer from a specific product or a service. In other words, itis important to decide from customer’s point of view what isimportant for him or what are his priorities while paying for aparticular product or service.

(ii) **Identifying value streams:** This refers to identification of thevalue added activities which go into delivering specific productsand services to customers. Non-value added activities have tobe eliminated.

(iii) **Making the value stream flow:** This requires the various piecesof equipment placed in a manner in sequence of themanufacturing processes thereby enabling a continuous singlepiece flow of production. The employees should be crossed-trainedto perform all the steps within the cell they are working.Thus, lean accounting uses cellular work arrangements that pulltogether people and equipment from physically separated andfunctionally specialized departments.

(iv) **Implementation of a pull system:** This involves introduction ofa system where visual controls are used to trigger upstream linksin the value stream to initiate additional production. For instance,when a storage bin of components becomes empty up to arequired level for replenishing a fresh supply it automatically signalsthe upstream link in the value stream to replenish the componentswithout the need of any paper work, viz., material or purchaserequisition slip etc.

(v) **Strive for perfection:** There is continuous effort for makingimprovements. A management seeks also frontline employees'opinion for improvement in the flow of value to the customers.Thus, the management views all employees as intellectual assets.

**Conclusion**

Lean accounting is still in a work-in-process stage. And hence, theprinciples, practices and tools of lean accounting are being graduallyformed, transformed, improved and updated. A wide range of companiesare adopting lean accounting methods making the required adjustmentsin the principles, methods, techniques to meet the companies specificneeds besides maintaining adherence to generally accepted accountingprinciples and external reporting requirements and regulations. It isexpected that in the years to come lean accounting will become a way of life for corporate for providing better cost effective information forthe decision making and create display and remit simple and timelyaccounting reports for all stake holders in the organization.

## 5.8.3 INTERNATIONAL ACCOUNTING

**Introduction:**

The present LPG era, i.e., the era of liberalization, privatization andglobalization has brought a revolutionary change in the accounting world.National corporate bodies have overnight become multinationalcorporate having their businesses in different locations in the world.Such corporations have their stake holders, i.e., shareholders, creditors,customers, employees from all over the globe. It has, therefore, becomenecessary for such corporate to have universally acceptableaccounting principles, procedures and practices for making meaningfulcomparative analysis and drawing appropriate conclusions andinterpretation of the financial statements by interested stakeholders.The international accounting or global accounting is a directconsequence of this necessity.

***Meaning of International Accounting***

It may broadly be defined as accounting that incorporates the functionalareas of financial accounting, managerial accounting, taxation andaccounting information systems to generate the requisite accountinginformation for stakeholders all over the globe.

The meaning and scope of international accounting may varydepending upon the extent to which the corporate have internationaloperations.

- **(i) Super national International Accounting:** This accountingincludes in its fold standards, guidelines and rules ofaccounting, auditing, taxation issued by super nationalorganizations, viz., United Nations, the Organization ofEconomic Cooperation and Development, the InternationalFederation of Accountants, etc.
- **(ii) Company Level International Accounting:**Thisaccounting encompasses the standards, guidelines andpractices that a company follows for its internationalbusiness activities and foreign investment. These standardsor practices may relate to accounting for transactions in aforeign currency, the techniques for evaluating theperformance of a company's foreign operations etc.
- **(iii)Country Level International Accounting:** This is thebroadest definition of international accounting. It includes thestudy of standards guidelines and rules of accounting,auditing and taxation that exist within each country and theircomparative study. It may be noted that generally acceptedaccounting principles and practices may vary marginallyfrom country to country due to requirements of eachcountry's national accounting or statutory bodies. Thetaxation provisions may also differ from country to country.Thus, the country level international accounting will includein its scope a study of accounting principles and practicesprevalent in different countries and their comparativeanalysis. International accounting according to this concept,therefore, covers in its scope enormous amount of territoryboth geographically and topically.

## 5.8.4 FORENSIC ACCOUNTING

**Introduction:**

Forensic accounting is a fast emerging field in the world of accountingand gaining constant increased prominence due to rapid increase infinancial frauds and white collar crimes resulting in collapse of manycorporate giants, viz., Maxwell Communication Group in UK, Enron &Lehman Brothers in USA and Satyam in India. The corporate auditorslargely at present are only expected to check the compliance ofcompanies' books of account to the generally accepted accountingprinciples, auditing, standards and companies policies. However, manywhite collar crimes and financial frauds could not be detected by theauditors because they were not trained to look the business reality ofthe situation. This created the need for development of an accountingsystem integrating accounting, auditing and investigative skills. Thisresulted in the emergence of a new concept of accounting popularlyknown as 'Forensic Accounting'.

### *Meaning of Forensic Accounting*

The meaning of forensic accounting is changing in response to thegrowing needs of business and industry. In simple words, forensicaccounting is accounting that is suitable for legal review offering thehighest level of assurance about the accuracy of the financial statementsbased on scientific and objective verification.Some of the definitions of forensic accounting are as under:

- *"Forensic Accounting is the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes."* – ***George A. Mannie***
- *"Forensic Accounting is the application of financial skills and an investigative mentality to unresolved issues conducted within the context of rules of evidence. As an emerging discipline it encompasses financial expertise, fraud, knowledge and understanding of business reality and the working of the legal system."* - ***Bologana& Lind Quist***
- *"Forensic Accounting is the application of accounting principles, theories and discipline to facts or hypotheses at issues in a legal dispute and encompasses every branch of accounting knowledge."* ***– American Institute of Certified Public Accountants (AICPA)***

From the above definitions it can be concluded that forensicaccounting includes the use of accounting, auditing and investigatingskills to assist in legal matters. Thus, forensic accounting is the bridgewhich connects accounting system to legal system. It consists of twomajor components:

(i) Litigation services that recognize the role of an accountantas an expert consultant; and
(ii) Investigative services for looking deep into the financial books,records and data to uncover for hidden assets, siphonedfunds, etc.

### Role of Forensic Accountant

An accountant engaged in the forensic accounting is known as forensicaccountant. He utilizes his understanding of business information,financial reporting systems, accounting and auditing standards,investigative techniques and legal knowledge in performance of his jobwhich may include the following:

(i) Investigating and analysing financial evidence.
(ii) Developing appropriate computerized applications which couldhelp in the analysis and presentation of financial evidence.
(iii) Communicating his findings in the form of documents, reports,exhibits, etc.
(iv) Assisting in legal proceedings including testifying in a law courtas a key and expert witness.

It may be noted that a forensic accountant does not win or lose acase but seeks only the truth by conducting evaluations, examinationsand enquiries. The services of a forensic accountant are in greatdemand in the following areas:

**(i) Assessment and settlement of insurance claims:**Theclaims may relate to loss of property, loss of profits or lossdue to any other risk insured.
**(ii) Detection of fraud committed by employees:** Such fraudsmay relate to loss of property or embezzlement of funds bydishonest employees.
**(iii)Assistance in criminal investigation proceedings:** Acriminal offence may also have financial implications. Theservices of a forensic accountant are quiet useful in preparingand presenting the desired evidence.
**(iv)Arbitration services**: The parties to a dispute may like toget the financial liability settled through arbitration. In somecases, settlement of dispute through arbitration may bemandatory as per the terms of the agreement. The servicesof a forensic accountant may be used in such cases.
**(v) Miscellaneous disputes:** These disputes may relate to thefollowing matters:
   a. Settlement of dues of an outgoing partner.
   b. Liability for professional negligence.
   c. Matrimonial matters.
   d. Infringement of patents and trademarks etc.

## 5.9 SUMMARY

- Some of the indicators/criteria which can be used to measurethe social costs and benefits associated with projects are givenin this unit.
- Financial statement which shows how much value (wealth) hasbeen created by an enterprise through utilization of its capacity,capital, manpower and other resources, and how it is allocatedamong different stakeholders (employees, lenders, shareholders,government, etc.) in an accounting period is known as a ValueAdded Statement.

- Financial reporting and disclosure are potential and importantmeans for the management to communicate a firm's performanceand value to outside investors. Higher means of disclosure willbe helpful to reduce information gap between a company and itsstakeholders.
- The recent trends in published accounts are:
  - Brand Accounting
  - Lean Accounting
  - Forensic Accounting
  - International Accounting

## 5.10 KEY TERMS

- **Social accounting:** Accounting concerned with measuring anddisclosing costs and benefits to the society as a result of operatingactivities of a business enterprise.
- **Social benefit:** Any benefit to the society or any of its elementswhether economic or non-economic, internal or external.
- **Social cost:** Any cost or sacrifice or determent to the society orany of its elements whether economic or non-economic, internalor external.
- **Brand accounting:** Accounting concerned with valuation ofbrands and their reflection in the financial statements of onenterprise.
- **Economic value added:** The operating profits after tax less thecharge for the capital both equity as well as debt used in thebusiness.
- **Environmental accounting:** Management of environmental costseffectively, presenting and disclosing environmental informationin a suitable form
- **Lean accounting:** Applying lean methods to the accountingprocesses.
- **Forensic accounting:** It is accounting that is suitable for legalreview
- **International accounting:** Accounting that incorporates thefunctional areas of financial accounting, managerial accounting,taxation and accounting information systems to generate therequisite accounting information for stakeholders all over the globe.
- **Value added:** The increase in the value of a product or serviceresulting from an alteration in the form, location or availabilityexcluding the cost of bought out material or services

## 5.11 QUESTIONS AND EXERCISE

1. Explain the concept of Social Cost Benefit Analysis.
2. Discuss the different methods for measurement of Social Costand Benefits.
3. "A new dimension of financial reporting is the growing demandfor reports and activities which reflect the contribution of anenterprise to the society at

large."Discuss the above concept and illustrate how the performanceof an enterprise to the society at large is evaluated.

4. When should capitalization of borrowing costs cease in relationto assets and to investments. Discuss.
5. Write a short note on corporate Social Reporting.
6. What is 'Social Reporting'? Explain briefly the major areas coveredin social reporting.
7. Explain the concept of Value Added. State the advantages andlimitations of a Value Added Statement.
8. Define the term Economic Value Added State its utility. Explain itscomputation by giving an imaginary example.

## 5.12 PRACTICAL PROBLEMS

**1.** From the following information taken from the books of F Ltd. relating tostaff and community benefits, prepare a statement classifying the variousitems under the appropriate heads required under Corporate SocialReporting:

| | ***Rs.*** |
|---|---|
| Environmental Improvements | 20,10,000 |
| Medical Facilities | 45,00,000 |
| Training Programmes | 10,25,000 |
| Generation of Job Opportunities | 60,75,000 |
| Municipal Taxes | 10,70,000 |
| Increase in Cost of Living in the vicinity due to a | |
| thermal power station | 16,55,000 |
| Concessional Transport, Water Supply | 11,25,000 |
| Extra Work put in by staff and officers for drought relief | 18,50,000 |
| Leave Encashment and Leave Travel Benefits | 52,00,000 |
| Educational Facilities for children of staff members | 21,60,000 |
| Subsidized Canteen Facilities | 14,40,000 |
| Generation of Business | 25,00,000 |

[***Ans.*** Net Social Benefits to Staff Rs.1,36,00,000;Net Social Benefits to Community Rs.1,00,00,000]

2. From the following Profit and Loss Account of X Limited, prepare (i) GrossValue Added Statement, and (ii) show the Reconciliation between GrossValue Added and Profit before taxation:

**PROFIT AND LOSS ACCOUNT**

***for the year ended 31st March, 2002***

| ***Income*** | ***Rs. In Lakhs*** | ***Rs. In Lakhs*** |
|---|---|---|
| Income | | 800 |
| Sales | | 50 |
| Other Income | | 850 |
| Expenditure | 600 | |
| Production and Operational Expenses | 30 | |
| Administrative Expenses | 30 | |
| Interest and Other Charges | 20 | 680 |
| Depreciation | | 170 |
| Profit before taxes | | 30 |
| Provision for taxes | | 140 |
| Balance as per last Balance Sheet | | 10 |
| | | 150 |
| Transferred to: | | |
| General Reserve | | 80 |
| Proposed Dividend | | 20 |
| Surplus carried to Balance Sheet | | 50 |
| Break-up of some of the Expenditure is | | 150 |
| as follows: | | |
| Production and Operational Expenses: | | 320 |
| Consumption of Raw Materials and Stores | | 60 |
| Salaries, Wages and Bonus | | 20 |
| Cess and Local Taxes | | 200 |
| Other Manufacturing Expenses | | 600 |

| | | |
|---|---|---|
| Administrative Expenses: | | 6 |
| Audit Fee | | 8 |
| Salaries and Commission to Directors | | 6 |
| Provision for Doubtful Debts | | 10 |
| Other Expenses | | 30 |
| Interest and other Charges: | | 10 |
| On Working Capital Loans from Bank | | 15 |
| On Fixed Loans from ICICI | | 5 |
| On Debentures | | 30 |

[**Ans.** Gross Value Added (` in lakhs) Rs.298 (including other Income), Application of Value Added: To Employees Rs. 60, To Directors Rs.8, To Government Rs.50, To Providers of Capital Rs.40, For Maintenance and Expansion Rs. 140]