FINANCIAL ACCOUNTING

Author's Name :

Dr. Bhagyadhar Nayak

Edited By :

Dr. Sujit Kumar Acharya

Dr. Biswa Ranjan Mishra

Dr. Rashmi Ranjeeta Das

UTKAL UNIVERSITY

Directorate of Distance & Continuing Education

Bhubaneswar

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Author's Name : **Dr. Bhagyadhar Nayak**
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Edited By : **Dr. Sujit Kumar Acharya**

Dr. Biswa Ranjan Mishra

Dr. Rashmi Ranjeeta Das

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INTRODUCTION

The book now incorporates the changes necessitated by recent Accounting Standards, SEBI Guidelines and changes in the listing agreement and the Companies Act. All the chapters have been updated. Opportunity has been taken to introduce new problems from the recent question papers of both the professional and university examinations by way of illustrations and assignment material. I have provided learning objective at the beginning of each chapter, so that a student understands the chapter.

This book entitled as a "Financial Accounting" is written for various management programmes. The related matters are written in a simple and easily understandable. While writing this book, an attempt has been made to present the concepts briefly with examples. The present work of us has sincerely tried to highlight the practical areas of accounting. The language used is very lucid and more informative to both a beginner as well as a professional.

This book aims to provide required course content of the Financial Accounting which is divided in twelve units. Each and every unit is explained with structure and illustrations. Short and long questions and practical problems at the end of each unit and carefully selected the view of examination and practice of assignments. I wish this book will be of immerse value to the student's who have interest in a Financial Accounting.

CHAPTER - 1 MEANING AND SCOPE OF ACCOUNTING

Chapter Outlines

1.0 INTRODUCTION

A business basically undertakes economic activities involving regular purchase and sale of goods and services for the purpose of earning profit. Traditionally the accountant was expected to compile and present the financial information to the owners to the entity at the end of the accounting period. Accounting is now considered as a service activity and important tools of management for decision making. This unit attempts to analyse the role of accounting and the accountant keeping this perspective in view.

1.1 LEARNING OBJECTIVES

After studying this chapter you should be able to :

- Recognise accounting as a field of challenging career opportunities.
- Explain accounting as a language of business.
- Define accounting and describe its function.
- Know the users of accounting information.
- Explain the role of Accounting in society.
- Explain the relationship of Accounting with other disciplines.
- Explain meaning and need of Accounting.

1.2 ACCOUNTING: THE LANGUAGE OF BUSINESS

Accounting is often called the language of business. The basic function of any language is to serve as means of communication. As the purpose of accounting is to communicate or report the performance and health of a business enterprise, it is therefore called as the language of business. The task of learning accounting is very similar to the task of learning a new language.

But accounting is not exactly a foreign language like English and Japanese. In the words of Anthony and Reece, the problem of learning accounting is more like that of an American learning to speak English as it is spoken in Great Britain. For example, the food grain that Americans call 'wheat' is called 'corn' by the British; and the British use the word 'maize' for what Americans call 'corn'. Unless they are careful, Americans will fail to recognise that some words are used in Great Britain in a different sense from that used in America.

Similarly, some words, e.g., goods, assets, liabilities, debtors, creditors, etc. are used in a different sense in accounting than in their dictionary meaning. For example, the term 'goods' appears in accounting records. Its meaning according to Oxford Advanced Learner's Dictionary of Current English is 'movable property'. However, such meaning is incorrect in accounting. The correct meaning of 'goods' in accounting is 'the things purchased for the purpose of sale'. In accounting, goods are usually termed as inventory. In the previous example, the garments purchased by Mr. Shuvam Sahu are goods or inventories for his business as they are meant for sale. If Mr. Suvam Sahu purchases a table and a chair for the shop, the table and chair are not the goods, rather these are the assets of the business. So we can conclude that the goods are meant for resale whereas the assets help in the operation of the business.

1.3 DEVELOPMENT OF ACCOUNTING

Accounting is as old as money itself. However, the act of accounting was not as developed as it is today because in the early stages of civilisation, the number of transactions to be recorded was so small that each businessman was able to record and check for himself all his transactions. Accounting was practiced in India twenty-three centuries ago as is clear from the book named “Arcthashastra” written by Kautilya, king Chandragupta’s minister. This book not only relates to politics and economics but also explains the art of proper keeping up Accounts in the office of Accountants’ describes records of accounts to be maintained in accountant’s office and methods of checking accounts. However the modern system of Accounting based on the principles if double Entry system owes its origin to Luco pacioli who first published the principles of double Entry System in 1994 at Venice in Italy. Thus the art of accounting has been practiced for centuries but it is only in the late thirties of 20th century that the study of the subject’ Accounting has been taken up seriously.

In the recent years large scale production, cut throat competition, widening of the market and changes in the technology have brought remarkable changes in the field of accounting. In the words of Gordon and Gordon shilling law. It has come to be recognized as a tool for mastering the various economic problems which a business organization may have to face. It systematically writes the economic history of the organization. It provides information that can be drawn upon by those responsible for decisions affecting the organisation’s future. This history is written mostly in quantitative terms. It consists partly of files of data, partly of reports summarizing various portions of these data and partly of the plan established by management to guide its operations.

1.4 DEFINITION AND FUNCTIONS OF ACCOUNTING

Meaning of Accounting

Every person be he a salaried employee or a businessman, is involved in an economic activity. As the economic activity occurs, the person enters into various transactions and events. To derive the results of the economic activity be has to record such transactions and events and then determine its results. The process of recording transactions and events of a business in a useful manner so as to determine and analyse the financial performance and financial position is called accounting.

Definition of Accounting

A committee of the American Institute of Certified Public Accountants has defined Accounting as follows:

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

According to R.N. Anthony "Nearly every business enterprise has accounting system. It is a means of collecting summarising analyzing and reporting in monetary terms information about business".

According to Smith and Ashburn "Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretation of these transactions and events and communicating the results to persons who must take decisions or from judgments."

Functions of Accounting

Above definition of accounting explains the main functions of Accounting. These can be summarized as under:

1. **Recording:** Accounting involves recording of financial transactions in a systematic manner, such recording is done through journal or subsidiary books. In it accounting transactions are recorded through supporting vouchers such as purchase bills, payment vouchers, Deposit slips etc.
2. **Classification:** second step in accounting is to put information regarding one type of transactions at one place. This is done by way of posting in the ledger. In it one finds different accounts relating to expenses classified us salary, Advertisement. Thus all expenses which are recorded in journal are classified under different account heads in ledger.
3. **Summarising:** All the transactions recorded in journal and posted in the ledger are summarized in such a manner that these are useful for the user of accounts. This is done by preparing Trial Balance and final accounts.
4. **In terms of Money:** Accounting records transactions in terms of money. Money represents the currency of the country where accounts are maintained money gives a common basis if measurement.
5. **Transactions and Events:** In business, both transactions and events are recorded. If business is involved with outsiders, it is a transaction such as buying and selling of goods, taking a loan, paying salary, rent etc. There are a number of happenings, that do not concern outsiders, these are called "Events" such as loss due to fire, depreciation of assets etc. Both transactions and events are recorded in accounts.
6. **Financial Character:** The transaction or event to be recorded should have monetary value. If it cannot be measured in terms of money it will not be recorded in accounts. Thus, through the salary given to employee will be recorded, but how honestly and efficiently employee has worked will not be recorded.
7. **Communication and Interpretation of results:** Accounting also involves communication and interpretation of the results of the business. Communication implies reporting to the end users. The accounting information in desired form so as to enable them to understand the historical information e.g. preparation of profit and loss Account to understand the results, Balance Sheet to understand the financial position. Interpretation involves meaningful comparison which simplifies understanding of financial reports.

1.5 BOOK KEEPING AND ACCOUNTING

Book keeping is defined as a process of recording business events in a systematic manner. It involves recording of transactions. It refers to the record making stage of accounting. This stage of accounting is mechanical and repetitive. However, maintenance of proper records help a business organization to know its health and performance. Accounting on the other hand, includes not only the maintenance of accounting records but also preparation of summary statements, their analysis and interpretation. Thus book-keeping is only a small and simple part it accounting.

But the term accounting is used in a broader sense Covering all the accounting activities including preparation of final statements and their reporting to interested parties. Thus book-keeping is an aspect of the accounting process. It is a sub-field of accounting.

1.6 IS ACCOUNTING A SCIENCE OR AN ART?

Accounting is a science as well as an art because it contains the ingredients of both science and art.

Science is a systematic body of knowledge consisting a number of principles, methods and techniques which have universal applications. Likewise, accounting has certain principles and rules that are followed all over the world. For example recording of transaction at cost is universally followed. However, accounting is not an exact science like physics and chemistry where cause and effect relationship is established. In accounting the cause and effect relationship is not studied. Thus to conclude accounting is a science but not an exact science. It is a social science.

On the other hand Art refers to the application of knowledge to achieve the desired objectives. Knowing the principles and rules is not enough. These rules should be applied intelligently to solve the real life problems. Rigorous practice is necessary to achieve a desired skill. For example, the more a dancer practices the more perfect he will be. Similarly the accountant must apply the principles of accounting again and again to gain efficiency. Application of accounting knowledge is of vital importance to prepare records and summary statements. Therefore accounting is also an art.

1.7 USERS OF ACCOUNTING INFORMATION:

Accounting information is used by various persons. In addition to proprietors, such information is used by creditors, Government, financial institutions and others.

1. **Proprietor:** Proprietor is the main user of accounting, through accounts he ascertains operating result of his business. Further he knows his financial position. He uses accounting information to know amounts due to others and due from others.
2. **Management:** In large business organization, ownership and management are separate functions management has to plan, control and execute. Accounting information is used for fulfilling various management functions. Accounting data is useful in decision making at various stages.
3. **Suppliers of Goods and Services:** Persons who supply goods and services to business on credit are interested in knowing liquidity position of the business. They have to ensure repayment capacity of the business. They use accounting information for this purpose.
4. **Banks and Financial Institutions:** Banks and other financial Institutions who provide loan to the business are interested to know credit worthiness of the business. At the time of granting loan they are keen to know past performance of the firm, study profit and loss Account and Balance Sheet of the firm of previous years to know capacity of the firm to repay interest and principal amount.
5. **Prospective Investors:** Persons who are interested to make investments in some Company, may study annual reports of the Company before making final decision of investments. They may select the company in which investment is to be made by comparing past performance of these companies.
6. **Government:** Government uses accounting information for levying various taxes. In the absence of accounting data it is difficult to assess proper tax.
7. **Customers:** Customers who place orders and are dependent on a specific business organization for their supplies have to ensure the capability of the firm to execute the orders. This can be done by studying accounts of that business organisation.
8. **Employees:** Employees use accounting information for various purposes. They can assess their salary increase and bonus by studying profitability of the business. If business is constantly incurring Losses, they may decide to leave the organization and if business is constantly earning they may be more settled and expect carrier promotion in some enterprise.
9. **Regulatory Agencies:** Various regulatory agencies such as ROC, REI, IRDA, SEBI, require information to be filed with them under law. By examining these accounting information they ensure that concerned companies are following the rules and regulations.
10. **Courts:** In case of disputs regarding indebtedness insolvency etc. Courts use accounting information and other related data as evidence.
11. **Researchers and statisticians:** Research scholars who undertake research on any aspect of business activity, may use accounting information for the purpose of analysis. Accounting reports of various companies and of various years may be compared for this purpose.

1.8 Relationship of Accounting with others Disciplines

In order to appreciate fully the role of accounting in modern society, it is essential to consider the environment in which accounting functions. Accounting is related closely to economics and statistics. It is often greatly influenced by law and by government action, accounting is often considered to be mathematical at least arithmetical.

But economics and statistics touch fundamental nature of accounting. For the subject matter, accounting is inescapably economic and its basic methodology is unquestionably statistical in character.

1. Accounting and Statistics: Accounting method is statistical in character because its central mechanism consists of accounts, and accounts are classification categories used for compressing and simplifying amass of enterprise transactions. The chief function of statistical method is to classify, compress and simplify masses of data so that their significance may setter be understood. Accounting has the same functions.

Accounting has some statistical peculiarities of its own. Every ledger account is a dual category. Items on the debit are of one class, items on the credit are of an opposite class, yet both are related to the single class of data indicated by the account name. Internal transactions reallocate expenses and revenues among fiscal periods. Accounting is the connecting link, it ties the mass of activity data to the need for understanding activities. Accounting is a service that records, classifies, compresses, simplifies a mass of detail into a few understandable related totals and sub-totals.

2. Accounting and Economics: From the definition of accounting quoted earlier it can be seen that the setting in which accounting serves, is an economic one because accounting is concerned with business transactions. Accounting is oriented most closely to economics.

It is an economic purpose of accounting to produce data helpful to business management and investors. Accounting contributes factual materials to the formation of business policies. Expenses and revenues result from buying policies, spanding policies, pricing policies, selling policies, employment policies. The result of accounting therefore can be clues to good and bad policies. According to Wheeler the mutuality of interests of the two fields is so great that it is often difficult to fall where accounting leaves off and economics begin.

3. Accounting and law : According to Kester the influence of law on accounting "In as much as business must be carried on within the provisions of the law, principles or rules of law have exerted a powerful influence on the principles of accounting, they may well be said to have established. Some of the principles of accounting, obviously, accounting principles and rules dare run counter to established legal principles.

All economic activities of a business are effected by governing laws e.g. all transactions of purchase and sale are effected by contract act, transactions of Bills of exchange and Banking transactions are effected by negotiable instrument Act. Entry sometimes is itself created/governed by laws e.g. partnerships are governed by partnership Act, Companies by Companies Act, Banking Companies by Banking Regulation Act etc. governing laws provide strict compliance with stated provisions relating to book keeping, accounting and except the reporting be done in laid-down manner.

However in current scenario the accounting is not just effecting law. But laws are also been effected by accounting.

4. Accounting and Management: Obviously the environment of accounting is one of business while accounting provides useful services to individual and fraternal, religious, government, and educational organizations, its principal service deals with the business enterprise. Kester has stated that accounting is primarily and basically a service tool of management.

The growth and development of accounting is closely parallel to that of business enterprise. With the growth of the large corporation come a corresponding growth of accounting services. Consequently the recognition of the public aspects of corporate administration brought a realization that accounting responsibilities transcend service to the owners and the management of corporations. Today accounting while serving the business enterprise, serves society.

5. Accounting and Mathematics: Double entry book-keeping is based on an algebraic equation i.e. liabilities + capital = asset.

Arithmetical and algebraic calculations are required for making accounting computations. Therefore knowledge of arithmetic and algebra is necessary for accounting proficiency. Examples are calculation of interest, lease rent, depreciation creation of sinking fund etc. with the increasing use of computer accounting, knowledge of mathematics has been more essential. Further, statistical models are used for constructing various accounting models for the use of management.

1.9 ROLE OF ACCOUNTANT

The accountant, obtain referred to as controller, is the manager of accounting information used in planning, control and decision making area. He is responsible for collecting, processing and reporting information that well help managers decision makers in their planning, controlling and decision making activities. He participates in all accounting activities within the organization.

The following are the Roles of Accountant

1. **Participating in management process:** The management accountant occupies a pivotal position in the organization. He performs a staff function and also has line authority over the accountant and other employees in his office. He educates executives on the need for control information.
2. **Maintaining optimum Capital Structure:** Management accountant has a major role to play in raising of funds and their application. He has to decide about maintaining a proper mix between debt and equity raising of funds through debt is cheaper because of tax benefits.
3. **Investment opportunities:** A management accountant can assist either person or a firm regarding the investment in different ways. He can suggest how, when and where the investment should be made so that the investor or the firm will earn a maximum return.
4. **Financial Investigations:** A management accountant can assist the management about the financial investigations which is extremely desired to determine the financial position for the interested parties. Relating to issue of shares, amalgamation or mergers, or reconstructions etc to ascertain the reason of decreasing profit or increasing costs, it so happened.
5. **Long-term and Short –term planning :** Management accountant plays an important role in forecasting future business and economic events for making future plans i.e., long-term plans, strategic management accounting, formulating corporate strategy, market study etc.
6. **Participating in management process:** The management accountant occupies a pivotal position in the organisation. He performs a staff function and also has line over the accountant and other employees in his office. He educates executes on the need for control information and on the ways of using it. He shifts relevant information from the irrelevant and reports the same in a clear from to the management and sometime to interested external parties.
7. **Decision making ;** Management accountant provides necessary information to management in taking short-term decision e.g. optimum product mix, make or buy, lease or buy, pricing of product discontinuing a product etc and long-term decisions e.g., capital budgeting. Investment appraisal, project financing.However, the job of management accountant is limited to provision of required information in a comprehensive as well as reliable form to the management for decision making purposes.
8. **Control :** The management accountant analysis accounts and prepares reports e.g., standard costs, budgets, variance analysis and interpretation, cash and funds flow analysis, management of liquidity, performance evaluation and responsibility accounting etc. for control.
9. **Developing management information System :** The routine reports as well as reports for long term decision making are forwarded to managerial personnel at all levels to take connective action at the right time and also uses these reports for taking important decisions.
10. **Stewardship Accounting:** Management accountant designs the framework of cost and financial accounts and prepares reports for routine financial and operational decision making.
11. **Corporate planning:** He can assist management for long-term planning and advise management regarding amalgamation or mergers or reconstructions, including financial planning to see whether effective utilization of resources is made or not. Thus the role of management accountants cannot be ignored. Its such, there services are primarily desired for the efficient management of an undertaking.

1.10 BRANCHES (SUB-FIELDS) OF ACCOUNTING

Accounting is generally divided into two different branches : (i) Financial Accounting and (ii) Management Accounting.

Financial Accounting:

It deals with financial statements that are intended primarily for external use by owners, creditors and other outside parties. The important financial statements prepared by this branch are : Profit and Loss Account, Balance Sheet and Cash Flow Statement.

The objectives of financial accounting are : to maintain systematic records; to ascertain profit or loss and health of the business; and to provide accounting information to users for decision making.

Management Accounting:

It covers the generation of accounting information for management decisions. So its user group is the management.

Thus, management accounting is primarily concerned with the supply of information which is useful to management in decision making. It helps the management to perform all its functions including planning, organising, staffing, directing and controlling.

1.11 DIFFERECE BETWEEN FINANCIAL ACCOUNTING AND MANAGEMENT ACCOUNTING

1. **Objective:** Financial Accounting aims at recording business transaction systematically to ascertain profit or loss and financial position at the end of the financial year.
   The aims of management Accounting at preparing various statements for material planning, control and decision making.
2. **Time period:** In Financial Accounting the accounts are prepared for a particular period. Whereas in management accounting the reports are prepared from time to time to update with the changing business environment.
3. **Audit:** In Financial Accounting under Company law Financial accounts are subject to compulsory Audit. Whereas in management Accounting audit is optional. However, management is there is to ensure efficiency and productivity of the employees and system.
4. **Principles :** Financial Accounting is prepared as per Generally Accepted Accounting principles (GAP). In Management Accounting No set of standing principle are followed. However, accounting standards are followed to take managerial decisions more effective.
5. **Nature:** Financial Accounting is concerned with historical data. It records only those transactions which have already taken place. Thus the accounts prepared here are like postmortem report.
   The management Accounting is concerned with both historical data and estimated data.
6. **Publication:** In Financial Accounting, Financial Statements are published annually for external parties interested in the accounting information.
   In management Accounting the statements and reports are not published. They are meant for internal use of the management.
7. **Quickness:** In Financial Accounting, reporting is slow and time consuming one has to wait till the end of the accounting year.
   In management accounting, reporting is very quick as it is meant for decision making.
8. **Nature of Information:** Financial Accounting is concerned with quantitative information expressed in terms of money. Management Accounting is concerned with both qualitative and quantitative information.
9. **Reporting:** In Financial Accounting, Financial reports are prepared not only for the organization but for others interested in the accounting information of the business.
   In management Accounting the reports prepared for internal use only.
10. **Legal Comparison :** In Financial Accounting, preparation of financial accounts is compulsory to comply statutory requirements. In Management Accounting. It is not compulsory, it helps in the administration and smooth functioning.

1.12 IMPORTANCE OF ACCOUNTING

1. **Keeps systematic records:** All the financial events which occur in a business organisation are recorded systematically in the books and therefore, there is no need to rely on memory.
2. **Prepares financial statements:** With the help of information contained in the accounting records, the financial statements like the Profit and Loss Account and the Balance Sheet can be easily prepared. These financial statements help the users to know the net results of the business operations.
3. **Helps decision making:** Accounting provides accounting informations to various interested parties such as owners, lenders, creditors etc. which help them in their decision making.
4. **Helps in planning and control:** Accounting information helps management in planning operations and controlling all business activities.
5. **Facilities a comparative study:** Accounting information helps to compare the present performance of the enterprise with that of the past and with that of the similar organisations. It helps the interested parties to know the performance of the enterprise.

6. **Provides control over assets:** An organisation has many assets like cash in hand, cash at bank, the stock of goods, furniture etc. Accounting keepts systematic record of all these assets so that the management can control these assets and use them in the best possible way.
7. **Acts as reliable evidence :** Systematic accounting record of business transactions is generally treated by courts and tribunals as good evidence in case of disputes.
8. **Helps in complying tax matters:** The Government levies various taxes such as income tax, sales tax, custom duty and excise duty. Accounting records help the enterprise in filling of tax returns and settlement of tax and other statutory matters.
9. **Helps in determining the value of business:** The need for ascertaining the value of the business organisation arises in the event of its sale or take over by another business house. The accounting records help to determine the purchase or sale price of the business.
10. **Helps in detecting errors and frauds :** Accounting records are balanced periodically which helps in early detection of errors and frauds.

1.13 KEY TERMS

- **Accounting:** The process of identifying, measuring and communicating economic information to permit information judgements and decisions by the users of information.
- **Financial Accounting :** The art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are at least in part of a financial character and interpreting the results.
- **Management Accounting:** The presenting of accounting information in such a way as to assist management in the creation of the policy and in the day-to-day operation of the undertaking.

1.14 SUMMARY

- The concept of accounting and the role of the accountant have undergone a revolutionary change. Accounting, today is more of an information system than a mere recording system.
- Accounting is considered to be both a science and an art.
- Accounting is closely related with other disciplines like economics statistics, law, financial management etc.
- Accounting aims at providing enough information necessary for the stakeholders to know the profitability and financial position of the business. It also facilitates rational decision making by the management.

1.16 QUESTIONS AND EXERCISES

1. Define Accounting. State its functions. How does it differ from book-keeping?
2. State the persons who should be interested in accounting information.
3. Explain the role of the accountant in the present-day economy.
4. Why is accounting regarded as an aid to management?

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CHAPTER - 2 ACCOUNTING PRINCIPLES AND STANDARDS

Chapter Outlines

2.0 INTRODUCTION

The Accounting principles Board of AIOPA states "Generally accepted accounting principle incorporate the consensus at any time as to which economic resources and obligations should be recorded as assets or liabilities, which changes in them should be recorded, how recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how should it be disclosed and which financial statements should be prepared. These accounting principles are man-made and are derived from experience and reason, when they prove useful they become accepted as principles of accounting."

Accounting Principles are body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exit.

2.1 LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Explain the conceptual framework of Accounting
- Define the Generally Accepted Accounting Principles.
- Explain the widely accepted accounting concepts and conventions.
- Know the fundamental accounting assumptions.
- Explain cash-basis and accrual basis accounting.

2.2 MEANING OF ACCOUNTING PRINCIPLES

Accounting statements are to be prepared in some standard language and common rules. These rules are called 'Generally Accepted Accounting Principles' (GAAP) . In other words, generally accepted accounting principles, concepts and conventions are the fundamental rules of Accounting which are universally used and accepted by the Accountants all over the world as general guidelines for preparing. Accounting Statements. In other words, the rules and conventions of accounting are commonly referred to as 'Principles'. The word principle is here used to mean's general law or a rule adopted or professed as a guide to action; or a settled basis of conduct or practice.' These principles have developed in accordance with usage, experience, historical precedents, professional bodies, government regulations with the passage of time and with changing needs of business.

2.3 ACCOUNTING CONCEPTS

Principles which are accepted without any evidence are concepts. They are also known as Axioms. Postulates or Assumptions. Conventions are based on general acceptance. It, is a practice followed by accountants since very long period. Hence let us take them one by one and learn the accounting implications of each as under:

(1) Separate Entity Concept: According to this concept business is treated to have a distinct accounting entity from its owners, who controls the resources of the concern and is accountable therefore. All the accounts are kept for a business entity as distinguished from the persons associated with it. They will record transactions between the owner and the firm; for instance if proprietor withdraws some Cash or Goods, such is treated as drawings but not as business expense. Thus, capital of the owner is reduced by the amount of drawings. This concept is based on the sense that proprietors resources are handed over to the management and the management is expected to use these resources to the best advantage of the firm, and to account for their sources placed at its disposal. The failure to recognize the business as a separate accounting entity, would make it extremely difficult to evaluate the performance of the business alone ; since the private transactions would get mixed and introduce bias in the results.

(2) Money Measurement Concept : In accounting a record is made of only those transactions and events that can been expressed in terms of Money. Those events which can not be expressed in money terms do not find place in the accounts; for instance, salary paid to an employee is recorded in the books but his competence which cannot be expressed in monetary terms is not recorded in books. The applications of this concept makes accounting information and data relevant and easy to understand, homogeneous and comparable. The importance of money measurement concept is that even a layman is able to understand and appreciate the things stated in money. Despite merits stated above, the concepts suffer from the following limitations:

(i) The value of money is not constant. It changes because of inflation or deflation in the country.

(ii) All the assets of business cannot be measured in money terms. It is very difficult to calculate the value of goodwill or measure the competency or morale of employees.

(3) Going Concern Concept: This concept assumes that the business will continue for a fairly long period to come. On the basis of this concept acquisitions of assets is recorded on historical cost basis and the increase or decrease in their value is not considered. The going concern concept is based on the following : (i) the life of business is indefinite ; (ii) depreciation of assets is made on the basis of the expected life without caring for their current value ; (iii) when new innovations and inventions take place the effect is measured in financial terms and assets are depreciated to allow for such changes.

(4) Dual Aspect Concept: The Dual Aspect concept is based on double entry book-keeping, which means every transaction entered into by a firm or an institution will have two aspects. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts. However, the total amount debited is always equal to the total amount credited.

As such this system of recording transactions on this principle is called, 'Double entry system'. It is because of this principle that both the sides of Balance Sheet are always equal. Thus the following accounting equation will always hold good at any point of time :

(5) Cost Concept: According to this concept all transactions are entered in the books of accounts at the price actually paid to acquire it, that is at its cost. This amount will be the basis for all subsequent accounting for the assets. But the cost concept does no mean that the assets will always be shown at cost. The assets may be recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation. However, if it is certain that business will last for a limited period of time, the accounting records will keep the expected life in view and treating all expenditures alike, may be capital or revenue. In case of revaluation of assets by the firm in the long run if surplus or deficit is transferred to Capital Reserve, it is not a violation of going conern concept since revaluation is made on permanent basis to reflect current values of Assets.

The rationable for the cost concept is the application of three basis criteria of relevance, objectivity and feasibility. But the concept is not much relevant for investors and other users because they are more interested in knowing what the business is actually worth today rather than the original cost.

(6) Revenue Recognition Concept: This concept indicates the amount of revenue that should be recognised from a given sale. It does not necessarily mean that the revenue must be realised in cash. Thus revenue is recognised when (a) earning process is reasonably complete and (b) the amount is realised. It should be note that the events like return of goods by customers and bad debts etc. reduce the revenue which has been earlier taken as realised .

(7) Matching Principle: This principle holds that expenses should be recognised in the same period as associated to revenues. It is very important for correct determination of profitability which is a measure of performance. In fact, according to this principle, expenses incurred in an accounting period should be matched with the revenues realised in the same period. If the revenue is realised on certain goods delivered during a particular period, all costs attributable to those goods should also be charged as expenses in the same period. To sum up, of the total amount spent, that part against which benefit will be received on revenue earned in the future is shown in the balance sheet as an asset and the rest is treated as an expense or the loss.

(8) Accrual Concept: Actual receipt or payment of cost may be made at any time, but according to this concept, transaction is recorded in the period to which income or expenditure is related. Wages and Salaries paid in July for the month of April are deemed to be the expenditure of April. It requires adjustment of outstanding and prepaid expenses, accrued or unearned income, etc.

(9) Accounting Period Concept: This concept is also known as Periodically Concept or Time Period. According to this concept the economic life of an enterprise is decided into arbitrary periods for preparing financial statements.

This concept would not be needed if the accountant could wait to prepare the financial statements of an enterprise till its termination or liquidation. But this is not a feasible proposition. No group of users - management, investors, creditors, and others - can wait indefinitely for such information. In Today’s business environment, all enterprises deem it necessary to report the results of their operations more frequently.

As a financial, Calendar or Diwali year is of 12 months, the enterprises usually have a cutoff period every 12 months for reporting the results of their economic activities. The three seasons - winter, summer and rainy - also recur after a period of 12 months. The Government also levies taxes on income on an annual basis. In spite of dividing the total life of an enterprise into segments based on annual time periods, the idea of accounting periods is quite useful.

Accounting time periods could be also a month or a quarter or half a year. Monthly, quarterly and half-yearly time periods are often referred to as In terlim Periods. Reports for such shorter periods are called Interim Reports. Interim Reports are usually less reliable than annual reports, since the shorter the time period, the more difficult it becomes to determine the proper net income for the period. Many estimates have to be made because accurate data for many items for short-time periods are not available. Yet, the quicker the information, even though less reliable, the more relevant it is for decision making. Timely information is more useful than delayed information.

2.4 ACCOUNTING CONVENTIONS

To make the accounting information more reliable, relevant, meaningful, consistent and intelligible, accounting concepts and principles need to be modified. For instance materiality consistency, conservatism, timeliness, industry’s practices, cost benefit relationship and other considerations have to be taken into account for making the information useful and meaningful. Thus, these modifying principles known as accounting conventions are as under:

1. **Convention of Conservatism**

This convention holds that when more than one accounting or measurement alternative is permissible for a transaction, the one having the least favourable immediate effect on profits or capital usually should be adopted. Providing for all future possible losses and not to anticipate any future earning is a golden rule. According to international accounting standard, “uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in financial statements. Prudence does not, however, justify the creation of secret or hidden reserves. 'Hence convention of conservation is the policy of 'Playing Safe'. Based on this convention, the stock in hand is shown at 'Lower of Cost or Market Price', provision for bad debts, Joint life policy or policies are shown not at actual amount of premiums paid but at surrender value etc. are few examples of conservatism. Based on this convention, the stock in hand or certain categories of investment are shown at 'lower of cost or market price'.

2. **Convention of Full Disclosure**

This convention says that accounts must be honestly prepared and all significant information must be disclosed therein. Standard forms of balance sheet and schedule of contents of the profit and loss account are prescribed by law to make disclosure of all relevant facts compulsorily. Disclosure of material fact does not mean leaking out the business secrecy. But it means disclosing all information of interest of the properties and investors. This is done for not to overburden accounts with information but to present facts without any malafied intention.

3. **Convention of Materiality**

The term material refers to the relative imporatance of an item or an event. Accounting should disclose all the material information and not to attempt to record so insignificant events which are not justified by the usefulness of the results. In other words, materiality here means the information which would have changed the results of the business if it would have been disclosed. Sometimes certain information may be furnished in footness as (a) information regarding contingent liabilities, (b) information regarding market price of investments etc. materiality will differ with the size, nature and traditions of the business. International accounting standards-5 states that "all material information should be disclosed which is necessary to make the financial statements clear and understandable."

4. **Convention of Consistency**

Since business is a going concern which has to continue indefinitely, it is necessary to make accurate comparison that the methods and practice of recording and presentation of accounts does not change. The procedure for determination of value of stock, the mode of charging depreciation etc. should continue to be the same. According to international accounting standards-1 consistency is a fundamental assumption and it is assumed that accounting polices are consistent from the period to another. Where this convention is not followed, the fact should be disclosed clearly along with reason thereof.

5. **Convention of Applicability of Law**

There are many different accounting policies and laws in use even in relation to the same subject. Judgment is required in selecting and applying those which in the circumstances of the enterprise are best suited to present properly its financial position and the results of its operation. Different industries such as mining, banking, electricity etc. have their own peculiar features and practices that required carefree considerations while preparing their financial statements. As accounting focuses on usefulness and feasibility, the industrial practices at principles permits, special accounting treatment for specific items where there is a clear precedent in the industry based on uniqueness, usefulness and feasibility, may be adopted.

Accounting Equation

All transactions in a business are recorded on dual aspect principle. Accounting to this basic concept, every business transaction has a twofold effect. Thus, every receiver is also a giver, and every giver is also a receiver.

The entire system of recording business transactions is based on accounting equation. All business transactions are recorded as having a Dual Aspect. Accounting equation is a statement of equality between debits and credits. It signifies that the assets of a business are always equal to the total of liabilities and capital (owner's equity). When this relationship is shown in the equation form it is known as 'Accounting Equation'. Thus

Assets = Liabilities + Capita;

The above equation may be elaborated as under:

Capital = Assets – Liabilities

or Liabilities = Assets – Capital

or Assets = Capital + Liabilities

or Assets – Capital – Liabilities = Zero.

Accounting equation is thus an accounting formula expressing equivalence of the two expressions of Assets and Liabilities as shown just above. Since the accounting equation depitcs the fundamental relationship among the components of the Balance Sheet, it is also called the Balance Sheet Equation. An example of the simple Balance Sheet in T-shape form is given as under :

M/s Ganguli & Co.
Balance Sheet as on ....

Liabilities	`	Assets	`
Capital	1,50,000	Land and Buildings	1,20,000
General Reserve	50,000	Plant and Machinery	60,000
Loans	70,000	Furniture	50,000
Bills Payable	30,000	Stock	40,000
Creditors	25,000	Debtors	45,000
Expenses Accrued	5,000	Cash at Bank	15,000
	3,30,000		3,30,000

In the above Balance Sheet Capital plus General Reserve, represent Owner's Equity or Capital whereas, Loans, Bills Payable, Creditors and Accrued Expenses represent outside Liabilities. All these taken together are equal to the Assets or aggregate of fixed assets (i.e., Land and Building, Plant and Machinery and Furniture), and current assets (i.e., Stock, Debtors and Cash at Bank). On the basis of above study, the important points to be noted are:

1. Every transaction or event has two aspects.
2. Total assets are always equal to capital and liabilities or in other words, Capital is always equal to Assets minus liabilities.
3. The Profit belongs to the owner which shall increase his Capital.
4. The owner has to bear the losses, as such his Capital will be reduced by the amount of the Loss.

Thus, recording of both the aspects of transactions and events answer that account books will also show the accuracy of the Accounting Equation.

Effect of Transactions on Accounting Equation :

Illustration-2.1 : Suppose Manu starts a new business and the following successive transactions take place:

Transaction - 1 : Manu started business with ` 1,50,000 as capital.

The effect of the transaction will be that the firm has received assets totalling ` 1,50,000 in the form of cash and the claim against the firm are also ` 1,50,000 in the form of Capital. The transaction can be expressed in the form of an accounting equation as follows :

Assets	=	Liabilities	+	Capital
Cash	=	Liabilities	+	Capital
1,50,000	=	0	+	1,50,000

Transaction - 2 : Manu purchased Plant for Cash ` 10,000.

The effect of this transaction is that the cash is reduced by ` 10,000, but a new asset of the same amount has been acquired. The transaction decreases one asset and at the same time increases the other asset with the same amount, leaving the total of the assets unchanged. The equations now will appear as follows:

	Assets			=	Liabilities	+	Capital
	Cash	+	Plant	=	Liabilities	+	Capital
Old Equation	1,50,000	+	0	=	0	+	1,50,000
Transaction	(–) 10,000	+	10,000	=	0	+	0
New Equation	1,40,000	+	10,000	=	0	+	1,50,000

Transaction - 3 : Manu purchased goods for Cash ` 40,000.

As a result of this transaction, each balance is reduced and anothe Asset (Stock of goods) has come into existence, leaving the total of the Assets unchanged. The equation will appear as follows :

	Assets		=	Liabilities	+	Capital
	Cash	+ Plant + Stock of Goods	=	Liabilities	+	Capital
Old Equation	1,40,000	+ 10,000 + 0	=	0	+	1,50,000
Transaction	(–) 40,000	+ 0 + 40,000	=	0	+	0
New Equation	1,00,000	+ 10,000 + 40,000	=	0	+	
	1,50,000					

Transaction - 4 : He purchased goods on credit for ` 32,000.

This transaction will increase stock of goods on the assets side and will create a liability in the form of creditors. The persons from whom goods have been bought on credit are called (Creditors). The equation will be as follows :

	Assets			=	Liabilities	+	Capital
	Cash	+ Plant	+ Stock of Goods	=	Creditors	+	Capital
Old Equation	1,00,000	+ 10,000	+ 40,000	=	0	+	1,50,000
Transaction	0	+ 32,000		=	32,000	+	0
New Equation	1,00,000	+ 10,000	+ 72,000	=	32,000	+	1,50,000

Transaction - 5 : Goods costing `12,000 sold on credit for ` 15,000.

This transaction will give rise to a new asset in the form of Debtors to the extent of `15,000. Debtors are those persons to whom goods have been sold on credit. But the stock of goods will be reduced only by `12,000, the cost of goods sold. The net increase in Assets `3,000 is the amount of profit which will be added to the Capital. The effect of the transaction has been explained in the following equation :

Assets					= Liabilities	+	Capital
	Cash	+ Plant	+ Stock of Goods	+ Debtors	= Creditors	+	Capital
Old Equation	1,00,000	+ 10,000	+ 72,000	+ 0	= 32,000	+	1,50,000
Transaction	0	+ 0	– 12,000	+ 15,000	= 0	+	3,000
New Equation	1,00,000	+ 10,000	+ 60,000	+ 15,000	= 32,000	+	1,53,000

Transaction - 6 : Paid `4,000 for rent.

The effect of the transaction is that firstly, it reduces Cash and since the rent is an expense, it result in a Loss which decreases the Capital. The revise equation will appear as below :

Assets					= Liabilities	+	Capital
	Cash	+ Plant	+ Stock of Goods	+ Debtors	= Creditors	+	Capital
Old Equation	1,00,000	+ 10,000	+ 60,000	15,000	= 32,000	+	1,53,000
Transaction	(–) 4,000	+ 0	+ 0	+ 0	= 0	+	(–) 4,000

New Equation	96,000	+	10,000	+ 60,000	+ 15,000	= 32,000	+	1,49,000

From the study of the aforesaid transactions it may be concluded that every transaction has a double effect and in each case Assets = Liabilities + Capital. In other words 'Accounting Equation is true in all cases'. The last equation appearing in the books of Manu may also be presented in the form of a statement named as Balance Sheet (also called Position Statement) which will appear as below :

Balance Sheet on Manu as on ......

Liabilities	`	Assets	`
Sundry Creditors	32,000	Cash	96,000
Capital of Manu	1,49,000	Plant	10,000
		Stock (Goods)	60,000
		Sundry Debtors	15,000
	1,81,000		1,81,00

Illustration-2.2: Calculate total equity (Total Assets) on the basis of information given below and also owner's equity at end :

1. Capital as the start of business (Owner's equity `1,00,000).
2. Creditors at end ` 30,000.
3. Revenue earned during the year `80,000.
4. Expenses incurred during the year `30,000.

Solution : Closing Capital = Opening Capital + Revenue earned – Expenses incurred

= `1,00,000 + 80,000 – 30,000

= `1,50,000 (Increase in capital on account of Profit earned)

Total Equity (Total Assets) = Owner's Equity + Creditors

= ` 1,50,000 + 30,000 or ` 1,80,000.

llustration 2.3 : Prove the Accounting Equation is satisfied in all the following transactions and prepare a Balance Sheet of Mr. Sachin

		`			`
1.	Sachin started business with cash	1,60,000	6.	Received commission	10,000
2.	Purchased goods for cash	1,00,000	7.	Withdrew cash for private use	12,000
3.	Purchased goods on credit	1,40,000	8.	Sold goods on credit (cost price ` 30,000)	40,000
4.	Purchased furniture for cash	20,000	9.	Paid to trade creditors	10,000
5.	Paid rent of the Premises	10,000			

Solution :

Accounting Equation

	Transaction		**Assets**								**Liabilities**		**Capital**
			Cash	+	Stock	+	Furniture	+	Debtors	=	Creditors	+	Capital
1.	Sachin started business with ` 1,60,000		1,60,000	+	0	+	0	+	0	=	0	+	1,60,000
		Equation	1,60,000	+	0	+	0	+	0	=	0	+	1,60,000
2.	Purchased goods for cash ` 1,00,000		(–) 1,00,000	+	1,00,000	+	0	+	0	=	0	+	0
		New Equation	60,000	+	1,00,000	+	0	+	0	=	0	+	1,60,000
3.	Purchased good on credit ` 40,000		(–) 0	+	40,000	+	0	+	0	=	40,000	+	0
		New Equation	60,000	+	1,40,000	+	0	+	0	=	40,000	+	1,60,000
4.	Purchased good on credit ` 20,000		(–) 20,000	+	0	+	20,000	+	0	=	0	+	0
		New Equation	40,000	+	1,40,000	+	20,000	+	0	=	40,000	+	1,60,000
5.	Paid rent ` 10,000		(–) 10,000	+	0	+	0	+	0	=	0	(–)	10,000
		New Equation	30,000	+	1,40,000	+	20,000	+	0	=	40,000	+	1,50,000
6.	Received commission	` 10,000	+ 10,000	+	0	+	0	+	0	=	0	+	10,000
		New Equation	40,000	+	1,40,000	+	20,000	+	0	=	40,000	+	1,60,000
7.	Withdraw cash for private use ` 12,000		(–) 12,000	+	0	+	0	+	0	=	0	+	12,000
		New Equation	28,000	+	1,40,000	+	20,000	+	0	=	40,000	+	1,48,000
8.	Sold goods on credit for	` 40,000 (cost ` 30,000)	0	–	30,000	+	0	+	40,000	=	0	+	10,000
		New Equation	28,000	+	1,10,000	+	20,000	+	40,000	=	40,000	+	1,58,000
9.	Paid to creditors ` 10,000	(–) 10,000	+	0	+	0	+	0	=(–) 10,000		+	0	
		Final Equation	18,000	+	1,10,000	+	20,000	+	40,000	=	30,000	+	1,58,000

List of Accounting Standards issued by ICAI L

Accounting standards	What it covers	Accounting standards	What it covers
AS – 1	Disclosure of Accounting policies.	AS – 17	Segment reporting
AS – 2	Valuation of inventories.	AS – 18	Related party disclosure
AS – 3	Cash flow statement	AS – 19	Leases
AS – 4	Contingencies and events occurring after Balance Sheet date.	AS – 20	Earning per share
		AS – 21	Consolidated financial statements
AS – 5	Net profit or loss for the period, prior period items and changes in accounting policies.	AS – 22	Accounting for taxes in income
		AS – 23	Accounting for investment in associates in consolidated financial statement.
AS – 6	Depreciation Accounting		
AS – 7	Construction contracts	AS – 24	Discontinuing operations
AS – 8	Accounting for research and development (withdrawn)	AS – 25	Interim financial reporting
		AS – 26	Intangible assets
AS – 9	Revenue recognition	AS – 27	Reporting of interest in joint venture
AS – 10	Accounting of fixed assets		
AS – 11	Change in foreign exchange rate.	AS – 28	Impairment of assets
AS – 12	Government grants	AS – 29	Contingent liabilities and assets.
AS – 13	Investment	AS – 30	Financial instruments- recognition and measurement.
AS – 14	Amalgamation		
AS – 15	Retirement benefits of employees	AS – 31	Financial instrument presentation
AS – 16	Borrowing cost	AS – 32	Financial instrument - disclosure

AS : 1 Disclosure of Accounting Policies

The main features of the Standard AS : 1 announced by the ASB, regarding Disclosure of Accounting Policies, are as follows :

1. **Fundamental Accounting Assumptions :** Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed.

(i) Funamental accounting assumptions are :

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

(b) *Consistency.* It is assumed that accounting policies are consistent from one period to another.

(c) *Accrual.* Revenue and costs are accrued, i.e., recognised 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 assumption are not dealt within this statement).

In case any of the above fundamental accounting assumptions is not followed, the fact should be disclosed in the financial statements together with reasons.

2. **Accounting Policies :**

(i) Accounting policies refer to the specific accounting principles and methods of applying those principles adopted by enterprises in the preparation and presentation of financial statements. There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which the enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

(ii) The following are the examples of the areas in which different accounting policies may be adopted by different enterprises :

(a) Methods of depreciation, depletion and amortization; (b) Treatment of expenditure during the construction; (c) Conversion of translation of foreign currency items; (d) Valuation of inventories; (e) Treatment of goodwill; (f) Valuation of investments; (g) Treatment of retirement benefits; (h) Recognition of profit on long-term contracts; (i) Valuation of fixed assets, (j) Treatment of contingent liabilities.

The above list of example is not intended to be exhaustive.

(iii) The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policy, should represent a true and fair view of the state of affairs of the enterprise, as on the balance sheet date and of the period ended on that date. For this purpose, the major considerations governing the selection of and application of accounting policies are :

(a) *Prudence.* Uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in preparing financial statements. Prudence does not, however, justify the certain of secret or hidden reserves.

(b) *Substance over form.* Transformations and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

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

(iv) To ensure proper understanding of financial statements, all significant accounting policies adopted in the preparation should be disclosed.

(v) The disclosure of the significant accounting policies as such should form a part of the financial statements and the significant accounting policies should normally be disclosed at one place.

(vi) Any change in the accounting policy which has a material effect in the current period or which is reasonably expected to have a material effect in the later periods should be disclosed. In the case of a change in the accounting policy which has a material effect in the current period, the amount by which an item, in the financial statement is affected by such a change, should be disclosed to the extent ascertainable. Where such an amount is not ascertainable wholly or in part, the fact should be indicated.

Difference Between fundamental accounting presumptions and accounting policies :

It is clear from whatever has been stated above the IASC has made distinctions between Fundamental Accounting Assumptions and Accounting Policies. The distinctions are as follows :

1. Fundamental accounting presumptions are assumed to have been used and accepted in the preparation of financial statements while no such presumption can be made in respect of accounting policies.
2. In case of fundamental accounting assumptions, the management has no discretion. They have to be necessarily followed. However, in the case of accounting policies, the management may make a choice. It should use its judgment in selecting and applying such policies which are best suited to the business.
3. In case of fundamental assumptions are not followed, the fact has to be disclosed together with reasons. In case of accounting policies, disclosure has to be made about the policy which has been followed by the management. In case the policy is changed in subsequent years, the reasons for change and the resulting financial consequences have also to be disclosed.

Distinction Between Double Entry and Single Entry :

Difference	Double Entry	Single Entry
1. Accounts kept	It records all account - personal, real and nominal.	It records only personal account and in some cases cash account also.
2. Record	It provides a complete record of all transactions.	It shows an incomplete record.

3. Principle	It follows the double entry accounting principles.	Some transactions are recorded as per double entry and other are kept in a haphazard way.
4. Reliability	Accounts are reliable	Accounts are not reliable.
5. Arithmetical accuracy	Under this method arithmetical accuracy of the books of accounts can be checked by preparing Trial Balance.	Arithmetical accuracy of the books of accounts can not be checked.
6. Suitability	It is suitable and appropriate for large concerns.	It is suitable for small concerns.
7. Profit	Profit can be ascertained through preparation of Profit and Loss A/c.	Profit can be calculated by comparing capital in the beginning with the capital at the end.

2.5 INDIAN ACCOUNTING STANDARDS

In order to bring about uniformly in terminology, approach and presentation of accounting results, the Institute of Chartered Accountants of India established on 22nd April, 1977, an Accounting Standards Board (ASB). The main function of the ASB was to formulate accounting standards so that such standards would be established by the Council of the Institute of Chartered Accountants. While formulating the accounting standards, the ASB was to give due consideration to the International Accounting Standards and try to integrate them to the extent possible. It was also to take into consideration the applicable laws, customs, usages and the business environments prevailing in India.

2.5.1. Preface to the Statements of Accounting Standards (Revised 2004)

The following are the specific features of the Preface to the Statements of Accounting Standards (Revised 2004), issued by the Council of the Institute of Chartered Accounts of India. With the issuance of this revised Preface, the Preface to the Statements of Accounting Standards, issued in January 1979, stands superseded.

1. Formation of the Accounting Standards Board

1. The Institute of Chartered Accountants of India (ICAI), recognising the need to harmonise the diverse accounting policies and practices in use in India, constituted the Accounting Standards Board (ASB) on 21st April, 1977.
2. The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, the following are represented on the ASB :
   - (i) Nominee of the Central Government representing the Department of Company Affairs on the Council of the ICAI.
   - (ii) Nominee of the Central Government representing the Office of the Comptroller and Auditor General of India on the Council of the ICAI.
   - (iii) Nominee of the Central Government representing the Central Board of Direct Taxes in the Council of the ICAI.
   - (iv) Representative of the Institute of Cost and Words Accountants of India.
   - (v) Representative of the Institute of Company Secretaries of India.
   - (vi) Representative of Industry Associations (1 from Associated Chambers of Commerce and Industry (ASSOCHAM), 1 from Confederation of Indian Industry (CII) and 1 from Federation of Indian Chambers of Commerce and Industry (FICCI).
   - (vii) Representative of Reserve Bank of India.
   - (viii) Representative of Securities and Exchange Board of India.
   - (ix) Representative of Controller General of Accounts.
   - (x) Representative of Central Board of Excise and Customs.
   - (xi) Representative of Academic Institutions (1 from Universities and 1 from Indian Institutes of Management).
   - (xii) Representative of Financial Institutions.
   - (xiii) Eminent professionals co-opted by the ICAI (they may be in practice or in industry, government, education, etc.).

(xiv) Chairman of the Research Committee and the Chairman of the Expert Advisory Committee of the ICAI, if they are not otherwise members of the Accounting Standards Board.

(xv) Representative(s) of any other body, as considered appropriate by the ICAI.

2. Objectives and Functions of the Accounting Standards Board

1. Following are the objectives of the Accounting Standards Board :
   (i) To conceive of and suggest areas in which accounting standards need to be developed.
   (ii) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.
   (iii) To examine how far the relevant International Accounting Standard/International Financial Reporting Standard (see paragraph 3 below) can be adapted while formulating the Accounting Standard and to adapt the same.
   (iv) To review, at regular intervals, In Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.
   (v) To provide, from time to time, interpretations and guidance on Accounting Standards.
   (vi) To carry out such other functions relating to Accounting Standards.
2. Important function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. While formulating the Accounting Standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India.
3. The ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board's (IASB) pronouncements in the country with a view to facilitate global harmonisation of Accounting Standards. Accordingly, while formulating the Accounting Standards, the ASB will give due to consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (Predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.
4. The Accounting Standards are issued under the authority of the Council of the ICAI. The ASB has also been entrusted with the responsibility of propagating the Accounting Standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from Accounting Standards. The ASB will also review the Accounting Standards at periodical intervals and, if necessary, revise the same.

3. General Purpose Financial Statements

1. For discharging its functions, the ASB will keep in view the purposes and limitations of financial statements and the attest function of the auditors. The ASB will enumerate and describe the basic concept to which accounting principles should be oriented and state the accounting principles to which the practices and procedures should conform.
2. The ASB will clarify the terms commonly used in financial statements and suggest improvements in the terminology wherever necessary. The ASB will examine the various current alternative practices in vogue and endeavour to eliminate or reduce alternatives within the bounds of rationality.
3. Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature. (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial,

industrial of business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

4. The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various shareholders. Governments and their agencies and the public. References to financial statements in this Preface and in the standards issued from time to time will be constructed to refer to General Purpose Financial Statements.
5. Responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

4. Scope of Accounting Standards

1. Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standards is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.
2. The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements.
3. The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The data from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the ICAI. However, no standard will have ertroactive application, unless otherwise stated.
4. The institute will use its best endeavours to persuade the Government, appropriate authorities, industrial and business community to adopt the Accounting Standards in order to achieve uniformity in preparation and presentation of financial statements.
5. In formulation of Accounting Standards, the emphasis would be on laying down accounting principles and not detailed rules for application and implementation thereof.
6. The Standards formulated by the ASB include paragraphs in bold italic tyep and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principle. An individual standard should be read in the context of the objective stated in that standard and this Preface.
7. The ASB may consider any issue requiring interpretation on any Accounting Standards. Interpretations will be issued under the authority of the Council. The authority of interpretation is the same as that of Accounting Standard to which it relates.

5. Procedure for Issuing an Accounting Standard

Broadly, the following procedure is adopted for formulating Accounting Standards :

1. The ASB determines 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, the 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. The draft of the proposed standard will normally include the following :
   (a) Objective of the Standard,
   (b) Scope of the Standard,
   (c) Definitions of the terms used in the Standards,
   (d) Recognition and measurement principles, wherever applicable,
   (e) Presentation and discloure requirements.

4. The ASB will consider the preliminary draft prepared by the Study Group and if any revision of the draft is required on the basis of deliberations, the ASB will make the same or refer the same to the Study Group.
5. The ASB will circulate the draft of the Accounting Standard to the Council members of the ICAI and the following specified bodies for their comments :
   - (i) Department of Company Affairs (DCA).
   - (ii) Comptroller and Auditor General of India (C&AG)
   - (iii) Central Board of Direct Taxes (CBDT)
   - (iv) The Institute of Cost and Works Accountants of India (ICWAI)
   - (v) The Institute of Company Secretaries of India (ICSI)
   - (vi) Associated Chambers of Commerce and Industry (ASSOCHAM), Confederation of Indian Industry (CII) and Federation of Indian Chambers of Commerce and Industry (FICCI).
   - (vii) Reserve Bank of India (RBI).
   - (viii) Securities and Exchange Board of India (SEBI).
   - (ix) Standing Conference of Public Enterprises (SCOPE)
   - (x) India Bank's Association (IBA).
   - (xi) Any other body considered relevant by the ASB keeping in view the nature of the Accounting Standard.
6. The ASB will hold a meeting with the representatives of specified bodies to ascertain their view on the draft of the draft of the proposed Accounting Standard. On the basis of comments received and discussion with the representatives of specified bodies, the ASB will finalise the Exposure Draft of the proposed Accounting Standard.
7. The Exposure Draft of the proposed standard will be issued for comments by the members of the Institute and the public. The Exposure Draft will specifically be sent to specified bodies (as listed above), stock exchanges, and other interest groups, as appropriate.
8. After taking into consideration the comments received, the draft of the proposed standard on the relevant subject will then be issued by the ICAI.
9. The Council of ICAI will consider the final draft of the proposed Standard, and if found necessary, modify the same in consultation with the ASB. The Accounting Standard on the relevant subject will then be issued by the ICAO.
10. For a substantive revision of an Accounting Standard, the procedure followed for formulation of a new Accounting Standard, as detailed above, will be followed.
11. Subsequent to issuance of an Accounting Standard, some aspect(s) may require revision which are not substantive in nature. For this purpose, the ICAI may make limited revision to an Accounting Standard. The procedure followed for the limited revision will substantially be the same as that to be followed for formulation of an Accounting Standard, ensuring that sufficient opportunity is given to various interest groups and general public to react to the proposal for limited revision.

6. Compliance with the Accounting Standards

1. The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in the audit reports so that the users of financial statements may be aware of such deviation.
2. Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Stututes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 1956 (Section 211), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies Regulations, 2000.
3. Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable Standard.

2.6 SYSTEM OF BOOK - KEEPING

Book-keeping, as explained earlier, is the art of recording pecuniary of business transactions in a regular and systematic manner. The recording of transactions may be done according to any of the following two systems :

1. Single entry system : An incomplete double entry system can be termed as a single entry system. According to Kohler, "it is a system of book-keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances". This system has been developed by some business houses, who for their convenience, keep only some essential records. Since all records are not kept, the system is not reliable and can be used only by small firms. The working of this system has been discussed in detail later in a separate chapter.

2. Double entry system : The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteen century, is the only system of recording the two-fold aspect of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept' earlier in this chapter. The system recognizes that every transaction have a two-fold effect. If someone receives something, them either some other person must have given it, or the first-mentioned person must have lost something, or some service etc. must have been rendered by him.

2.7 SYSTEM OF ACCOUNTING

The period at which the transactions are to be recorded is an important aspect in accounting. When should be accountant record a transaction ? There are three basis of accounting on the basis of which transactions are to be recorded.

(i) Cash-Basis of Accounting
(ii) Accrual-Basis of Accounting
(iii) Hybrid or mixed Basis

The timing of recording business transactions is another important aspect of accounting. When should be accountant record the transactions ? There are two answers to this question.

(i) Under cash-basis accounting, transactions are recorded when either cash is received or paid.
(ii) Under accrual-basis accounting, transactions are recorded when they occur or happen.
(iii) Under hybrid system, income are recorded under cash-basis where as expenses are recorded under accrual basis.

Cash Basis Accounting

Under this system transactions are recorded in the books of accounts only when cash is paid or received. In other words, monetary transactions will not be recorded until cash is paid or received. Transactions relating to revenue, cost, assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made. In this system, there is no place for accrued items such as salary outstanding, interest accrued etc. Profit under this method is calculated by comparing the revenues received in cash with the expenses paid in cash. Government accounting is based on this system.

Advantages

(i) Accounting records become more reliable as transactions are recorded when cash is paid or received.
(ii) Recording under this method is easier. Professional people like doctor, lawyer, etc. and the government prepare its accounts under cash basis.

Disadvantages

(i) It ignores the non-cash resources and obligations.
(ii) True profit or loss cannot be found out as it does not match the actual expenses with actual revenues.

Accrual Basis or Mercantile System

Under this system transactions are recorded when they occur. Transactions are brought also accounts regardless of the fact whether cash is paid or received. Effects of transactions and events are recognised when they happen. In other words besides cash transactions, the non-cash (the accruals) transactions are also taken into account to calculate profit or loss of a business. All incomes and expenses related to an accounting period are recorded even if these are not transacted in cash. It may be mentioned here that all business houses follow this system.

This system is also known as merchantile system of accounting. Under this system transactions relating to revenue, cost, assets and liabilities are reflected in the account in the period in which they accrue. Transactions are recorded when they occur - it does not matter whether cash is paid or received. For example, when business effects sale and incurs expenses, these are recorded even if cash is not received or paid. This basis includes items relating deferrals, allocation, depreciation and amortization.

Hybrid or Mixed Basis

As the name indicates, this system of accounting combines both the basis i.e., cash as well as accrual basis. This system is based on the concept of conservation.

Under this system incomes are recognised as in cash-basis and expenses are recorded under accrual basis. So incomes are recorded when they are received in cash but expenses are recorded during the accounting period in which they arise irrespective of when they are paid.

2.8 KEY TERMS

Accounting Period: The period for which books of accounts are usually maintained. Generally, it is a period of twelve months.

Cost: The price paid to acquire as asset.

Concepts: Concepts are 'Generally Accepted Accounting Principles' (GAAP) - also called conventions by many authors.

Conventions: Some authors define conventions as traditions which guide the accountants while preparing the accounting statements. Conventions are also called as concepts by many authors.

Expense: An expenditure incurred for receiving some benefit or service.

Income: Amount earned through business operations.

Partnership Firm: A business unit owned by two or more persons who have agreed to share the profits of the business carried on by all or any of them acting for all.

Principle: A general law or rule adopted as a guide to action.

Sole of Proprietorship: A business unit owned by one person.

2.9 SUMMARY

- The rules and conventions of accounting are commonly referred to as the conceptual framework of accounting. These set of rules guide the accountant and bring uniformity in the preparation of accounting records.
- The rules and conventions of accounting are also termed as 'Generally Accepted Accounting Principles'. To explain these principles, different authors have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions etc.
- According to business entity concept, a business is treated as a separate entity, which is completely separate from its owners. Accounting records are kept separately for these entities.
- According to money measurement concept, only those events which can be expressed in monetary terms are recorded.
- Accounting assumes that an entity is a 'going concern' and it will continue to operate for an indefinitely long period in future.
- Materiality concept holds that events of relatively small importance need not be given a detailed and theoretically correct treatment.
- Full disclosure concept states that all significant financial informations should be reported fully on the financial statements of an organisation.
- According to Accounting Standard - I, 'Going Concern', 'Consistency' and 'Accrual' are treated as the fundamental accounting assumptions.
- The two basic approaches to modern accounting are cash-basis accounting and accrual accounting.
- The principles of cash-basis of accounting is applied when a monetary transaction is not recorded until cash is received or paid for.
- Accrual accounting takes into consideration the measurement of non-cash resources and obligations to determine the true profit of an enterprise.

2.10 CHECK YOUR PROGRESS AND ANSWERS

I. Choose the correct answer

(a) Which of the following is not a criteria for accepting an accounting principle ?

(i) Materiality (ii) Objectivity

(iii) Feasibility (iv) Relevance

(b) The business entity concept is applicable to :

(i) Soleproprietorship (ii) Partnership

(iii) Joint stock company (iv) All the organization

(c) Which concept of accounting limits the scope of accounting ?

(i) Money measurement concept (ii) Going concept concept

(iii) Dual aspect concept (iv) Business entity concept

(d) The concept which gives rise to accounting equation is :

(i) Cost (ii) Dual aspect

(iii) Going concern (iv) Matching

(e) Making provision for doubtful debt in anticipation of bad debt is an application of :

(i) Consistency (ii) Materiality

(iii) Conservatism (iv) None of these

(f) Which of the following concepts is observed at the recording stage ?

(i) Dual aspect (ii) Matching

(iii) Consistency (iv) Conservation

Ans. : a. (i), b. (iv), c. (i), d. (ii), e. (iii), f. (i)

2.11 QUESTIONS AND EXERCISES

1. What do you mean by Generally Accepted Accounting Principles ? Why are they required ?
2. Briefly explain the accounting concepts which are widely accepted ?
3. What do you mean by accounting concepts ? Discuss five accounting concepts with examples.
4. Discuss with examples the three fundamental accounting assumptions.
5. Discuss the two basic approaches of modern accounting.
6. What do you mean by accounting equation ? Explain the mechanism with suitable examples.
7. What do you mean by transactions and events ? Explain with one example. Discuss the differences between transactions and events.
8. Write short notes on:

(i) Business Entity Concept (ii) Money Measurement Concept

(iii) Going Concern Concept (iv) Cost Concept

(v) Realisation Concept (vi) Accrual Concept

(vii) Accounting Period Concept (viii) Matching Concept

(ix) Dual Aspect Concept (x) Consistency Concept

(xi) Conservatism Concept (xii) Materiality Concept

(xiii) Objective Evidence Concept (xiv) Full Disclosure Concept

2.12 PRACTIAL PROBLEMS

1. Mr. Sanjay Lenka had the following transactions. Use accounting equation to show the impact of the transactions on his financial position.

(a) Commenced business with cash ` 1,00,000.

(b) Deposited into bank ` 40,000.

(c) Purchased goods from Nupur Traders ` 50,000 on credit.

(d) Sold goods for cash ` 50,000 whose cost is ` 40,000.

(e) Rent paid ` 5,000.

(f) Bought furniture for ` 5,000.

(g) Paid to Nupur Traders ` 50,000.

2. M/s Tulika Enterprise started business with cash of ` 40,000, a table costing ` 2000 and a chair costing ` 750. The following transactions have been recorded during a month. Show its financial position at the end of the month by the help of accounting equation.
   (a) Goods purchased for ` 20,000.
   (b) Rent paid in advance ` 3000.
   (c) Collected commission ` 3500.
   (d) Goods worth ` 1000 was taken by the proprietor for personal use.
   (e) Paid telephone bill ` 500.
   (f) Sold goods worth ` 12,000 to Mr. Sanjay at a price of ` 10,000.
   (g) Sanjay paid the amount the proprietor who kept it with her.
3. Take imaginary examples for the following transactions and show their effects on accounting equation.
   (a) Purchase of an asset on credit.
   (b) Payment of expenses.
   (c) Accrued income
   (d) Sale of asset for profit
   (e) Prepaid expenses.
4. For the transactions given below, one of the aspect involved is given. State the other aspect.

	Transaction	Aspects involved	
(a)	Soumya started business with ` 10,000.	(i) Cash	(ii) __________
(b)	Discount allowed to Mohan.	(i) Mohan	(ii) __________
(c)	Freight paid for purchase of machinery.	(i) Cash	(ii) __________
(d)	Furniture sold for cash.	(i) Furniture	(ii) __________
(e)	Creditors are paid by cheque.	(i) Creditor	(ii) __________
(f)	Amount charged by bank as bank charges.	(i) Bank charges	(ii) __________

Ans. (a) Capital, (b) Discount, (c) Machinery, (d) Cash, (e) Bank, (f) Bank.

2.13 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari

Financial Statement Analysis – John N. Meyer

Management Accounting – Khan and Jain.

Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.

Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER – 3 JOURNALISING TRANSACTIONS

Chapter Outlines

3.0 INTRODUCTION

Accounting is primarily concerned with designing the system for recording, classifying, summarising the recorded data and interpreting them for internal and external users. The first two steps, i.e., recording and classifying are known as book keeping and are done by the book keeper. A book keeper is responsible for keeping all the records of a business. The books maintained by the book keeper are known as books of accounts. Journal is an important book which records all the transactions in a chronological order.

3.1 LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Explain important books maintained by an organisation.
- Define journal.
- Know the steps in journalising.
- Explain the entry of important transactions in the journal.
- Outline different types of journal entry.
- Explain the advantages and limitations of journal.
- Make the sub-division of journal.

3.2 CLASSIFICATION OF ACCOUNTS

We have discussed the major components of accounting equation, i.e., assets, liabilities and capital. Under each major category, there are several classification of items. Under assets, there may be cash, goods, furniture etc. The period of each individual classification is known as an account. So an account is simply a statement where similar transactions and events which occur during a particular period are accumulated and summarised. The account is designed in such a way as to reflect the increase and decrease in a particular item.

In order to understand what an account is, let us take the following example :

1. Mr. Suvam Sahu started business with cash ` 50,000.
2. He paid `500 for purchasing a chair and ` 2,000 for purchasing a table.
3. He borrowed ` 5,000 from Ram.
4. He purchased a computer for ` 20,000.,O 5 He deposited of ` 20, 000 in bank.

To know the balance of cash at the end of these transactions, we have to take the help of Accounting equation, i.e., Assets = Liabilities + Capital.

			As sets	=	**Liabilities**	+	**Capital**
			`		`		`
1.	Cash	-	50,000	=	-	+	50,000
2.	Cash	-	47,500				
	Chair	-	500				
	Table	-	2,000	=	-	+	50,000
3.	Cash	-	52,500				
	Chair	-	500				
	Table	-	2,000	=	Ram- 5,000	+	50,000
4.	Cash	-	32,500				
	Chair	-	500				
	Computer	-	2,000	=	Ram- 5,000	+	50,000
5.	Cash	-	12,500				
	Chair	-	500				
	Table	-	2,000				
	Computer	-	20,000				
	Bank	-	20,000	=	Ram- 5,000	+	50,000

To know the cash balance at the end of the day, all transactions which increase cash are put in one column and all transactions which decrease the cash balance are put in another column. Then the closing balance can be easily found out. Taking the above transactions, the balance of cash can be determined as follows :

	Transactions which increase cash			*Transactions which decrease cash*	
		`			`
1.	Capital	50,000	2.	Purchase of chair	500
			2.	Purchase of table	2,000
3.	Ram's loan	5,000	4.	Purchase of computer	20,000
			5.	Bank deposit	20,000
					42,500
				BALANCE	12,500
		55,000			55,000

The balance of cash after all transactions is `12,500.

The above statement in 'T' form is a simple form of what we call an "Account". Hence an account is a statement in 'T' form showing the various changes which have occurred in relation to a particular item for a given period and summarised for finding the net result. The general form of an account is given below.

Dr.			**Capital Account**				Cr
Date	Particulars	F	Amount	Date	Particular	F	Amount
			`				`

Note : 'F' denotes folio or page number of the book of prime entry, i.e., journal, cash/bank book.

An account can be opened for each asset, liability, person, income and expenses to find out the next effect of transactions relating to each item. The main object of opening a person's account is to know the net amount due to or due from him. The object of opening an asset account is to know its balance at the end of the year. Similarly, the purpose of opening expenses and income accounts is to find out the total expenses and incomes for a particular period. The book which contains the various accounts is called 'Ledger Book'. The details regarding how an account is maintained is discussed under the chapter called 'Ledger'.

In order to have a better understanding of the nature of accounts, it is necessary to classify them under different categories. There are two approaches which are used for classifying the accounts :

(i) British Approach / Traditional Classification.

(ii) American Approach / Fundamental Approach / Modern Classification.

British Approach / Traditional Classification

According to this approach, the business transactions can broadly be classified into three categories.

(i) Transactions relating to Persons

(ii) Transactions relating to Assets and Properties

(iii) Transactions relating to Income and Expenses

On this basis it becomes necessary for the business to keep the accounts of

(a) Each person with whom the business deals : Personal Account.

(b) Each property or asset and rights : Real Accounts

(c) Each item of income and expenses : Nominal Accounts.

American Approach / Fundamental Approach / Modern Classification

According to this approach, the business transactions have been divided into five categories.

(i) Transactions regarding Proprietor, i.e., Capital.

(ii) Transactions relating to Liabilities.

(iii) Transactions relating to Assets.

(iv) Transactions relating to Expenses.

(v) Transactions relating to Revenue.

On this basis, the account maintained by a business houses are classified as :

(a) Capital Accounts

(b) Asset Accounts

(c) Liability Accounts

(d) Expense Accounts

(e) Income Accounts

The classification of account is given in the following chart.

Traditional Classification

Personal Account: The accounts relating to individuals, firms, associations or companies known as personal accounts. These accounts are further sub-divided into three types.

(a) Natural person's Account

(b) Artificial person's Account

(c) Representative person's Account

(a) Natural person's Account: The accounts which relate to persons created by nature, i.e., individual human beings are termed as natural persons account. The examples of such accounts are : Rama account, Suvam account, Gopala account, Naresh account etc.

(b) Artificial person's Account: These accounts are related to artificial persons like companies, partnership firms, societies, corporations, educational institutions and clubs. Other examples of such accounts are: NALCO, BPL Ltd., State Bank of India, Ravenshaw College, Rotary Club, M/s Nayak and Associates etc.

(c) Representative person's Account : The accounts which represent expenses payable, expenses paid in advance, incomes receivable, and income received in advance are also personal accounts. For example, the salaries of the employees of a business firm, which have not been paid before closing of the books of accounts for the year, the recorded in "Salaries Outstanding A/c". It is regarded as a personal account because it represents the employees to whom salaries are payable by the firm. Such a personal account is called as Representative Personal Account. Similarly, two accounts are opened to represent the owner, so that his accounts can be easily distinguished from other personal accounts. These two accounts are (i) Capital account and (ii) Drawings account.

Real Accounts: The accounts relating to all tangible and intangible things (assets and properties) are called real accounts. Transactions relating to those things which can be seen and touched, are known as tangible real accounts. Such accounts are goods account, cash account, building account, furniture account, land account etc. The accounts relating to things which cannot be seen and touched are called intangible real accounts. Such accounts are goodwill, patent, trade mark, copy right etc.

Nominal Account The accounts which relate to expenses, losses, incomes and gains are callled nominal accounts. The example of such accounts are salary account, wages account, freight account, rent account, commission account etc.

Note : Usually, when a prefix or suffix is added to the nominal account, the new account becomes a personal account. For example, Rent account is nominal account. If we add 'outstanding' as prefix then new account "Outstanding Rent A/c" will be a personal account.

Nominal Account	Personal Account
Rent Account	Prepaid Rent Account or Outstanding Rent Account
Commission Account	Accrued Commission Account Commission Received in Advance Account

Illustration - 3.1

State under what heading (both in modern approach and traditional approach) would you classify each of the following accounts :

(a) Bank account
(b) Bad debt account
(c) Rent Received account
(d) Television account
(e) Goodwill account
(f) Salary prepaid account
(g) Ramesh (creditor) A/c
(h) Bank loan account
(i) Arabinda (customer) account
(j) Bills Receivable A/c
(k) Land account
(l) Carriage account
(m) Capital account
(n) Bills Payable account
(o) Computer account

Solution : Table showing category of accounts :

	Account	Modern Approach	Traditional Approach
(a)	Bank account	Asset	Personal
(b)	Bad debt account	Expense	Nominal
(c)	Rent Received account	Income	Nominal
(d)	Television account	Asset	Real
(e)	Goodwill account	Asset	Real (Intangible)
(f)	Salary Prepaid account	Asset	Personal (Representative)
(g)	Ramesh (Supplier)	Liability	Personal
(h)	Bank Loan account	Liability	Personal
(i)	Arabinda (Customer)	Asset	Personal
(j)	Bills Receivable account	Asset	Real
(k)	Land account	Asset	Real
(l)	Carriage account	Expense	Nominal
(m)	Capital account	Capital	Personal (Representative)
(n)	Bills Payable account	Liability	Personal
(o)	Computer account	Asset	Real

Identification of Accounts - Transaction Analysis

We know that an account is the record of each individual classification. For identifying the accounts involved in a transaction, we have to analyse the transaction to determine the items affected by the transaction; each individual item will be one account. For this purpose, we have to expand the accounting equation. When the accounting equation is expanded for the purpose of incorporating incomes and expenses, the accounting equation is :

$$\text{Asset (A)} = \text{Liabilities (L)} + [\text{Capital (C)} + \text{Income (I)} - \text{Expenses (E)}]$$

In order to eliminate negative sign in the equation, the Expense can be transferred to left hand side algebraically. So the accounting equation is :

$$\boxed{A + E = L + C + I}$$

Thus, there are five major elements in the accounting equation. The items under these elements which are affected by a transaction will be the accounts involved in the transaction. In order to have a clear understanding, let us take the following example :

1. Suvam started business with ` 50,000 cash.

In this transaction, the effects on business are :

(a) There is an increase in the asset of the business in the form of cash.

(b) There is an increase in liability in the form of Suvam's capital.

So the accounts involved are :

(i) Cash account and

(ii) Suvam's Capital account

2. Bought furniture for ` 5,000 in cash.

Effect of the transaction	*Account involved*
(a) Increase in asset in the form of furniture	Furniture account
(b) Decrease in asset in the form of cash	Cash Account

3. Purchased goods worth ` 10,000 from Raja & Co.

Effect of the transaction	*Account involved*
(a) Asset increases for goods	Goods Account
(b) Liability increases in favour of Raja & Co.	Raja & Co. Account

4. Paid rent ` 2,000 in cash

Effect of the transaction	*Account involved*
(a) Expenses increases for rent paid	Rent Account
(b) Asset decreases for cash payment	Cash Account

5. Received commission ` 5,000

Effect of the transaction	*Account involved*
(a) Income increases for commission received	Commission Account
(b) Asset increases for cash received	Cash Account

6. Salary due ` 1,000

Effect of the transaction	*Account involved*
(a) Expenses increases for salary	Salary Account
(b) Liability increases for salary outstanding	Salary Outstanding Account

7. Paid ` 5,000 to Raja & Co.

Effect of the transaction	*Account involved*
(a) Liability decreases in favour of Raja & Co.	Raja & Co. Account
(b) Asset decreases due to cash payment	Cash Account

8. Goods worth ` 20,000 are sold for ` 18,000.

Effect of the transaction	*Account involved*
(a) Asset decreases as goods are sold.	Goods Account
(b) Loss increase as less value is received	Loss on sale of Goods Account
(c) Asset increases as cash is received.	Cash Account

9. Settled account of Raja & Co. by paying ` 4,900.

Effect of the transaction	*Account involved*
(a) Liability decreases in favour of Raja & Co.	Raja & Co.
(b) Asset decreases as cash is paid	Cash Account
(c) Income increases as discount is received (Instead of paying ` 5,000, ` 4,900 is paid. So there is a gain of ` 100 as discount received.)	Discount Account

Transactions involving goods

There are several transactions relating to the movement of goods. The different movements of goods are :

(i) Purchase of goods

(ii) Sale of goods

(iii) Return of goods purchased

(iv) Return of goods sold

(v) Consumption of goods by proprietor for his personal use.

(vi) Distribution of goods for charity or advertisement.

If one single "Goods Account" is maintained for all the transactions relating to goods, it will not serve the useful purpose. For example, if we want to know the total purchase at any point of time, it will be difficult to know because, (1) When record in Goods A/c and (2) When sold goods are returned, then also we record in Goods A/c. As in both the cases goods account is involved, it is very difficult to distinguish which entry is for purchases and which one is for sales returns.

Same difficulty arises for the entries in Goods account for goods sold and purchase returns. Even when goods are distributed as charity or for the purpose of advertisement, then also we record in Goods account. So give separate information for each movement of goods, the Goods account is divided into several accounts each showing a particular movement.

(a) For purchase of goods : Instead of Goods Account, open Purchase Account.

(b) For sale of goods : Open Sales Account in place of Goods Account.

(c) For return of goods purchased : Open Purchases Return Account or Return Outward Account.

(d) For return of goods sold : Open Sales Return Account or Return Inward Account.

(e) For withdrawal of goods by proprietor : Reduce the balance of Purchase Account instead of Goods Account, because the amount of goods withdrawn reduces the amount of purchase for the business organisation.

(f) When goods are distributed as free samples or for charity : Reduce the balance of the Purchase account as it reduces the value of purchases.

We can summarise the above discussions as under :

Type of Goods Transaction	**Substitute of Goods Account**
(a) Purchase of goods :	Purchase Account
(b) Sale of goods :	Sales Account
(c) Return of goods purchased :	Purchase Return/Return outward A/c
(d) Return of goods sold :	Sales Return/Return inward A/c
(e) Goods taken by proprietor for personal use :	Purchase Account
(f) Goods distributed as free samples :	Purchase Account
(g) Balance of goods in hand :	Closing Stock Account

3.3 RULES OF DEBIT AND CREDIT UNDER BRITISH/TRADITIONAL APPROACH

1. Personal Accounts : The rules of debit and credit for personal accounts are :

Debit the receiver Credit

The person who receives something from the organisation, his account is debited. In other words, the entry is made in the left side of his account. Similarly, if the person gives something, his account is credited, i.e., the entry is made in the right side of his account.

Example : If Hari purchases goods from the business organisation on credit, his account is debited as he is the receiver of goods. If goods are purchased from Shyam Traders, the amount of Shyam Traders will be credited as he is the giver of goods.

2. Real Account : The rules of debit and credit are as follows :

Debit what comes in
Credit what goes out.

Real accounts refer to the accounts of assets and properties. If the asset/property comes to the business, the concerned asset/property account is debited, i.e., the entry is made in the left side of the account. Similarly, if the asset/ property goes out from the business, that asset/property account is credited, i.e., the entry is made in the right side of the account.

Example: If furniture are purchased for ` 10,000 by the business, there are two real accounts involved in this transaction, i.e., Furniture Account and Cash Account. As furniture are coming into the business, the Furniture Account is debited as per our rule "Debit what comes in". As the cash is going out from the business, the Cash Account is credited, i.e., the entry is made in the right side of Cash Account.

3. Nominal Account : The following rules are applied to nominal accounts :

Debit expenses and losses
Credit income and gains.

Nominal accounts include the accounts of expenses, losses, incomes and gains. When any expenses or loss is incurred by the business, that expense or loss account is debited. Similarly, if the business earns any income or gain, this income/gain account is credited.

Example : When salaries are paid to employees by the business, the Salary Account is debited as it is an expense. When interests are earned from bank deposits, the Interest Earned Account is credited as it is an income.

Under traditional approach, the rules of debit and credit are summarised below :

Type of Account	Debit	Credit
1. Personal Account	The receiver	The giver
2. Real Account	What comes in	What goes out
3. Nominal Account	Expenses and losses	Incomes and gains

The above rules are explained by the help of the following examples :

(Dr) as it comes in (Real Account)

1. Cash sale of goods for ` 5,000.

(Cr) as it goes out (Real Account)

(Dr) as he is the receiver (Personal Account)

2. Goods returned to Supplier ` 2,000.

(Cr) as it goes out (Real Account)

(Dr) as it comes in

3. Purchased goods from Shyam Traders ` 30,000.

(Cr) as he is the giver

(Dr) as it comes in

4. Purchased furniture for cash ` 5,000.

(Cr) as it goes out.

(Dr) as it is an expense (Nominal Account)

5. Paid cash for stationery ` 200.

(Cr) as it goes out

(Dr) as it comes in.

6. Received commission in cash ` 1,000.

(Cr) as it is an income.

Illustration - 3.2 :

In the following transactions, mention the nature of the account in the traditional approach and state whether the accounts will be debited or credited :

(a) Capital introduced, (b) Rent paid, (c) Purchase of machinery, (d) Sale of land, (e) Payment of bank loan.

Solution :

Table showing debit and credit

Account	Nature	Debit or Credit
(a) Cash Capital	Real Account Personal Account	Debit (it comes in) Credit (Owner is the giver of money)
(b) Rent Cash	Nominal Real	Debit (it is an expense) Credit (it goes out)
(c) Machinery Cash	Real Real	Debit (it comes in) Credit (it goes out)
(d) Cash Land	Real Real	Debit (it comes in) Credit (it goes out)
(e) Bank Loan Cash	Personal Real	Debit (Bank is the receiver) Credit (it goes out)

Rules of Debit and Credit under American / Modern Approach :

(1) Assets : In case of assets the rule is :

Debit : means increase
Credit : means

Dr **Asset Account** Cr. Increase (+) Decrease (–)

In any transaction, if there is increase in assets then it will be recorded in the debit side of the asset account and if in any transaction there is decrease in assets, then it will be recorded in the credit side of the asset account.

Example : Furniture purchased for ` 10,000 from Narmada Furniture on credit. This transaction involves [a] Furniture (an asset) Account, and [b] Narmada Furniture (a liability) Account. Since furniture is an asset and by this transaction it increases, it will be recorded in the left hand side of the asset account as the rule is "increase in asset is debited".

Illustration - 3.3 : If the following transactions, mention the nature of account in modern approach and state whether the account will be debited or credited.

(a) Capital introduced (b) Rent (c) Purchase of machinery

(d) Sale of land (e) Payment of bank loan

Solution :

Table showing debit and credit

Account	Nature	Debit or Credit
(a) Cash Capital	Asset Capital	Debit (increase in asset) Credit (decrease in capital)
(b) Rent Cash	Expense Asset	Debit (increase in exp ense) Credit (decrease in asset)
(c) Machinery Cash	Asset Asset	Debit (increase in asset) Credit (decrease in asset)
(d) Cash Land	Asset Asset	Debit (increase in asset) Credit (decrease in asset)
(e) Bank Loan Cash	Liability Asset	Debit (decrease in liability) Credit (decrease in asset)

3.4 JOURNAL

The word journal is derived from the French word "jour" means a day. Journal, therefore means a book in which daily transactions are recorded. It records the daily transactions chronologically. In double entry system, it is the first book in which all the transactions are recorded date wise and occurrence wise. So it is called the book of prime entry or original entry.

Entry in proper Format :

After analysing the transaction, the journal entry is recorded in the Journal Book. A journal book contains usually five columns in the following format :

Format of Journal

Date	Particulars	Ledger Folio	Debit Amount `	Credit Amount `

Date : The first column is the date column in which the year, month and date of the transaction are written.

Particulars : In the second column, the names of the accounts involved are written in a logical manner. First, the account to be debited is written with the word debit or 'Dr' towards the end of the column. In the next line, after leaving a little space to the left, the name of the account to be credited is written with the word 'To' in the beginning. The second line, i.e., credit line is indented to differentiate it from the first line, i.e., debit line and to identify it easily. In our example of furniture purchased for cash, the particulars column will contain the following :

Furniture A/c   Dr.

    To Cash A/c

The above entry is to be read as "Furniture Account debited to Cash Account".

The details about the transaction known as the 'narration' of the journal, is written below the entries made in the particulars column. This helps to understand the nature of transaction without any ambiguity. The narration may be written as follows :

(Being furniture purchased for cash) or (Furniture purchased for cash).

The narration is a brief explanation of the nature of transaction in the journal.
It usually starts with the word 'Being'.

Ledger Folio : The third column is the ledger folio column. The page number of the ledger on which the particular account is maintained is entered in this column. Suppose Furniture Account is maintained in page no. 15 of the ledger, then '15' will be entered in the Ledger Folio (L.F.) column against it. This number is written in the journal after the posting is made in the ledger.

Debit Column : This is the fourth column in which the amount to be debited is recorded corresponding to the account debited.

Credit Column : This is the fifth and last column. The amount to be credited is recorded in this column corresponding to the account which is credited.

Illustration - 3.4 : Mr. Bijay Sahu started business on 1.4.2013 with cash `75,000. The following transactions have taken place during the month of April. Journalise them in the books of accounts of Mr. Bijay Sahu.

April 5 Purchased goods for `25,000.

April 6 Goods worth `1,000 were distributed as free samples.

April 7 Took a loan of `50,000 from Bank of Baroda.

April 8 Purchased goods from Mr. Debashis for ` 10,000.

April 9 Goods worth `500 was taken by Mr. Bijay Sahu for personal use.

April 10 Paid to Mr. Debashis `9,750 by cheque in full settlement of his account.

April 18 `300 were paid to Mohan out of business fund for repair of Bijay Sahu's residential house.

April 30 Paid `2,000 to Dinesh as the salary for the month of April.

Solution :

Journal of Mr. Bijaya Sahu

Date	Particulars		L.F.	Debit	Credit
				`	`
April 1	Cash A/c	Dr		75,000	
	To Bijay Sahu's Capital A/c				75,000
	(Being the amount invested by Bijay Sahu in the business as capital)				
April 5	Purchase A/c	Dr		25,000	
	To Cash A/c				25,000
	(Being goods purchased for cash)				
April 6	Advertisement A/c	Dr		1,000	
	To Purchase A/c				1,000
	(Being goods distributed as free samples)				
April 7	Bank A/c	Dr		50,000	
	To loan from Bank of Baroda A/c				50,000
	(Being load received from Bank of Baroda)				
April 8	Purchase A/c	Dr		10,000	
	To Mr. Debashis A/c				10,000
	(Being goods purchased from Mr. Debashis)				
April 9	Drawings A/c	Dr		500	
	To Purchase A/c				500
	(Being goods taken by the owner for personal use)				

April 10	Debashis A/c	Dr	10,000	
	To Cach A/c			9,750
	To Discount A/c			250
	(Being Cash paid to Mr. Debashis in full settlement of his dues)			
April 18	Drawings A/c	Dr	300	
	To Cash A/c			300
	(Being cash paid for repair of the owner's residence)			
April 30	Salary A/c	Dr	2,000	
	To Cash A/c			2,000
	(Being salary paid in cash to Dinesh for the month of April)			

3.5 OPENING ENTRY

Every business house closes the books of accounts at the end of each accounting year and starts new books in the beginning of every new year. The first entry in the journal in the new year is to record the balance of various assets and liabilities which were at the end of the previous year and brought forward to the new year, i.e., currect accounting, ear. These balances of assets and liabilities are known as the opening balance of the current year which were the closing balance of the previous year. The journal entry passed at the beginning of every accounting year to record the opening balances of assets and liabilities is known as 'Opening Entry'.

Opening Entry

Opening entry of a continuing business

Opening entry in case of purchase of continuing business

3.5.1 Opening entry of a continuing business

In case of a continuing business, the opening entry is passed by debiting all the assets brought from the previous year and crediting all the liabilities brought forward. If there is any difference in assets and liabilities, the difference is capital, since Assets – Liabilities = Capital (from accounting equation). So the capital account is also credited for the difference.

Hence, Assets A/c Dr

To Liabilities A/c
To Capital A/c

Illustration - 3.5 :

The following assets and liabilities are found, in the books of Chandrasekhar on 1st January, 2003.

Cash - `5,000 Bank - `8,000 Stock - `4,000 Furniture - `2,000

Building - `20,000 Sundry Debtors - `6,000 Sundry Creditors - `3,000

Bills payable - `2,000 pass the necessary opening entry.

Solution :

Journal

Date	Particulars	L.F.	Debit	Credit
2003			`	`
January	Cash A/c Dr		5,000	
	Bank A/c Dr		8,000	
	Stock A/c Dr		4,000	
	Sundry Debtors A/c Dr		6,000	
	Furniture A/c Dr		2,000	
	Building A/c Dr		20,000	
	To Sundry Creditors A/c			3,000
	To Bills payable A/c			2,000
	To Capital A/c*			40,000
	(Being the opening entry)			

Capital Account = Total Assets – Liabilities

i.e., 45,000 – 5,000 = 40,000

3.5.2 Opening entry in case of Purchase or Taken over of Running Business :

Purchase of a running business means purchase of the assets and liabilities of that business by paying a certain amount. The amount paid by the buyer for purchasing the business is known as the capital of the buyer. So the journal entry to be passed is,

Assets A/c Dr
To Liabilities A/c
To Capital A/c

Sometimes the assets purchased are not equal to the liabilities taken over and the capital paid for. So the following two situations arise :

(i) the assets are more than liabilities and capital, or

(ii) the assets are less than liabilities and capital.

If the assets are more than liabilities and capital, the difference is put to 'Capital Reserve Account' on the credit side. But if the assets are less than the liabilities and capital, the difference is put to 'Goodwill Ac count' on the debit side.

Illustration - 3.6 :

Mohan paid ` 50,000 for purchasing a running business with the following assets and liabilities.

Assets	`	Liabilities	`
Cash	20,000	Creditors	10,000
Land	20,000	Bank Overdraft	20,000
Furniture	10,000		
Stock	40,000		

Pass the necessary opening entry.

Solution:

Journal

Date	Particulars		L.F.	Debit `	Credit `
	Cash A/c	Dr		20,000	
	Stock A/c	Dr		40,000	
	Land A/c	Dr		20,000	
	Furniture A/c	Dr		10,000	
	To Creditors A/c				10,000
	To Bank Overdraft A/c				20,000
	To Capital A/c*				50,000
	To Capital Reserve A/c**				10,000
	(Being the opening entry)				

Capital Account is ` 50,000 as Mohan has paid `50,000 for purchase of business.

In this case total assets = ` 90,000 and the liabilities : `30,000 + Capital `50,000 = ` 80,000.

Since assets exceed liabilities and capital by (90,000 – 80,000) = `10,000, it is put to 'Capital Reserve Account'. In the above example, suppose Mohan pays `70,000 to purchase the business. So the entry will be :

Journal

Date	Particulars		L.F.	Debit `	Credit `
	Cash A/c	Dr		20,000	
	Stock A/c	Dr		40,000	
	Land A/c	Dr		20,000	
	Furniture A/c	Dr		10,000	
	Goodwill A/c*	Dr		10,000	
	To Creditors A/c				10,000
	To Bank Overdraft A/c				20,000
	To Capital A/c				70,000
	(Being the opening entry)				

Here total assets = ` 90,000 and the liabilities and capital = ` 1,00,000.

Hence, the assets are less than the liabilities and capital by `10,000 (1,00,000 – 90,000), it is put to 'Goodwill Account.

3.6 COMPOUND JOURNAL ENTRY

If a journal entry contains more than one account in its debit or more than one account in its credit or both, it is called a compound journal entry.

Example : Received cash `7,500 from Ram in full settlement of his account `7,700.

The journal entry for this transaction is :

Cash A/c	Dr	` 7,500	
Discount A/c	Dr	` 200	
To Ram A/c			` 7,700

Compound entry can be passed where :

- Transactions are of similar nature.
- Transactions occur on the same day, and
- Accounts involved are more than two.

A compound journal entry may be recorded in any of the following three ways :

I. One particular account may be debited while several other accounts may be credited (debit aspect of the transaction is common.)

Example : Paid ₹7,000 to Ram in full settlement of his dues of ₹7,150. In this transaction more than two accounts are involved.

(a) Cash Account
(b) Discount Account
(c) Ram Account

The entry is :

Ram A/c	Dr.	₹7,150	
To Cash A/c			₹7,000
To Discount A/c			₹150

Actually this is the combination of two simple journal entries which occur on a same day and where the debit aspect is common. In the above example the two simple journal entries are :

(a)	Ram A/c	Dr.	₹7,000	
	To Cash A/c			₹7,000
(b)	Ram A/c	Dr.	₹150	
	To Discount A/c			₹150
	(Being discount received)			

In this transaction Ram (the debit aspect) is common. So we can combine the transaction as follows :

Ram A/c	Dr.	₹7,150 (7,000 + 150)	
To Cash A/c			₹7,000
To Discount A/c			₹150

II. One particular account may be credited while several other accounts may be debited (credit aspect of the transaction is common).

Suppose on 30th September rent paid ₹ 1,500 and wages paid ₹500. The two transactions can be journalised as :

(a)	Rent A/c	Dr.	₹1,500	
	To Cash A/c			₹1,500
(b)	Wages A/c	Dr.	₹500	
	To Cash A/c			₹500

In the above example, cash account is common in both the transactions. So instead of passing two journal entries, we can pass the following compound journal entry :

Rent A/c	Dr	₹1,500	
Wages A/c	Dr	₹500	
To Cash A/c			₹2,000

III. Several accounts may be debited and several accounts may be credited.

Example : ₹800 in cash and ₹300 in cheque was paid to Hari towards his wages for ₹ 600 and commission ₹ 500. The accounts involved in the transaction are (a) Wages A/c, (b) Commission A/c, (c) Cash A/c and (d) Bank A/c. So the journal entry is :

Wages A/c	Dr	₹600	
Commission A/c	Dr	₹500	
To Cash A/c			₹800
To Bank A/c			₹300

3.7 KEY TERMS

Account: An account is a statement which shows all the transactions relating to a particular item during a period of time.

Credit: Credit means right side of an account.

Debit: Debit means left side of an account.

Drawings: Money or goods withdrawn by the owner from the business for personal use is known as drawings.

Accrued Income: Income due but not received.

Bad Debt: Amount irrecoverable from debtors.

Cash Book: A book to record all cash receipts and cash payments.

Cash Discount: Discount allowed for prompt payment.

Charity: Cash of goods donated to different institutions or persons.

Dishonour of cheque : The collecting banker fails to collect or receive the amount of the cheque.

3.8 SUMMARY

- An account is a statement in which transactions and events relating to a particular item occurring during a particular period are recorded. The accounts maintained by a business organisation are : Cash Account, Capital Account, Furniture Account, Loan Account, Salary Account, Commission Account etc.
- Under modern classification, the accounts are classified as : (a) Capital Account, (b) Asset Account, (c) Liability Account, (d) Expense Account, and (e) Income Account.
- Under traditional classification, the accounts are classified as (a) Personal Account, (b) Real Account, and (c) Nominal Account.
- Each transaction involves at least two accounts. If one account is debited (entry is made in left side), the other account must be credited (entry must be made in the right side of that account).
- All business organisations maintain at least three important books, named Cash Book, Journal and Ledger.
- Journal records daily transactions chronologically. It is also called the book of prime entry.
- A journal entry which contains one account in the debit and one account in the credit is known as simple journal entry.
- If a journal entry contains more than one account in its debit or in its credit, it is called compound journal entry.

3.9 CHECK YOUR PROGRESS AND ANSWERS

I. Choose the correct answer.

(a) In case of a debt becoming bad, the amount should be credited to :

(i) Sales A/c (ii) Debtor's A/c (iii) Bad debt A/c (iv) Cash A/c

(b) Salary paid to a clerk should be debited to:

(i) Personal A/c (ii) Cash A/c (iii) Salary A/c (iv) Capital A/c

(c) In case of recovery of bad debt, the amount is credited to:

(i) Cash A/c (ii) Debtor's A/c (iii) Bad debt A/c (iv) Bad debt recovered A/c

(d) Goods donated to a religious organisation should be credited to:

(i) Charity A/c (ii) Purchase A/c (iii) Receiver's A/c (iv) Advertisement A/c

(e) Security deposit received from Ram should be credited to:

(i) Ram's A/c (ii) Cash A/c (iii) Security deposit A/c (iv) Bank A/c

[**Ans.** : (a) - (ii), (b) - (iii), (c) - (iv), (d) - (ii), (e) - (iii).]

3.10 QUESTIONS AND ANSWERS

1. What is the book of prime entry usually maintained by a business concern? Discuss its objectives and features.
2. What do you mean by Journal? Discuss the rule and procedure of recording transactions in journal.

3. Define journal. Discuss in detail its advantages and limitations.
4. Discuss in detail the procedure of recording transactions in journal relating to the following :
   (a) Personal expenses of the owner.
   (b) Loss of goods by fire.
   (c) Exchange of old assets for new one.
   (d) Incomes due but not received.
5. Name the types of journal entries. Discuss the procedure of passing opening entry in case of
   (a) a continuing business and (b) purchase of a running business.
6. Discuss the role of journal in modern accounting system. What are the source documents for writing journal ?

3.11. PRACTICAL PROBLEMS

1. State the fundamental elements of book keeping and the accounts involved for the following transactions and classify them on personal, real and nominal basis.

	`
Suvam Sahu commenced business with cash	50,000
Deposited in Bank	40,000
Bought goods for cash	10,000
Bought goods on credit from Ambik	25,000
Sold goods for cash	12,000
Paid Rent	5,000
Sold goods to Bhaskar (worth `18,000)	15,000
Bought goods from Amaresh	9,000
Withdrew from Bank	10,000
Received cash from Bhaskar	15,000
Wages due	5,000
Interest received	2,000

2. Write the narration for each of the following journal entry in the books of Mr. A Agrawal :

			`	`
(a)	Bank A/c	Dr	10,000	
	To Hari Bhai A/c			10,000
(b)	Purchase A/c	Dr	8,000	
	To Global Trader A/c			8,000
(c)	Buildings A/c	Dr	20,000	
	To Cash A/c			8,000
	To Bank A/c			12,000
(d)	Cash A/c	Dr	2,000	
	To Bad debts recovered A/c			2,000
(e)	Cash A/c	Dr	1,450	
	Discount A/c	Dr	50	
	To Tulika Stores A/c			1,5000
(f)	Cash A/c	Dr	4,000	
	Stock A/c	Dr	6,000	
	Furniture A/c		5,000	
	To Capital A/c			15,000

3. Rectify the following journal entries in the books of Bijay assuming the narrations as correct.

	Particulars		`	`
(a)	Mohan A/c	Dr	28,000	
	To Sales A/c			28,000
	(Being goods sold to Mohan on cash)			
(b)	Bank A/c	Dr	3,000	
	To Basu Das A/c			3,000
	(Being the entry for cheque no. 123456 received from Basu Das not deposited into bank)			
(c)	Return inward A/c	Dr	1,000	
	To Badri Prasad A/c			1,000
	(Being defective goods returned to Badri Prasad)			
(d)	Cash A/c	Dr	850	
	To Dibakar A/c			850
	(Being cash received from Dibakar against a debt previously written off)			
(e)	Rent A/c	Dr	1,000	
	To Cash A/c			1,000
	(Being rent paid for the building, 30% of which is used for owner's residence)			
(f)	Dalvir A/c	Dr	1,500	
	To Bank A/c			1,500
	(Being dishonour of cheque received against sale of goods for `1,500 less 2% discount)			

4. On 1st April 2000, Mr. Dhaniram invested `20,000 for purchasing the business of Dukhiram with the following assets and liabilities.

Assets	`	Liabilities	`
Stock	4,500	Creditors	6,500
Building	20,000	Loan from Sethji	2,000
Furniture	1,600		
Machinery	8,000		

During the month he had the following transactions :
April 2 Opened a bank account with SBI `7,200.
April 5 Sold the entire stock to Kaliram on cash for `7,200.
April 8 Cleared the dues of creditors less 10%.
April 12 Purchased goods from N.K.Dash `4,800.
April 15 Paid `2,000 to Sethji by cheque.
April 18 Sold goods worth `2,000 to Banarasi Das at 40% above the cost less 10% trade discount.
April 20 Sold old furniture worth `400 for `500.
April 23 Donated `250 to a charitable trust.
April 25 Received cash `500 and cheque `1,500 from Banarasi Das on account. April
27 Deposited into bank the cheque received from Banarasi Das.
April 29 Paid salary `850.
April 30 Received the balance in cash from Banarasi Das.
April 30 Paid rent by ` 500 for residential house of Dhaniram.

5. Enter the following transactions in the book of prime entry of Rajesh.

(i) `300 in cash and `500 in cheque was given to Harish towards his wages `600 and insurance premium of a vehicle `200.

(ii) Purchased a building for a price of ` 1,00,000. A cash down payment of `25,000 was made and a bill payable was accepted for `75,000 for the balance of the purchase price.

(iii) Returned to Allright Suppliers a typewriter worth ` 5,400 as it was found defective.

(iv) Taken a loan of `20,000 from Syndicate Bank and deposited ` 10,000 in SBI.

(v) Paid Maruti Traders ` 2,750 by cheque in full settlement of his dues `2,800.

(vi) Paid ` 350 for the repair of proprietor's residential house.

(vii) An old manual typewriter having book value of `5,000 is exchanged for a new electronic typewriter costing ` 12,000 by paying ` 10,000 in cash.

(viii) Machinery purchased `10,000, carriage paid on machinery ` 250 and installation charge amounted `500.

(ix) Salary for the previous month paid ` 2,500.

(x) Goods worth `5,000 were destroyed by fire. Insurance company admitted claim for 80% of the value.

6. Show the correct journal entry and wrong journal entry from the following:

(a) Purchased machinery costing ` 10,000 and carriage paid on it ` 300 is debited to carriage account.

(b) ` 750 paid for rent was debited to landlord account.

(c) Goods worth `600 withdrawn by the proprietor for his personal use has been credited to sales account.

(d) ` 250, the cost of repairing the roof of a house has been charged to building account.

(e) Cheque of `1,200 received from Manohar has been credited to Manmohon account.

(f) Goods worth `160 returned by a customer has been wrongly recorded `106.

3.12 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER - 4LEDGER POSTING AND TRIAL BALANCE

Chapter Outlines

4.0 INTRODUCTION

Ledger is the most important books of accounts because it includes all the summaries of the transactions. It is also called the "Principal Book" or "Main Book" or "Chief Book". It provides a permanent record of financial transactions of a firm and helps in achieving the objectives of accounting.

4.1 LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Define ledger and explain its form.
- Explain the procedures of posting.
- Know the process of balancing an account.
- Understand the significance of debit and credit balance.

4.2 MEANING OF LEDGER

Ledger is a book which contains all the accounts of a business enterprise in a summarised and classified form. Ledger is normally a register having a number of pages which are numbered consecutively. One account is usually assigned one page in the register, i.e., ledger. However, if the transactions pertaining to a particular account are more, it may be assigned more than one page in the ledger. An index of various accounts opened in the ledger is given at the beginning of the ledger for the purpose of easy reference. A ledger may be kept in any of the following forms,

(a) Bound ledger, and (b) Loose leaf ledger.

The bound ledger is inflexible because addition of pages whenever required, can not be done. As such the modern business organisations do not prefer its use. The loose leaf ledger is becoming more popular because it is more flexible and permits rearrangement of the accounts. New accounts may be placed wherever desired and the unused or completely filled sheets may be removed. Banks usually prepare loose leaf ledger.

4.2.1 Features of ledger

- Ledger is the main book containing all the accounts of the business organisation.
- The pages of the ledger are numbered consecutively and usually one page is assigned to one account.

- An index of various accounts contained in the ledger is given in the beginning of the ledger.
- A ledger can be kept in the form of bound ledger or loose leaf ledger.
- Ledger provides full information regarding assets, liabilities, capital, incomes and expenses of the organisations.

4.3 POSTING

Every transaction is first recorded in the journal in form of journal entry. From the journal it is transferred to the concerned accounts in the ledger. This process of transferring the transactions from journal to ledger is known as posting.

Posting is the act or process of transferring the debit and credit aspects of transactions from the journal to their respective account in the ledger.

This posting from journal is done at periodical intervals, such as weekly, monthly, quarterly etc. It is advisable to keep the more active accounts posted to date. The examples of such active accounts are cash account, bank account and the various personal accounts.

4.4 RULES REGARDING POSTING

The following procedures are followed while posting transactions in the ledger from the journal.

1. Location of accounts in the ledger : The first step in posting of entries is to be locate the concerned account in the ledger. For this purpose, the help of an index or chart of accounts can be taken.

To explain the process of posting, an example of journal entry can be taken as follows :

Journal (Folio - 2)

Date	Particulars		L.F.	Debit Amount `	Credit Amount `
1.04.03	Furniture A/c	Dr	51	5,000	
	To Cash A/c		01		5,000
	(Being furniture purchased)				

For the purpose of posting the above entry we have to locate "Furniture A/c" and also "Cash A/c" in the ledger by the help of an index of accounts.

2. Entry in the date column : The day, month and year for each entry in journal are recorded in the date column of the ledger account as mentioned above.

3. Posting of debit entry of journal to Ledger : Now on the debit side 'particular' column of the account debited in journal, the name of the account credited is entered with a prefix "To". In the above example, since the furniture account is debited in the journal we have to enter "To Cash Account" on the debit side of furniture account as follows:

Dr Furniture Account (Folio - 51) Cr

Date	Particulars	F	Amount `	Date	Particulars	F	Amount `
				1.04.03	To Cash A/c	2	5,000

4. Posting of credit entry of journal to ledger : Now the credit entry in the journal is posted to the credit side of the concerned account with a prefix "By" with the name of the account debited. The date, folio and the amount is also posted to the credit side of the ledger account.

In our example the posting of credit side will be as follows :

Dr **Cash Account** **(Folio - 01)** Cr

Date	Particulars	F	Amount `	Date	Particulars	F	Amount `
				1.04.03	By Furniture A/c	2	5,000

5. Entry in the Folio Column : After the date and particulars column, the next posting is made in the folio column. In this column, the page number of the journal, from which the particular entry is brought, is entered. In the above example, 2 will be entered in the folio column if the journal entry is made on page no.2 of the journal. This is called paging. This serves the purpose of cross reference to simplify the tracing of entries from journal to ledger and vice versa. The L.F. column in journal which records the page numbers of the ledger containing the account, also serves the purpose of showing whether an entry has been posted or not.

6. Entry in the Amount Column : The amounts corresponding to the accounts debited and credited are entered in the amount column of the concerned account in the ledger. After this, the posting of the account is complete. In our example, the posting in ledger account of the furniture will be made as follows :

Dr **Furniture Account** Cr

Date	Particulars	F	Amount `	Date	Particulars	F	Amount `
1.04.03	To Cash A/c	2	5000				

Remember

Each debit entry in journal is posted to the debit side and each credit entry is posted to the credit side of respective account in the ledger along with date, amount and page number of the journal (Folio).

The Procedure of Posting in brief

1. Location of the accounts of journal entry in the ledger.
2. At first, the posting of the account which is debited in journal, is made as follows :
   Date column - Date of the transaction as appearing in journal.
   Particulars column - The name of the accent credited in the journal is posted with a prefix 'To".
   Folio column - The page number of the journal from which the entry is transferred is recorded.
   Amount Column - The amount debited in journal corresponding to the particular account is recorded.
3. Now the posting of the account which is credited in the journal is made on the credit side of the account. Posting on credit side of the account. Posting on credit side is made as follows :
   Date column - Date of transaction as appearing in journal.
   Particulars column - The name of the account debited in journal is recorded with a prefix "By".
   Folio column - The page number of journal from which the entry is transferred is recorded.
   Amount column - The amount credited in journal corresponding to the particular account is recorded.

Illustration - 4.1

Enter the following transactions in the journal and post them to ledger.

(a) On 5th January, P.K.Sinha started a business with ` 50,000 cash.

(b) Purchased goods costing ` 10,000 from Ram and Co. on credit on 10th January.

Solution :

(a) **Journal Book** Folio No. 1

Date 2003	Particulars		L.F.	Debit Amount `	Credit Amount `
Jan. 5	Cash A/c	Dr	6	50,000	
	To P.K.Sinha's Capital A/c		20		50,000
	(Being the entry for cash introduced as capital)				
Jan. 10	Purchase A/c	Dr	25	10,000	
	To Ram & Co. A/c		30		10,000
	(Being the entry for purchase of goods on credit)				

LEDGER

Dr **Cash Account** (Folio No. 6) Cr

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`				`
Jan. 5	To Capital A/c	1	50,000				

Dr **Capital Account** (Folio No. 20) Cr

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003		`	
				Jan. 5	By Cash A/c	1	50,000

Dr **Purchase Account** (Folio No. 25) Cr

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`				`
Jan. 10	To Ram & C. A/c	1	10,000				

Dr **Ram & Co. Account** (Folio No. 30) Cr

Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003		`	
				Jan. 10	By Purchase A/c	1	10,000

Balancing of Accounts

The word 'Balance' means the difference between the total amounts of two sides of an account. Periodically, the businessmen are interested to know the cumulative effect of the entries in the accounts or to know the net position of the accounts. For this purpose they total the two sides of an account separately and find out the difference of the two sides which is called the net balance of the account.

Balancing of an account is the process of finding out the difference between totals of two sides of an account and recording it on the shorter side of the account.

The balance ascertained is put on the shorter side of the account with a reference "Balance c/d". The 'c/d' (carried down) is written to indicate that the balance has been carried down to tally (i.e., to balance) both sides.

REMEMBER

Balance	Meaning
1. To Balance b/d	Opening Debit Balance
2. By Balance b/d	Opening Debit Balance
3. To Balance b/d	Opening Debit Balance
4. By Balance b/d	Opening Debit Balance

Illustration - 4.2

On 1st April 2003, the following were the ledger balances of Ashoka & Co.

Cash in hand - `9,000;	Cash at Bank - `21,000	Soni - (Cr.) `5,000;
Zahir - (Dr.) `12,400;	Stock - `20,000	Prasad - (Cr.) `3,000;
Satish - (Dr.) `4,500;	Motar car - `50,000	Bank Loan - `40,000

Transactions during the month were :

		`
April 2	Bought goods from Prasad	8,000
April 3	Sold to Satish	15,000
April 5	Bought goods on cash	13,600
April 7	Goods taken for personal use	1,200
April 13	Received from Zahir in full settlement	12,000

April 20 Paid full amount of Soni
April 22 Paid cash for stationery 500
April 23 Paid to Prasad by cheque in full settlement 2,800
April 30 Rent due to landlord 1,500
Journalise the above transactions and post them to ledger accounts.

Solution :

Journal

Date	Particulars		L.F.	Debit	Credit
2003				`	`
April 1	Cash A/c	Dr		9,000	
	Bank A/c	Dr		21,000	
	Zahir	Dr		12,400	
	Satish A/c	Dr		4,500	
	Stock A/c	Dr		20,000	
	Motor car A/c	Dr		50,000	
	To Soni A/c				5,000
	To Prasad A/c				3,000
	To Bank Loan A/c				40,000
	To Capital A/c				68,900
	(Being the opening entry)				
April 2	Purchase A/c	Dr		8,000	
	To Prasad A/c				8,000
	(Being goods purchased from Prasad)				
April 3	Satish A/c	Dr		15,000	
	To Sales A/c				15,000
	(Being goods sold to Satish)				
April 5	Purchase A/c	Dr		13,600	
	To Cash A/c				13,600
	(Being goods purchased on cash)				
April 7	Drawings A/c	Dr		1,200	
	To Purchase A/c				1,200
	(Being goods taken for personal use)				
April 13	Cash A/c	Dr		12,000	
	Discount Allowed A/c	Dr		400	
	To Zahir A/c				12,400
	(Being ` 12,000 cash received from Zahir in full settlement of his dues of ` 12,400)				
April 20	Soni A/c	Dr		5,000	
	To Cash A/c				5,000
	(Being cash paid to Soni against his dues in full settlement)				
April 22	Stationery A/c	Dr		500	
	To Cash A/c				500
	(Being stationery purchased on cash)				
April 23	Prasad A/c	Dr		3,000	
	To Bank A/c				2,800
	To Discount Received A/c				200
	(Being cheque paid to Prasad in final settlement of his old dues)				
April 30	Rent A/c	Dr		1,500	
	To Outstanding rent A/c				1,500
	(Being rent for April due to landlod)				

LEDGER

Cash Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		9,000	April 5	By Purchase A/c		13,600
April 13	To Zahir A/c		12,000	April 20	By Soni A/c		5,000
				April 22	By Stationery A/c		500
				April 30	By Balance c/d		1,900
			21,000				21,000
May 1	To Balance c/d	1,900					

Bank Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		21,000	April 23	By Prasad A/c		2,800
				April 30	By Balance c/d		18,200
			21,000				21,000
May 1	To balance c/d		18,200				

Motor Car Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		50,000	April 30	By Balance c/d		50,000
			50,000				50,000
May	To Balanced b/d		50,000				

Stock Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		20,000	April 30	By Balance c/d		20,000
			20,000				20,000
May	To Balanced b/d		20,000				

Zahir Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		12,400	April 13	By Balance c/d		12,000
				April 13	By Discount Allowed		400
			12,400				12,400

Satish Account

Dr							Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		4,500				
April 3	To Sales A/c		15,000	April 30	By Balance c/d		19,500
			19,500				19,500
May 1	To Balance b/d		19,500				

Dr			Bank Loan Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		40,000	April 1	By Balance b/d		40,000
			40,000				40,000
				May 1	By Balance b/d		40,000

Dr			Capital Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 1	To Balance b/d		68,900	April 1	By Balance	b/d	68,900
			68,900				68,900
				May 1	To Balance b/d		68,900

Dr			Soni Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 20	To Cash A.c		5,000	April 1	By Balance b/d		5,000
			5,000				5,000

Dr			Prasad Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 23	To Bank A/c		2,8000	April 1	By Balance b/d		3,000
April 23	To Discount Received		200	April 2	By Purchase A/c		8,000
April 30	To Balance c/d		8,000				
			11,000				11,000
				May 1	By Balance b/d		8,000

Dr			Purchase Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 2	To Parasd A/c		8,000	April 7	By Drawings		1,200
April 5	To Cash A/c		13,600	April 30	By Balance c/d		20,600
			21,600				21,600
May 1	To Balance b/d		20,400				

Dr			Sales Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 30	To Balance c/d		15,000	April 3	By Satish A/c		15,000
			15,000				15,000
				May 1	By Balance b/d		15,000

Dr			Discount Received Account				Cr
Date 2003	Particulars	F	Amount `	Date 2003	Particulars	F	Amount `
April 30	To Balance c/d		200	April 23	By Prasad A/c		200
			200				200
				May 1	By Balance b/d		200

Dr			Drawings Account				Cr
Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003			`
April 7	To Purchase A/c		1,200	April 30	By Balance c/d		1,200
			1,200				1,200
May 1	To Balance b/d		1,200				1,200

Dr			Discount Allowed Account				Cr
Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003			`
April 13	To Zahir A/c		400	April 30	By Balance c/d		400
			400				400
May 1	To Balance b/d		400				

Dr			Stationery Account				Cr
Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003			`
April 22	To Cash A/c		500	April 30	By Balance c/d		500
			500				500
May 1	To Balance b/d		500				

Dr			Rent Account				Cr
Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003			`
April 30	To Outstanding rent		1,500	April 30	By Balance c/d		1,500
			1,500				1,500
May 1	To Balance b/d		1,500				

Dr			Outstanding Rent Account				Cr
Date	Particulars	F	Amount	Date	Particulars	F	Amount
2003			`	2003			`
April 30	To Balance b/d		1,500	April 30	By Rent A/c		1,500
			1,500				1,500
				May 1	By Balance b/d		1,500

4. 5 DIFFERENCE BETWEEN JOURNALANDLEDGER

	Points	Journal	Ledger
1.	Time :	Transactions are recorded in the journal as soon as they occur.	Transactions are posted to ledger after they are recorded in journal.
2.	Manner of recording :	Journal records the Transactions in a chronological manner.	Ledger records the Transactions in a classified manner.
3.	Name of recording :	The process of Transactions in the journal is known as journalising.	The process of recording in ledger is known as posting.

4.	Balancing :	Journal is not balanced.	Every account in the ledger is balanced periodically.
5.	Narration :	Narration is required against each journal entry.	No narration is required while posting in the ledger.
6.	Period of recording :	Transactions are recorded in the journal on daily basis.	Transactions are posted to ledger periodically and not on daily basis.
7.	Nature of book :	Journal is the book of primary or original entry.	Ledger is the book of secondary of final entry.
8.	Dependency :	Journal is an independent record.	Ledger is not an independent record, because Transactions posted in ledger are taken from journal.
9.	Basis :	The Transactions are recorded in journal on the basis of money receipts, vouchers and invoices.	Journal is the basis for posting Transactions to ledger.

4.6 TRIAL BALANCE

Under the double entry system, for every debit, there must be an equal and corresponding credit. If all the transactions are recorded prefectly in the books of accounts, then the total of the debits should be equal to the total of the credits. Similarly, if all the accounts are correctly balanced, the total of the accounts with debit balances must be equal to the total of the accounts with credit balances. In order to verify whether the two totals (total debits and total credits) are equal or not, a statement is prepared periodically showing the debit items in one column and the credit items in another. This statement is called the 'Trial Balance". If the total of the two columns are equal, it is assumed that the recording and posting of transactions are done accurately as well as the accounts are balanced correctly. In simple words the equality of the total debit and credit balances indicates the arithmetical accuracy of the books of accounts. If the two totals do not tally, it implies that some errors have been committed while posting the transactions into the ledger or while balancing the accounts.

Meaning : A Trial Balance is "a statement of balances of all the accounts, prepared on a specific date to ascertain the arithmetical accuracy of the books of accounts."

Note : The tallying of two totals of the Trial Balance ensures only arithmetical accuracy but not accounting accuracy.

4.7 FEATURES OF TRIAL BALANCE

1. The trial balance is simply an abstract or list of all the accounts in ledger and cash book. So it is prepared only when the posting in ledger in complete.
2. The balances are listed in the order in which they appear in the ledger.
3. The trial balance is prepared on a specific date. It is normally prepared at the end of a certain period, such as at the end of each month and in all the cases, before yearly closing of the books at the end of the financial period.
4. The two amount columns (debit and credit) should tally. Tallying of the columns indicates the arithmetical accuracy of the books of accounts.
5. If the two columns do not tally, it implies that some errors have occurred while posting in the ledger or while balancing the individual accounts.
6. Tallying of the two totals of the trial balance ensures arithmetical accuracy, but not the accounting accuracy.

4.8 OBJECTIVES / FUNCTIONS OF TRIAL BALANCE

1. **Test of arithmetical accuracy :** Trial balance acts as a device to check the arithmetical accuracy of the books of accounts. It represents a summary of all ledger balances and therefore if the two sides of it agrees, it is an indication of the accuracy maintained in the books of accounts. Of course there exists certain errors in spite of agreed trial balance. For example one transaction is completely omitted from the books, in that case trial balance will agree but the books of accounts remain incorrect.
2. **Summarised Information of ledgers :** The trial balance contains the balances of all ledger accounts on a particular date. It shows the names of ledger accounts and the amount of their debit and credit balance. The summarised information about all ledger accounts can be obtained at a glance from the Trial Balance.

4.9 PREPARATION OF A TRIAL BALANCE

The trial balance is usually prepared on a loose sheet(s) which has the following five columns.

Column (1) : Serial Number – contains consecutive serial numbers of all accounts.

Column (2) : Head of Account - contains the name or title of the accounts.

Column (3) : Ledger Folio - contains the ledger folio number from where the balance is taken.

Column (4) : Debit Balance - contains either debit balance or total of the debit amount of an account.

Column (5) : Credit Balance : contains either credit balance or total of the credit amount of an account.

The trial balance is always headed with the following words :

"Trial Balance of M/s .... as on ....".

The format of a trial balance is as follows :

Trial Balance of Mr. Sahu as on 31st March 2003.

Sl. No	Accounts Title	L.F.	Debit Amount `	Credit Amount `

1. Trial Balance with Balances / Balance Method

In this method all ledger accounts are balance first. In other words, the two sides (debit and credit) are totalled and then balanced to know which side is greater than the other. The side showing the greater balance is the balance of that account. If the debit side is more than the credit then, it is a debit balance of that accou nt or the vice-versa.

In this method, all ledger accounts showing debit balance are taken in the debit amount column and all ledger accounts showing credit balance are taken in the credit amount column. To understand it clearly let us go through the following example :

Illustration : 4.3

Mr. Sahu had the following transactions during the month of January, 2003. Prepare a trial balance with balances from these transactions.

Jan 10 : He started business worth cash ` 50,000.

Jan 18 : Purchased goods worth ` 30,000 on cash.

Jan 22 : Goods sold on cash ` 40,000,

Jan 30 : Paid salary for the month ` 1000.

Journal

Date	Particulars	L.F.	Debit `	Credit `
Jan. 10	Cash A / c Dr			
	To Capital A / c		50, 000	
	(Being cash introduced for the business)			50, 000
Jan.18	Purchase A / c Dr			
	To Cash A / c		30, 000	
	(Being goods purchased for cash)			30, 000
Jan. 22	Cash A / c Dr			
	To Sales A / c		40, 000	
	(Being goods sold on cash)			40, 000
Jan.30	Salary A / c Dr			
	To Cash A / c		1000	
	(Being salary for the month paid)			1000

LEDGER

Cash Account

Dr Cr

Date Particulars	L.F.	`	Date	Particulars	L.F.	`
Jan. 10 To Capital A / c		50, 000	Jan.18	By Purchase A / c		30, 000
Jan. 22 To Sales A / c		40, 000	Jan. 30	By Salary A / c		1000
			Jan.31	By Balance c / d		59, 000
		90, 000				90, 000

Capital Account

Date Particulars	L.F.	`	Date	Particulars	L.F.	`
Jan. 31 To Balance c / d		50,000	Jan.10	By Cash A / c		50,000
		50,000				50,000

Purchase Account

Date Particulars	L.F.	`	Date	Particulars	L.F.	`
Jan. 18 To Cash A / c		30,000	Jan.31	By Balance c / d		30,000
		30,000				00,000

Sales Account

Date Particulars	L.F.	`	Date	Particulars	L.F.	`
Jan. 31 To Balance c / d		40,000	Jan.22	By Cash A / c		40,000
		40,000				40,000

Salary Account

Date	Particulars	L.F.	`	Date	Particulars	L.F.	`
Jan. 30	To Cash A / c		1,000	Jan.31	By Balance c / d		1,000
			1,000				1,000

In the above example, "To / By Balance c/d" in various accounts shows the credit/debit balance of a particular account.

(a) Cash A/c shows debit balance of ` 59,000.

(b) Capital A/c shows debit balance of ` 59,000.

(c) Purchase A/c shows debit balance of` 59,000.

(d) Sales A/c shows debit balance of `59,000.

(e) Salary A/c shows debit balance of ` 59,000.

Let us prepare the trial balance taking the above balances, which will be as follows :

Trial Balance of as on 31st March 2003.

Sl.No.	Accounts Title	L.F.	Debit Amount `	Credit Amount `
(a)	Cash A / c		59,000	
(b)	Capital A / c			50, 000
(c)	Purchase A / c		30,000	
	Sales A / c			
(d)	Salary A / c			40, 000
(e)	Total		1000	
			90, 000	90, 000

2. Trial Balance with Totals/Total Method :

Under this method, the trial balance is prepared by taking the total of each side of the accounts instead of taking the balancing amount of the accounts. The debit side total and credit side total of Cash A/c are shown in the debit amount column and credit amount column of the trial balance respectively.

In both the sides of an account are same, then it may or may not be shown in the trial balance as there is no balance in the account and has no impact on the trial balance.

This method of preparing trial balance is not usually followed, because it can not help in preparing the financial statements.

Illustration - 4.4

Let us prepare the trial balance of mrs by total method taking the previous transactions.

(a) In Cash A/c : Total Debit = ` 90,000 and Total Credit = ` 31,000.

(b) In Capital A/c: Total Debit = nil, and Total Credit = ` 50,000.

(c) In Purchase A/c: Total Debit = ` 30,000 and Total Credit = nil.

(d) In Sales A/c : Total Debit = nil, and Total Credit = ` 40,000.

(e) In Salary A/c : Total Debit = ` 1000 and Total Credit = nil.

Trial Balance of as on 31st March 2003.

Sl.No.	Accounts Title	L.F.	Debit Amount `	Credit Amount `
(a)	Cash A / c		90, 000	31, 000
(b)	Capital A / c		nil	50, 00
(c)	Purchase A / c		30, 000	nil
(d)	Sales A / c		nil	40, 000
(e)	Salary A / c		1000	nil
			1, 21, 000	1, 21, 000

3. Trial Balance with Balances and Totals :

Under this method the trial balance is prepared with both the balances as well as with the totals of the various accounts. This method is the combination of both 1st and 2nd method. This trial balance has two more columns than the ordinary trial balance. We can follow the previous illustration here for clear understanding.

Trial Balance of as on 31st March 2003.

Sl.No.	Accounts Title	L.F.	Debit Balance `	Credit Balance `	Debit Total `	Crebit Total `
(a)	Cash A / c		59, 000	nil	90, 000	31,000
(b)	Capital A / c		nil	50, 000	nil	50,000
(c)	Purchase A / c		30, 000	nil	30, 000	nil
(d)	Sales A / c		nil	40, 000	nil	40, 000
(e)	Salary A / c		1000	nil	1, 000	nil
	Total		90, 000	90, 000	1, 21, 000	1, 21, 000

Comprehensive Illustration : Illustration - 4.5

From the following transactions prepare journal, ledger and trial balance with balance and total method for February, 2003.

February 1 Sati started business with cash ` 20,000 and goods ` 5,000
February 2 Purchased goods worth `8,000 from Shyam.
February 4 Purchased furniture for ` 5,000.
February 5 Sold goods `7,000.
February 8 Purchased goods for `2,000.
February 10 Paid cartage`50.
February 14 Sold goods to Mohan `2,500. February
21 Cash withdrawn from business, ` 500. February
22 Goods returned by Mohan` 300.
February 25 Goods sold for cash ` 2,500.
February 28 Sundry expenses ` 450.
February 28 Salary paid `7,500.

Solution :

Journal

Date	Particulars		L.F.	Debit `	Credit `
Feb. 1	Cash A/c	Dr		20,000	
	Stock A/c	Dr		5000	
	To Capital A/c				25,000
	(Being cash and stock introduced by Sati for the business)				
Feb. 2	Purchase A/c	Dr		8000	
	To Shyam A/c				8000
	(Being goods purchased from Shyam on credit)				
Feb. 4	Furniture A/c	Dr		5000	
	To Cash A/c				5000
	(Being furniture purchased on cash)				
Feb. 5	Cash A/c	Dr		7000	
	To Sales A/c				7000
	(Being goods sold for cash)				
Feb. 8	Purchase A/c	Dr.		2000	
	To Cash A/c				2000
	(Being goods purchased on cash)				
Feb. 10	Cartage A/c	Dr.		50	
	To Cash A/c				50
	(Being cartage paid)				
Feb. 14	Mohan A/c	Dr.		2500	
	To Sales A/c				2500
	(Being goods sold to Mohan on credit)				
Feb. 21	Drawings A/c	Dr.		500	
	To Cash A/c				500
	(Being cash withdrawn by the proprietor for personal use)				
Feb. 22	Sales Return A/c	Dr.		300	
	To Mohan A/c				300
	(Being goods sold to Mohan returned)				
Feb. 25	Cash A/c	Dr.		2500	
	To Sales A/c				2500
	(Being sales made on cash)				
Feb. 28	Sundry Expenses A/c	Dr.		450	
	To Cash A/c				450
	(Being sundry expenses paid)				
Feb. 28	Salaries A/c	Dr.		7500	
	To Cash A/c				7500
	(Being salaries paid)				

LEDGER

Cash Account

Dr.							Cr
Date	Particulars	LF	`	Date	Particulars	L.F	`
Feb 1	To Capital Ac		20,000	Feb 4	By Furniture A/c		5000
Feb 5	To Sales A/c		7000	Feb 8	By Purchase A/c		2000
Feb 25	To Sales A/c		2500	Feb 10	By Cartage A/c		50
				Feb 21	By Drawings A/c		500
				Feb 28	By Sundry Exps. A/c		450
				Feb 28	By Salaries A/c		7500
				Feb 28	By Balance c/d		14,000
			29,500				29,500

Stock Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 1	To Capital A / c		5000	Feb. 28	By Balance c / d		5000
			5000				5000

Capital Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
				Feb. 1	By Cash A / c		20, 000
Feb. 28	To Balance c / d		25, 000	Feb.1	By Stock A / c		5000
			25, 000				25, 000

Purchase Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb.2	To Shyam A / c		8000				
Feb. 8	To Cash A / c		2000	Feb.28	By Balance c / d		10, 000
			10, 000				10, 000

Shyam Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 28	To Balance c / d		8000	Feb. 2	By Purchase A / c		8000
			8000				8000

Furniture Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 4	To Cash A / c		5000	Feb. 28	By Balance c / d		5000
			5000				5000

Sales Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
				Feb. 5	By Cash A / c		7000
				Feb.14	By Mohan A / c		2500
Feb. 28	By Balance c / d		12, 000	Feb. 25	By Cash A / c		2500
			12, 000				12, 000

Cartage Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 10	To Cash A / c		50 50	Feb. 28	By Balance c / d		50 50

Mohan Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 14	To Sales A / c		2500	Feb. 22 Feb.28	By Sales Re turn A / c By Balance c / d		300 2200
			2500				2500

Drawings Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 21	To Cash A / c		500 500	Feb. 28	By Balance c / d		500 500

Sales Return Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 22	To Mohan A / c		300 300	Feb. 28	By Balance c / d		300 300

Sundry Expenses Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 28	To Cash A / c		450 450	Feb. 28	By Balance c / d		450 450

Salaries Account

Date	P articulars	L.F.	`	Date	P articulars	L.F.	`
Feb. 28	To Cash A / c		7500 7500	Feb. 28	By Balance c / d		7500 7500

Trial Balance of Mr. Sati as on 28 Feb. 2003 (Balance Method)

Sl. No.	Accounts Title	L.F.	Debit	Credit
(1)	Cash A/c		14,000	–
(2)	Stock A/c		5000	
(3)	Capital A/c			25,000
(4)	Purchase A/c		10,000	
(5)	Shyam A/c		–	8000
(6)	Furniture A/c		5000	
(7)	Sales A/c		–	12,000
(8)	Cartage A/c		50	
(9)	Mohan A/c		2200	
(10)	Drawings A/c		500	
(11)	Sales Return A/c		300	
(12)	Sundry Expenses A/c		450	
(13)	Salaries A/c		7,500	
			45,000	45,000

Trial Balance of Mr. Satish as on 28 Feb. 2003 (Total Method)

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(1)	Cash A/c		29,500	15,50
(2)	Stock A/c		5000	
(3)	Capital A/c			25,000
(4)	Purchase A/c		10,000	
(5)	Shyam A/c		–	8000
(6)	Furniture A/c		5000	
(7)	Sales A/c		–	12,000
(8)	Cartage A/c		50	
(9)	Mohan A/c		2200	
(10)	Drawings A/c		500	
(11)	Sales Return A/c		300	
(12)	Sundry Expenses A/c		450	
(13)	Salaries A/c		7,500	
			60,500	60,500

4.10 VOUCHER SYSTEM

In a small organization, it is possible for the proprietor to supervise all important matters personally. However, in case of large organizations, delegation of authority is required and therefore, it is necessary to have a proper internal check system for prevention of errors and frauds in recording the transactions and receiving or making final cash payments. The chances of frauds in case of cash payments are all the more. It is almost impossible for the disbursing official to have all information regarding the goods and services in respect of which he is required to make payments. This is because even in case of organizations of moderate size, the responsibility for issuing purchase orders, inspecing commodities received, verifying contractual and arithmetical details of invoices is divided among the employees of the various departments. The disbursing official should, therefore, have the assurance of all concerned officials before making payments that the terms of the contract have been complied with and he is paying the exact amount of obligation. This is possible only when all the activities mentioned above are properly coordinated and linked with the ultimate issuance of cheques to the creditors. One of the most effective systems employed for this purpose is termed as Voucher System.

The Voucher System may therefore be defined as "a plan and method of procedure for the verification, recording and payment of all items (other than items to be paid from petty cash) which require the disbursement of cash." As a matter fact, it is mainly a plan of internal check for all cash disbursement items. There are three basic requirements of the Voucher System :

(a) A Voucher is to be prepared for each item of expenditure.

(b) No payment shall be made without a properly verified and authorized voucher.

(c) Development of a proper and efficient system for determining the amount to be paid on each day. This helps the disbursing official in determining the amount to be paid and the management in conveniently and continuously forecasting the amount of the cash required to meet maturing obligations.

The following documents are used in the Voucher System :

1. Vouchers. In general terms, a Voucher means a documentary evidence in support of a business transaction. It is a documentary evidence by which the accuracy of an entry made in the books of account can be substantiated. It may be a receipt, a counterfoil of a receipt book, an invoice or even correspondence with the concerned parties. The term Voucher has a narrower meaning when applied to the Voucher System. It is a special form on which is recorded the pertinent data about a liability and the particulars of its payments.

Vouchers are generally prepared by the accounting department on the basis of invoices or returns that serve as the evidence of expenditure. This is done after the following comparisons and verifications have been completed and noted on the invoices :

(i) Comparison with the copy of Purchase order to verify the quantities, prices and terms.

(ii) Comparison with the Goods Received Returns to determine the receipt of items recorded in the invoices.

(iii) Verification of the arithmetical accuracy of the invoices.

After making the above verifications and comparisons, the invoices or other supporting evidence is attached to the voucher and is presented to the concerned official for his final approval.

2. Voucher Register : The Voucher Register is a columnar journal giving the details about the Voucher Nos. and different items of expenses in respect of which payments have to be made. A proforma of a Voucher Register is given later.

The Vouchers are recorded in a numerical sequence. The credit is given to the accounts payable while debit is given to the account or accounts to be charged for expenditure. On making payment, the date of payment and the number of cheques are inserted in the appropriate columns in the Voucher Register. The objective of such a recording is to provide ready information about determining the amount of individual unpaid vouchers. The total outstanding liability on account of vouchers unpaid at a particular date can be found out by adding up the individual amount of the unpaid vouchers as shown in the Voucher Register.

3. Unpaid Voucher File. After the vouchers have been prepared and recorded in the Voucher Register, they are filed in an Unpaid Voucher File. They remain there till they are paid. The amount due on each Voucher represents the credit balance of an account payable. Each Voucher in itself is comparable to an individual account in the Creditors Ledger. Hence, no separate Creditors Ledger is necessary.

4. Cheque Register. The payment of a Voucher is recorded in a Cheque Register, the proforma of which is given below :

VOUCEHER REGISTER

Date	Payee	Voucher	Paid		Credit	Debit					
			Date	Cheque	Voucher	Purchases	Wages	Salaries	Office	Selling	Sundries
		No.		No.	Payable				Expenses	Expenses	
1995					`	`	`	`	`	`	`
May 1	Mohan	501	May 5	430	250	250					
May 8	Kishan	502	–	–	300	300					
May 15	David	503	May20	431	500	–	500				
					1,050	550	500				

CHEQUE REGISTER

Date	Cheque No.	Payee	Voucher No.	Accounts Payable Dr.	Discount Cr.	Bank Cr.
May 5	430	Mohan	501	250	10	240
May 15	431	David	503	500	5	495
				750	15	735

The Cheque Register is modified form of Cash Payment Journal and it is so called because it is a complete record of all cheques issued. It is customary to record all cheques in a Cheque Register in the order of their sequence to avoid mistake in their recording.

When a Voucher is to be paid, it is removed from the Uapaid Voucher File. On issue of a cheque, the date, the number of chque and amount are listed on the back of the Voucher. This helps in recording the payments in the Cheque Register. The paid vouchers and the supporting documents are cancelled through a cancelling stamp to prevent their accidental or intentional reuse.

5. Paid Voucher File. After payments, Vouchers are generally filed in numerical sequence in the Paid Voucher File. They are then readily available for examination by employees or independent auditors who may require information about a specific expenditure. The paid Vouchers are finally destroyed in accordance with the firm's policy concerning the retention of records.

6. Voucher's Payable Account : Vouchers Payable Accounts is similar to Total Creditors Account. It is credited with the total amount payable on account of different Vouchers and is debited with the amount of payments made. The balance of the Voucher Payable Account should agree with the total of the Unpaid Vouchers File and also with the sum of unpaid Vouchers as shown in the Voucher Register. A proforma of a Vouchers Payable Account is given below.

VOUCHERS PAYABLE ACCOUNT

Date	Particulars	Amount	Date	Particulars	Amount
1986				1986	
May 31	To Cheque Register	765	May 31	By Voucher Register	1,050
	To Discount	15			
	To Balance c/d	300			
		1,050			1,050

Advantages of the Voucher System

The Voucher System offers the following advantages :

(i) *Safeguards cash disbursements.* Voucher System provides for a Systematic plan for the verificatioin and approval of all invoices, bills and other items requiring disbursement of cash. Thus, it safeguard all cash disbursements.

(ii) *Reduces book-keeping work.* The Voucher System considerably reduces the book-keeping work. The voucher itself works as an account of the creditor and total amount due to the creditors canbe found out with the help of the Unpaid Vouchers File.

(iii) *Recording of all current liabilities.* The Voucher System provides for the immediate recording of all current liabilities. It is generally found that firms which do not use Voucher System fail to record bills for items such services and expenses till such time they are actually paid. As a matter of fact, it is desirable to show all liabilities in the books of the business from the time they are incurred.

(iv) *Strengthening of internal check system.* The placing of responsibilities for verification and approvals strengthens the system of internal check.

(v) *Planning future cash requirements.* Voucher System provides continuous information for planning the future cash requirements. This enables the management to make maximum use of cash resources. Invoices in respect of which cash discounts are allowed can be paid within the discount period. Other invoices can be paid in accordance with the credit items. This helps in minimising cost and maintaining a favourable credit standard. Moreover, seasonal borrowings for working capital can also be planned more effectively resulting in saving in interest cost.

Limitations of the Voucher System : The Voucher System has the following limitations:

(i) *Unsuitable for small concerns.* The Voucher System is neither suitable nor necessary for small business enterprises, particularly those with a high degree of proprietary supervision and control.

(ii) *Proper personnel and finances required.* The Voucher System requires sufficient personnel as well as finances for its successful operation. It will be a cumbersome exercise especially for an enterprise which is not wel organized. If an enterprise which uses the Voucher System does not have sufficient cash and is not in a position to pay the approved vouchers according to schedule, it may develop an unwidely file of approved unpaid vouchers.

(iii) *Fails to provide overall creditor's account position.* The system does not provide for giving an overall position of a creditor's account.

(iv) *Difficulties in case of partial payments returns etc.* The system proves a hindrance rather than as a help incase of concerns which have many returns of gods and other corrections after approving and recording of purchase invoices. Such concerns have to make many partial payments of approved vouchers. In some cases, they have to defer payments also.

From the above, it may be concluded that the Voucher System is suitable only for an enterprise which is well equipped both in respect of personnel and finances. It is not suitable for small concerns. Moreover, suitable modifications may have also to be made in the operation of the system as to meet the specific needs of a particular enterprise.

4.11 KEY TERMS

Balancing: Process of finding out and recording the difference between the two sides of an account.

b/d: Brought down.

c/d: Carried down.

Credit balance: Excess of credit total over the debit total of an account.

Debit balance: Excess of debit total over the credit total of an account.

Ledger: Ledger is a book containing all the accounts of a firm in a summarised and classified form.

Posting: Process of transferring entries from journal to ledger.

Balance: It is the difference between the amounts of the two sides of an account.

Trial Balance: It is a statement of balances of all the accounts to test the arithmetical accuracy of the books of accounts.

4.12SUMMARY

- **Trial Balance** is a statement of balances of all the accounts, prepared on a specific date to ascertain the arithmetical accuracy of the books of accounts.
- **'Trial Balance with balances'** shows separately the debit balances and credit balances of all the accounts maintained in the ledger.
- **'Trial Balance with totals'** shows the total of each side of all the accounts instead of balances.
- **'Trial Balance with both balances and totals'** shows both the balances as well as totals of the various accounts.

4.13CHECK YOUR PROGRESS AND ANSWERS

1. State whether each of the following statement is true of false.

(a) Ledger records the transactions in an analytical manner.

(b) The posting of entries are done in journal.

(c) Transactions are recorded first in the ledger.

(d) Ledger is the principal books of accounts.

(e) While posting in ledger, the account debited in journal is credited in ledger.

(f) Ledger is a set of accounts.

(g) Ledger is the book of prime entry.

Ans. True : (a), (d), (f); False : (b), (c), (e), (g).

4.14 QUESTIONS AND EXERCISES

1. Fill in the blanks with the appropriate words.

(a) All the debit and credit balance of accounts are taken to________.

(b) Trial Balance is a________of balances of all accounts.

(c) The equalisation of the two sides of a Trial Balance indicates________of the books of accounts.

(d) Trial Balance is a________of balances on a________date.

(e) The Trial Balance, which contains the total debit and credit amount of different accounts is known as _______

[**Ans. :** (a) Trial Balance, (b) statement, (c) arithmetical accuracy, (d) statement, particular, (e) Gross Trial Balance]

2. What do you mean by ledger ? What are its advantages ?
3. What is posting ? Write the procedure of posting entries in the ledger.
4. What is ledger ? Differentiate between journal and ledger.
5. What is balancing ? Write the procedure of balancing an account.
6. What is Trial Balance ? Discuss the main objectives and the ways of preparing Trial Balance.
7. What is Trial Balance ? Discuss its advantages and limitations.
8. A Trial Balance is merely a proof of arithmetical accuracy. Explain the statement.

4.15 PRACTICAL PROBLEMS

1. Prasad had the following balances on 1st January 2003 :

   Cash in hand ` 5,200, Bank balance `8,700, Stock `4,300
   Furniture `2,500 Jagdish (Dr) `1700, Prakash (Cr) `3100.

   Transactions during January 2003 were as follows :
   January 1 Sold goods to Jadgish ` 2400 on credit.
   January 5 Purchased from Prakash on credit.
   January 10 Drew for personal use ` 1300.
   January 13 Paid Prakash on account ` 2000.
   January 15 Received a cheque from Jagdish `3200. January
   20 Paid for stationery `680.
   January 23 Deposited into bank `1000.
   January 30 Paid salary `2500 by cheque.
   Journalise the transactions. Carry out the posting in the ledger and balance the accounts. Verify that total debit balances are equal to total credit balances.

   (**Ans.** Total debit balances ` 25,400)

2. Mr. T. Dhanpati is an important customer of XYZ Ltd. He had the following transactions with XYZ Ltd. during July 2002.
   July 1 Amount due to XYZ Ltd. `10,200.
   July 5 Credit purchases ` 50,000.
   July 9 Defective goods returned ` 5700.
   July 15 Payment made on account ` 20,000.
   July 20 Cash received by XYZ Ltd. on behalf of Mr. Dhanpati ` 15,600. July
   23 Goods sold to Dhanpati ` 12,000.
   July 30 Mr. Dhanpati settled his account by cheque at a discount of 5%.
   (a) Journalise the above transactions in the books of XYZ Ltd.
   (b) Prepare the account of Mr. Dhanpati in the books of XYZ Ltd.
   (c) How much is the balance of the account at the end of the month and what does it signify ?

   (**Ans.** Closing balance - nil)

3. Post the following transactions in the ledger and balance the accounts. Prepare a list of such balances and show that total debit balances agree with total credit balances.
   2003

April 1 Commenced business with cash ` 50,000, building worth ` 1,00,000 and furniture worth ` 15,000.
April 3 Deposited ` 30,000 into SBI Main branch.
April 8 Bought goods from P. Someswar ` 12,860.
April 10 Purchased stationary from M/s Prasanti on-credit `4800. April
12 Sold to Naresh on credit `3540 and to Gopal on cash ` 5250. April
15 Paid to P.Someswar `12,800. He allowed a discount `60.
April 20 Withdrew for office use from the bank `10,000.
April 22 Settled M/s Prasanti account less 10%.
April 25 Received from Naresh in full settlement ` 3500.
April 30 Paid salary for the month `4600.
April 31 Bank credit ` 150 as interest.

(**Ans.** Total debit balances ` 1,74,440; Cash - ` 17,030; Bank - ` 20,150)

4. During the year 2000, Kalamandir, Bhubaneswar had the following transactions with X and Y.

	X (`)	Y (`)
Sales : Cash	3,00,000	
Credit	1,50,000	
Purchases : Cash		2,00,000
Credit		1,20,000
Cash paid		1,00,000
Cheque paid		50,000
Bills issued		80,000
Discount received		7,500
Return outward		15,000
Cash received	1,60,000	
Cheque received	90,000	
Bills received	70,000	
Discount allowed	4,800	
Return inward	24,000	
Bills receivable dishonoured	5,000	

(a) Prepare the account of X and Y in the books of Kalamandir.

(b) Find out the balance of both the accounts at the end of the year. What does the balance of each account signify?

(**Ans.** X - Credit balance `1,93,800 : Y - Debit balance ` 1,32,500)

5. Enter the following transactions in the books of Manmohan and post them to ledger. Find out the total debit and credit balances of all the accounts in the ledger.

2002

March 1 Started business with cash ` 25,000 and deposited ` 10,000 out of it in the bank. March
3 Bought goods from Satish `12,000.
March 5 Sold goods to Dinesh on credit `18,000.
March 8 Paid to Satish on account `8,000.
March 10 Received a cheque from Dinesh `15,000.
March 12 Sold to Arun ` 4,500.
March 15 Received a cheque from Arun `1,500.

March 18 Paid to Satish `3,900 in full settlement of his account. March

20 Dinesh cleared his account by saying ` 2,850.

March 22 Bought goods from Birakishor `6,000.

March 23 Arun's cheque returned unpaid.

March 25 Paid wages `3,250.

March 27 Goods returned to Birakishor `800.

March 29 Issued a cheque on favour of Birakishor `5,000.

March 30 Arun became insolvent and his estate paid only 40 paise in the rupee.

March 31 Interest allowed by the bank `350 and bank charges debited by bank ` 60.

(**Ans.** Total debit balance `48,850; Cash balance ` 4,500; Bank balance ` 20,290)

6. From the following Trial Balance (containing errors) prepare a correct Trial Balance.

	Dr. (`)	Cr.(`)
Purchase	60, 000	
Reserve Fund	20, 000	
Sales		1, 00, 000
Purchase Returns	1000	
Sales Returns		2000
Opening Stock	30, 000	
Closing Stock		40, 000
Expenses		20, 000
Outstanding Expenses	2000	
Bank Balance	5000	
Assets	50, 000	
Debtors		80, 000
Creditors		30, 000
Capital	94, 000	
Suspenses (difference in books)	10, 000	
	2, 72, 000	2, 72, 000

4.16 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari

Financial Statement Analysis – John N. Meyer

Management Accounting – Khan and Jain.

Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.

Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER - 5 BANK RECONCILIATION STATEMENT

Chapter Outlines

5.0 INTRODUTION

Bank provides different services to the business so the business enterprises operate different types of Accounts in the Bank. Generally, the following account are operated by a bank: (i) Savings Bank Account; (ii) Recurring Deposit Account; (iii) Current Account, (iv) Fixed Deposit Account. The most suitable account for a business enterprise is 'Current Account'. Bank provides overdraft facility and cash credit facility to the current account holders. The business enterprise records the banking transaction in the bank column of cash book. The bank column of cash book is debited when amount is deposited into Bank and it is credited when amount is withdrawn from the Bank. Bank also maintains a separate ledger account for each account holder (Firm) in its ledger. On receipt of any amount from the account holder, (customer), his account is credited and on payment to the customer, his account is debited by the bank. The bank provides copy of the ledger account to its customers which is called 'Pass Book' or Bank Statement.

As all the transactions with the bank are recorded in both the books namely in the Cash Book by the merchant and in the Bank's ledger by the Bank, there should be no difference between the balances disclosed by cash book as well as the Pass Book. The balances of these two books must tally with each other, because when the merchant debits the Bank, Bank will give credit to the customer in its ledger. Similarly, if some money is withdrawn from the bank, the firm records it on credit side of bank column of cash book, the bank at the same time enters it on the debit side of the Firm's account. Thus, all the entries recorded on the debit side of the cash book must tally with the entries recorded on the credit side of Pass Book and vice versa. As such the bank balance, as shown by the Cash Book, must tally with the balance shown by the Pass Book.

5.1LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Know the meaning, nature and recording of banking transactions.
- Understand the meaning of, need for, and advantages of bank reconciliation statement.
- Explain the nature and procedure of recording in cash book and pass book.
- Distinguish between cash book and the pass book.
- Ascertain the causes of difference between the balances of cash book and pass book.
- Know the procedure of preparing bank reconciliation statement in the case of favourable and unfavourbale balances.
- Know the procedure of adjusting the cash book at the end of the year and prepare bank reconciliation statement using adjusted cash balance.
- Understand the alternative method of preparing bank reconciliation statement.

5.2 UTILITY/NEED FOR PREPARING BANK RECONCILIATION STATEMENT

It is necessary and essential to prepare this statement because of the following reasons:

(i) The errors and omission committed by the bank or by the customer (firm) would be detected. It should be rectified accordingly.

(ii) This will reflect the actual position of bank balance of the customer which will help him in making further transactions with the Bank.

(iii) This shall facilitate the preparation of revised cash book by making necessary entries regarding bank charges, bank interest allowed or charged, direct payments made by the bank understanding instructions issued by the merchant and so on

(iv) It will prevent frauds in recording banking transactions. Chances of embezzlement by any member of stuff of the firm or of the Bank are minimised.

(v) It will also assist in detecting the reasons for unnecessary delay in collection and clearing of cheques etc. by the Bank.

5.3 MEANING AND OBJECTIVE OF BANK RECONCILIATION STATEMENT

On certain date, the bank balance shown by Cash Book and the balance shown by Pass Book may not tally. This is because of the fact that some entries recorded in Cash Book might not have been entered in the Pass Book and vice versa. Therefore, a statement is prepared to identify the reasons for the differences and to reconcile the balances of the two books, cash book and the pass book. Such a statement which is prepared for aforesaid reactions is called '**Bank Reconciliation Statement**'.

Bank Reconciliation Statement is a document which is prepared to reconcile the balances of the cash book and the Bank Pass Book.

It is important to note that debit balance of 'Cash Book' and Credit balance of 'Pass Book' is called ordinary balance whereas the credit balance of Cash Book and debit balance of Pass book is termed as 'Overdraft'.

5.4 CAUSES OF DIFFERENCES IN BALANCES OF CASH BOOK AND BANK PASS BOOK

The difference in two balances as disclosed by cash book and the pass book may arise on a specified date because of the following reasons:

(1) Cheques issued but not yet presented for payment in the Bank: When a cheque is issued to any party or person it is immediately entered in Cash Book by crediting the Bank Account. This has t he effect of reducing the bank balance in customer's cash book. But he receiving party may not present the cheque to the Bank for payment upto the date of preparing Bank Reconciliation Statement. The bank debits the customer 's account only when the cheque is presented for payment. So long as it is not presented for payment, the balance shown in Pass Book is more than the balance shown in the Cash Book of the customer.

(2) Cheques paid into the bank for collection but not yet collected and credited by the Bank **:** When a firm receives cheques, drafts, bills, hundies etc. from its customers, which are deposited into bank for collection. An entry is made on the debit side of the bank column of the cash book. But the bank will credit the firm's account only when it has actually collected the payment of these cheques, bill etc. from other Banks. There will be a gap of some days between the depositing of the cheques into the bank and credit given by the Bank. In case of outstation cheques, this gap may be quite longer. Thus, until the cheques are collected and credited by the bank, the Cash Book will show an increased balanced in comparison to the Pass Book.

(3) Cheques paid into the bank for collection but dishonoured : When the cheques received from outside parties are deposited with the bank, these are immediately recorded on the debit side of the bank column of the cash book. If these cheques are dishonoured then, bank will not make any entry on the credit of customer's account. As a result, the cash book will show an increased balance in comparison to the pass book.

(4) Interest charged by the bank on overdraft: When the bank allows the customer facility of withdrawing in excess of its deposits, its excess withdrawn is called overdraft. The bank charge int erest on this overdraft and debits the firm's account for such interest from time to time. But the entry for interest will be made in the cash book only when the customer receives advice or the bank statement. Till then, the balance as per pass book would be less than the balance as per cash book.

(5) Interest credited by Bank and entered in Cash Book: When the Bank allows interest to a customer, it credits the account of the customer. As a result his bank balance would be increased. But the customer comes to know about it only when the pass book is completed or the advice is received. Until then, the bank balance as per pass book would be more than the balance as per cash book.

(6) Bank charges not entered in Cash Book: The bank charges some amount from each customer by way of incidental charges, and collection charges etc. It debits the customer's account for this amount from time to time and reduces his bank balance. But the customer comes to know about these charges only when the receives the bank statement, or the advice from the Bank to credit the bank and reduce his balance in the bank. Until then the bank balance as per pass book would be less than the bank balance as per cash book.

(7) Amount directly deposited into Bank by some customers: When any amount is directly deposited by a customer into the Bank account of the merchant, the bank will credit his account immediately. But the merchant would know about it only when the advice is received from the bank. Until then the bank balance as per pass book would be higher than that of the balance in bank column of the cash book.

(8) Dividend and Interest collected by Bank but not recorded in Cash Book: When the bank collects dividend and interest on behalf of the customer, it gives credit. The customer's account would be credited and bank balance would be increased. But the customer will make the entry only when he receives advice from the bank. Till then, the bank balance as per pass book will be more than that of the balance as per cash book.

(9) Direct payment made by the Bank on the behalf of the customer or the merchant: When an account holder gives a standing order to the bank to make certain payments, such as insurance premium, locker rent (transfer) etc., on his behalf, the bank makes these payments and debits the customer 's account. But the customer will make the entry only when he receives the advice from the bank. Until then the Bank balance as per pass book will be less than the balance as per cash book.

(10) Wrong entry made by the Bank: When an error is committed by the Bank in recording a wrong entry in customer 's account, it causes a difference in the balance as disclosed by two sets, namely balance as per pass book and the balance as per cash book. These differences will be corrected only when the error is detected.

(11) Other Reasons: The differences in cash book balance and Pass book balance may also be on account of the following reasons :

(a) Cheques issued and handed over to a creditor but omitted to be recorded in cash book.
(b) Cheques received and entered in cash book but omitted to be sent for collection.
(c) Error in totaling or balancing the bank column of cash book.

5.5 IMPORTANCE OF BANK RECONCILIATION STATEMENT

1. It is prepared when the balance as shown by bank pass book does not agree with the balance shown by the cash book.
2. It is prepared on a particulars date. Its heading would be 'Bank Reconciliation Statement' as on ... ... (mention the date).
3. It can be prepared, starting with the balance either as per Bank column of cash book, or with the balance as per pass book. The balance of cash book may be debit or credit. Similarly the balance as per pass book may be credit or debit.
   (a) Debit balance as per cash book indicates favourable or deposit balance in the bank.

(b) Credit balance as per cash book indicates overdraft balance.
(c) Credit balance as per pass book indicates the deposit balance of the party in the bank.
(d) Debit balance as per pass book indicates the excess withdrawals over deposits, called overdraft balance as per pass book.

4. If noting is mentioned in the question about debit or credit balances, the usual balance of cash book is treated as debit (deposit) and that of pass book as credit (deposit).
5. A Bank Reconciliation Statement can be started with any of the balance mentioned below :
   (i) Dr. Balance as per cash book, (ii) Cr. Balance as per cash book, (iii) Cr. Balance as per pass book, (iv) Cr. Balance as per pass book

5.6 TECHNIQUE OR PROCESS OR METHODS FOR PREPARATION OF BANK RECONCILIATION STATEMENT

The following bases may be taken as starting base for preparation of Bank Reconciliation Statement :

(A) Balance of Cash Book, and (B) Balance of Pass Book.

(A) When Balance of Cash Book is taken as starting base: The Balance of cash book may be debit or credit. The debit balance is called ordinary balance and is shown by positive sign (+) whereas the credit balance is called 'overdraft' and is shown by negative sign (–). The balance of Cash Book is required to be adjusted in accordance with the entries made in the Bank Pass Book. If the bank increases the customer's Balance, the cash book balance should also be increased accordingly and in the contrary, if the bank deceases the balance, the cash book balance should also be decreased.

The following items are to be added to the balance of Cash Book :

(a) Cheques issued but not yet presented for payment in the bank.
(b) Interest credited by bank for deposit balance of the customer in the bank.
(c) Dividends, interest on investments collected by bank but not yet recorded in the cash book.
(d) Direct payment made by some of our debtors (customers) but no entry was passed in cash book due to lack of advice received from the bank.

The following items are to be deducted from the balance given as per cash book :

(a) Cheques deposited into the bank, but not yet collected and credited by the bank.
(b) Interest charged by bank on its overdraft, but not yet recorded in the cash book.
(c) Bank charges debited by the bank in customer's account but not yeat recorded in the cash book.
(d) Any payments made by bank under standing instructions by the customer, but not yet recorded in the cash book.
(e) Cheques dishonoured but not yet recorded in the cash book since no advice was received.

The resultant figure will be the balance as per cash book.

(B) When Balance of Pass Book is taken as starting base : If the balance as per pass book is taken as the starting base, the procedure to be followed be reversed of the above i.e., add the items to the pass book balance which are deducted from cash book balance, and deduct the items from pass book balance which are added to the cash book balance.

In short, the adjustment of various items of differences depend upon the starting base which is summarized in the following Chart :

Bank Reconciliation Statement as on ....

	When Cash Book is starting point		When Pass Book Balance Balance is starting point	
Transactions	**Normal Balance (Dr. Bal.)**	**Overdraft Balance (Cr. Bal.)**	**Normal Balance (Cr. Bal.)**	**Overdraft Balance (Dr. Bal.)**
1. Cheques issued but not yet presented for payment.	Add	Less	Less	Add
2. Cheques deposited into Bank but not yet collected.	Less	Add	Add	Less
3. Interest allowed by Bank but not yet entered in Cash Book.	Add	Less	Less	Add
4. Bank charges not yet entered in Cash book.	Less	Add	Add	Less
5. Direct deposits into the bank by a customer.	Add	Less	Less	Add
6. Direct payments made by Bank not yet entered in Cash Book.	Less	Add	Add	Less
7. Direct collection made by Bank but not yet entered in Cash Book.	Add	Less	Less	Add
8. Cheques issued and payment received by the customers but not yet entered in Cash Book.	Less	Add	Add	Less
9. Cheques paid into Bank for collection but omitted to be entered in Cash Book.	Add	Less	Less	Add
10. Dishonour of a cheque for which no entry was passed in Cash Book.	Less	Add	Add	Less
11. Cheques entered in Cash Book but omitted to be banked.	Less	Add	Add	Less

Illustration - 5.1

At the end of the year on 31st March 2007 Mr. Mohit's Cash Book showed a Bank Balance of ` 53,650. On comparing it with the Bank Pass Book it was noticed as follows:

(i) He issued three cheques towards the end of the year for ` 6,000, 3,950 and 1,550 but they were presented for payment in April, 2007.

(ii) He deposited two cheques for `15,000 and `6,500 for collection but were collected and credited in April, 2007.

(iii) Bank has debited the firm with `460 for commission which has not been recorded in the Cash Book.

(iv) The Bank has also credited `100 for interest on deposit which has also not been recorded in the Cash Book.

Prepare Bank Reconciliation Statement of Mr. Mohit as on 31st March, 2007.

Bank Reconciliation Statement as on ....

As on 31st March, 2007

	Particulars	**Details (`)**	**Total (`)**
	Debit Balance as per Cash Book		53,650
Add :	Cheques issued but not presented till 31st March, 2007		
	(` 6, 000 + 3, 950 + 1, 550)	11, 500	

Add :	Interest Credited by Bank but not recorded in Cash Book	100	11,600
			65, 250
Less :	Cheques deposited for collection but collected and credited in April 2007 : (` 15, 000 + 6, 500)	21, 500	
Less :	Bank commission charged by Bank	460	21, 960
	Credit Balance as per Bank Pass Book		43, 290

Illustration 5.2 : Prepare a Bank Reconciliation Statement from the following particulars as on 31st March, 2007:

	`
(i) Debit balance as per bank column of the cash book.	40,000
(ii) Cheques issued to creditors but not yet presented to the bank for paymenr.	16,800
(iii) Cheques deposited into bank for collection but not yet collected by the bank.	11,800
(iv) Bank charges not recorded in cash book.	800
(v) Bank paid house tax on our behalf but no information was received from bank in this connection.	1,400
(vi) A cheque deposited into bank was dishonoured but no intimation was received.	4,500
(vii) Dividend received by the bank but not yet entered in the Cash book.	700
(viii) Interest credited by Bank but not yet recorded in the Cash book.	350

Solution :

Bank Reconciliation Statement as on ....
As on 31st March, 2007

	Particulars	Details (`)	Total (`)
	Debit Balance as per Cash Book		40,000
Add :	Cheques issued to creditors but not yet presented to the bank for payment.	16,800	
	Dividend received by the bank	700	
	Interest allowed by the bank	350	17,850
			57,850
Less :	Cheques deposited into bank but not yet collected	11,800	
	Bank charges	800	
	House tax paid by Bank	1,400	
	Cheque deposited but was dishonoured	4,500	18,500
	Credit Balance as per Bank Pass Book		39,350

The above example may also be solved in another way. According to this method there are two columns for the amount, one for plus items and another for minus items. Plus items are those which will increase the Bank balance of the customer, while minus items means those which will decrease the customer's balance. If this alternative method is adopted, the solution will appear as follows :

Bank Reconciliation Statement as on ....

Particulars	Plus (+)	Minus (–)
(i) Debit Balance as per Cash Book	40,000	
(ii) Cheques issued but not yet presented for payment	16,800	
(iii) Cheques deposited but not yet collected		11,800
(iv) Bank charges		800
(v) House Tax paid by Bank		1,400
(vi) Cheque diposited but was dishonoured		4,500

(vii) Dividend received by Bank		700	
(viii) Interest credited by Bank		350	
		57,850	18,500
Credit Balance as per Bank Pass Book			39,350
	Total	57,850	57,850

~~Illustration - 5.3 :~~

Prepare a Bank reconciliation statement from the following particulars of Master Tara Chand as on 31st March, 2007 :

Cash Book shows a credit balance of `1,05,000, but Bank statement shows a difference due to the following reasons :

1. Cheque No. 055 for `5,4000 in favour of Ravikant has not been presented.
2. A post dated cheque for `3,000 has been debited in bank column of cash book but could not be cleared by Bank.
3. Four cheques totalling `12,000 sent to bank for collection but could not be collected and cleared till this date.
4. A cheque for `4,000 received from Chetan was sent to bank but was dishonoured, not recorded in cash book.
5. Fire insurance premium `500 and locker rent `600 were charged by Bank understanding instructions, but not entered in cash book.
6. A bill for `10,000 was retired by the bank under a rebate of `150 but the full amount of the bill was credited in the bank column of cash book.

Solution :

Bank Reconciliation Statement as on ....

As on 31st March, 2007

Particulars	**Plus (`)**	**Minus (`)**
Overdraft as per Cash Book		1,05,000
1. Cheque issued but not yet presented for payment	5,400	
2. Cheque sent for collection but could not be cleared by bank		3,000
3. Four cheques deposited with bank for collection but could not be credited as yet.		12,000
4. Chetan's cheque sent to bank but was dishonoured		4,000
5. Payments made by bank understanding instructions :		
Fire Insurance Premium		500
Locker Rent		600
6. A bill retired under rebate by the bank on customer's behalf, rebate not recorded in cash book.	150	
Total of Plus and Minus	5,550	1,25,000
Overdraft (Debit Balance) as per Bank Pass Book	1,19,550	

Illustration - 5.4 : On 31st March, 2007 the Bank Pass Book of a trader showed a Credit Balance of `46,720 but the Cash Book balance was different for the following reasons :

(a) Cheques issued to Ram for ` 6,050 and to Rahim for `4,720 were not yet presented for payment.

(b) Bank has debited `570 for Bank charges.

(c) Arif directly deposited `7,840 into the Bank account of the trader which were not entered in the Cash book.

(d) Two cheques one from Anil for `4,870 and another from Sunil for `14,300 were collected in the first week of April, 2007 although they were banked on 27.3.2007.

(e) Interest allowed by Bank `870.

Prepare Bank Reconciliation Statement as on 31st March, 2007.

Solution:

Bank Reconciliation Statement as on ....
As on 31st March, 2007

	Particulars	Plus (`)	Minus (`)
	Credit Balance as per Pass Book	46,720	
(a)	Cheques issued but not yet presented for payment :		
	Ram		6,050
	Rahim		4,720
(b)	Bank Charges debited by the bank but not yet recorded in Cash Book.	570	
(c)	Arif directly deposited into Bank		7,840
(d)	Cheques sent to Bank for collection but not yet collected :		
	Anil	4,870	
	Sunil	14,300	
(e)	Interest allowed by bank		870
	Total	66,460	19,480
	Debit Balance as per Cash Book	–	46,980
		66,460	66,460

Illustration - 5.5 : On 31st December, 2007 Mr. Anil has an overdraft of `1,24,000 as shown by his Pass Book. He had issued cheques amounting to `25,000 of which `20,000 worth only seems to have been presented for payment. Cheques amounting to `10,000 had been deposited into the Bank for collection on 30th December, but out of these only `6,500 had been collected. There is a debit in the pass book of `2,5000 for interest on overdraft. An entry of `8,700 of payment by a customer directly into the bank appears in the Pass Book. Anil's Pass Book also showed a credit of `6,000 to his account, being interest on investments collected directly by his Bankers.

Prepare Bank Reconciliation Statement as on 31st December, 2007 in the books of Mr. Anil.

Solution:

Bank Reconciliation Statement as on ....

Particulars	Plus (`)	Minus (`)
Overdraft : (Debit) Balance as per Bank Pass Book		1,24,000
Cheques issued but not yet presented for payment		5,000
Directly deposited by a customer in the bank		8,700
Interest on investments collected by the bank		6,000
Cheques deposited but not yet collected by the bank	3,500	
Cheques entered in the cash book but omitted to be banked	1,000	
Interest on overdraft not recorded in cash book	2,500	
Total	7,000	1,43,700
Overdraft : (Credit) Balance as per Cash Book	1,36,700	

Illustration - 5.6:

On 31st March, 2007 the Bank Pass Book of Shreedhar showed a debit balance of `3,46,670. On comparing it with the cash book the following differences were found out :

(i) The following cheques were issued in the last week of March, 2007 :

(a) Mr. Ram `22,000; (b) Mr. Gopal is `97,000

(c) Mr. Peters `47,500; (d) Mr. Saleem `83,200.

Out of these, only Ram and Peter shave presented t heir cheques for payment upto 31st March, 2007.

(ii) Interest on Bank overdraft not entered in the Cash Book ` 4,350.

(iii) Outstation cheques amounting to `76,850 were sent to the bank for collection on 25th March, 2007 but were not collected upto 31st March, 2007.

(iv) A Bill for collection `1,12,500 due on 31st March, 2005 was sent to the bank but not credited in the Pass Book till 5th April, 2007.

(v) Bank charges debited in pass book but not entered in the cash book `1,280.

(vi) The bank paid subscription to chamber of commerce according to standing instructions but it was not entered in the cash book `3,670.

Prepare Bank Reconciliation Statement of Mr. Shreedhar as on 31st March, 2007.

Solution :

Bank Reconciliation Statement
As on 31st March, 2007

Particulars	Plus (`)	Minus (`)
Debit Balance (Overdraft) as per Bank Pass Book		3,46,670
(i) Cheques issued but not yet presented for payment :		
Mr. Gopal		97,000
Mr. Saleem		83,200
(ii) Interest on Bank Overdraft	4,350	
(iii) Outstation cheques sent to the bank for collection but yet collected.	76,850	
(iv) Bill for collection deposited but not yet credited in Pass Book	1,12,500	
(v) Bank Charges	1,280	
(vi) Subscription paid by Bank to chamber of commerce under standing instructions.	3,670	
	1,98,650	5,26,870
Credit Balance (Overdraft) as per Cash Book	3,28,220	
	5,26,870	5,26,870

Illustration - 5.7 :

Prepare Bank Reconciliation Statement from the following particulars as on 31st March, 2007.

	`
(i) Bank overdraft as per Cash Book	60,400
(ii) Cheques deposited into bank but no entry was passed in the Cash Book.	2,700
(iii) Cheques received but not sent to Bank although entered in Cash Book.	7,400
(iv) Credit side of the bank column of Cash Book cash short.	3,500
(v) Insurance premium paid directly by bank understanding order.	7,000
(vi) Bank charges entered in Cash Book twice.	150

(vii) Cheques received and deposited into bank but returned by bank. No entry was passed in cash book for it. 6,250

(viii) Cheques issued but returned on technical grounds. 2,650

(ix) Bills directly collected by bank. 2,470

(x) Bank charges debited by bank but not recorded in Cash Book. 115

(xi) Cheques received and deposited into bank but entered twice in the Cash Book. 4,760

(xii) Bill discounted dishonoured. 36,750

Illustration - 5.8 :

From the following extracts of the Cash Book and Bank Pass Book for the month of January 2007, prepare the Bank Reconciliation Statement as on 31st January, 2007.

Dr. **Cash Book** **Cr**

Date	**Particulars**	**L.F**	**Amount** `	**Date**	**Particulars**	**L.F**	**Amount** `
2007				2007			
Jan. 1	To Balance b/d		45,000	Jan.2	By M		12,300
Jan.3	To Cash		3,000	Jan. 6	By Wages		30,000
Jan. 10	To K		10,000	Jan. 14	By K (cheque dishonoured)		10,000
Jan. 15	To L		23,000				
Jan. 17	To Cash		6,000	Jan. 15	By X		3,000
Jan. 20	To A		15,500	Jan. 18	By Q		4,700
Jan. 24	To B		7,400	Jan. 24	By Cash		4,000
Jan. 31	To C		21,300	Jan. 28	By Y		7,800
				Jan. 31	By Z		3,400
				Jan. 31	By Balance c/d		56,100
			1,31,300				1,31,300
2007							
Feb. 1	To Balance b/d		56,100				

Bank Pass Book

Date	**Particulars**	**Withdrawals** `	**Deposits** `	**Dr. or Cr.**	**Balance** `
2007					
Jan. 1	To Balance b/d			Cr.	45,100
Jan.3	By Cash		3,000	Cr.	48,100
Jan. 6	To Self-Cash	30,000		Cr.	18,100
Jan. 10	To M	12,300		Cr.	5,800
Jan. 16	By L		23,000	Cr.	28,800
Jan. 17	By Cash		6,000	Cr.	34,800
Jan. 20	To Q	4,700		Cr.	30,100
Jan. 24	To Cash	4,000		Cr.	26,100
Jan. 31	To Bank charges as per instructions	100		Cr.	26,00
Jan. 31	To Life Insurance Premium (standing instructions)		2,5000	Cr.	23,000
Jan. 31	By Interest on Government Securities		3,000	Cr.	26,500

Solution :

The Cash book and the Pass book given above are for the same period. Three cheques received and sent to Bank for collection are debited in cash book. If collection would have made, the same will appear in deposit column of the Pass book. Similarly, cheques issued, are credited in Cash book. When the same are presented for payment, bank record them in withdrawals column. On careful comparison of the two, it reveals that :

(i) Cheques of A `15,500 B `7,400, C` 21,300 are not collected.

(ii) K’s cheques was dishonoured but entered in the cash book only. There is no entry in the pass book as receipt of the cheque and dishonour of the cheque. The cash book entries have been cancelled so the Reconciliation Statement will not be affected.

(iii) Cheques issued to X `3,000, Y `7,800 and Z `3,400 seems to have not yet presented for payment.

(iv) Bank charges `100 and life insurance premium paid `2,500 are not recorded in Cash book.

(v) Interest on Government securities `3,000 collected by bank is also not recorded in Cash book.

Solution :

Bank Reconciliation Statement

As on 31st January, 2007

	Particulars		**Details (`)**	**Total (`)**
	Debit Balance as per Cash Book			56,100
Add :	Cheques issued but not yet presented for payment :	`		
		X 3,000		
		Y 7,800		
		Z 3,400	14,200	
	Interest on Government Securities collected directly and credited by bank but not entered in Cash Book.		3,000	17,200
				73,000
Less :	Cheques deposted but not yet collected :	`		
		A 15,500		
		B 7,400		
		C 21,300	44,200	
	Bank charges debited by the bank but not yet entered in the Cash Book		100	
	Life Insurance Premium paid by bank but not yet entered in the Cash Book		2,500	46,800
	Credit Balance as per Pass Book			26,500

5.7 KEY TERMS

Cash book: It is a book of primary entry which records all cash and bank transactions.

Cheque: It is an unconditional order drawn upon a specified banker. It is in printed form and supplied by the bank to its customers for making payments.

Dishonor: It refers to non-payment of a cheque or bill of exchange on the due date.

Overdraft: It is an arrangement with the bank by which an account holder is allowed to overdraw his account up to certain limit.

Pass book: It is in the form of a bound book which reflects the entries in the customers ledger account maintained by the bank.

5.8 SUMMARY

- In order to exercise effective control over cash, a businessman prefers to handle his receipts and payments through a bank. He is given a copy of his account in the bank called pass book and a cheque book for making payments.
- The main aim of bank reconciliation statement is to indicate the causes of difference between the balance shown by the cash book and the bank pass book on a given date. Besides, it helps knowing the exact balance of cash at bank, reveals any error of fraud, avoids dispute with the bank and helps maintaining good relation with the bank.
- A pass book which reflects the customer's ledger account in the bank is credited for all deposits and debited for all withdrawals. On the contrary, all deposits/receipts are shown on the debit side of cash book whereas payments are written on the credit side. As a result, a cash book will have a debit balance when the pass book is showing a credit balance and vice-versa.
- A pass book may not agree with the cash book because of certain transactions recorded either in cash book only or in pass book only. In addition, there may be errors and omissions in any of the books for which the balance of one may not agree with the other.
- At the end of every year, it is necessary to adjust the cash book in the light of the receipts and payments recorded only in pass book and errors committed in the cash book. The balance of cash at bank after such adjustments is shown on the asset side of balance sheet. A final/annual reconciliation statement is also prepared taking into account those items which are recorded in pass book only and errors, if any, committed in the pass book.

5.9 CHECK YOUR PROGRESS AND ANSWERS

Fill in the Blanks:

(i) Credit balance as per cash book means_______balance as per pass book.
(ii) Deposits are credited, withdrawals are debited in the_______book.
(iii) Cheques issued but not yet presented for payment will be added to the_______balance to reconcile it with the ____ balance.
(iv) Bank charges are_______in the pass book.
(v) _______columns of the cash book is used for the purpose of reconciliation.

Ans. (i) debit (ii) pass (iii) cash book, pass book (iv) debited (v) bank

5.10 QUESTIONS AND EXERCISES

1. What is bank reconciliation statement? What is its importance? How will you prepare it?
2. Write the procedure of preparing a bank reconciliation statement. What are the advantages of bank reconciliation statement?
3. What is a pass book? How is it different from cash book? Give a specimen of pass book.
4. What are the causes of disagreement between the balance of cash book and pass book? How would you reconcile them when there is a favourable balance?
5. What are the transactions which are first recorded in the pass book and then recorded in the cash book? How are they reconciled in the cash book with a favourable balance?
6. How would you reconcile a cash book with the pass book in case you find out the following :
   (a) Cheque issued but not yet presented for payment.
   (b) Cheques deposited but not credited.
   (c) Dishonour of a bill of exchange discounted with the bank.

5.11 PRACTICAL PROBLEMS

When the favourable or debit balance as per cash book is taken as the basis

1. From the following particulars prepare a Bank Reconciliation Statement as on 31st December 2008 of Jayshree Chemicals who had cash at bank as per cash book `10,5000 and as per pass book `12.076.30.

(a) The following cheques were deposited on 30th and 31st December, but were not collected by 31st December 2008.
    (i) `250 (ii) `480 (iii) `160.50
(b) The following cheques were issued but not cashed by 31st December 2008.
    (i) `230.25 (ii) `350 (iii) `358.80
(c) The bank collected a bill of `1,500 on the 31st December 2008 but no intimation was received till 31st December.

(d) The bank allowed interest`38.25 and a commission of `10.50 was charged on 31st December, which have not been recorded in the cash book.

(**Hints :** Take the balance as per the cash book `10,500 as the basis and add (b), (c) and (d) ` 38.25, deduct (a) and (d) ` 10.50.)

[**Ans.** Balance as per pass book`12,076.30]

2. On 31st December 2008, the cash book of a businessman showed a bank balance of ` 4,980.75 on comparing the bank pass book with cash book, the following discrepancies were noticed.

(a) Cheques issued for `780.30 were not presented to the bank till 1st January 2009.

(b) Cheques amounting to `260.25 were deposited in the bank but were not collected till 1st January 2009.

(c) A cheque of `75.20 received from a customer and deposited in the bank was dishonoured and advice of non-payment was not received.

(d) Interest allowed by the bank `80.50 is not recorded in the cash book.

(e) Bank charges and commission `16.80 do not appear in the cash book.

Prepare a Bank Reconciliation statement and show the balance on 31st December 2008 in the pass book.

[**Ans.** Balance as per pass book `5,489.30]

{**Hints :** Add : (a) and (d)} Less : (b), (c) and (e)}

3. The cash book of Rameswari Cloth Store shows `5,325 as the balance at the bank as on 31st December 2008 but you find that this does not agree with the balance as per the bank Pass Book. On scrutiny, you find the following discrepancies.

(i) On 15th December 2008, the payments side of the cash book was, under cast by `20.

(ii) A cheque for `200 issued on 25th December 2008 was recorded in the cash column.

(iii) Of the total cheques amounting to `8,780 drawn in the last week of December 2008, only cheques aggregating `3,960 were encashed in December.

(iv) Of the total cheques amounting to `2,850 deposited for collection, cheques with `1670 are collected in January 2009.

(v) Bank collected a dividend of `250. This has not been entered in the cash book.

Prepare a Bank Reconciliation statement.

{**Hints :** Add : (iii) ` 4820 and (v), Less : (i), (ii) and (iv) `1670}

[**Ans.** Balance as per pass book `8,505]

4. From the following particulars as certain the balance in the cash book of Souri Prasad as on 31st March 2008 by preparing a reconciliation statement credit.

(i) Balance as per pass book `4,980.

(ii) Cheques drawn but not cashed by the customer prior to 31st March 2008 `1270.

(iii) Cheques paid into bank but not collected before 31st March 2008 ` 2320.

(iv) A cheques for `650 entered into the cash book was omitted to be banked.

(v) Bank has debited `15 as collection charges on outstation cheques but not yet entered in cash book.

[**Ans.** Balance as per pass book `6,695]

{**Hints :** Add (iii), (iv), (v) and deduct (ii)]

5. The following particulars relate to the business of Jitendra Prasad who requires you to reconcile his pass book balance with his cash book balance.

(a) Balance as per pass book `1860 (Cr)

(b) Cheques drawn but not yet credited `420.

(c) Cheques deposited but not yet credited`630.

(d) Life insurance premium paid by bank not recorded in the cash book `140.

(e) Bills discounted with the bank but dishonoured `350.

(f) Interest allowed by the bank not entered in the cash book `130.

[**Ans.** Balance as per pass book`2,430]

{**Hints :** Add (c) (d) (e) and deduct (b) (f) from the balance as per pass book).

6. At the end of the year 2008, Mr. Suvam Sahu's pass book showed a balance of `2837.65. On comparing the same with his cash book, he discovered the following discrepancies.

(a) Cheques amounting `1280.85 had been deposited towards the close of the year `460.30 of which were cleared in January next.

(b) He had issued cheques worth `860.75 on 30th December of which cheques for `245.60 were presented for payment in January.

(c) The bank has credited his account with `125.80 as interest and has debited him with `18 as collection charges.

(d) Dividend collected by the bank and recorded in the pass book only ` 260.50.

Prepare a Bank Reconciliation Statement as on 31st December 2008.

[**Ans.** Balance as per pass book `2,684.05]

7. On 31st December 2008 the cash book of Mr. Toni showed an unfavourable balance of `36,000 with the state bank of India. This balance did not agree with the balance as shown by the bank pass book. On scrutiny, the following facts were noted.

(a) Mr. Toni had paid into the bank on 28th December 2008 three cheques for `45,000, `9,000 and `6,000, of these the cheque for `9,000 was credited by the bank in January 2009.

(b) He had issued on 25th December cheques totalling `28,000, out of these only cheques for `18,000 had been presented for payment till 31st December 2008.

(c) Interest on overdraft for six months ending on 31st December 2008 amounts to `720.

(d) Bank has debited `180 as collection charges on outstation cheques which is not recorded in cash book.

[**Ans.** Overdraft as per pass book `35,900]

8. From the following particulars, as certain the balance by means of a Bank Reconciliation Statement that would appear in the pass book of M/s Dibakar Suppliers as on 31st March 2008.

(i) Overdraft as per cash book `8,350 on 31st March 2008.

(ii) Cheques drawn but not cashed by customer prior to 31st March 2008, `3,920.

(iii) Cheques deposited but not collected before 31st March 2008 `2,860.

(iv) Interest on Debentures `500 collected directly by bank yet taken in cashbook.

(v) Interest on overdraft debited by bank `400.

(vi) Mr. Mahesh Chand a customer, has directly deposited in our account - `3,900.

[**Ans.** Overdraft as per pass book ` 3,290]

9. The following facts were extracted as at 31st March 2008 from the books of Sri R.K. Sahu. Balance as per pass book ` 2,860 (Dr.)

(i) Cheques issued to suppliers `1,080 in March 2008 not yet presented for encashment.

(ii) Cheques paid into bank ` 820 not yet cleared.

(iii) Cheques received from customers ` 1520 not yet sent to bank for collection.

(iv) Collection charges debited by bank ` 80.

(v) According to the standing order of Sri Sahu bank has paid the following :

Insurance premium	`200
Rent	`300
Interest	`480

[**Ans.** Overdraft as per pass book `540]

10. Pass Book of Bhahani Shankar showed a debit balance of `12,360 on 31.12.08. Find out the cash book balance by preparing BRS from the following information as on 31.12.08.

(i) Uncredited cheques `3,850.

(ii) Interest on securities collected by the bank but not recorded in cash book `870.

(iii) Cheques not presented for payment `2,750.

(iv) Cheques issued returned back on account of technical grounds `660.

(v) Biils directly collected by bank ` 420.

[**Ans.** Overdraft as per pass book `13,150]

5.12 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER – 6 FINAL ACCOUNTS: DETERMINATION OF BUSINESS INCOME AND FINANCIAL POSITION

Chapter Outlines

6.0 INTRODUCTION

The main motive of running a business is to earn profit. Owner of a business is interested to know periodically the success of his business. Accounts are maintained to measure the degree of success at the end of each accounting period. Transactions are recorded in journal, posted to the respective ledger accounts and balances are taken to the Trial Balance to check the arithmetical accuracy of books and accounts. Finally, summary statements are prepared to ascertain the net result of the business at the end of the year. Such summary statements are conventionally termed as "Financial Statements" or "Final Accounts".

6.1LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Understand the meaning, objectives and composition of Financial Statements.
- Know the Closing Entries
- Understand and prepare Manufacturing Account
- Understand and prepare Trading Account
- Understand and prepare Profit and Loss Account
- Understand and prepare Balance Sheet
- Know the order of Arrangement of Assets and Liabilities in Balance Sheet.

6.2 TRADING ACCOUNT

In Trading Account, sales revenues are compared with cost of goods sold.

Cost of Goods Sold or Marchandising Cost:

The main activity of a trading firm is purchase and sale of goods. Goods are first purchased from producers, brought to the godown by spending direct expenses like freight, octroi, cartage etc. Sometimes, the total goods purchased may not be sold during the current accounting year. The value of unsold goods becomes the closing stock at the end of the year. The closing stock of one year becomes the opening stock for the next year.

Cost of goods sold or merchandising cost will be calculated as follows:

Opening stock of goods		xxxx
Add : Goods purchased		xxxx
(cash purchase + credit purchase – returns)		
Add : Direct expenses :		
Wages	xxx	
Carriage inward	xxx	
Freight inward	xxx	
Octroi	xxx	xxxx
Less : Closing stock of goods		xxxx
Cost of Goods Sold		xxxx

Cost of goods sold = Opening stock + Purchases + Direct expenses – Closing stock.

Here, **Direct expenses =** Wages + Carriage inward + Freight inward + Octroi.

Note : The expenses incurred to bring the goods from the place of purchase to the place of sale are called direct expenses.

Illustration - 6.1

Mr. B. Tripathy had a stock of goods worth `18,000 on 1st January 2002. During the year he purchased goods worth ` 35,000 for cash and ` 28,000 on credit. He paid `6000 as freight and ` 4000 as carriage on goods purchased. On 31st December 2002, he had unsold goods worth `12,000. Calculate cost of goods sold.

Solution :

Cost of goods sold = Opening stock + Purchase + Direct expenses – Closing stock.

Here, Total purchases = Cash purchases + Credit purchases

= ` 35,000 + ` 28,000 + ` 63,000

Direct expenses = Freight + Carriage = ` 6000 + ` 4000 = `10,000.

Hence, cost of goods sold = `18,000 + ` 63,000 + ` 10,000 – `12,000 = ` 79,000.

Illustration - 6.2

From the following particulars of Mr. Gupta, calculate cost of goods sold.

	`
Stock on 1.1.2002	24,000
Cash purchases	50,000
Credit purchases	62,000
Carriage inward	10,000
Carriage outward	8,000
Return outward	2,000
Freight inward	15,000
Wages	20,000
Closing stock	22,000

Solution:

Cost of goods sold = Opening stock + Purchase + Direct expenses – Closing stock.

= ` 24,000 + (50,000 + 62,000) + (10,000 + 15,000 + 20,000) – 22,000 = `1,59,000.

Note : Carriage outward is an indirect expenses. So it is not included.

6.2.1 Purpose of Trading Account

It is an account prepared at the end of an accounting period to know the net result of a business from trading, i.e., buying and selling of goods. It shows gross profits or gross loss of a business from its trading activities. It is a nominal account in which sales revenues are compared with the cost of goods sold. The sales revenues representing net sales is credited to this account whereas cost of goods sold is shown on the debit side. If net sales are more than the cost of goods sold, it shows gross profit. In case, net sales are less than the cost of goods sold, trading account shows gross loss.

6.2.2 Features of Trading Account

1. It is prepared at the end of an accounting period.
2. It shows gross profit or loss from the buying and selling of goods.
3. It is a nominal account.
4. Net sales is shown on the credit side and cost of goods sold on the debit side.
5. The balance of this account is transferred to Profit and Loss Account.
6. It is prepared before the preparation of Profit and Loss Account.

Need and Importance of Trading Account

The main purposes of preparing Trading Account are as follows:

(i) **To determine gross profit or gross loss:** Trading Account is prepared to provide information about the gross profit earned or gross loss suffered by the business during a particular accounting period.

(ii) **To know the trading performance:** Trading Account shows the trading performance of the business, i.e., the result of buying and selling of goods and services.

(iii) **To know the profitability:** The relationship between gross profit and sales shows the general profitability of a business.

(iv) **To provide control over purchase, direct expenses and sales:** Trading Account shows the purchases, direct expenses and sales of goods during a particular period. These items can be analysed and compared with previous years to know the changes and to exercise control over them.

(v) **To forecast the future performance:** The gross profit of the current year and previous years can be taken as the base to estimate the gross profit to be earned during next accounting period. The helps the business to know the future performance.

6.2.3 Preparation of Trading Account

The main principle for the preparation of Trading Account is to match the cost of goods sold against net sales. The calculation of cost of goods sold has already been discussed. Net sales represent cash sales plus credit sales minus sales return or return inwards. Where a separate manufacturing account is not prepared, all the manufacturing expenses such as coal, gas, water, power, oil, lighting and heating, consumable stores etc. are also debited to Trading Account. Usually closing stock is shown on the credit side of Trading Account instead of deducting it from cost of goods sold on the debit side.

Gross Profit: Gross profit represents the excess of net sales over the cost of goods gold. It is shown on the debit side of Trading Account and transferred to the credit side of Profit and Loss Account.

Gross Profit: Net sales – Cost of goods sold.

Gross Loss = Cost of goods sold – Net sales.

Net Sales = Cash sales + Credit sales – Return inward

Cost of Goods sold = Opening stock + Purchases + Direct expenses – Closing stock.

Illustration - 6.3

Calculate gross profit or gross loss from the following information.

	`		`
Opening stock	12,000	Wages	15,000
Cash sales	45,000	Freight	10,000
Credit sales	55,000	Carriage inward	6000
Return inward	5000	Carriage outward	5000
Return outward	8000	Octroi	2000
1Cash purchase	25,000	Closing stock	24,000
Credit purchases	38,000		

Solution :

Here, Net sales = Cash sales + Credit sales – Return inward

= ` 45,000 + ` 5000 = ` 95,000.

Cost of goods sold = Opening stock + Purchase – Return outward + Direct expenses – Closing stock.

= ` 12,000 + (25,000 + 38,000 – 8000) + (15,000 + 10,000 + 6,000 + 2000) – 24,000

= ` 12,000 + `55,000 + ` 33,000 – ` 24,000 = `76,000.

Since net sales is more than cost of goods sold, the balance will be gross profit.

Gross profit = Net sales – Cost of goods sold.

= `95,000 – ` 76,000 = ` 19,000.

Specimen of Trading Account:

Trading Account is prepared in 'T' form. As it is prepared for a particular accounting period, its heading is written as "Trading Account for the year ended 31st .... 20 ....". It has two columns in each side named particulars column and amount column. The form of Trading Account showing various items which usually appear on the two sides is given below.

Trading Account on M/s ....

for the year ended .... 20......

	Particulars	Amount `	Amount `		Particulars	Amount `	Amount `
To	Opening stock		xxxx	By	Sales	xxxx	
To	Purchases	xxxx			(cash and credit)		
	Less : Purchase returns	xxx	xxxx		Less : Sales returns	xxx	xxxx
To	Manufacturing wages		xxxx				
To	Carriage / freight inward		xxxx	By	Closing stock		xxxx
To	Factory expenses		xxxx				
To	Consumable stores		xxxx				
To	Motive stores		xxx				
To	Coal, gas and water		xxx				
To	Lighting and Heating		xxx				
To	Octroi		xxx				
To	Dock charges		xxx				
To	Royalties on production		xxx				
To	Import duty		xxx				
To	Cleaning charges		xxx				
To	Gross Profit (transferred to P & L Account)		xxxx	By	Gross Loss (transferred to P & L Account)		xxx
			xxxx				xxxx

Items shown on the Debit side of Trading Account

1. Opening Stock: It is the closing stock of previous year. It is entered by passing an opening entry in the beginning of the year. So it always appears in the trial balance. It is shown as the first item on the debit side of trading account. In case of new business, there will be no opening stock.

2. Purchases: The Purchases account (debit balance) will show the gross amount of purchases of goods. The purchases returns account (credit balance) will show the return of goods to the supplier. The actual purchase or net purchase is "purchases less purchase returns".

Sometimes, 'adjusted purchases' is given in the trial balance which means both opening and closing stock are adjusted in purchases. In that case 'adjusted purchases' is shown on the debit side of the trading account. So closing stock need not be shown on the credit side of trading account as it has already been adjusted.

3. Buying Expenses: These expenses are incurred from the time goods are purchased till they reach at the godown or factory. The various buying expenses appear as debit balances in the trial balance. These are shown on the debit side of trading account. These expenses include, (a) freight, (b) carriage inwards, (c) coolie and cartage, (d) excise duty and import duty, (e) dock charges, clearing charges, octroi etc. These are otherwise called direct expenses.

4. Factory Expenses: All these expenses are incurred for running a factory. These include factory lighting and heating, factory insurance, factory rents and rates etc. where a separate manufacturing account is not prepared, these expenses are debited to trading account.

5. Manufacturing Expenses: These expenses are incurred in the process of conversion of raw materials into finished product or rendering goods in saleable condition. These expenses include motive power, coal, coke, gas, water, grease, royalities, foreman and supervisor's salary etc. where a separate manufacturing account is not prepared, these expenses are shown on the debit side of trading account.

Items shown on the Credit Side to Trading Account

1. Sales: The Sales Account (credit balance) indicates the total sales (cash and credit) made during the year. The sales return account (debit balance) shows the total amount of goods returned by customers. Net sales, i.e., 'sales' less sales returns' are shown on the credit side of Trading Account.

2. Closing Stock: This represent the value of unsold goods lying in stock at the end of the year. It is valued at cost or market price whichever less is. The cost price of unsold goods is determined by taking the physical quantity at the end of the period and multiplying it with the cost price per unit. Proportionate manufacturing expenses and factory expenses, if incurred, will be added to determine the value of closing stock. It is compared with the market price and the lowest of the cost and market price is taken as the value of closing stock.

- Usually, closing stock is given outside the trial balance, because its value is determined after the preparation of trial balance. In that case, it is shown on the credit side of trading account in order to find out cost of goods sold. The entry is :

  Closing Stock A/c Dr.
  To Trading A/c

- Where closing stock is given in the trial balance, it means it has already been adjusted in purchase account by passing the following entry :

  Closing Stock A/c Dr.
  To Purchase A/c

In this case, it is not shown on the credit side of trading account but appears on the asset side of balance sheet.

Note: Sales Tax : Sales tax is an indirect tax in the sense that it is collected by the seller from the customer and deposited in the Government's A/c as per requirements of the Sales Tax Act. Therefore, sales tax is generally deducted from gross sales figures and the sales tax liability is shown as current liability in the Balance Sheet.

6.2.5 Closing Entries relating to Trading Account

Nominal accounts are opened for one accounting period, and at the end of every year, these accounts are closed by transferring them to Trading, Profit and Loss Account. The entries which are passed to close the nominal accounts are called closing entries.

1. ***For items shown on the debit side of trading account and sales return:***

   Trading Account Dr
   To Opening stock A/c
   To Purchases A/c
   To Sales Return A/c
   To Wages A/c
   To Freight A/c
   To Carriage A/c

Note : Sales return is an item on the debit side of Trading Account. Usually, it is deducted from sales instead if showing it on the debit side. Alternatively, we can close sales return account by transferring it to sales account. The entry will be :

Sales A/c Dr
To Sales Return A/c

2. ***For items shown on the credit side of Trading Account :***

Sales A/c Dr
Purchase Return A/c Dr
Closing Stock A/c Dr
To Trading Account

Note: Purchase return is an item on the credit side of Trading Account. Usually it is deducted from purchase instead of showing it on the credit side. Alternatively, we can close purchase return account by tra nsferring it to purchase account. The entry is :

Purchase Return A/c Dr
To Purchase A/c Dr

3. ***For closing Trading Account:***

(a) If trading account shows gross profit :
Trading Account Dr
To Profit & Loss A/c

(b) If trading account shows loss :
Profit & Loss A/c Dr
To Trading Account

Illustration - 6.4 :

Following are the balances drawn from the books of Mr. at the end of 2002. Pass the necessary closing entries.

	`		`
Sales	45,000	Return outward	800
Purchases	26,000	Freight	1,800
Opening stock	15,000	Wages	6000
Return inward	1400	Carriage on purchases	200
Closing stock	7500		

Solution :

In the books of Mr.

Journal

Date 2002	Particulars		L.F.	Debit `	Credit `
Dec. 31	Return outward A/c To Purchase A/c (Being return outward account closed by transfer to purchase account)	Dr		800	800
Dec. 31	Sales A/c To Return inward A/c (Being return inward account closed by transfer to sales account)	Dr		1400	1400

Date	Particulars		Debit	Credit
Dec. 31	Trading Account	Dr	49,000	
	To Opening stock A/c			15,000
	To Purchases A/c			26,000
	To Wages A/c			6000
	To Freight A/c			1800
	To Carriage on purchases A/c			200
	(Being the various accounts closed by transfer to trading account)			
Dec. 31	Sales A/c	Dr	45,000	
	Closing stock A/c	Dr	7500	
	To Trading Account			52,000
	(Being the accounts showing credit balances closed by transfer to Trading Account)			
Dec. 31	Trading Account	Dr	2900	
	To Profit & Loss Account			2900
	(Being gross profit transferred to Profit and Loss Account)			

Illustration - 6.5 :

Prepare Trading Account of Mr. Prabhu from the following balances for the year ended 31st December 2002.

	₹		₹
Stock on 1.1.2002	15,000	Clearing charges	450
Purchases	36,000	Power	1000
Sales	78,000	Freight	800
Purchases return	1000	Coal, gas and water	1200
Sales return	3000	Factory expenses	1600
Productive wages	12,000	Import duties	2500
Carriage inward	2550	Discount on purchases	1650
Octroid	200	Stock on 31.12.2002	18,500

Solution :

Trading Account of Mr. Suresh Prabhu for the year ended 31st December 2002.

	Particulars	Amount			Particulars	Amount	
		₹	₹			₹	₹
To	Opening stock		15,000	By	Sales	78,000	
To	Purchases	36,000			Less : Return inward	3000	75,000
	Less : Return outward	1000	35,000	By	Closing stock		18,500
To	Productive wages		12,000				
To	Carriage inward		2500				
To	Freight		800				
To	Factory expenses		1600				
To	Power		1000				
To	Coal, gas and water		1200				
To	Octroi		200				
To	Import duty		2500				
To	Clearing charges		450				
To	Gross Profit (transferred to P & L Account)		21,250				
			93,500				93,500

Note : Discount on purchases is an indirect income. It is the cash discount received from the purchase of goods.

6.3 MANUFACTURINGACCOUNT

A manufacturing concern prepares 'Manufacturing Account' in addition to Trading and Profit and Loss Account. Where a separate Manufacturing Account is prepared. Trading Account will contain only those items which are related to the purchase and sale of finished goods. The opening and closing stock, purchases, sales and return of finished goods will form the part of Trading Account in addition to the cost of production transferred from Manufacturing Account. The opening stock of finished goods, cost of production and purchases (if any) are debited where as sales and closing stock of finished product are credited to Trading Account. The specimen to Trading Account of a manufacturing organisation will be as under:

Trading Account of a Manufacturing Organisation
for the year ended 31st .... 20 ....

	Particulars	Amount	Amount	Particulars	Amount	Amount
		`	`		`	`
To	Opening stock (finished goods)		xxxx	By Sales (finished goods)	xxxx	
To	Purchase (finished goods)	xxxx		Less : Return inward	xxxx	xxxx
	Less : Return outward	xxxx	xxxx	By Closing stock of		xxxx
To	Cost of production			finished goods		
	(as per manufacturing account)		xxxx			
To	Gross Profit		xxxx	By Gross Loss		xxxx
	(transferred to P & L Account)			(transferred to P & L Account)		
			xxxx			xxxx

6.3.1 *Advantages of Trading Account*

Following are the main advantages of Trading Account:

(i) It helps in the preparation of Profit and Loss Account.

(ii) It shows the rate of gross profit earned on sales which is useful in studying the trading performance of the business.

(iiii) The percentage of average stock on sales helps in measuring the rate of stock turnover during the year.

(iv) The relation between cost of goods sold and sales helps in deciding whether expenses have been incurred judiciously.

(v) The future selling price can be adjusted if the expected rate of gross profit is not being earned.

6.4 PROFITAND LOSS ACCOUNT

After preparation of Trading Account, the next step is the preparation of Revenue Account or Profit and Loss Account. The main object of Profit and Loss Account is to ascertain net profit or net loss, i.e., net results of the business operations. In other words, it shows financial performance of a business.

Profit and Loss Account is a nominal account. It is debited with all indirect expenses and losses and credited with gross profit and all indirect incomes and gains. The difference between the two sides is either net profit or net loss. If the total of the credit side is more than the total of the debit side, the result is net profit, in case, the debit side exceeds the credit side, it represents net loss. The net profit is added to the capital and net loss is deducted from it.

Format of Profit and Loss Account

Profit and Loss Account is prepared for a particular accounting period generally for one year. Hence, its heading is written as "Profit and Loss Account of M/s .... for the year ended 31st .... 20 ....". Like Trading account, it is prepared in 'T' form with similar columns on each side. These columns are :

(a) particulars, and (b) amount.

Profit and Loss Account of M/s ....
for the year ended ....

Particulars	Amount	Particulars	Amount
	`		`
To Gross Loss b/d*	xxxx	By Gross Profit b/d*	xxxx
To Salary (salaries and wages)	xxxx	By Rent received	xxxx
To Rent, Rates and Taxes	xxxx	By Discount received	xxxx
To Printing and Stationery	xxxx	By Commission received	xxxx
To Postage and Telegrams	xxxx	By Interest received	xxxx
To Telephone, Telex and Fax	xxxx	By Dividend received	xxxx
To Insurance Premium	xxxx	By Income from Investment	xxxx
To Legal charges	xxxx	By Apprentice Premium	xxxx
To Trade expenses	xxxx	By Bad debts recovered	xxxx
To Entertainment expenses	xxxx	By Interest on Drawings	xxxx
To Charity and Donations	xxxxx		
To Audit Fees	xxxx		
To Office expenses	xxxx		
To Establishment expenses	xxxx		
To Live stock expenses	xxxx		
To Office lighting	xxxx		
To Licence fees	xxxx		
To Bank charges	xxxx		
To Discount allowed	xxxx		
To Interest on capital	xxxx		
To Interest on loan	xxxx		
To Sales men salary and commission	xxxx		
To Freight / carriage outward	xxxx		
To Packaging expenses	xxxx		
To Export Duty	xxxx		
To Advertising and marketing expeses	xxxx		
To Travelling Expenses and conveyance	xxxx		
To Godown rent/ Warehouse charges	xxxx		
To Delivery van expenses	xxxx		
To Promotional expenses / free samples	xxxx		
To Repairs and renewals	xxxx		
To Brokerages and commission	xxxx		
To Bad debts	xxxx		
To Depreciation	xxxx		
To Provision for Bad debt	xxxx		
To Loss of goods by fire / theft	xxxx		
To Loss on sale of fixed assets	xxxx		
To Manager's commission	xxxx		
To Net Profit**(transferred to capital account)	xxxx	By Net Loss** (transferred to capital account)	xxxx
	xxxx		xxxx

Note:

The items included in the above profit and loss account are illustrative in nature and not exhaustive. Even though the exact number and name of items to be included will vary from firm to firm, the principle on the basis of which the profit and loss account is prepared, remains unchanged.

Explanation of certain items of Profit and Loss Account:

1. **Salaries or 'Salaries and wages':** Salaries represent the remuneration paid to the employees working in the office. It is debited to profit and loss account being indirect expenses. The term wages is used here to represent the amount paid to workers who are not directly engaged in production, e.g., payment to sweepers and messengers. Such wages are indirect expenses. They may be given separately or clubbed with salaries and shown as "Salaries and Wages'. It is taken to Profit and Loss A/c.

Note : "Wages and Salaries" is debited to Trading Account (or Manufacturing A/c) Here the term 'Wages' represents the remuneration paid to workers who are directly engaged in the production of goods. The term 'salaries' represents the remuneration paid to supervisors, foremen and work managers. Thus, "Wages and Salaries" are treated as direct expenses.

2. **Rent:** Rent on office building, show room, godown or warehouse are shown on the debit side of profit and loss account.
3. **Rates and Taxes:** There are levied by local authorities like Notified Area Council, Municipality and Metropolitian corporation.
4. **Trade expenses:** These are otherwise called sundry expenses, general expenses or miscellaneous expenses. The expenses included in trade expenses are small in amount and therefore separate accounts are not opened for them. These are shown as indirect expenses.
5. **Insurance Premium :** Insurance premium paid on office building, office furniture, showroom or insurance on goods sent etc, are treated as indirect expenses and debited to Profit and Loss Account.
6. **Depreciation :** Depreciation is the reduction in the value of a fixed asset due to wear and tear or use over time. It is calculated as a fixed percentage on the value of the fixed asset as appearing in the beginning of the year or on the date of its acquisition.
7. **Live Stock Expenses:** These are the expenses relating to maintenance of animals like fodders and medication and wages paid to the animal keeper. These are debited to profit and loss account as indirect expenses.
8. **Discount :** Discount allowed (cash discounts for prompt collection of dues) is treated as indirect expenses and debited to profit and loss account. However, discount received is an income and is credited to profit and Loss Account.
9. **Commission and Brokerage:** Sometimes to enhance sales turnover, the agents are appointed and are paid commission as a percentage on their sales as their remuneration. Likewise to transact securities and real estate business, the brokers are engaged on percentage basis and their charges are known as brokerage. These are indirect expenses of the business and are debited to profit and loss account. However, if commission and brokerage is received by the business for rendering services, it is credited to profit and loss account.
10. **Bank Charges:** These are the charges debited by bank for providing various services like DD/TT/MT commission, incidental charges, bills collection charges, processing fees etc. These are the indirect expenses and debited to profit and loss account.
11. **Interest:** Interest paid on capital or on bank loans or institutional finances or on borrowings from any other sources are indirect expenses which are debited to profit and loss account. But interest received is an income and credited to profit and loss account.
12. **Printing and Stationery:** It includes expenses on printing of books of accounts, bills, invoices, letter pads, paper, pen, file and other items of stationery. It is charged to debit side of Profit and Loss Account.
13. **Bad debts:** When a debtor (who purchased goods on credit) fails to repay the amount, the debt is called bad debt. As it is a loss, it is charged to Profit and Loss Account.
14. **Abnormal Losses:** There are some abnormal losses whcih may occur during the accounting period. These include goods lost by fire or theft and not covered by insurance, loss on sale of equiment and mechinery, cash defalcation etc.
15. **Apprentice premium:** Some business firms provide training to workers on various trades. Apprenticeship premium is the fees charged by the business firm from the trainees. As it is an income, it is credited to Profit and Loss Account.

Items not shown in Profit and Loss Account

Following expenses relating to the proprietor of a business are not shown in profit and loss account.

1. **Life Insurance Premium:** If an insurance policy is taken on the life of either the propritor of his dependants, the premium paid out of business cash is not treated as business expenses but as drawings by the proprietor. So any life insurance premium paid is not to be debited to profit and loss account. It should be debited to Drawings account which will be adjusted against his capital.
2. **Income Tax:** Income tax charged by Income tax authorities on the business income is a business expense and is charged to Profit and Loss account. However, if any income tax is paid by the business on the income of the proprietor, it should be debited to his drawings account and not the profit and loss account.
3. **Domestic Expenses :** All the household expenses of the proprietor such as payment of personal telephone bill, marriage expenses, children's education expenses etc, are not to be treated as business expenses and should not be debited to profit and loss account. Rather, these should be debited to drawings account.

REMEMBER

Item	Debit to P & L Account	Credit to P & L Account
Rent :	Rent (Dr.) Paid	Rent (Cr.) Received
Discount :	Discount (Dr.) Allowed	Discount (Cr.) Received
Commission :	Commission (Dr.) Paid	Commission (Cr.) Received / Earned
Interest :	Interest (Dr.) Paid	Interest (Cr.) Received / Earned
Interest of owner :	Interest on Capital	Interest on Drawings
Bad debt :	Bad debts	Bad debts recovered

6.4.1 Closing Entries relating to Profit and Loss Account

In order to show various expenses, losses and incomes in profit and loss account, it is necessary to close them in the ledger by passing closing entries. All nominal accounts representing expenses and losses are closed by debiting to the profit and loss account and crediting the individual expense accounts. Similarly, all indirect income accounts are closed by crediting to profit and loss account. Since profit and loss account is a nominal account, it is also closed by transferring its balance (i.e., net profit or net loss) to the capital account.

Following are the closing entries relating to profit and loss account:

(1) For closing various indirect expenses and losses accounts:

Profit and loss account Dr.
  To Salary A/c
  To Rent A/c
  To Discount A/c
  To Printing and Stationery A/c
  To Commission A/c
  To Interest A/c
  To Depreciation A/c etc.

(2) For closing various indirect incomes accounts :

Rent Received A/c Dr
Dividend Earned A/c Dr
Discount Earned A/c Dr
Commission Earned A/c Dr
Bad debts Recovered A/c Dr
Apprentice Premium A/c Dr

    To Profit and Loss Account

(3) For closing profit and loss account :

(a) If it shows credit balance (i.e., net profit)
Profit and Loss Account Dr

    To Capital A/c Dr

(b) If it shows debit balance (i.e., not loss)
Capital A/c Dr

    To Profit and Loss Account

Illustration - 6.6 :

From the following balances extracted from the books of M/s Raj Motors on 31st December, 2002, pass necessary closing entries and prepare profit and loss account.

	`
Trading account (Cr.)	29,000
Salaries	3,200
Discount (Dr.)	700
Trade Expenses	300
Bank charges	250
Interest on Investment	750
Warehouse rent	800
Advertising	650
Dividend received	350
Audit fees	200
Delivery van expenses	400
Carriage outward	250
Income tax	500

Solution :

Closing Entries :

Date 2002	*Particulars*		*L.F.*	*Debit* `	*Credit* `
Dec. 31	Trading Account	Dr		29,000	
	To Profit and Loss A/c				29,000
	(Being trading account closed by transferring gross profit to Profit and Loss A/c)				
Dec. 31	Profit and Loss A/c	Dr		6750	
	To Salaries A/c				3200
	To Discount A/c				700
	To Trade Expenses A/c				300

	To Bank charges A/c			250
	To Warehouse rent A/c			800
	To Advertising A/c			650
	To Audit fees A/c			200
	To Delivery van Expenses A/c			400
	To Carriage outward A/c			250
	(Being various accounts showing debit balance closed by transferring to Profit and Loss A/c			
Dec. 31	Interest on Investment A/c	Dr	750	
	Dividend Received A/c	Dr	350	
	To Profit and Loss A/c			1,100
	(Being various accounts showing credit balances closed by transferring to Profit and Loss A/c)			
Dec. 31	Profit and Loss A/c	Dr	23,250	
	To Capital A/c			23,250
	(Being the net profit transferred to Capital Account)			

Profit and Loss Account of M/s Raj Motors for the year ended 31st December, 2002.

Particulars	Amount `	Particulars	Amount `
To Salaries	3,2000	By Gross Profit b/d	29,000
To Discount	700	By Interest on Investment	750
To Trade Expenses	300		350
To Bank Charges	250		
To Warehouse Rent	800		
To Advertising	650		
To Audit fees	200		
To Delivery van expenses	400		
To Carriage outward	250		
To Net profit (transferred to capital account)	23,350		
	30,100		30,100

Note: It has been assumed that the income tax paid is on the income of the proprietor and not on the income of the business.

6.5 BALANCE SHEET

Balance sheet is a summary statement which shows the financial position of a business on a particular date. It is also a Statement of Financial Position. Financial Position refers to the position of a business in terms of what it owns i.e., assets and what it owes to outsiders and the owner, i.e., liabilities and capital. Excess of assets over liabilities to outsiders represents the capital and is indicative of the financial soundness of a business.

6.5.1 Features of a Balance Sheet

(i) It is a statement and not an account. It has no debit side or credit side.

(ii) It is prepared only after the preparation of Profit and Loss Account.

(iii) It is usually prepared on the last day of the year by taking into account real and personal accounts existing in the trial balance.

(iv) It shows the Financial Position of a business in terms of what it owns (assets) and what it owes (liabilities) on a particular date. It is not prepared for a particular period.

(v) It reveals the Financial Position (or health) of the business and not of the owner.

(vi) The Financial Position as disclosed by a Balance sheet holds good at a given date, i.e., on the date of preparation. On the next day, the Financial Position may change.

(vii) Both the sides of a balance sheet should always agree. If it is not, there are certainly some errors.

Need and Importance of Balance Sheet

The main functions preparing a Balance Sheet are as follows:

(i) To know the nature and value of assets: The Balance Sheet shows the nature and value of the resources/ assets of a business as on a particular date.

(ii) To ascertain the nature and amount of liabilities: The Balance Sheet shows the nature and amount of liabilities, i.e., what the business owes on a particular date.

(iii) To know the capital: The Balance Sheet shows the capital which is the owners' claim on the business as on a particular date.

(iv) To show the health of the business: The Balance Sheet shows the financial position or health of a business as on a particular date.

6.5.3 Preparation of Balance Sheet

Balance Sheet is prepared after the preparation of Trading and Profit and Loss Account. As mentioned earlier, all nominal accounts are shown in Trading and Profit and Loss Accounts. The remaining accounts in the Trial Balance represent real and personal accounts which are taken to Balance Sheet. All real and personal accounts showing debit balances represent assets and are shown on the right hand side of the Balance Sheet called Asset side. Similarly, all the personal accounts having credit balances represents liabilities and are shown on the left hand side called Liabilities side. The net profit as shown by the Profit and Loss Account is added to the capital on the liabilities side. In case Profit and Loss Account shows net loss, it is to be deducted from capital, Drawings made by the proprietor are also deducted from capital.

Note: In India, we follow the British style of preparation of Balance Sheet, i.e., liabilities in the left side and assets in the right side. But in U.S.A. and Australia, the style is just the reverse, i.e., assets are shown in the left side and liabilities in the right side.

Format of Balance Sheet

Balance Sheet is prepared in 'T' form having two columns on each side. The left hand side of Balance Sheet represents liabilities and their amount where as assets and their amounts are shown on the right hand side. The various assets and liabilities are shown in the Balance Sheet without the word 'To' or 'By'. It is because of the fact that the Balance Sheet is a statement but not an account. Balance Sheet is prepared on a particular date, i.e., on the last day of the year. It is not meant for a particular period.

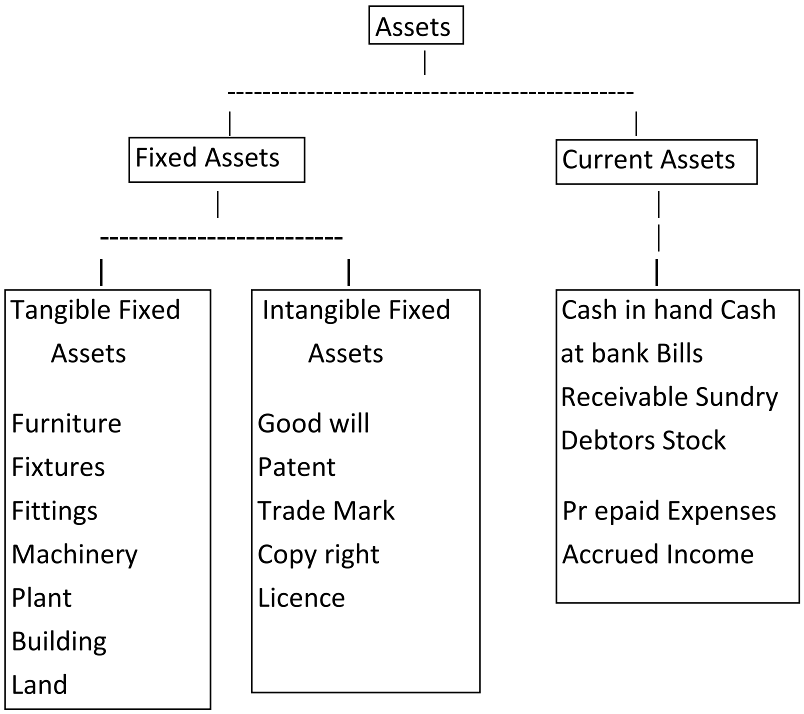
Balance Sheet of M/s ....

As on 31st .... 20 ....

Liabilities	Amount `	Assets	Amount `

Assets shown in the Balance Sheet:

"Assets are things of value owned." Assets include properties, possessions or rights owned by a business which have monetary value. The various assets shown in the Balance Sheet are classified as under :



Fixed Assets: These assets which are acquired for long term use in the business and not meant for resale are called fixed assets. These assets are used in the business for the purpose of earning revenue. Fixed assets are collectively known as 'Block'. The example of such assets are land, building, furniture, plant and machinery etc. Fixed assets are of two types.

(a) Tangible Fixed assets (b) Intangible Fixed assets

(a) Tangible Fixed Assets: The assets which have particular shape, size and can be seen and touched are known as tangible assets. These are furniture, fixtures and fittings, plant and machinery, building, land etc.

(b) Intangible Fixed Assets: The assets which cannot be seen and touched are called intangible assets. These include goodwill, patent, trademark, copyright, license etc.

1. Current Assets or Circulating Assets: Those assets which are in cash form or can be converted into cash within a short period (normally one accounting year) are called current assets. There are also called circulating assets because these go on changing their form in the ordinary course of business, e.g., from cash to raw materials, raw materials to work-in progress, work-in-progress to finished goods, finished goods to debtors and receivables, and from receivables to cash. Current assets include the following :

(i) Cash in hand (ii) Cash at bank
(iii) Bills receivable (iv) Sundry debtors
(v) Short terms loans and advances.
(vi) Inventories which include the stock of raw materials, work-in-progress, stores and spares and finished goods.
(vii) Prepaid expenses (viii) Accrued incomes

A part of the current assets which can be readily converted into cash without loss of value are known as liquid assets. The liquid assets include cash in hand, cash at bank, bills receivables, sundry debtors and short term loans and advances. The rest of the current assets are less liquid assets which include inventories, prepaid expenses and accrued incomes.

Note: Fictitious Assets: These are not actually assets but shown on the asset side of balance sheet as they show debit balance. They neither help in earning revenues nor have any value. These include preliminary or formation expenses, discount on issue of shares and debentures, etc. These are also called 'imaginar y' assets or value less assets.

6.5.4 Distinction between Fixed Assets and Current Assets

Point of Distinction	Fixed Assets	Current Assets
1. Resources:	Fixed assets are the long term resources of the business.	Current assets represent the short-term resources of the business.
2. Benefits received:	Fixed assets provide benefits to the business for a longer period.	The benefits are received from current assets during one accounting period.
3. Valuation:	Fixed assets are valued at cost less depreciation.	Current assets are valued at cost or market value which ever is less.
4. Profit on Sale:	Profit on sale of fixed assets is a capital profit.	Profit on sale of current assets like inventory is a revenue profit.
5. Circulation:	Fixed assets do not circulate in the business.	Current assets change their form and circulate in the business.
6. Conversion to Cash:	Fixed assets are not usually converted into cash.	Current assets like inventory sundry debtors etc. are usually converted to cash.
7. Intangible Assets:	Fixed assets consist of tangible and intangible assets.	Current assets do not include intangible assets.
8. Examples :	Examples of fixed assets are : Land, Building, Machinery, Furniture, goodwill, patents, etc.	Examples of current assets are : Cash, bank balance, inventory, debtors, bills receivable, etc.

Liabilities shown in the Balance Sheet

The obligation of a business to pay the outsiders and the owner is called as liabilities. Following is the classification of liabilities shown in the balance sheet.

Liabilities

Fixed Liabilities	**Long term Liabilities**	**Curent Liabilities**
Capital	Debentures	Bills Payable
	Long – term loans	Sundry Creditors
		Outstanding Expenses
		Bank Overdraft

1. **Fixed Liabilities:** Those obligations which are required to be paid after a very long period of time, i.e., on the termination of the business are termed as fixed liabilities. The liability to the owner, i.e., capital is a fixed liability.
2. **Long-term Liabilities:** Those liabilities which are not payable within one accounting period are called current liabilities. These include debentures, long-term loans etc.
3. **Current Liabilities:** Those liabilities which are required to be paid out of current assets within one accounting period are called current liabilities. These include bills payable, sundry creditors, short term loans, bank overdraft, outstanding expenses etc.

Note : Contingent Liabilities : Those liabilities which are not actual liabilities at present but may become actual liabilities on the happening of some event which is uncertain these liabilities have two important uncertainties:

(i) Uncertainty about the payment.

(ii) Uncertainty about the amount

These liabilities are not shown as part of the Balance Sheet, but their existence is shown by way of a foot note below the Balance Sheet. Contingent liabilities include the following:

(a) Liability of a case pending in the court: If some other party has filled a case against the firm for some claim, the firm may be liable to pay if the other party wins the case.

(b) Guarantee given by the business for a loan: If the form has stood surety for a loan, it may be liable to pay the amount if the other person fails to pay.

(c) Bills of exchange discounted: If a firm discounted its bills receivable in a bank, it may be liable to pay to the bank if the acceptor of the bill fails to pay.

6.5.5 Distinction between Assets and Liabilities

Point of Distinction	**Assets**	**Liabilities**
1. Meaning :	Assets are the properties owned by the business.	Liabilities are the obligations of the business to outsiders.
2. Application / Source :	It shows the application of the funds of the business.	It shows the sources of funds of the business.
3. Balance :	It always shows a debit balance.	It always shows a credit balance.
4. Side of Balance Sheet :	Assets are shown in the right hand side of the Balance Sheet.	Liabilities are shown in the left hand side of the Balance Sheet.
5. Over statement :	If asset value is overstated, it will result in overstatement of capital and vice versa.	If a liability amount is overstated, it will result in understatement of capital and vice versa.
6. Change :	Due to change in price level, the value of some assets change.	Due to change in price level, the amounts of liabilities do not change.
7. Examples :	Cash, Bank balance, Debtors, Bills Receivables, Inventory, Land and Building, Machinery, Furnuture, etc.	Creditors, Bills Payable, Loans, Outstanding expenses etc.

Arrangement (Marshalling) of Assets and Liabilities

The arrangement of assets and liabilities in Balance Sheet is otherwise called 'Marshalling of Assets and Liabilities'. The various assets and liabilities are required to be shown in Balance Sheet in a particular order. There are two orders of arrangement of assets and liabilities :

(a) Order of liquidity (b) Order of permanence.

(a) Order of liquidity : In liquidity order, assets which are easily convertible into cash are shown first and are followed by assets which are less easily convertible into cash. Similarly, liabilities which are immediately payable are shown first and are followed by other liabilities. This order is usually followed by sole proprietorship and partnership business. The balance sheet in order of liquidity will appear as follows :

Balance Sheet as on ....
(In order of liquidity)

Liabilities	Amount `	Assets	Amount `
Current Liabilities		Current Assets	
Bills payable		Cash in hand	
Sundry creditors		Cash at bank	
Bank overdraft		Bills Receivable	
Outstanding expenses		Sundry debtors	
Long-term Liabilities :		Investment	
Loan from Bank		Closing Stock	
Debentures		Prepaid expenses.	
Fixed Liabilities :		**Tangible Fixed Assets :**	
Capital		Furniture	
		Fixtures	

Motor car
Machinery
Plant
Land and Building
Intangible Fixed Assets :
Patents
Copy right
Trademarks
Licenses
Goodwill

(b) Order of permanence: This is the reverse of the order of liquidity. In the order of permanence, the most permanent assets are shown first followed by less permanent assets. Similarly most permanent liabilities are placed first and are followed by less permanent liabilities. This order is followed by companies. This order of arrangement is shown below.

Balance Sheet as on ....
(In order of liquidity)

Liabilities	Amount `	Assets	Amount `
Fixed Liabilities :		**Intangible Fixed Assets :**	
Capital		Goodwill	
Long-term Liabilities :		Licences	
Debentures		Trademark	
Long term loans		Copy rights	
Current Liabilities :		Patents	
Outstanding Expenses		**Tangible Fixed Assets :**	
Bank Overdraft		Building	
Sundry Creditors		Plant	
Bills payable		Machinery	
		Motor car	
		Furniture	
Current Assets :			
		Prepaid Expenses	
		Closing Stock	
		Investment	
		Sundry Debtors	
		Bills Receivables	
		Cash at Bank	
		Cash in hand	

6.5.6 Distinction between Balance Sheet and Trial Balance :

Points of Distinction	***Balance Sheet***	***Trial Balance***
1. Purpose :	The main purpose of preparing Balance sheet is to show the financial position of a business.	Trial Balance is prepared to check the arithmetical accuracy of books of accounts.

2. Sides :	The two sides of balance sheet are called debit and credit columns.	Trial Balance has two columns called 'Liabilities' and 'Assets' sides.
3. Time :	Balance sheet is prepared at the end of the accounting period, i.e., on the last date of the year.	Trial Balance can be prepared periodically, i.e., monthly, quarterly, half yearly, or annually.
4. Necessity:	The preparation of Balance sheet at the end of the year is compulsory.	The preparation of Trial Balance is not mandatory.
5. Type of Account:	Balance sheet shows only personal and real accounts.	Trial Balance contains all the three types of accounts, i.e., personal, real and nominal.
6. Base:	Balance sheet is prepared from the information given in the Trial Balance.	Trial Balance is prepared from ledger accounts.
7. Order:	Balance sheet is prepared after the preparation of Trading and Profit and Loss Account.	Trial Balance is prepared before the Trading and Profit and Loss Account is prepared.
8. Closing Stock:	The closing stock forms part of the assets shown in the Balance sheet.	Usually, Trial Balance does not contain closing stock.
9. Adjustment items:	Balance sheet takes into account adjustments such as outstanding prepaid expenses, accrued and unearned incomes etc.	Usually adjustment items are not shown in the Trial Balance.

6.5.7 Distinction between Profit and Loss Account and Balance Sheet

Point of Distinction	Profit and Loss Account	Balance Sheet
1. Object :	The objective of Profit and Loss Account is to ascertain net profit or net loss of a business for a particular period.	The objective of Balance sheet is to ascertain financial position of a business on particular date.
2. Nature :	It is a summary account of incomes and expenses for a period.	It is a summary statement of assets and liabilities on a particular date.
3. Side :	Two sides of this account are debit side and credit side.	Two sides of a Balance sheet are asset side and liabilities side.
4. Coverage of accounts :	It is prepared with the balances of nominal accounts.	It is prepared with the balances of personal and real accounts.
5. Equally of two sides :	The two sides of Profit and Loss Account are not equal.	The two sides of Balance sheet must be equal.
6. Sequence of preparation.	It is prepared before preparation of Balance sheet.	It is prepared after preparation of Profit and Loss Account.

6.5.8 Advantages (Merits) of Balance Sheet

Balance Sheet provides information to various interested parties/users for their decision making. The following are the main uses of a balance sheet.

(i) Financial position: Balance Sheet shows the health of financial position of a business as on a particular date.

(ii) Capital: Balance Sheet shows the claims of the owners in the business.

(iii) Ability to pay: Balance Sheet shows the ability of the business to pay current liabilities and long-term liabilities from the resources available.

(iv) Profitability: Balance Sheet helps to establish relationship between profit and investment to know the profitability and profit earning capability of the business.

(v) Efficiency: Analysis of the Balance Sheet helps to know the efficiency of the business organisation in managing its resources / assets.

6.5.9 Limitations (Demerits) of Balance Sheet

Even though Balance Sheet is considered as the most important summary statement to know the health of the business, yet it suffers from the following limitations :

(i) Value of assets: Balance Sheet shows the book value of the fixed assets (i.e., cost of the asset less depreciation) which may not represent the real value of the assets.

(ii) Inflation: Due to inflation, the values of certain assets like land and building increase substantially. Balance Sheet fails to disclose this change in the price level and its impact on the assets.

(iii) Human Resources: Balance Sheet fails to disclose the value of an important resource / asset of the business, known as human resource or employees of the organisation.

(iv) Other Assets: Balance Sheet fails to disclose some other assets of the business like licenses, contracts, dependable customers and suppliers, good location etc.

(v) Fictitious Assets: Sometimes, the asset side of the Balance Sheet contains fictitious or valueless assets like preliminary expenses and advertisement expenses to introduce a new product. The inclusion of these assets unduly increase the total value of assets.

Illustration - 6.7

The following Trial balance was extracted from the books of Mr. X on March 31st 2006. You are required to prepare a Trading Account and Profit and loss account for the year ended March 31, 2006 and a Balance sheet as on that date.

Trial Balance

Particular	Amount (`) Debit	Amount (`) Credit
Debtors	12,000	
Creditors		7900
Capital		30,00
Drawings	2900	
Rent and rates	250	
Trade Expenses	670	
Purchases	8640	
Sales		14,290
Returns Outwards		280
Returns Inwards	190	
Carriage Inwards	250	
Wages	2920	
Salaries	1200	
Stock (1st April 2005)	3100	
Discount received		240
Discount allowed		180
Bad Debts		200
Plant and Machinery		2510
Furniture and Fittings		1810
Cash in Hand		500
Cash at Bank		15,400
Total	**52,710**	**52,710**

Solution :

Trading and Profit and Loss Account For the ending 31st March, 2006.

Particulars		Amount `	Particulars		Amount `
To Opening Stock		3100	By Sales	14,290	
To Purchases	8640		Less : Returns	190	14,100
Less : Returns	280	8360			
To Wages		2920	By Closing Stock		14,220
To Carriage Inwards	250				
To Gross Profit transferred					
to P/L A/c	13,690	28,320			28,320
To Rent and Rates		250	By Gross Profit transferred		
To Trade expenses		670	from Trading Account		13,690
To Salaries		1200	By Discount received		240
To Discount allowed		180			
To Bad Debts		200			
To Net Profit transferred					
to Capital Account		11,430			
		13,930			13,930

Balance Sheet of Mr. X as on 31st March, 2006

Liabilities		Amount (`)	Assets	Amount (`)
Current Liabilities :			**Current Assets :**	
Creditors		7900	Cash in hand	500
Proprietorship :			Cash at Bank	15,400
Owner's Capital	30,000		Debtors	12,000
Add : Net Profit	11,430		Closing Stock	14,220
	41,430		Fixed Assets :	
Less : Drawings	–2,900		Plant and Machinery	2510
		38,530	Furniture and Fittings	1800
		46,430		46,430

Notes :

(i) Return outward (purchases return) has been deducted from purchases at the debit side of Trading Account. In the same way, returns inward has been deducted from sales.

(ii) Carriage inward is a direct expenses.

(iii) Drawings has been shown as deducted from capital at the liabilities side of balance sheet.

(iv) Closing stock belongs to adjustment, so it has been shown at two places, i.e., credit side of Tradi ng Account and asset side.

Illustration - 6.8 :

Prepare Trading and profit and loss account and a Balance sheet as on 31st December 2005 from theunder mentioned Trial Balance Mr. J. Junior. Closing Stock was valued at ` 9,000.

Trial Balance as on 31st December - 2005

Ledger Accounts		Amount Debit (`)	Credit (`)
Opening Stock		10,000	
Purchases and Sales		20,000	40,000
Returns		2000	1000
Discount		1000	2000
Capital and Drawings		5000	65,000
Cash and Bank Overdraft		7000	12,000
Debtors and Creditors		19,000	12,000
Carriage and Cartage		3000	
Freight Outward		4000	
Salaries and wages		6000	
Stationery		4000	
Land and Building		35,000	
Pland and Machinery		15,000	
Fixtures and Fittings		5000	
Bills Receivable and Payable		6000	4000
General Reserve		6000	
	Total	**1,42,000**	**1,42,000**

Trading and Profit and Loss Account
For the year ended 31st December, 2005

Particulars		Amount `	Particulars		Amount `
To Opening Stock		10,000	By Sales		40,000
To Purchases	20,000		Less : Sales Returns	2000	
Less : Purchases Returns	1000			38,000	
		19,000	By Closing Stock		9,000
To Carriage Inwards		3000			
To Gross Profit transferred to P/L A/c		15,000			
		47,000			47,000
To Discount A/c		1000	By Gross Profit transferred from trading account		15,000
To Freight Outward		4000	By Discount		2000
To Salaries and wages		6000			
To Stationery		4000			
To Net Profit transferred to capital A/c		2000			
		17,000			17,000

Balance Sheet of Mr. J. Junior as on 31st December, 2005

Liabilities	Amount `	Assets	Amount `
Bank overdraft	12,000	Cash in hand	7000
Creditors	12,000	Debtors	19,000

Bills payable		4000	Closing Stock	9000
Capital	65,000		Bills receivable	6000
Add : Net profit	2000		Land and Building	35,000
	67,000		Plant and Machinery	15,000
Less : Drawings	(–) 5,000		Fixtures and Fittings	5000
		62,000	General reserve	6000
		96,000		96,000

Notes :

(i) Purchases and sales: The item has been given under one heading. The amount at the debit side is purchases as it has got debit balance. In the same way, the amount appearing at the credit of Trial balance is sales.

(ii) Returns: Purchases have got debit balance. So purchases return will have just the reverse, i.e., credit balance. In this way, `1000 at the credit side of trial balance will be purchases return and will be deducted from purchases at the debit side of Trading account. In the same way, sales return has debit balance. So `2000 appearing at the debit side of Trial balance will be deducted from sales at the credit side of Trading account.

(iii) Discount: Discount allowed has debit balance and discount received has credit balance. In this way, `1000 at the debit side of trial balance is the amount of discount allowed and debited to profit and loss account. `2000, which is the amount discount received, is shown in the credit side of profit and loss account.

(iv) Capital and drawings: Capital account shows credit balance. So `65,000 represents capital. Drawings account shows debit balance. So `5000 is the amount of drawing which shall be deducted from capital at the liabilities side.

(v) Cash and Bank overdraft: Cash as an asset always shows debit balance. So `7000 appearing at the debit side of Trial balance is cash, which will be shown at the assets side. Bank overdraft as a liability, shows credit balance. So it is shown at the liabilities side.

Illustration - 6.9 : Following is the Trial Balance of Ram Prasad as at December 31, 2002.

Debit Balances	`	Credit Balances	`
Adjusted purchases	5,20,000	Capital Account	40,000
Carriage on purchases	800	Loan from Dinesh	15,000
Carriage on Sales	700	Sales	3,65,000
Drawings	2500	Discount	850
Electricity	3200	Sundry creditors	24,000
Salaries	4500		
Buildings	35,000		
Furniture	10,000		
Sundry Debtors	12,000		
Rates and Insurance	1600		
Cash in hand	1270		
Cash at Bank	20,380		
Closing Stock	32,600		
Interest	300		
	6,44,850		6,44,850

Prepare a Trading, Profit and Loss Account for the year ending 31st December 2002 and a Balance sheet as on that date.

Solution:

Trading and Profit and Loss Account of Mr. Ram Prasad for the year ending 31st December 2002.

Particulars	Amount `	Particulars	Amount `
To Adjusted Purchases	5,20,000	By Sales	5,65,000
To Carriage on Purchases	800		
To Gross Profit c/d	44,200		
	5,56,000		5,56,000
To Salaries	4500	By Gross Profit b/d	44,200
To Carriage on Sales	700	By Discount	850
To Electricity	3200		
To Rates and Insurance	1600		
To Net Profit transferred to Capital A/c	34,750		
	45,050,		45,050

Balance Sheet of Mr. Ram Prasad as on 31st December, 2002

Liabilities		Amount `	Assets	Amount `
Creditors		24,000	Cash in hand	1270
Loan from Dinesh		15,000	Cash in Bank	20,380
Capital	40,000		Sundry Debtor	12,000
Add Net Profit	34,750		Closing stock	32,600
	74,750		Furniture	10,000
Less : Drawings	2500	72,250	Buildings	35,000
		1,11,250		1,11250

Illustration - 6.10 :

From the following Trial Balance of Vinary Sahani prepare Trading and Profit and Loss Account for the year ending 31st March 2003 and Balance Sheet as on that date.

Particulars	Dr. (`)	Cr.(`)
Purchases	48,000	
Plant and Machinery	80,000	
Capital Account	–	1,00,000
Sales	–	90,000
Returns	2500	1500
Opening Stock	25,000	–
Discount	800	1000
Salaries	10,200	
Travelling Expenses	400	
Carriage Inward	350	
Carriage outward	250	
Administration Expenses	200	
Trade Expenses	700	
Interest	300	
Buildings	15,000	

Furniture	500	
Debtors and Creditors	3280	4250
Cash in hand	6170	
Bills Receivable	2900	
	1,96,750	1,96,750

Stock on 31st March 2003 is ` 24,500.

Solution:

Trading and Profit and Loss Account of Vinary Sahani for the year ended 31st March 2003

Particulars		Amount	Particulars		Amount
	`	`		`	`
To Opening stock		25,000	By Sales	90,000	
To Purchases	48,000		Less Returns	2500	87,500
Less Returns	1500	46,500	By Closing stock		24,500
To Carriage inward		350			
To Gross profit b/d	40,150				
	112,000				112,000
To Salaries	10,200		By Gross profit b/d		40,150
To Discount	800		By Discount		1000
To Travelling Expenses	600				
To Carriage outward	250				
To Administration Expenses	200				
To Trade Expenses	700				
To Interest	300				
To Net Profit transferred to Capital A/c	28,100				
	41,150				41,150

Balance Sheet of Mr. Vinary Sahani as on 31st March 2003

Liabilities		Amount	Assets	Amount
		`		`
Sundry Creditors		4250	Cash in hand	6170
Capital	1,00,000		Bills Receivable	2900
Add Net Profit	28,100	1,28,100	Closing stock	24,500
			Debtors	3280
			Furniture	500
			Plant and Machinery	80,000
			Buildings	15,000
		1,32,350		1,32,500

Illustration - 6.11 :

From the following balances prepare Profit and Loss Account for the year ending 31st December 2002 and a Balance Sheet as on that date.

	`		`
Trading Account (Dr.)	15,680	Salary	2120
Cash	1200	Rent Received	2850
Drawings	1800	Bills payable	4300

Debtors	15,800	Bank overdraft	9600
Creditors	5400	Trade Expenses	1350
Machinery	20,000	Buildings	25,000
Furniture	7500	Motor van	10,000
Loan to Mr. Sharma	4000	Dividend received	2380
Bank Balance	8500	Discount allowed	1420
Travelling Expenses	700	Interest on overdraft.	960
Depreciation	4200	Closing stock	12,300
Capital	110,000	Life Insurance Premium	2000

Solution :

Profit and Loss Account for the year ending 31st December 2002.

Particulars	Amount `	Particulars	Amount `
To Gross loss b/d	15,680	By Rent received	2850
To Salary	2120	By Dividend received	2380
To Trade Expenses	1350		
To Discount allowed	1420		
To Travelling Expenses	700		
To Interest on overdraft	960	By Net loss transferred	
To Depreciation	4200	to Capital account	21,200
	26,430		26,430

Balance Sheet of as on 31st December, 2002

Liabilities		Amount `	Assets	Amount `
Bills payable		4300	Cash	1200
			Bank balance	8500
Creditors		5400	Debtors	15,800
Bank overdraft		9600	Closing stock	12,300
Capital	1,10,000		Loan to Mr. Sharma	4000
Less-drawing	1800		Furniture	7500
Less-Life Insurance			Motor van	10,000
premium	2000		Machinery	20,000
Less Net loss	21,200	85,000	Building	25,000
		104,300		104,300

Illustration - 6.12 :

Prepare Trading and Profit and Loss account of M/s Konar y Enterprise for the year ended 31st March 2003.

Debit Balance	`	Credit Balance	`
Stock on 1.4.02	35,200	Miscellaneous Income	1250
Insurance office	1150	Income	1250
Insurance godown	800		
Export duty	1600	Returns outward	1850
Salesmen Commission	500	Interest on drawings	320
Loss by fire	1700	Interest on investment	560

Purchases	1,08,760		
Returns inward	1220	Profit on Sale	
Carriage	780	of fixed asset	780
Drawings	2000	Cash Sales	78,960
Sales tax	350	Credit Sales	72,520
Repairs and Renewals	950	Current Liabilities	97,500
Bank Charges	630		
Wages	4850	Long-term Liabilities	49,990
Legal Expenses	320		
Depreciation	1870	Capital	2,00,000
Current Assets	1,00,250		
Fixed Assets	2,37,520		
Fictitious Assets	3280		
	5,03,730		5,03,730

Solution : Trading and Profit and Loss Account of M/s Konary Enterprise for the year ending 31st March 2003

Particulars	`	Amount `	Particulars	`	Amount `
To Opening stock		35,200	By Sales : Cash	78,960	
To Purchases	108,760		Credit	72,520	
Less : Return	1850	106,910		151,480	
To Wages		4850	Less : Returns	1220	150,260
To Carriage		780	By Closing stock		48,700
To Gross Profit c/d		51,220			
		198,960			198,960
To Insurance : Office	1150		By Gross Profit b/d		51,220
Godown	800	1950	By Miscellaneous Income		1250
To Export Duty		1600	By Interest on Drawings		320
To Salesmen Commission	500		By Interest on Investment		560
To Loss by fire		1700			
To Sales Tax		350	By Profit on Sale of fixed assets		780
To Repairs and Renewals		950			
To Bank Charges		630			
To Legal Expenses		320			
To Depreciation		1870			
To Net profit transferred to Capital A/c		44,260			
		54,130			54,130

Balance Sheet of M/s Konary Enterprise as on 31st March 2003

Liabilities		Amount `	Assets	Amount `
Current Liabilities		97,500	Current Assets	100,250
Long-term Liabilities		49,990	Closing Stock	48,700
Capital	200,200		Fixed Assets	237,520
Add : Profit	44,260		Fictitious Assets	3280
	244,260			
Less : Drawings	2000	242,260		
		389,750		389,750

6.6 ADJUSTMENT ENTRIES

"Adjustments" refer to the transactions and events which have not been recorded or included in the trial balance, they are relate to the accounting period for which financial statements are prepared (e.g., outstanding salary). Adjustments also refer to those transactions which have been recorded in the books, but they don't relate to the current accounting period (e.g., prepaid insurance premium). If we want to determine true profit of the business, we have to make adjustments for finding out the total expenses and total incomes of the current year for which the financial statements are prepared.

6.6.1 Need or Rationale of Making Adjustments

The important considerations in the preparation of financial statements with adjustments are as under :

(i) Accounting for the Expenses/Income of current year not yet recorded : Accounting to the Matching Principle, all expenses of the current year which have been paid or not, and all revenues of the current year which have been received or not, should be taken into consideration for the determination of true profit. Thus, outstanding expenses and accrued incomes are adjusted to find out total expenses and total incomes of the business for the current year.

(ii) Adjustment of the Expenses / Incomes which do not belong to the Current year : The Matching principle says that the expenses and incomes relating to the current year shall be taken for calculation of profit or loss. Therefore, the prepaid expenses and the incomes received in advance which belongs to the next accounting period, should be adjusted for the determination true profit.

(iii) Accounting for non-cash expenses and provisions: For the calculation of true profit some non-cash expenses (no outflow of cash) like depreciation and provisions like provision for doubtful debts should be taken into consideration. If such items are not adjusted, the final accounts will not reveal the true and fair picture of the state of affairs.

The usual adjustments relate to the following:

- Closing Stock
- Prepaid Expenses
- Income received in advance
- Interest on capital
- Interest on loans
- Bad debts and provision for doubtful debts
- Provision for discount on debtors.
- Abnormal loss of goods (Loss by Fire)
- Goods used in Business (Distributed as free samples)
- Goods taken by proprietor
- Adjustment of errors
- Outstanding Expenses
- Accrued Incomes
- Depreciation
- Interest on drawings.
- Interest on loans and advances.
- Provision for discount on creditors.
- Deferred revenue expenditure.
- Goods sent on sale or return basis
- Hidden adjustments.
- Goods in Transit
- Management remuneration and Commission.

The above items, which require adjustments, are usually given below the trial balance in the form of additional information. It is to be remembered that all these adjustments have a double effect on the final accounts. Thus, each adjustment is to be treated in two places out of the following three :

1. Trading Account 2. Profit and Loss Account 3. Balance Sheet

1. Closing Stock (Asset) : Closing stock refers to the stock of unsold goods at the end of the current accounting period. It is valued at cost or net realisable value (market price) whichever is lower. Since closing stock is known at the end of the year, it does not appear inside the trial balance. Rather it appears as additional information below the trial balance. Its accounting treatment is as follows :

(i) Adjusting entry to be passed	Closing Stock	Dr
	To Trading Account	
(ii) Treatment in Trading Account	Shown on the credit side	
(iii) Treatment in Balance Sheet	Shown in the assets side as Current Asset.	

Illustration 6.13 :

Closing stock as at 31st March 2006, `10,000 appears below the trial balance as additional information or adjustment. Pass an adjusting entry and show its treatment in final accounts.

Solution : Adjusting Entry :

Closing Stock Dr. `10,000

To Trading Account `10,000

Treatment in Final Accounts :

Trading Account for the year ended 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Closing Stock	10, 000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Current Assets : Closing Stock	10, 000

Note : If Closing Stock already appears in the Trial Balance : No adjusting entry is required for closing stock since it has already been taken into account and has been adjusted in the purchases along with opening stock to find out "Adjusted Purchases" or "Cost of Goods Sold". Therefore, closing stock will be shown only in the Assets side of Balance Sheet and not in the Trading Account. The example given below will explain this point.

Illustration 6.14:

Trial Balance (extract) on 31st March, 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(1)	Adjusted purchases		30,000	–
(2)	Closing Stock		18,000	–

Show the treatment of the above items in Final Accounts.

Solution : *Treatment in final accounts :*

Trading Account for the year ended 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Adjusted purchases	30, 000		10, 000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Current Assets : Closing Stock	18, 000

Remember :

(i) Where closing stock is given under adjustments: It is shown on the credit side of the Trading Account to find out cost of goods sold. It is also shown in the assets side of the Balance Sheet as it is an asset.

(ii) Where adjusted purchases and closing stock are given in the trial balance: Adjusted purchase is shown in the debit side of the Trading Account and closing stock appears on the asset side of Balance Sheet. Closing Stock is not shown on the credit side of the Trading Account as it has already been adjusted in the purchase.

2. Outstanding Expenses (Liabilities):

Some expenses accrue from the day-to-day operations of the business but are recorded in the books of accounts at the time of their payment. Under such circumstances, some amount of expenses always remain unpaid at the end of the account period. Such expenses are known as outstanding expenses. So all such expenses which are due for payment in the current year but not paid, are called as outstanding expenses. The following are the examples of outstanding expenses :

(i) Unpaid rent for the month of March (where accounting period is April to March).

(ii) Unpaid salary and wages for the last month of the accounting year.

Since outstanding expenses is a part of the total expenses of the accounting year, it is to be taken into account along with the expenses already paid and appearing in the trial balance. The accounting treatment for outstanding expenses is as follows :

I.	Adjusting Entry to be passed	Concerned Expenses A/c Dr. To Outstanding Expenses A/c
II.	Treatment in Trading A/c (If it is a direct expense)	Added to the concerned expenses (e.g., wages), on the debit side.
III	Treatment in P & L A/c (If it is an indirect expense)	Added to the concerned expenses (e.g., salaries), on the debit side.
IV	Treatment in Balance Sheet	Shown on the Liabilities side as a Current Liability

Illustration 6.15 :

Trial Balance (extract) on 31st March 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(1)	Wages A / c		3, 600	–
(2)	Salaries A / c		55, 000	–

Adjustment : Wages `300 and Salaries `5000 are unpaid for the month of March. Give adjusting entries and show their treatment in the Final Accounts.

Solution :

For the outstanding expense, the following adjusting entries are to be passed:

Trading Account for the year ended 31st March, 2006

Particulars		Amount `	Particulars	Amount `
To Wages / Ac	3600			
Add : Wages outstanding	300	3, 900		

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Salaries 55,000 Add : Outstanding 5,000	60, 000		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Current Liabilities : Wages Outstanding Salaries Outstanding	300 5, 000		18, 000

Note: If outstanding expenses are given in the trial balance : It means the outstanding amount has already been adjusted through the particular expense account. Hence, it is not shown in the Trading or Profit and Loss Account. But it must be shown as a liability in the Balance Sheet as it is payable.

3. ***Prepaid Expenses (Asset):***

Usually some expenses like insurance premium, rent for the shop etc. are paid in advance. As the benefit from these expenses already spent, will be available in the next accounting year, the unused part of these expenses is carried forward to the next year. These unused services (expenses) are known as prepaid expenses.

For example, fire insurance premium of `1200 is paid on 1st July 2002. Since the insurance premium is usually paid for one year, the benefit will accrue till 30th June 2003. The accounting year closes on 31st March 2003. So out of the total premium paid, `300 belongs to the next accounting period (i.e., insurance premium of 3 months period of 1st April to 30th June, 2003). The insurance premium of 3 months which is carried forward to next year is known as prepaid insurance (or prepaid expenses). The accounting treatment for prepaid expenses is as follows :

I.	Adjusting Entry to be passed	Prepaid Expenses A/c Dr. To Concerned Expenses A/c
II.	Treatment in Trading A/c (If it is a direct expense)	Deducted from the concerned expenses (e.g., wages), on the debit side.
III	Treatment in P & L A/c (If it is an indirect expense)	Deducted from the concerned expenses (e.g., insurance premium), on the debit side.
IV	Treatment in Balance Sheet	Shown on the Liabilities side as a Current Liability

Illustration 6.16 :

Trial Balance (extract) on 31st March 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(10)	Insurance A / c		1, 200	–

Adjustment : Insurance premium includes `300 as prepaid on a policy expiring on 30th June, 2006. Give adjusting entry and show its effect in Final Accounts.

Solution:

Here, insurance premium from 1st April to 30th June is treated as prepaid insurance which comes to ₹ 300. The adjustment entry for the above will be

Prepaid Insurance A/c	Dr	₹300	
To Insurance A/c			₹ 300

Profit and Loss Account for the year ending 31st March 2006.

Particulars	Amount ₹	Particulars	Amount ₹
To Insurance 1200 Less : Prepaid 300	900		

Balance Sheet as on 31st March 2006.

Liabilities	Amount ₹	Assets	Amount ₹
		Current Assets : Prepaid Insurance	300

Note: If prepaid expenses is given in the trial balance: It means the amount of prepaid expense has already been deducted from the particular expense account. So it will not be shown in Trading or Profit and Loss Account. But it must be shown in the asset side of the Balance Sheet as it is an asset (receivable) on the date of preparation of Balance Sheet.

4. ***Accrued Income (Asset):***

Certain incomes like interest on securities, dividend on shares, commission, etc. are earned during the current year but not received. For example, the interest on investment in bank has not been received from January to March. As the closing date is 31st March, income for three months is earned but till the closing date, the cash is not received. Such an income which is earned but not received is called an accrued income. Though not received, this is a part of the total income of the current year and is credited to the corresponding income account. As the income is receivable, it is treated as an asset. The accounting treatment for accrued income is as follows:

I.	Adjusting Entry to be passed	Accrued Income A/c Dr. To Concerned Income A/c	
II.	Treatment in P & L A/c	Added to the concerned Income (e.g., Interest on Investment), on the debit side.	
III	Treatment in Balance Sheet	Shown on the Assets side as a Current Asset.	

Illustration 6.17 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit ₹	Credit ₹
(12)	Insurance A / c			1, 200

Adjustment : Interest accrued on investment ₹ 300.

Give the adjusting entrty and its treatment in the Final Accounts.

Solution :

Here interest has accrued but not received on the date of yearly closing. It is to be adjusted by passing the following adjustment entry :

Accrued Interest A / c	Dr	` 300	
To Interest A / c			` 300

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Interest A / c 1200 Add : Int. Accrued 300	1500

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Current Assets : Accrued Interest	300

Note: If a Accrued income is given in the trial Balance: In this case, the amount accrued will not be added to the particular income account in the credit side of the Profit and Loss account as it has already been adjusted. But it will be shown on the asset side of the Balance Sheet as it is receivable.

5. ***Unearned Income / Income Received in Advance (Liabilities):***

Sometimes a trader receives money during a particular accounting year without rendering the services. Such income though actually received and therefore recorded, is not an earned income of the current year. For example, a tenant occupied a house on 1st January 2003 and paid `7,200 as rent for 6 months. The landlord should not treat the whole amount `7,200 as the income of the accounting year 2002-2003 because 3 months rent upto March 2003 belongs to the current accounting year and remaining 3 months rent belongs to the next accounting year which is received in advanced and for which no service has been rendered. The accounting treatment for unearned income is as follows :

I.	Adjusting Entry to be passed	Concerned Income A/c Dr. To Unearned Income A/c
II.	Treatment in P & L A/c	Deducted from the concerned Income (e.g., Rent received in advance), on the debit side.
III	Treatment in Balance Sheet	Shown on the Liabilities side as a Current Liability.

Illustration 6.18 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(13)	Commission A / c			2800

Adjustment : One fourth of commission relates to the next period. Give the adjusting entry show its treatment in the Final Accounts.

Solution :

Here, the adjustment entry for commission received in advance is :

Commission A/c Dr `700

To Commission received in advance A/c

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Commission A / c 2800 Less : Comm. received in advance 700	2,100

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Current Liabilities : Commission received in advance	700		300

Note: If income received in advance appears in the trial balance: It means, it has already been adjusted in the respective income account. So it need not be shown as a deduction from the income account in the Profit and loss account. However, it will be shown in the liability side of the balance sheet as it is payable on the date of preparation of Balance Sheet.

6. *Depreciation:*

Depreciation is a permanent and continuous reduction in the value of a fixed asset due to wear and tear (use), expiry of time and obsolescence. In simple words, depreciation is the decrease in the value of fixed asset due to use in the business. So it is an operating expense. Therefore, it must be written off so as to arrive at the true results of business.

Why to charge depreciation?

The objectives / needs for charging depreciation are as follows :

(i) Ascertaining true profit: Depreciation is an operating expense. True profit or loss cannot be determined without taking depreciation.

(ii) Presentation of financial position: Depreciation is deducted from the cost of the fixed assets to find out their real value. Unless real value of the assets are presented, the Balance Sheet will not show true financial position.

(iii) Money for replacement of assets : By charging depreciation, the money is retained in the business. When the life period of the asset is over, the total money retained (accumulated depreciation) is used to purchase a new asset.

Calculation of Depreciation:

Three factors, i.e., cost of the asset, estimated working life and estimated scrap value influence the amount of depreciation. There are many methods of calculating depreciation. Of these, the two most important methods are discussed here.

(i) Straight Line Method or Fixed Installment Method: Under this method, a fixed percentage of the original cost of the asset is charged as depreciation every year. The annual depreciation remains fixed every year.

The formulae is :

$$\text{Annual depreciation} = \frac{\text{Cost price of asst-Scrap value}}{\text{Estimated life of asset in years}}$$

Here, scrap value means the value of the asset at the end of its working life.

Illustration 6.19 :

A machine costing ` 1,00,000 is purchased. Its working life is estimated to be 10 years and scrap value is estimated to be `10, 000 at the end of its working life. Calculate annual depreciation.

Solution:

$$\text{Annual Depreciation} = \frac{1.00,000\text{-}10,000}{10} = \text{\`}9000$$

llustration 6.20: On 1st April 2005, a machine is purchased for ` 60,000. On 1st October 2005 another machine was purchased for ` 40,000. Calculate depreciation at 10%p.a. on original cost at the end of the year, i.e., 31st March 2006.

Solution:

Here, depreciation will be charged for 12 months on the first machine and for 6 months on the second machine.

Total depreciation = 6,000 + 2, 000 = ` 8, 000

Note: Depreciation should be charged on the asset for the period of its use in the business.

(ii) Diminishing Balance method or Written Down Value method:

Under this method annual depreciation is calculated at a fixed percentage evert year on the balance of the asset which is brought forward from the previous year. The amount of annual depreciation goes on diminishing every year.

Illustration 6.21 : A machine is purchased on 1st January 2004 for ` 1, 00, 000. Calculate depreciation at 10% for 2004, 2005 and 2006 under diminishing balance method.

Solution :

$$\text{Depreciation for 2004} = 1,00,000 \times \frac{10}{100} = \text{\`}\ 10,000$$

Depreciated value of machine on 1st January 2005 = 1, 00, 000 × 10,000 = ` 90, 000

$$\text{Depreciation for 2005 } 90,000 \times \frac{10}{100} = \text{\`}9,000$$

Depreciated value of machine on 1st January 2006 = 90,000 – 9, 000 = ` 81,000.

$$\text{Depreciation for 2006} = 81,000 \times \frac{10}{100} = \text{\`}\ 8.100$$

The accounting treatment for depreciation is as follows :

I.	Adjusting Entry to be passed	Depreciation A/c Dr. To Concerned Asset A/c
II.	Treatment in P & L A/c	Shown on the debit side as a separate item.
III	Treatment in Balance Sheet	Shown on the Assets side by way.of deduction from the value of concerned fixed assets.

Illustration 6.22 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(3)	Commission A / c		2, 50, 000	

Adjustment : Provide for depreciation at 2% on building.

Give adjusting entry and show its treatment in Final Account.

Solution :

After calculating the amount of depreciation, the following entry is to be passed:

Depreciation A/c Dr ` 5, 000

To Building A/c `5,000

Its treatment in final accounts will be made as under :

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Depreciation	5, 000		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets		Amount `
		Building Less : Depreciation	50,000 5,000	45, 000

Note : If depreciation appears in the trial balance : In this case, depreciation is only debited to the Profit and Loss Account as it is an operating expense. It is not shown in the Balance Sheet as a deduction from asset concerned as it has already been adjusted.

Illustration 6.23:

Pass necessarily adjustment entries in the books of Mr. on 31st March 2006.

(a) Stock on hand was valued at `11,200

(b) Salary of Mr. Bose for the month of March ` 5,000 is due.

(c) Rent for April 2006 paid on 30th March `5000.

(d) Mr. Das took ` 800 against his salary of April.

(e) Divided from XYZ Limited receivable `200.

(f) Advance commission received on an unfinished contract amounts to ` 1, 400.

(g) Provide for depreciation on building `4,000 and on furniture ` 600.

Solution :

In the books of Mr.

Journal

Date 2006	Particulars		L.F.	Debit `	Credit `
Mar. 31	Closing Stock A/c	Dr		11,200	
(a)	To Trading A/c				11,200
	(Being closing stock transferred to Trading A/c)				
(b)	Salaries A/c	Dr		5000	
	To Outstanding Salaries A/c				500
	(Being salary of Mr. Bose is outstanding)				
(c)	Prepaid Rent A/c	Dr		5000	
	To Rent A/c				5000
	(Being rent of April paid in advance)				

(d)	Prepaid Salary A/c	Dr	800	
	To Salaries A/c			800
	(Being salary of Mr. Das paid for April)			
(e)	Accrued Dividend A/c	Dr	200	
	To Dividend A/c			200
	(Being dividend for the year receivable from XYZ Ltd.)			
(f)	Commission Earned A/c	Dr	1400	
	To Comm. Received in Advance A/c			1400
	(Being commission received in advance)			
(g)	Depreciation A/c	Dr	4600	
	To Building A/c			4000
	To Furniture A/c			600
	(Being depreciation provided for on building and furniture)			

7. *Interest on Capital*

In accounting, the businessman or owner is treated as a creditor or lender. In order to find out tru e profit or loss, interest is allowed on the capital contributed by the owner(s). Interest on capital is a charge against business income and is debited to profit and loss account. Generally such interest is calculated at the end of the accounting year and is provided for at the time of yearly closing. The accounting treatment for interest on capital is as follows :

I.	Adjusting Entry to be passed	Interest on Capital A/c Dr. To Capital A/c
II.	Treatment in P & L A/c	Shown on the debit side as a separate item.
III	Treatment in Balance Sheet	Shown on the Liabilities side by way.of addition to the capital.

Illustration 6.24 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(3)	Commission A / c		2, 50, 000	

Adjustment : Provide for 8% interest on capital..

Give adjusting entry and show its effect in final account.

Solution :

To provide for interest on capital, we have to pass the following adjustment entry.

Interest on Capital A/c	Dr	`8, 000	
To Capital A/c			` 8,000

Its treatment in final accounts will be made as under :

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Interest on Capital	8, 000		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Capital 1,00,000 Add : Interest 8000			

Note : If interest on capital is given in the trial balance : It is only shown on the debit side of the profit and loss account as it is an expense of the business. It is not shown in the liability side of the balance sheet as it has either been paid or credited to Capital Account.

8. *Interest on Drawings*

When the proprietor withdraws money from the business for personal use, it almost amounts to temporary loans by the business to the proprietor. This is treated at par with the loan to an outsider and interest is also charged. Interest on drawings is an income for the firm and is generally adjusted at the time of yearly closing. This amount should be paid by the proprietor to the business. But in real practice, it is not paid by the proprietor but deducted or adjusted from the capital. The accounting treatment for interest on drawings is as follows :

I.	Adjusting Entry to be passed	Capital A/c Dr. To Capital A/c
II.	Treatment in P & L A/c	Shown on the credit side as a separate item.
III	Treatment in Balance Sheet	Shown on the Liabilities side by way of addition to the capital.

Illustration 6.25 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(2) (20)	Capital A / c Drawings A / c		30, 000	1, 00, 000

Adjustment : Charged interest at 8% p.a. on drawings.

Give adjusting entry and show its treatment in final account.

Solution :

After calculating interest on drawings, the following adjustment entry is be passed.

Drawings A/c Dr ` 2400

To Interest on drawings A/c ` 2400

Its treatment in final accounts will be made as under :

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
		By Interest on Drawings	2400

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Capital 1,00,000 Less : 30,000 Less : Int. on drawing 8000	67, 000		

Note : If interest on drawings is given in the trial balance : It means, it has already been adjusted in Drawings A/c and it will not be shown in the Balance Sheet; but it will be shown on the credit side of the profit and loss account as it is treated as an income for the business.

9. *Interest on Loan*

Business may obtain loans from private parties, banks and financial institutions. The interest on loan is an expense for the business and is debited to Profit and loss account. Where a part of the total interest due has been paid during the year, the balance amount is treated as outstanding interest. The accounting treatment for interest on loan is as follows :

I. Adjusting Entry to be passed (for outstanding interest)	Interest on Capital A/c Dr. To Outstanding Interest A/c (or Lender's A/c	
II. Treatment in P & L A/c	Interest on loan is shown on the debit side.	
III Treatment in Balance Sheet	Outstanding Interest is added with the loan on the Liabilities side.	

Illustration 6.26 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(11)	Loan A / c			40, 000

Adjustment : Charge interest @ 12% p.a. on loan amount.

Give adjusting entry and show its effect in final account.

Solution:

After calculating interest which comes `4800, the following adjustment entry is to be passed :

Interest on Loan A/c	Dr	` 4,800	
To Outstanding Interest A/c			`4,800

Its treatment in final accounts will be made as under:

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Interest on loan A / c	4800		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Loan 40,000 Add : Interest 4800	44, 800		

Note: If interest on loan appears inside the Trial Balance: It is taken to the debit side of Profit and Loss Account as it is an expense. It is not taken to Balance Sheet as it has already been paid.

10. *Interest on Loans and Advances (Income)*

A business firm not only borrows money, but also gives loans and advances. In such a case, it charges interest on such lending at the end of the year, which is an income of the business. Interest on such lending or advances are debited to the concerned advance account are credited profit and loss account. The accounting treatment for interest on loans and advances is as follows:

I. Adjusting Entry to be passed — Loans and Advances A/c Dr.
To Interest on Loans and Advances A/c

II. Treatment in P & L A/c — Interest on loan is shown on the credit side.

III Treatment in Balance Sheet — Interest is added with the loans and advances on the Assets side.

Illustration 6.27 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(11)	Loan & Advances A / c		40, 000	

Adjustment : Charge interest @ 10% p.a. on loan amount.
Give adjusting entry and show its treatment in final account.

Solution :

After calculating interest which is ` 4000, the following adjustment entry is passed:

Loans and Advances A/c Dr ` 4, 000

To Interest on Loans and Advances A/c ` 4,000

Its treatment in final accounts is as under :

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
		By Interest on Loans & Advances A / c	4000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets		Amount `
		Loans & Advances	40,000	44, 000
		Add : Interest	4000	

Note : If interest on loans and advances is given in the trial balance : It is not shown in the balance sheet as it has already been adjusted, but it is shown in the credit side of the Profit and loss account a s it is an income.

11. Bad Debts and Provision for Doubtful Debts :

A. Additional Bad Debts :

Bad debt is the amount which is irrecoverable from the customers to whom credit sales are made. It is a loss for the business and therefore debited to Profit and Loss account. If bad debt is given under adjustments, it shows that it is additional bad debts and has not been recorded. The accounting treatment for additional bad debts is as follows:

I. Adjusting Entry to be passed — Bad debts A/c Dr.
To Sundry Debtors A/c

II. Treatment in P & L A/c — Shown on the debit side as a separate item.

III Treatment in Balance Sheet — Shown on the Assets side by way of deduction from the "Sundry Debtors".

Illustration 6.28:

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(11) (14)	Bad debts Sundry debtors		500 40,000	

Adjustment : Provide further bad debt amounting `1000.

Show the accounting treatment in Bad Debts A/c, profit and Loss Account and Balance Sheet.

Solution :

Here, the bad debt given in the trial balance is already recorded. So only bad debt given in the adjustment is to be recorded. Hence, the following entry will be passed.

Bad Debts A/c Dr ` 1, 000

To Sundry Debtors A/c `1,000

Its treatment in Bad debts account and final accounts will be made as under :

Bad Debts Account

Particular	Amount `	Particulars	Amount `
To Balance b / d (Given in Trial Balance)	500		
To Sundry Debtors A / c (Additional bad debts)	1, 000	By Profit & Loss A / c	1, 500
	1, 500		1, 500

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Bad debts 500 Add : Further Bad debt 1000	1, 500		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 40,000 Less : Further bad debt 4000	39, 000

Note : If bad debts are appearing inside Trial Balance : It is not deducted from Sundry debtors as it has already been done. It is only shown on the debit side of Profit and Loss Account as it is a loss for the business.

B. . Provision for Doubtful Debts or Provision for Bad Debts :

We know that the amount due from customers on account of credit sales/services is called book debts. Such debts can be divided into three parts.

(a) Good debts (b) Doubtful debts (c) Bad debts.

Where the debt due from customers is certain to be received in the near future, that debt is called good debt. If the debt is irrecoverable, it is called bad debt. Debts which are considered doubtful of recovery are called doubtful debts. It indicates possible loss in the collection from debtors.

According to the conservatism principle of accounting, all possible losses should be provided in the financial statements. So it is necessary to make provision for doubtful debts by setting aside a part of the profit to meet the bad debts which will arise in future.

Calculation of required provision for doubtful debts:

The required provision for doubtful debt is the provision to be maintained for next year. It is calculated at a fixed percentage on debtors as follows:

(i) When there is no further bad debt under adjustment, i.e., no additional bad debt :

Required provision =

$$\text{Sundry Debtors } \times \frac{\text{Rate}}{100}$$

(ii) When there is additional bad debt given under adjustment:

$$\text{Required provision} = (\text{Sundry Debtors} - \text{Additional Bad Debts}) \times \frac{\text{Rate}}{100}$$

Illustration 6.29:

Sundry Debtors on 31st December 2005 was ` 50,000 before writing off bad debt ` 2000. Create a provision of 5% on sundry debtors.

Solution: Here, required provision = (50,000 – 2000) × 5/100 = `2400.

The accounting treatment for provision for doubtful debts is as follows :

I.	Adjusting Entry to be passed	Profit and Loss A/c Dr. To Provision for Doubtful Debts A/c
II.	Treatment in P & L A/c	Shown on the debit side as a separate item.
III	Treatment in Balance Sheet	Shown on the Assets side by way of deduction from the "Sundry Debtors".

Calculation of the amount to be charged to P & L A/c:

Usually, a part of the profit is kept aside every year as provision for doubtful debts for meeting possible bad debts next year. But how much is to be charged to profit depends upon the amount of bad debt and the provision already existing from previous year. The procedure is as follows:

Bad debt	xxx xxx
Add : Additional bad debt Total bad debts	xxx xxx
Add : New provision required	xxx xxx
Total charge	xxx
Less : Existing provision for doubtful debt	
Amount charge to Profit & Loss A / c	

Illustration -6.30:

From the following extracts of trial balance and additional information, calculate the required provision for doubtful debts and the amount to be charged to profit.

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title `	L.F. `	Debit	Credit
(11)	Bad debts		1200	
(14)	Sundry debtors		60, 000	
(15)	Provision for doubtful debts / Bad debt reserve			2500

Adjustment : (i) Write off a further bad debt of ` 1000 from debtors.
(ii) Create a provision for doubtful debts at 5% on debtor.

Solution:

Required provision = (Sundry Debtors – Additional Bad Debt) $\times \dfrac{\text{Rate}}{100}$

$$=\left(60,000-1000\right)\times\frac{5}{100}=59,000\times\frac{5}{100}=\text{Rs. }2950.$$

Amount to be charged to profit and loss account.

= Bed debt + Additional Bad debt + Required new provision – Existing provision

= 1200 + 1000 + 2950 – 2500 = ` 2650.

The adjustment entry is :

P & L Account Dr `2650

To Provision for doubtful debts `2650.

Treatment of Provision for Doubtful Debts:

The treatment of provision for doubtful debt in the profit and loss account will be as under:

(i) **If the old or existing provision is less than the sum of bad debt and new or required provision:** Show the difference on the debit side of profit and loss account.

Illustration 6.31:

Additional Bad Debts	` 1500
Existing provision for doubtful debts	`2000
New provision for doubtful debts required	`2500

Solution :

In this case, existing provision, i.e., `2000 is less than the sum of bad debt and new provision by ` 2000 (i.e., 1500 + 2500 – 2000). So the difference will be shown on the debit side of Profit and Loss Account as under:

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Bad debts 1500 Add : Provision required 2500 4000 Less : Existing provision 2000	2000		

Bad Debts Account

Particulars	Amount `	Particulars	Amount `
To Sundry Debtors A/c	1,500 1,500	By Provision for Doubtful Debts A/c	1,500 1,500

Note : If there is provision for doubtful debts, then bad debts are transferred to provision account. If there is no provision, bad debts are transferred directly to Profit and Loss A/c.

Provision for Doubtful Debts Account

Particulars	Amount `	Particulars	Amount `
To Bad Debts A/c (Total bad debts) To Balance c/d (New provision required)	1,500 1,500 4, 000	By Balance b/d (Existing provision in Trial Balance) By Profit and Loss A/c (Balancing figure)	2,000 2,000 4,000

(ii) If old or existing provision is more than the sum of bad debts and required provision :

In this case, the old provision created in earlier year is in excess. The difference in amount will be shown on the credit side of profit and loss account.

Illustration 6.32 : Bad debts ` 1200

Further bad debts `800

Existing provision `5,000

Provision required `2,000

Show the treatment in Profit and Loss A/c. Prepare Bad debts A/c and Provision for Bad debts account.

Solution :

In this case, existing provision ` 5,000 is more than the sum of bad debt and new provision by ` 1, 000 [i.e., 5,000 - (1, 200 + 800 + 2,000)]. This excess provision represents an income and will be shown on the credit side of profit and loss account as under.

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars		Amount `
		By Bad debts Add : Further bad debt Add : New provision Less : Existing provision	1200 800 2000 2000 4000 5000	1000

Bad Debts Account

Particulars	Amount `	Particulars	Amount `
To Balance b/d (Existing bad debts)	1,200	By Provision for Doubtful Debts A/c	2,000
To Sundry Debtors A/c (Additional bad debts)	800		
	2,000		2,000

Provision for Doubtful Debts Account

Particulars	Amount `	Particulars	Amount `
To Bad Debts A/c (Total bad debts)	2,000	By Balance b/d (Existing provision in Trial Balance)	5,000
To Profit & Loss A/c (Balancing figure)	1,000		
To Balance c/d (New provision required)	2,000		
	5,000		5,000

(iii) If the amount of old provision is equal to the sum of bad debts and required provision :

In this case, there is no need to set aside any amount towards provision for doubtful debt. So the whole adjustment need not be shown in the profit and loss account.

Different types of questions relating to provision for Doubtful debts:

(a) If only provision for doubtful debts is given in trial balance :

In this case, the provision for doubtful debt given in the trial balance represents the provision created last year. If this is not utilised in the current year and also not required for the next year, then it is a gain and should be credited to Profit and Loss A/c.

Illustration 6.33 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(11)	Provision for doubtful debts			600

Treatment : The amount of ` 600 will be shown on the credit side of profit and loss account. It will not be shown in the balance sheet.

(b) If bad debts and provision for doubtful debts are given in the trial balance and adjustments are not given :

In this case, the treatments are :

(i) If old provision is less than the bad debt: Show the difference on the debit side of profit and loss account.

(ii) If old provision is more than the bad debt: Show the difference on the credit side of profit and loss account.

Illustration 6.34 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(11)	Bad debts		600	
(12)	Provision for doubtful debts			1, 000

Show their treatment in final accounts.

Solution :

Here, the difference of ` 400 (i.e., 1,000– 600) represents excess provision created earlier and will be shown on the credit side of profit and loss account as below.

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Provision for doubtful debts 1,000 Less : Bad debts 600	400

Both the items will not be shown in the balance sheet.

(c) If bad debts and provision for doubtful debts are given in the trial balance and the required provision is given under adjustments : It will be treated as follows :

(i) If the provision given in the trial balance is less than the sum of bad debt and new provision : Show the difference as provision to be created on the debit side of profit and loss account. The required provision will be deducted from sundry debtors on the asset side of balance sheet.

Illustration 6.35 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(9)	Sundry debtors		20, 000	
(11)	Bad debts		900	
(12)	Provision for doubtful debts			1, 5600

Adjustment : Create provision for doubtful debt at 5% on sundry debtor.

Show their treatment in final accounts.

Solution :

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Bad debts 900 Add : New provision 1000 1900 Less : Old provision 1500	400		

Balance sheet as on 31st March 2006.

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 20,000 Less : New provision 1000	19, 000

(ii) **If the provisions given in the trial balance is more than the sum of bad debt and new provision :** Show the difference as excess provision on the credit side of profit and loss account. Also deduct the new provision required from sundry debtors on the asset side of balance sheet.

Illustration 6.36 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(9)	Sundry debtors		40, 000	
(11)	Bad debts		1500	
(12)	Provision for doubtful debts			4000

Adjustment : Create a provision for bad debt at 5% on sundry debtor.
Show their treatment in final accounts.
Solution : Its treatment in final accounts will be made as under :

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Provision for doubtful debts 4000 Add : Bad debts 1500 Less : New provision 2000	500

Balance sheet as on 31st March 2006.

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 40,000 Less : New provision 2000	38, 000

(d) If bad debt and old provision for bad debt is given in the trial balance and further bad debt and required provision appear under adjustment :
This type of question have already been discussed under the treatment of provision for doubtful debt in profit and loss account. (See Example 17 and 18).

Illustration - 37 :

From the following trial balance extracted from the books of M/s Lalchand and Sons, prepare Trading and Profit and Loss account for the year ended 31st December 2005 and the Balance Sheet as on that date.

Trial Balance (extract) 31st December 2005.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
01.	Capital			22,000
02.	Drawings		2000	
03.	Building		20,000	
04.	Machinery		10,000	
05.	Purchases		25,000	
06.	Sales			42,000
07.	Rent			400
08.	Wages		2600	
09.	Salaries		800	
10.	Insurance		600	
11.	Postage		200	
12.	Sundry Debtors		8000	
13.	Bad debts		1400	
14.	Sundry creditors			8000
15.	Provision for Bad debts			2000
16.	Cash		800	
17.	Stock		3000	
			74,4000	74,400

Outstanding insurance `100, Prepaid wages of`400, write off `600 as bad debt and create provision of 5% on sundry debtors. Stock on 31st December was `18,000. Provide for depreciation at 5% on building and 2.5% on machinery.

Solution :

Trading and Profit and Loss Account of M/s Lalchand and Sons for the year ended 31st December, 2006

Particulars		Amount `	Particulars	Amount `
To Opening stock		3000	By Sales	42,000
To Purchases		25,000	By Closing stock	18,000
To Wages	2600			
Less : prepaid	400	2200		
To Gross Profit c/d		29,800		
		60,000		60,000
To Salaries		800	By Gross Profit b/d	29,800
To Postage		200	By Rent	400
To Insurance	600			
Add : outstanding	100			
To Bad debt	1400			
Add : further bad debt	600			
	2000			
Add : Req. provision	370			
	2370			

Less : old provision	2000	370	
To Depreciation			
on Building	1000		
on Machinery	250		
To Net profit transferred to			
Capital A/c	26,880		
	30,200		30,200

Balance Sheet of M/s Lalchand and Sons as on 31st December, 2005

Liabilities `	Amount `	Assets		Amount `
Capital 22, 000		Building 20, 000		
Less : Drawings 2000		Less: Depreciaton	1000	19, 000
20, 000		Machinery	10, 000	
Add : Net Profit 26, 880	46, 880	Less : Depreciatiion	250	9750
Sundry Creditors		Sundry Debtors	8000	
Outstanding Insurance	8, 000	Less : Bad debt	600	
	100		7400	
		Less : Re q. provision	370	
		Closing Stock		7030
		Cash in hand		
		Prepaid wages		18, 000
				800
				400
	54, 980			54, 980

12. Provision for Discount on Debtors :

It is a normal practice in every business to allow cash discount to customers if payment is received within a stipulated period. Provision for discount on debtors refers to the provision created to provide for discount likely to be allowed on good debtors in the next year.

Calculation of Provision for Discount:

As it is difficult to know the exact amount of cash discount to be allowed to customers in the next year, the amount of provision required can be estimated on the basis of past experience. We know that discount is allowed on good debtors who pay promptly. Hence, the amount of bad debt and provision for doubtful debt should be deducted from sundry debtors before calculating provision for discount.

Provision for Discount on Debtors = (Sundry debtors – Bad debts)
– Required provision for doubtful debts) × Rate / 100.

Illustration 6.38 :

On 31st December 2002, sundry debtors stood at `41,000 before writing off bad debt. During the year, bad debt amounted to `1000. It is necessary to create a provision of 5% for doubtful debts and 2% for discount on debtors. Calculate the required provision for doubtful debts and the provision for discount on debtors.

Solution:

Required Provision for doubtful debts = (Sundry debtors Bad debts) × Rate/100

= (41,000 – 1000) × 5/100 = ` 2000.

Required Provision for discount = (Sundry debtors Bad debts) × Rate/100

– Provision for doubtful debts) × Rate / 100.

= (41,000 – 1000 – 2000) × 2/100 = 38,000 × 2/100 = ` 760.

The accounting treatment of provision for discount on debtors is as follows :

The accounting treatment for provision for doubtful debts is as follows :

I.	Adjusting Entry to be passed	Profit and Loss A/c Dr. To Provision for Discount on Debtors A/c
II.	Treatment in P & L A/c	Shown on the debit side as a separate item.
III	Treatment in Balance Sheet	Shown on the Assets side by way of deduction from the "Sundry Debtors".

Illustration - 39:

From the following trial balance extracted from the books of Satish Shah, show the adjusting entry and treatment in final accounts relating to discount and provision for discount.

Trial Balance (extract) 31st March 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(9) (11) (12)	Sundry debtors Bad debts Provision for doubtful debts		50, 000 3000 1000	 2500

Adjustment : (i) Write off ` 1000 as further bad debt.

(ii) Create a provision 5% for doubtful debts and a provision of 2% for discount on sundry debtors.

Solution :

In this case, the sundry debtors given in the trial balance is after the deduction of bad debt of `3000. So the provision for discount will be calculated as follows:

Required Provision for discount on debtors = (Sundry debtors = Additional Bad debt)

– Required provision for doubtful debt) × Rate/100

= [50,00 – 1000 = {(50,000 – 1000) × 5/100}] × 2 / 100

= (49,000 – 2450) × 2 / 100 = 46,550 × 0.02 = `931.

Adjustment entry :

(i) Profit & Loss A/c Dr `931

To Provision for Discount on Debtors A/c ` 931

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Discount 1000 Add : Required provision for discount 931	 1931		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 50,000 Less : Further bad debt 1000 Less : Req. provision for bad debts 2450 Less : Req. provision for discounts 931	39, 000

13. Provision or Reserve for Discount on Creditors :

Like discount on debtors, a business firm receives discount from suppliers if payment is made before time. 'Provision or Reserve for Discount on Creditors' refers to the reserve created for discount likely to be earned from creditors on their payments.

The accounting treatment for provision for doubtful on creditors is as follows :

I. Adjusting Entry to be passed	Provision for Discount on Creditors A/c Dr. To Profit and Loss A/c
II. Treatment in P & L A/c	Shown on the debit side as a separate item.
III Treatment in Balance Sheet	Shown on the Liabilities side by way.of deduction from the "Sundry Creditors".

Illustration 6.40 :

Trial Balance (extract) 31st March 2006.

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(8)	Discount Received		1, 200	1200
(9)	Sundry Creditor		60, 000	20, 00

Adjustment : Create a provision for discount on sundry creditors at 3%.
Show the adjusting entry and treatment in final accounts.

Solution :

Here, required provision for discount = Sundry Creditors × Rate/100

= 20,000 × 3/100 = ` 600

Adjustment entry :

(a) For creating provision -

Provision for discount on creditors Dr `600

To Profit and Loss account ` 600

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Discount Received 1200 Add : Req. provision for discount 600	1800

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Sundry debtors 20,000 Less : Req. provision for discounts 600	19, 400		

Note : Provision for discount on creditors goes against the conservatism or prudence principle which tells us not to take into consideration the income like to be earned in future.

14. *Abnormal Loss of Goods (Loss By Fire) :*

Sometimes a business suffers from abnormal loss of goods such as goods lost by fire, flood, earthquake and accidents. Such a loss reduces the value of closing stock at the end of the year. As a result, the gross profit is reduced. So the cost of goods lost should be clearly explained in the trading account.

Generally these abnormal loss of goods are covered under an insurance policy. In case of such incidence, a claim is lodged with the insurance company to compensate the loss. When the loss is admitted by the insurance company, the amount of claim is credited to the abnormal loss account. The balance if any in the abnormal loss is then transferred to trading and profit and loss account. The accounting treatment of goods lost by fire is as follows:

(a) *When the goods are fully insured :*

The accounting treatment is as follows :

I. Adjusting Entry to be passed	(i) Loss by Fire A/c Dr To Trading A/c (ii) Insurance Claims A/c Dr To Loss by Fire A/c
II. Treatment Trading A/c	Shown on the debit side as a separate item.
III Treatment in Balance Sheet	Shown on the Assets side as a Current Asset.

(b) *When the goods are partly insured:*

Here a part of the total loss is covered by the insurance. So the balance is transferred to profit and loss account as abnormal loss. The accounting treatment is as follows :

I. Adjusting Entry to be passed	(i) Loss by Fire A/c Dr To Trading A/c (ii) Insurance Claims A/c Dr To Loss by Fire A/c
II. Treatment Trading A/c	Shown on the credit side as a separate item
III. Treatment in P & L A/c covered by insurance).	Shown on the debt side as a separate item (for the loss not
III Treatment in Balance Sheet as a Current Asset.	Shown on the Assets side (insurance claim receivable)

(c) *When the goods are not insured :*

The accounting treatment is as follows :

I. Adjusting Entry to be passed	(i) Loss by Fire A/c Dr To Trading A/c (ii) Profit and Loss A/c Dr To Loss by Fire A/c
II. Treatment Trading A/c	Shown on the credit side as a separate item.
III Treatment in P & L A/c	Shown on the debit side as a separate item.

Illustration 6.41 :

On 31st December 2005, a part of the goods in the godown were lost by fire. The value of loss is estimated to be ` 20,000. Pass journal entries in each of the following cases.

(a) If the goods are not insured.

(b) If the goods are fully insured.

(c) If the goods are partly insured and the insurance company admits a claim of ` 12,000.

Solution : In each case, the two journal entries can be combined and one entry can be made as follows :

Case (a) Profit & Loss A/c	Dr	`20,000	
To Trading A/c			`20,000
Case (b) Insurance Claim A/c	Dr	`20,000	
To Trading A/c			`20,000
Case (c) Insurance Claim A/c	Dr	`12,000	
Profit & Loss A/c	Dr	`8,000	
To Trading A/c			`20,000

15. *Deferred Revenue Expenditure*

It is a revenue expenditure which gives benefits for more than one accounting period. The expenditure is of non-recurring and special nature which involves large amount. It is usually spread over the number of years in which benefits will be available. A proportionate amount is charged every year to profit and loss account and the balance is carried forward to subsequent years as deferred revenue expenditure.

The accounting treatment of deferred revenue expenditure debts is as follows :

I. Adjusting Entry to be passed	(i) Deferred Revenue Expenditure A/c Dr. To Advertisement A/c (ii) Profit and Loss Ac/ Dr To Deferred Revenue Expenditure A/c
II. Treatment in P & L A/c	A portion shown on the debit side.
III Treatment in Balance Sheet	The balance is shown on the Assets side.

Illustration 6.42 :

If `5,00,000 is spent on advertisement to introduce a new product which may yield benefit for next 5 years. Show the revenue portions and the deferred revenue portions for five years.

Solution :

Year	Revenue `	Deferred Revenue `
1st Year	1, 00, 000	4, 00, 000
2nd Year	1, 00, 000	3, 00, 000
3rd Year	1, 00, 000	2, 00, 000
4th Year	1, 00, 000	1, 00, 000
5th Year	1, 00, 000	

Profit and Loss Account for the year ending 31st March, 2006 (1st year)

Particulars	Amount `	Particulars	Amount `
To Deferred Revenue Exp. (Advertisement)	1, 00, 000		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Deferred Revenue Exp. (Advertisement)	4, 00, 000

16. Goods used in Business or Goods Distributed as Free Samples :

Generally, goods are purchased for the purpose of resale. But sometimes, they are also used for charitable purposes or for distributing as free samples among customers and employees. Where goods are used for charitable purposes, the cost of such goods is debited to charity account as an expense. On the other hand, it reduces the cost of goods purchased of resale. So purchase account is credited. The accounting treatment of goods distributed as free samples or for charity is as follows.

I. Adjusting Entry to be passed	Goods distributed for charity/advertisement : Charity /Advertisement A/c Dr. To Purchases A/c
II. Treatment in Trading A/c	To value of goods distributed for charity and advertisement is shown by way of deduction from Purchases on the debit side.
III Treatment in P & L A/c	Total value of goods distributed for charity and advertisement are shown on the debit side as separate items.

Illustration 6.43 :

Goods were purchase for `60,000 and goods worth `600 were distributed as free samples among customers and goods worth `400 were given as charity to a blind school. Show its accounting treatment.

Solution : The adjusting entry is :

Advertisement A / c	Dr	`600	
Charity A / c	Dr	`400	
To Purchase A / c			` 1,000

Trading Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
Less : Advertisement Less : Charity	600 400		

Profit & Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
Less : Advertisement Less : Charity	600 400		

Note: If some goods are used in the business as stationery: The cost of such goods is deducted from the purchases and is debited to Stationery A/c. The journal entry is:

Stationery A/c Dr

To Purchases A/c

17. *Goods Taken By Proprietor:*

Sometimes goods are withdrawn by the proprietor for his personal use. In such a case drawing account is debited for cost of goods withdrawn and purchases account is credited.

The accounting treatment of goods withdrawn by proprietor is as follows.

I.	Adjusting Entry to be passed	Drawings A/c Dr To Purchases A/c
II.	Treatment in Trading A/c	To value of goods withdrawn is shown by way of deduction from Purchases on the debit side.
III	Treatment in Balance Sheet	Total value of goods withdrawn is shown by way of deduction from Capital on the Liabilities side.

Illustration 6.44 :

Goods worth `1,200 were taken by the owner for his personal use. Show the adjusting entry and treatment in final accounts.

Solution:

The adjusting entry is :

Drawings A/c	Dr	`1,200	
To Purchase A/c			`1,200

Trading Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Purchases xxxx Less : Drawings 1200	xxxx		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
Capital xxxx Less : Drawings 1200	xxxx		

18. Goods Sent on Sale or Return Basis :

When goods are sent on 'approval' or 'sale or return' basis, the customer has the option to retain or return the goods within a specified period. As the sale is yet to complete (title has not passed), it would be more appropriate if the sale is not recognised till the customer has communicated his approval or where the time period specified has passed. But when such transactions are few, these transactions are account ed for as an ordinary sale. If at the end of the year, goods are still lying with the customers and the specified period is yet to expire, the original entry made for sale is cancelled. Such goods are considered as closing stock lying with customers and are valued at cost. The accounting treatment of goods sent on sale or retur n basis is as follows :

I.	Adjusting Entry to be passed	(i) Sales A/c (with selling price) Dr To Debtors' A/c (ii) Stock with Customer's (with cost price) Dr To Trading A/c
II.	Treatment in Trading A/c	(i) Sales value of such goods is shown on credit side by way of deduction from sales. (ii) Cost of such goods is shown on the credit side by way of addition to closing stock.
III	Treatment in Balance Sheet	(i) Sales value of such goods is shown by way of deduction from debtors on the Assets side. (ii) Cost of such goods is shown on the Assets side by way of addition to closing stock.

Illustration 6.45 :

Trial Balance (extract) on 31st March, 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(9)	Sundry debtors		20, 000	
(14)	Sales			1,10, 000

Adjustements : Goods costing ` 1000 were sent to a customer on sale or return for ` 1200 on 28th March 2006 and has been recorded in the books as actual sales. Stock-in-hand on 31st March 2006, was valued at ` 8000. Show the accounting treatments in the final accounts.

Solution :

Trading Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars		Amount `
		By Sales	1,10,000	
		Less : Goods sent on sale or return	1200	1, 08, 000
		By Closing Stock	8000	
		Add : Goods sent on sale or return	1000	9000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Particulars		Amount `
		Current Assets :		
		Debtors	20,000	
		Less : Debtors for Goods sale on sale or return	1200	18, 800
		Stock – in – hand		8000
		Stock with customer		1000

19. Goods in Transit :

'Goods in transit' refer to those goods which have been purchased but not received during the current accounting period. As such goods have been purchased, it should be treated as part of closing stock.

The accounting treatment of goods in transit is as follows :

I.	Adjusting Entry to be passed	Goods in Transit A/c Dr To Trading A/c
II.	Treatment in Trading A/c	Cost of the goods in transit.
III	Treatment in Balance Sheet	Goods in transit is shown under Current Assets. on the Assets side.

Illustration 6.46 :

Invoices for goods costing ` 15,000 have been entered on 28th March 2006 against which the goods have not been received till 31st March 2006 on which date the books of accounts are closed. Show the accounting treatment in final accounts.

Solution:

Trading Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
		By Goods – in – transit	15, 000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Current Assets : Goods – in – transit	15, 000

20. Hidden Adjustments :

Sometimes, certain items are given in the trial balance which is to be treated as adjustments though nothing is mentioned regarding such items under adjustment. These items mostly relate to interest on loans, deposits and investments where rate of interest is mentioned against them. It should be treated as a hidden adjustment. Interest should be calculated and adjusted after taking into account the amount of interest already paid.

Illustration 6.47:

Trial Balance (extract) 31st March, 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(3)	5% Investment		20, 000	

Find out the hidden adjustment and give the adjustment entry.

Solution:

In this case, interest at the rate of 5% on investment for the whole year should be taken as a hidden adjustment as it is not appearing inside Trial Balance.

Interest = ` 20,000 × 5/100 = ` 1000.

The adjustment entry to be passed is :

Investment A/c Dr `1000

To Interest on Investment A/c ` 1000

Treatment :

(i) P & L A/c: Interest on investment should be credited to profit and loss account as it is an income.

(ii) Balance Sheet: The amount of interest should be added to investment on the asset side of balance sheet.

Illustration 6.48 :

Trial Balance (extract) 31st March, 2006

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
(4)	4% Loan on 1.1.2002			40, 000
(14)	Interest on Loan		600	

Find out the hidden adjustment and give the adjustment entry.

Solution:

Total interest on loan is `1600 (i.e., 40,000 × 4/100) out of which ` 600 has been paid during the year. So the balance amount of ` 1000 (i.e., 1600 – 600) should be treated as outstanding interest on loan. The following entry for the above is to be passed :

Interest on Loan	Dr	` 1000	
To 4% Loan A/c (or Interest Outstanding A/c)			`1000

Treatment:

(i) P & L Account: Add ` 1000 with interest on loan on the debit side of profit and loss account as it is outstanding.

(ii) Balance Sheet: Add `1000 with 4% loan account or interest outstanding account on the liabilities side of balance sheet.

21. Rectification of Errors:

Sometimes errors are discovered at the time of preparation of final accounts. Such errors are adjusted along with other usual adjustments by passing rectification entries. This has already been discussed under rectification of errors. In order to rectify an error in final account, we have to study its impact. If an error affects purchase, sales, returns, stock or nominal accounts, it will no doubt affect Trading and Profit and Loss Account. Where an error affects either assets or liabilities accounts, it will influence the balance sheet. Here, some of the important errors are discussed.

Purchased goods worth `2, 000 on credit. : The same has been taken into stock but no entry was passed in the purchase day book.

It is an error of omission which will be rectified by passing the following entry :

Purchase A/c	Dr	`2,000	
To Suppliers A/c			`2,000

It will be adjusted as follows,

(i) ` 2, 000 will be added with purchases on the debit side of Trading A/c.

(ii) Sundry Creditors will be increased by `2, 000 on the liabilities side of Balance sheet.

Wages include ` 800 spent on installation of machinery purchased.

This is an error of principle which will be rectified by passing the following rectifying entry.

Machinery A/c	Dr	`800	
To Wages A/c			`800

Its treatment in accounts will be,

(i) Add `800 to the value of machinery, (depreciation is calculated on the increased value of machinery).

(ii) Deduct `800 from wages account.

Sales proceeds of furniture sold for `1,700 wrongly credited to Sales account.

This is an error of positing to wrong accounts. The rectifying entry will be :

Sales A/c	Dr	`1,700
To Furniture A/c		`1, 700

Treatment:

(i) Deduct ` 1,700 from sales on the credit side of Trading A/c.

(ii) Deduct `` 1,700 from furniture on the asset side of balance sheet. Depreciation on furniture should be calculated after such deduction.

` **500 received from a debtor against a debt previously written off as bad,** has been wrongly credited to debtors account.

This is an error of posting to wrong account. Its rectifying entry is :

Sundry debtors A/c	Dr	`500	
To Bad debt recovered A/c			`500

Treatment:

(i) P and L A/c : Show bad debt recovered account on the credit side of profit and loss account as an income.

(ii) Balance Sheet : Increase sundry debtors by ` 500 on the asset side of balance sheet. (Provision for doubtful debt is calculated after such addition).

22. Manager's Commission Payable on Profit:

Sometimes, manager of managing Director of a business is allowed some percentage of profit as commission. The main aim is to give an incentive to the manager for improving the profitability of t he concern. As commission payable to manager is a chargeable expense against profit, the rate of commission is usually fixed in two ways.

(a) A fixed percentage on 'net profits before charging such commission.'

(b) A fixed percentage on'net profits after charging such commission'.

Calculation of Commission:

While calculating the amount of commission payable to a manager, the following procedure is adopted.

(a) Prepare Trading and profit and Loss Account in the usual manner.

(b) Finish all other adjustments and take up manager's commission as the last adjustment.

(c) Calculate the profit before charging commission by deducting the total of debit side of P and L A/c from the total of credit side.

(d) Now apply the following formulae for calculating commission.

(i) If commission is payable on net profit before charging such commission :

$$\text{Manger's commission} = \text{Profit before charging commission} \times \frac{\text{Rate}}{100}$$

(ii) If commission is payable on net profit after charging such commission :

$$\text{Manager's commission} = \text{profit before charging commission} \times \frac{\text{Rate}}{100 + \text{Rate}}$$

Note : Commission is not calculated if there is net loss in Profit and Loss Account. The accounting treatment of Manager's commission on profit is as follows :

The accounting treatment for provision for doubtful debts is as follows :

I. Adjusting Entry to be passed	Manager's Commission A/c To Outstanding Commission A/c	Dr.
II. Treatment in P & L A/c	Shown on the debit side as a separate item.	
III Treatment in Balance Sheet	Shown on the Liabilities side as a Current Liability	

Illustration 6.49 :

The manager of a concern is entitled to a commission of 10% on net profits after charging such commission. The net profit before charging such commission is `2,20,000 pass the necessary journal entry.

Solution : In this case, commission will be calculated as under :

Manager's commission = Net profit before charging commission $\times \dfrac{\text{Rate}}{100 + \text{Rate}}$

= 2,20,000 × 10 /110 = `20, 000

The adjustment entry is :

Commission A/c	Dr	`20, 000	
To Outstanding Commission A/c			`20, 000

Illustration 6.50 :

A trader prepared his trading account for the year ending on 31st March 2006 and found his gross profit to be `58, 000. He is unable to prepare his profit and loss account for which he sought your help. You have been provided with the following information Calculate his net profit.

Salary	6, 000
Selling expenses	4, 000
Advertisement	2, 000
Postage and Telegram	1, 400
Sundry income	2, 400
Interest on loan	1, 000
Office expenses	2, 000

Manager is to be allowed commission at 10% on net profit (a) before charging such commission, and (b) after charging such commission.

Solution:

In this case, net profit before charging commission

= 58, 000 + 2, 400 – (6, 000 + 4, 000 + 2, 000 + 1, 400 + 1, 000 + 2, 000)

= 60,400 – 16, 400 = `44, 000

(a) 10% commission on net profit before charging commission

= 44,000 × 10/ 100 =`4, 400.

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Salary	6,000	By Gross profit b/d	58,000
To Selling Expenses	4,000	By Sundry Income	2,400
To Advertisement	2,000		
To Postage and Telegram	1,400		
To Interest on Securities	1,000		
To Office expenses	2,000		
To Manager's commission	4,000		
To Net Profit transferred to Capital account	40,000		
	60,400		60,400

(b) If 10% commission is payable on net profit after charging such commission : Manager's commission = 44, 000 × 10/ 110 = ` 4, 000.

Profit and Loss Account for the year ending 31st March, 2006

Particulars	Amount `	Particulars	Amount `
To Salary	6,000	By Gross profit b /d	58, 000
To Selling Expenses	4,000	By Sundry Income	2, 400
To Advertisement	2,000		
To Postage and Telegram	1,400		
To Interest on Securities	1,000		
To Office expenses	2,000		
To Manager 's commission	4,000		
To Net Profit transferred to Capital account	40,000		
	60,400		60, 400

Comprehensive Illustrations

Illustration 6.51

Pass journal entries and show treatment in final accounts in each of the following cases.

(A) On 1st April 2005, the provision for doubtful debts in the books of S. Kumar shows a credit balance of `1600. During the year on amount of `1200 was written off as irrecoverable and `400 was received in respect of a debt previously written off in the last year. On 31st March 2006, debtors stood at `45,000 on which a provision of ` 2000 is to be created for next year.

(B) On 1st April 2005, the provision for doubtful debts showed a balance of `3200. On 1st April 2006 sundry debtors was`60,000 before writing off bad debt ` 2400. It is necessary to carry forward a provision for doubuful debts at 5% on debtors.

(C) On 1st April 2005 :

Provision for doubtful debts	`4500
On 31st March 2006 :	
Good debts	` 50,000
Bad debts	`2000
Doubtful debts	` 1500

A provision equal to the amount of doubtful debts is to be is to be created out of profit for next year.

(D) On 1st April 2005 :

Provision for doubtful debts	` 4500
Provision for discount on debtors	` 1500
During the year 2005-06	
Bad debts written off	` 1300
Discount allowed	` 900
On 31st March 2006 :	
Sundry debtors	` 50,000

Create a provision of 5% on debtors for doubtful debts and 3%

(E) On 31st March 2005 a firm's book showed a balance of `3400 and `1800 in respect of provision for doubtful debts and provision for discounts respectively. On 31st March 2006 sundry debtor stood at`42,000 after writing off bad debts of `3000, but before writing off discounts `2000. It is necessary to create provision of 10% and 2.5% for doubtful debts and discounts respectively.

Solution :** (A)* ***Journal

Date	Particulars		L.F.	Debit `	Credit `
2006	Bad debts A/c	Dr		1200	
Mar. 31	To Sundry debtors A/c				1200
	(Being bad debts written off)				
	Provision for doubtful debt A/c	Dr		1200	
	To Bad debt A/c			1200	
	(Being transfer of bad debt A/c)				
	Cash / Bank A/c	Dr		400	
	To Bad debt recovered A/c			400	
	(Being the amount received against a debt written off last year.)				
	P & L A/c Dr	1600			
	To Provision for doubtful debt A/c	Dr			1600
	(Being the amount required to bring up the balance of provision for doubtful debt A/c to required figure)				

Profit and Loss Account for the year ending 31st March, 2006

Particulars		Amount `	Particulars	Amount `
To Bad debts	1200			
Add : Required provision	2500			
	3200			
Less : Old provision	1600	1600		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets		Amount `
		Sundry debtors	45,000	
		Less : Req. provision	4000	43, 000

(B) **Journal**

Date	Particulars		L.F.	Debit `	Credit `
2006	Bad debts A/c	Dr		2400	
Mar. 31	To Sundry debtors A/c				2400
	(Being bad debts written off)				
	Provision for doubtful debt A/c	Dr		2400	
	To Bad debt A/c				2400
	(Being transfer of bad debt A/c)				
	P & L A/c	Dr		2080	
	To Provision for doubtful debt A/c	Dr			2800
	(Being the amount required to bring up the balance of provision A/c to required figure)				

Calculation of Required provision :

Required provision = (Sundry debtor – bad debt) × (rate/100)

= (60,000 – 2400) × (5/100) = 57,600 × 5/100 = `2880.

Amount to be charged to P & L Account = Bad debt + Required provision – Old provision

= 2400 + 2880 – 3200 = 5280 – 3200 =`2080.

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
To Bad debts 2400 Add : Required provision 2800 5280 Less : Old provision 1320	2080		

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 60,000 Less : Bad debt 2400 Less : Req. provision 2880	54, 720

(C) Total Debtors on 31 March 2006

= Good debtors + Bad debts + Doubtful debts

= 50,000 + 2000 + 1500 = `1500

Required provision for doubtful debts = `1500

Amount to be charged to profit and loss a/c

= Bad debt + Req. provision – Existing provision

= 2000 + 1500 – 4500 = (4500 = (–)` 1000

So there is an excess provision of `1000 which should be credited to P & L A/c.

Journal

Date	Particulars	L.F.	Debit `	Credit `
2006	Bad debts A/c Dr		2000	
Mar. 31	To Sundry debtors A/c			2000
	(Being bad debts written off)			
	Provision for doubtful debt A/c Dr		2000	
	To Bad debt A/c			2000
	(Being transfer of bad debt A/c)			
	Provision for doubtful debt A/c Dr		1000	
	To P & L A/c			1000
	(Being the transfer of excess amount to bring the balance of provision A/c to required figure)			

Profit and Loss Account for the year ending 31st March, 2006

Particular	Amount `	Particulars	Amount `
		By Provision for Doubtful debt 4500 Less : Bad debt 2000 Less : Req. provision 1520	1000

Balance Sheet as on 31st March, 2006

Liabilities	Amount `	Assets	Amount `
		Sundry debtors 53,500 Less : Bad debt 2000 Less : Req. provision 1500	50, 000

Illustration 6.52 :

From the following trial balance, prepare the Trading and Profit and Loss Account of Banarasi Das and Sons for the period ending 31st December 2005 and a Balance Sheet as on that date.

Trial Balance

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
01.	Capital			20,000
02.	Cash in hand		8600	
03.	Furniture		6500	
04.	Sundry debtors		10,800	
05.	Stock on 1.1.05		12,200	
06.	Net sales			48,000
07.	Interest received			1200
08.	Sundry creditors			6700
09.	Bank overdraft			8000

10.	Discount on purchase		900
11.	Wages	8500	
12.	Net purchases	25,600	
13.	Rent	2800	
14.	Trade expenses	1600	
15.	Administrative expenses	4200	
16.	Discount on Sales	1800	
17.	Commission on purchases	1400	
18.	Bank Charges	800	
		84,800	84,800

Additional Information :

(i) Stock on 31.12.2005 amounted to `10,400.

(ii) Wages outstanding ` 650.

(iii) Rent paid in advance `300.

(iv) Provide for depreciation on furniture at 5% p.a.

(v) Provide interest on capital at 10% p.a.

Trading and Profit and Loss Account of Mr. Banarasi Das for the year ending 31st December 2005

Dr Cr

Particulars		Amount `	Particulars		Amount `
To Opening Stock		12,200	By Net Sales		48,000
To Net Purchases		25,600	By Closing Stock		10,400
To Wages	8500				
Add : Outstanding	650	9150			
To Commission on purchases		1400			
To Gross profit c/d		10,050			
		58,400			58,400
To Rent	2800		By Gross Profit b/d		10,050
Less : Prepaid	300	2500	By Interest received		1200
To Trade expenses		1600	By Discount on purchases		900
To Administrative expenses		4200			
To Discount on sales		1800			
To Bank charges		800			
To Depreciation on furniture		325			
To Interest on capital		2000	By Net Loss transferred to Capital A/c		1075
		13,225			13,225

Balance Sheet of Mr. Banarasi Das as on 31st December 2005

Liabilities		Amount `	Assets		Amount `
Capital 20,000			Furniture	6500	
Add : Interest	2000		Less : Depreciation	325	6175
	22,000		Sundry debtors		10,800
Less : Net Loss	1075	20,925	Closing Stock		10,400
Sundry Creditors		6700	Prepaid Rent		300
Bank Overdraft		8000	Cash in hand		8600
Wages outstanding		650			
		36,275			36,275

Illustration - 6.53:

The following is the trial balance of Mahalaxmi Stores as on 31st March 2006. Prepare Trading and Profit and Loss Account for the year ended 31st March 2006 and the Balance Sheet as on that date.

Trial Balance

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
01.	Capital			80,000
02.	Building		20,000	
03.	Drawings		8500	
04.	Furniture		10,000	
05.	Motor Van		28,000	
06.	12% Loan			20,000
07.	Interest on 12% Loan		800	
08.	Sales		1,00,000	
09.	Purchases		80,000	
10.	Stock on 1.4.2005		18,000	
11.	Establishment expenses		12,000	
12.	Wages		4500	
13.	Rent		1000	
14.	Commission			3500
15.	Sundry Debtors		24,000	
16.	Sundry Creditors			26,500
17.	Bank Balance		16,000	
18.	Goodwill		7,000	
			2,30,000	2,30,000

Adjustments :

(a) The value of closing stock on 31.3.2006 is `15,000.

(b) Wages in arrears is ` 800.

(c) Unexpired rent is `400.

(d) Provide depreciation on building 2.5%, on furniture 5% and on motor van 7.5%.

(e) Charges interest on drawings `300.

Solution :

Trading and Profit & Loss Account of Mahalaxmi Stores for the year ending 31st March, 2006

Particulars		Amount `	Particulars	Amount `
To Opening stock		18, 000	By Sales	1,00, 000
To Purchases		80, 000	By Closing Stock	15, 000
To Wages	4, 500			
Add : Outstanding	800			
To Gross Profit c/d		11,700		
		1,15,000		1, 15, 000
To Establishment Expenses		12, 000	By Gross Profit b/d	11, 700
To Rent	1, 000		By Commission	3, 500
Less : Prepaid	400	600	By Interest on drawings	300

To Depreciation :				
on Building	500			
on Furniture	500			
on Motor van	2,100	3,100		
To Interest on loan	800			
Add : outstanding	1,600	2, 400	By Net Loss transferred	
			to Capital A/c	2, 600
		18,100		18,100

Balance Sheet of Mr. Banarasi Das as on 31st December 2005

Liabilities		Amount `	Assets		Amount `
Capital 80,000			Buildings	20,000	
Less : Drawings	8,500		Less : Depreciation	500	19,500
	71,500		Furniture	10,000	
Less : Int. on drawings	300		Less : Depreciation	500	9,500
	71,200		Motor Van	28,000	
Less : Net Loss	2,600	68,600	less: Depreciation	2,100	25,900
12% Loan	20,000		Goodwill		7,000
Add : Interest	1,600	21,600	Sundry Debtor		24,200
Sundry Creditors		26,500	Closing Stock		15, 000
Wages outstaanding		800	Unexpired rent		400
		Bank Balance	16,000		
		1,17,500			1,17,500

Illustration 6.54 :

On 31st December 2005 the following trial balance was extracted from the books of Shri Ghanashyam Das

Trial Balance

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
01.	Capital			1,40,000
02.	Building		80,000	
03.	Net Sales			1,20,000
04.	Net purchases		85,000	
05.	Opening Stock		25,000	
06.	Discount		850	
07.	Bank Charges		425	
08.	Salaries		12,500	
09.	Sundry Debtors		38,000	
10.	Sundry Creditors		25,000	
11.	manufacturing Wages		14, 800	
12.	Carriage inwards		625	
13.	Carriage outwards		500	
14.	Advertisement		1,300	
15.	Bad debt provision			750
16.	Rent			250
17.	Cash in hand		9, 000	
18.	Cash at Bank		18,000	

	2,86,000		2,86,000

Prepare the final accounts for the year ended 31st December 2005 and the balance sheet as on that date after considering the following adjustments.

(i) Closing stock `42,000.

(ii) Depreciate Building at 7%.

(iii) Bad debt provision required `600.

(iv) Interest on capital to be allowed at 5% per annum.

(v) wages prepaid ` 800.

Solution :

Trading and Profit and Loss Account of Sri Ghanashyam Das for the year ending 31st March, 2005

Dr | | | Cr

Particulars	Amount `	Particulars	Amount `
To Opening Stock	25,000	By Sales	1,20,000
To Net Purchases	85,000	By Closing Stock	42,000
To Manufacturing Wages 14,800			
Less : Prepaid 800	14,000		
To Carriage inward	625		
To Gross profit c/d	37,375		
	1,62,000		1,62,000
To Salaries	12,500	By Gross Profit b/d	37,375
To Discount	850	By Provision for bad debt 750	
To Bank charges	425	Less : Req. Provision 600	150
To Carriage outward	500	By Rent	250
To Advertisement	1,300		
To Interest on capital	7,000		
To Depreciation on Building	5,600		
To Net Profit transferred			
to capital A/c	9,600		
	37,775		37,775

Balance Sheet of Sri Ghanashyam Das as at 31st December 2005

Liabilities		Amount `	Assets		Amount `
Capital	1, 40, 000		Cash in hand		9000
Add : Interest on capital	7000		Cash at bank		18, 000
Add : Net profit		1, 56, 000	Sundry debtors	38, 000	
Sundry creditors	9600	25, 000	Less : Re q. provision	600	37.400
			Closing Stock		42, 000
			Prepaid wages		800
			Building 80, 000		
			Less : Depreciation	5600	74, 400
		1, 81, 600			1, 81, 600

Illustration - 6.55 :

Following is the trial balance of Ram Saran Gupta as at 31st March 2006.

Trial Balance

Sl. No.	Accounts Title	L.F.	Debit `	Credit `
01.	Capital			70,000
02.	Loan from Ganesh			15,000
03.	Sundry creditors			30,000
04.	Provision for Bad debt			600
05.	Bank overdraft			10,000
06.	Net Sales			5,40,000
07.	Discount			1400
08.	Land		80,000	
09.	Plant and Machinery		10,000	
10.	Furniture		8000	
11.	Goodwill		20,000	
12.	Sundry debtors		8000	
13.	Closing Stock		24,000	
14.	Cash in hand		3400	
15.	Drawings		1800	
16.	Adjusted purchases		5,00,000	
17.	Carriage inward		600	
18.	Carriage outward		450	
19.	Electricity charges		850	
20.	Salaries		6800	
21.	Trade expenses		1200	
22.	Insurance premium		1600	
23.	Bad debt		300	
			6,67,000	6,67,000

Prepare final accounts of Ram Saran Gupta as on 31st March after taking into consideration following points.

(i) Salaries outstanding ``600.

(ii) Loan from Ganesh was taken on 1.1.2006.

(iii) Plant and Machinery is to be depreciated at 2.5% and furniture at 5%.

(iv) The manager is entitled to a commission of 2% of net profit before charging such commission.

(v) A provision for doubtful debt is necessary at 5% on sundry debtors.

Solution :

Trading and Profit & Loss Account of Sri Ram Saran Gupta for the year ended 31st March 2006.

Particulars	Amount `	Particulars	Amount `
To Adjusted purchase	5,00,000	By Net Sales	5,40,000
To Carriage inward	600		
To Gross Profit c/d	39,400		
	5,40,000		5,40,000

To Salaries	6,800			By Gross profit b/d	39,400
Add : Outstanding	600	7,400		By Discount	1,400
To Electricity		850			
To Trading Expenses		1,200			
To Insurance Premium		1,600			
To Carriage ouitward		450			
To Bad debt	300				
Add : Req. provision	400				
	700				
Less : Old provision	600	100			
To Interest on Loan					
10% on 15,000 for					
3 months			375		
To Depreciation					
on plant and machinery 250					
on furniture 400			650		
To manager's commission			564		
To Net profit c/d			27,611		
			40,800		40,800

Balance Sheet of Sri Ram Saran Gupta as at 31st March 2006.

Liabilities		Amount `	Assets		Amount `
Sundry Creditor		30,000	Cash in hand		3,400
Outstanding salaries		600	Sundry Debtors	8,000	
Bank Overdraft		10,000	Less req. provision	400	7,600
Loan from Ganesh	15,000		Closing Stock		24,000
Add : Interest outstanding	375	15,375	Furniture	8,000	
Manager's commission payable		564	Less : Depreciation	400	7,600
Capital	70,000		Plant and Machinery	10,000	
Less : Drawings	1,800		Less : Depreciation	250	9,750
	68,200		Land		80,000
Add : Net profit	27,611	95,811	Goodwill		20,000
		1,52,350			1,52,350.

Illustration 6.56 :

The following is the trial balance of Mr. P. Patri on 31st March 2006.

	Debit`	Credit `
Cash in hand	1,080	
Cash at Bank	5,260	
Purchases	81,350	
Sales account		1,97,560
Returns inwards	1,360	
Returns outwards		1,000
Wages	20,960	
Fuel and power	9,460	

Carriiage on sales	6,400	
Carriage on purchases	4,080	
Stock (1 – 4 -05)	11,520	
Buildings	60,000	
Freehold land	20,000	
Machinery	40,000	
Salaries	30,000	
Patents	15,000	
General expenses	6,000	
Insurance	1,200	
Capital		1,42000
Drawings	10,490	
Sundry debtors	29,000	
Sundry creditors		12,600
	3,53,160	3,53,160

Taking into account the following adjustments, prepare Trading and Profit and loss account and the Balance sheet :

(a) Stock on hand on 31st March 2006 is ` 13, 600.

(b) Machinery is to be depreciated at the rate of 10% and patents at the rate of 20%.

(c) Salaries for the month of March 2006 amount to ` 3,000 were unpaid.

(d) Insurance includes a premium of `170 for next year.

(e) Wages include a sum of `4,000, spent on the erection of cycle -shed for employees and customers.

(f) A provision for bad and doubtful debts is to be created to the extent of 5% on sundry debtors.

Solution :

Trading and Profit & Loss Account of Mr. P. Patri for the year ended 31st March 2006.

Particulars		Amount `	Particulars		Amount `
To Openning Stock		11,520	By Sales	197560	
To purchase	81,350		Less : Return	(–) 1360	196200
Less : Return	(–) 1,000	80,350	By Closing Stock		13600
To Carriage on purchase		4,080			
To Wages		20,960			
Less : Erection of a cycle shed	(–)4,000	16,960			
To Fuel and Powers		9,460			
To Gross profit transferred P/L A/c		87,430			
		209800			209800
To Carriage Outward		6,400	By Gross Profit transferred from trading A/c		87430
To Salaries	30,000				
Add : Outstanding	3000	33000			
To General Exp.		6000			
To Insurance	1200				

Less : Pre-paid Insurance	170	1030		
To Depreciation on :				
Machinery	4000			
Patients	3000	7000		
To Provision for bad depts.		1450		
To Net Profit transferred to Capital A/c		32550		
		87430		87430

Balance Sheet of Mr. Mr. P. Patri as on 31st March 2006.

Liabilities		Amount `	Assets		Amount `
Creditors		12600	Cash in Hand		1080
Outstanding Salaries		3000	Cash in Bank		5260
Capital	142000		Debtors	29000	
Add : Net Profit	32550		Less : Provision	1450	
	174550				27550
Less : Drawings	– 10490		Insurance Prepaid		170
		164060	Closing Stock		13600
			Building	60000	
			Add : Cost of erection of a cycle shed 4000		64000
			Land		20000
			Machinery	40000	
			Less: Depreciation	– 4000	36000
			Patients	15000	
			Less: Depreciation	–3000	12000
		179660			179660

Note : Wages paid for erection of cycle shed is capital expenditure. Cycle shed is a part of building. It will increase the value of building, so wages paid for construction of shed has been wrongly included in the wages, So it should be subtracted from wages in the debit side of Trading account.

Illustration - 6.57 : The Trial balance of Mr. X as on 31st December, 2005 was as follows :

	Debit (`)	Credit (`)
Purchase	162505	
Sales		252400
Reserve for Doubtful debts		5200
Sundry Debtors	50200	
Sundry Creditors		30526
Bills Payable		3950
Opening Stock	36725	
Wages	23137	
Salaries	5575	
Furniture	7250	
Postage	4226	

Power and fuel	1350	
Trade expenses	5831	
Bad debts	525	
Loan to Ram @ 10% (September 1, 2005)	3000	
Cash in hand and at Bank	10000	
Trade Expenses accrued, not paid		700
Drawing A/c	4452	
Capital A/c		10000
Outstanding Wages		2000
Total	304776	304776

Prepare Trading and profit and loss account for the year December 31, 2005 and the Balance sheet as on that date after taking into consideration the following information :

(i) Depreciation on furniture is to be charged @ 10%.

(ii) Sundry debtors include in item of `500 due from a customer who has become insolvent.

(iii) Provision for doubtful debts is to be maintained @ 5% on Sundry debtors.

(iv) Goods of the value of `1500 have been destroyed by fire and insurance company admitted a claim for `1000.

(v) Stock on 31st December 2005 was `12,500.

Solution :

Trading and Profit & Loss Account of Mr. X for the year ended 31st December, 2005

Particulars	Amount	Particulars		Amount
	`			`
To Openning Stock	26,725	By Sales 252450		
To purchase	162,505	By Closing Stock		12500
To Wages	23,137	By Loss of stock by fire		5000
To Fuel and Powers	1350	By Insurance Company		1000
To Gross profit transferred P/L A/c	52,733			
	266,450			266,450
To Salaries	57575	By Gross Profit transferred		
To Postage	4226	from trading A/c		52733
To Trade Expenses	5831	By Interest Accrued on Loan to Ram		100
To Loss of Stock by fire	500	By Provision for Doubtful Debts	5200	
To Depreciation 10% on furniture	725	Less : Bad Debts	1025	
To Net Profit transferred	4175			
to Capital A/c	37,666	Less : Provision required	2485	1690
	54,523			54,523

Balance Sheet of Mr. Mr. X as on 31st March 2006.

Liabilities	Amount	Assets		Amount
	`			`
Creditors	30,526	Cash in hand and at Bank		10,000
Bills Payable	3950	Loan to Ram at 10%	3000	
Outstanding Wages	2000	Add : Interest Accrued	100	3100

Trade Expenses accrued but not paid		700	Debtors	50,200	
			Less : Provision for d/d	2485	
X's Capital		10,000	Further b/d	500	47,215
Add : Net Profit		37,666	Closing Stock		12,550
			Insurance Company		1000
Less : Drawings	4452	43,214	Furniture	7250	
			Less : Depreciation	725	6525
		80,390			80,390

6.7 KEY TERMS

Manufacturing Cost: It refers to the cost of raw materials and the cost of converting the raw materials into finished goods.

Gross Profit: It is the difference between Net Sales and Cost of Goods Sold.

Net Profit: It is the net result of the business operations and shows the financial performance of a business.

Net Sales: Difference between total sales and returns inwards (i.e., sales returns).

Gross Profit: Excess of net sales over the cost of goods sold.

Net Loss: Excess of indirect expenses and losses over the gross profit and other incomes.

Operating Profit: It refers to the profit earned from the operation of a business enterprise. It is the difference between the net sales and the operating cost.

Financial Position: It refers to the position of assets and liabilities of a business on a particular date.

Current Assets / Circulating Assets / Floating Assets: Assets which are likely to be converted into cash within a period of one year.

Intangible Fixed Assets: Assets in the form of rights which can not be seen and touched such as patent, trade mark, copy right, etc.

Fictitious Assets: Expenses and losses on the assets side of balance sheet but not yet written off.

Liquid Assets: Current assets which can be readily converted into cash without loss of value such as cash in hand and cash at work.

Contingent Liabilities: Liabilities which are not actual liabilities at present but may become actual liabilities on the happening of some uncertain event in future.

Current Liabilities: Liabilities which are required to be paid within one year.

Work-in-progress: Goods or works which are partly finished at the end of the year.

Adjustments: It refers to the events and transactions which are to be taken into consideration for the preparation of final accounts.

Depreciation: It is the decrease in the value of fixed assets due to use in the business.

Royalty: It is the consideration received/paid as per the agreement for having the right to use the asset.

Adjustment Entry: Journal entry passed to make an adjustment in the relevant accounts which are affected at the time of preparing financial statements.

Adjusted Purchases: Amount of purchase remaining after the adjustment of both the opening and closing stocks.

6.8 SUMMARY

- **Final Accounts,** i.e., Manufacturing Account, Trading Account, Profit and Loss Account and Balance Sheet are prepared to show periodic performance of a business and its finance position at the end of such period.
- **Manufacturing Account** is prepared by manufacturing organisations to show the cost of goods produced during a particular period.

- **Trading Account** is prepared at the end of an accounting period to know the gross profit/loss of a business from its trading activities. Gross Profit = Net Sales – Cost of Goods Sold.
- **Profit and Loss Account** is prepared at the end of an accounting period to know the net profit/loss of the business during the accounting period.
- **Balance Sheet** is a summary statement of assets and liabilities to show the financial position of a business on a particular date.
- **Adjustment's** are additional information which have to be taken into consideration for the preparation of final accounts. They relate to the expenses/incomes of current year not yet recorded, expenses/incomes which do not belong to the current year and non-cash expenses and provisions.
- All the adjustments appearing outside the Trial Balance have a double effect on the final accounts. Each adjustment is to be treated in two statements out of the following three, i.e., Trading Account, Profit and Loss Account and Balance Sheet.
- The items appearing inside the Trial Balance affects only one summary statement, i.e., either Trading Account, Profit and Loss Account and Balance Sheet.

6.9 CHECK YOUR PROGRESS AND ANSWERS

I. Choose the correct answer from the four alternative answers give below the questions :

(a) The excess of net sales over the cost of goods sold is called :

(i) Opening Profit (ii) Gross Profit
(iii) Net Profit (iv) None of these

(b) The balance of Profit and Loss Account representing net profit or net loss is transferred to :

(i) Drawing A/c (ii) Net Profit A/c
(iii) Capital A/c (iv) Asset A/c

(c) The Profit and Loss Account takes into account:

(i) Only indirect expenses (ii) Only indirect incomes
(iii) Both indirect expenses and incomes (iv) Both direct and indirect expenses.

(d) At the end of the year a busines has the following information.

Opening Stock	`12,000
Purchases	`35,000
Direct Expenses	`9000
Closing Stock	`16,000

What is the cost of goods sold ?

(i) `40,000 (ii) `72,000
(iii) `22,000 (iv) `56,000

(e) Which liability is not shown in the Balance Sheet ?

(i) Current liability (ii) Fixed liability
(iii) Long-term liability (iv) Contingent liability

[**Ans.** (a) - (ii), (b) - (iii), (c) - (ii), (d) - (i), (e) - (iv)]

II. Choose the correct answer from the four alternative answers given below the questions.

(a) At what price the closing stock is valued at the end of the year ?

(i) As cost price (ii) At invoice price
(iii) At cost or market price whichever is lower. (iv) At market price

(b) A permanent decrease in the value of fixed assets is otherwise called:

(i) Appreciation (ii) Depletion
(iii) Depreciation (iv) Amortisation

(c) The manager of a business is entitled to 5% commission on net profit after charging such commission. If the profit before charging commission `10,500, the amount of commission will be :

(i) `500 (ii) `550

(iii) ` 525 (iv) ` 1050

(d) Which of the following is shown on the liabilities side of Balance Sheet ?

(i) Accrued income (ii) Outstanding expenses

(iii) Prepaid expense (iv) Book debts

(e) The provision for doubtful debt ` 3,000 has been calculated at 7½% on sundry debtors. The amount of sundry debtors is :

(i) `50,000 (ii) `30,000

(iii) `40,000 (iv) ` 60,000

[**Ans.** (a) - (iii), (b) - (iii), (c) - (i), (d) - (ii), (e) - (iii)]

6.10 QUESTIONS AND EXERCISES

1. State the objective of preparing financial statements. Discuss briefly the composition of financial statements.
2. How would you classify the assets and liabilities of a business into different categories ? Explain with suitable examples.
3. Discuss the importance and preparation of Trading Account. What accounting entries are made for preparing a Trading Account ?
4. What do you mean by 'adjustment' and 'adjusting entries' ? Why is it necessary to pass adjusting entries at the time of preparing final accounts ? Discuss with two examples.
5. What do you mean by bad debt and provision for bad debt ? Why is it necessary to create provision for bad debt ? How will you treat bad debt and provision for bad debt in final accounts ?
6. How will you treat the following adjustments in the final accounts ? Explain by passing adjusting entries.

6.11. PRACTICAL PROBLEMS

1. From the following information prepare the profit and loss account Mr. Nanda for the year ending 31st March 2003.

	`
Rent and Rates	352
Discount received	680
Godown Rent	418
Bad debt	216
Interest received	315
Insurance	108
Travelling expenses	452
Apprentice Premium	325
Office expense	918
Advertising	312
Rent of building sublet	125
Trade Expences	228
Bank charges	165
Audit fees	245
Trading account (Cr)	4,920

[Ans : Net profit - ` 2,951]

2. From the following balances of Mr. Nandan prepare profit and loss account for the year ended 31st June 2002.

	`		`
Trading Account (Cr)	1,25,900	Income Tax	5420
Miscellaneous Income	2350	Export duty	3160
Interest on Investment	4580	Depreciation	2880

Postage	3250	Bad debts	1520
Repairs and Renewals	1980	Loss by fire	860
Carriage outward	425		

[Ans. : Net profit - ` 1,15,835]

3. From the following Trial Balance extracted from the books of Mohan Nag, prepare a Trading and Profit and Loss Account and show the Balance Sheet.

	`	`
Purchase and Sales	10,850,	13,840
Sundry debtors and creditors	3200	2400
Sales and Purchase Return	160	130
Bad debts and Bad debt Reserve	150	1250
Cash and bank overdraft	820	2460
Interest and commission	670	350
Drawing and capital	1800	18,000
Salary paid and Rent received	1620	140
Insurance Premium and Apprentice premium	650	900
Delivery van	10,000	
Furniture	2000	
Trade Expenses	1080	
Repairs to motor vehicle	470	
Wages	6000	
	39,470	39,470

Closing stock was `6,380.

[Ans. : G.P. - ` 3340; N.P. - ` 1340; Balance Sheet Total - ` 22,400].

4. Show the treatment of following adjustments in Trading and Profit and Loss account for the year ending 31st December 2002 and Balance Sheet on that date.

(a) On 1st April 2002 a machine costing ` 60,000 was purchased. On 1st July another machine costing `20,000 was purchased on which an installation expense of `5000 was spent. Provide for depreciation at 7½% p.a..

(b) Goods worth `6000 were distributed among the customers as free samples.

(c) On 30th December 2002, a fire occurred in the godown and goods worth `12,800 were destroyed. The goods were insured. The insurance company admitted claim for ` 9000 only.

(d) Factory Manager is enitled to a commission of 5% on the gross profit and general manager is entitled to 10% commission on the net profit after charging such commission. The gross profit and net profit before charging commission are ` 9000 and ` 3300 respectively.

(e) On 31st December 2002 Sundry debtors stood at ` 25,000 before charging a bad debt of ` 1500. A provision of 5% is to be maintained on debtors for doubtful debts.

[**Ans. :** (a) `4,312.50; (d) ` 750; (e) `1,175]

5. Following are the extracts from the Trial Balance of a trade on 31st December, 2002.

Particulars	Dr.(`)	Cr.(`)
Sundry Debtors	30,500	

Bad debt	800	
Discount	400	
Provision for Doubtful debt		1000
Provision for Discount		500

Additional Information :

(a) Write off further bad debt of `500.

(b) Provision for doubtful debt is to be maintained at 5% on debtor.

(c) Provision for discount is to be maintained at 3% on debtors.

Pass necessary journal entries. Prepare Bad debts A/c, Provision for bad debts A/c and show the treatment in Profit and Loss account and Balance sheet.

[**Ans.** Required provision for doubtful debt ` 1500, for discount `855, P & L. A/c ` 1800 (Dr) for doubtful debts and ` 755(Dr) for discount, Sundry Debtors ` 27,645].

6. From the following Trial Balance of Shyam, prepare Profit and Loss A/C and Balance Sheet for the year ended 31.3.2003 after making the necessary adjustments.

	Dr.(`)	Cr.(`)
Capital and drawings accounts	10,000	2,00000
Freehold property	60,000	
Plant and machinery	1,00,000	
Salaries	14,000	
Printing and Stationery	2000	
Furniture	4000	
Discounts	1500	
Bills payable		5700
Debtors and Creditors	25,000	40,000
Insurance	3000	
Bad debts	600	
Office Rent	2600	
Loose tools	2000	
Provision for doubtful debts		4800
Loan to Sudhir at 10% on 1.10.2002	40,000	
Interest on loan to Sudhir		1000
Cast at bank	25,000	
Cash in hand	10,500	
Stock on 31.3.2003	74,000	
Trading Profits		1,17,200
Outstanding wages on 31.3.2003		500
Insurance claim received on loss of goods		5000
	3,74,200	3,74,000

Adjustments:

(a) Outstanding salaries `700.

(b) Prepaid insurance ` 400.

(c) Value of loose tools on 31.3.2003 ` 1500.

(d) A new machinery was purchased on credit and installed on 28.2.2003 costing `15,000. No entry for the same had been made in the books.

(e) Depreciate (on closing balance) plant and machinery at 10% and Furniture at 5%.

(f) The provision for doubtful debts is to be maintained at 5%.

(g) Add insurance claim to gross profit.

[**Ans :** Net profit `92,925; Balance Sheet : `3,44,825]

{**Hints :** Depreciation on Plant and Machinery `10,125}

7. From the following balances were extracted from the books of Hari Prasad and other information prepare a Trading and Profit and Loss Account for the ended 31st December 2005 and a Balance Sheet as on that date.

	`		`
Stock (1.1.05)	40,000/-	Debtors	25,000/-
Purchase	90,300/-	Furniture	8000/-
Returns inwards	2200/-	Machinery	20,000/-
Salaries	11,000/-	Building	30,000/-
Insurance	2000/-	Drawings	5000/-
Postage and Stationery	2500/-	Sales (Cash)	78,800/-
Trade Investment	10,000/-	Sales (Credit)	6400/-
Cash	3500/-	Returns outwards	1300/-
Bad Debts	1000/-	Provision for doubtful debt	750/-
Rent and Rates	1500/-	Bank overdraft	40,000/-
Wages	3000/-	Commission (Cr.)	3250/-
Carriage Inwards	2000/-	Interest received	500/-
Capital	50,000/-	Sundry Creditors	24,000/-

Additional Information :

(a) Stock on 01-12-2005 ` 65,000/-.

(b) Goods worth ` 800 are taken by the proprietor for his personal use.

(c) Provide for doubtful debts @ 5% on debtor.

(d) Depreciate building @ 2% p.a.; machinery 10% p.a.; furniture 15% p.a.

(e) ` 400/- of the insurance paid relate to the quarter ending on 31.3.06.

(f) Salary outstanding ` 1000/-.

[**Ans :** Gross Profit ` 66,800/-; Net Profit ` 47,650/-, Balance Sheet Total ` 1,56,850/-.]

8. From the following balances extracted from the books of a Trader, prepare trading and profit and loss account for the year ended 31-12-2004 and a balance sheet as on that date.

Debit Balance	`	Credit Balance	`
Salaries	20,000/-	Capital	80,000/-
Wages	16,000/-	4% Bank Loan	20,000/-
Rent and Taxes	10,000/-	Bills payable	22,000/-
Bills Receivable	20,000/-	Sundry Creditors	24,000/-
Furniture	15,000/-	Sales	20,00,000/-
Plant and Machinery	60,000/-	Bad debt provision	12,00/-
Sundry Debtor	50,000/-		

Opening Stock	35,000/-		
Purchases	1,20,000/-		
Cash in hand	1,200/-		
TOTAL	**3,47,200/-**		**3,47,200/-**

Adjustments (Nearest to rupee) :

(a) Closing stock `40,000/-.

(b) Depreciate plant and machinery @ 5%, furniture @ 10%.

(c) Write off ` 500 as bad debt.

(d) Create a reserve for doubtful debt @ 2.5% on debtors.

(e) Outstanding Expenses are :

(i) Rent and Taxes ` 2000/-

(ii) Wages ` 3000/-

(iii) Salaries `4000/-.

[**Ans. :** Gross Profit ` 66,000/-; Net Profit ` 24,162/-, Balance Sheet Total ` 1,79,962/-]

9. From the following Trial Balance prepare the trading and Profit and Loss Account for the year ended 31st March 2005 and the Balance Sheet as on that date.

	`		`
Building	15,000/-	Bank interest	75/-
Income Tax	1,025/-	Sales	1,85,000/-
Loose Tools	1,000/-	Loan from Ramesh	2,500/-
Cash at Bank	16,200/-	Provision for doubtful debts	1600/-
Sundry Expenses	1990/-	Capital	47,390/-
Purchases	1,57,000/-	Dividend received	535/-
Wages	10,000/-	Bills payable	10,000/-
Carriage Inwards	1120/-		
Motor Van	12,500/-		
Cash in hand	335/-		
Bad Debts	100/-		
Sundry Debtors	9500/-		
Investments	6500/-		
Rent and Rates	850/-		
Furniture	3000/-		
Stock (1.4.2004)	27,350/-		
Discount allowed	630/-		
Drawings	2000/-		
TOTAL	**2,66,100/-**		**2,66,100/-**

Adjustments :

1. Provide for interest @ 12% p.a. due on loan taken on 1.6.2004.
2. Write off 5% for depreciation on Building and 40% on motor van.
3. Stock on 31.3.2005 was `15,000/-.
4. On 31.3.2005, loose tools were valued at `800/-.
5. Accrued Dividend on Investment `135/-.

6. Rates paid in advance `100/- and wages owing `450/-.

7. Write off further `300/- as bad debts and create a reserve for bad debt at 20% on debtor.

   [**Ans. :** Gross Profit `4,080/-; Net Loss `5383/-, Balance Sheet Total `71,180/-].

10. From the following Trial Balance of Surya Prakash prepare trading and profit and loss account for the year ended 31st December 2005 and balance sheet as on that date.

TRIAL BALANCE

Debit Balances	`	Credit Balances	`
Buildings	40,000/-	Sales	3,00,000/-
Drawings	10,000/-	Rents	2000/-
Furniture	5200/-	Creditors	27,800/-
Discount	3200/-	Bank Overdraft	8200/-
Bad debts	1600/-	Capital	60,000/-
Carriage on purchases	3600/-	Discount	4000/-
Commission	4400/-		
Salaries	18,000/-		
General Expenses	8000/-		
Returns Inwards	4000/-		
Purchases	2,20,000/-		
Debtors	36,000/-		
Stock (1.1.05)	44,000/-		
Taxes and Insurance	4000/-		
TOTAL	**4,02,000/-**		**4,02,000/-**

Adjustments :

1. Stock as on 31-12-05 `40,120/-.
2. There has been a loss of goods by fire on 30th December 2005 to the extend of `10,000/- not covered by insurance.
3. Provide for depreciation `2,000/- on building and `500/- on furniture and maintain provision for doubtful debt @ 5% on debtor.
4. Unexpired insurance amounted to ` 400/-.
5. Provide for interest on capital @ 5% p.a.

   [**Ans. :** Gross Profit ` 78,520/-; Net Profit ` 28,420/-, Balance Sheet ` 1,17,420/-]

6.12 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER- 7 INVENTORY VALUATION

Chapter Outlines

7.0 INTRODUCTION

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular, such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Thus inventory includes -

(a) Finished goods (Saleable).

(b) Work in Process (Semi finished).

(c) Materials and supplies. (Raw material), including loose tools, consumable items which help in production e.g. oil.

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

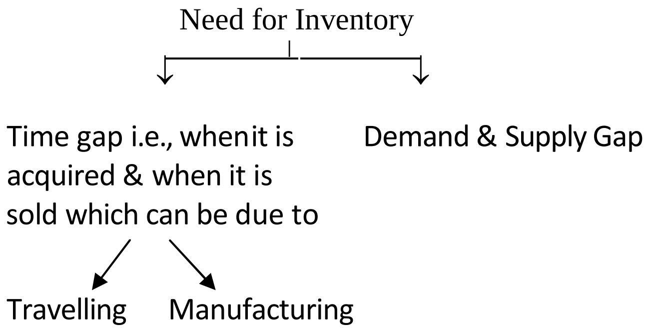
- Define the term inventory
- Appreciate the objective of inventory
- Explain different inventory systems
- Enumerate different methods of inventory valuation.
- Prepare inventory records according to different inventory systems/methods.
- Value in inventory for balance sheet purposes.
- List the essential requirements of Accounting Standard : 2 regarding valuation of inventories and
- Explain the meaning of certain key terms.

7.2 OBJECTIVES / NEED FOR INVENTORY VALUATION

An item to be included in Inventory depends upon circumstances of case. Rule of substance vs form applies. It is not necessary that all items in our possession may be our inventory e.g. if goods are received by consignee to be sold on consignment basis and are unsold, it is not included in consignee's inventory, but in inventory of consignor, because it is consignor who is enjoying risks and rewards of ownership.

Similarly, some goods which are not in our possession may be our inventory e.g.

1. Goods held by our branch.
2. Goods held by our consignee.
3. Goods sent in sales or approval basis and time limit for approval has not elapsed.
4. Goods sent on delivery basis and yet lying with the transporter.
5. Goods purchased but in transit.



1. Determination of results : It is only after accounting of inventory that an enterprise can find true profit/loss. Valuation of inventory is necessary so that proper matching of sale can be done with cost of goods sold.

Infact, Gross Profit = Sales – Cost of Goods Sold

Cost of Goods Sold = Opening Stock + Net Purchases + Direct expenses – Closing Stock.

Under valuation and over valuation of stock affect results of an enterprise. The effect on over valuation and under valuation on profits will be as under :

	Opening Stock	***Closing Stock***
	EFFECT ON PROFITS	
Under Valuation	Increase	Decrease
Over Valuation	Decreases	Increase

2. To determine Working Capital: A firm's assessment of Inventory amount determines its Working Capital (Current Assets – Current Liabilities). A correct assessment of working capital is necessary to maintain the running capability of an enterprise. It is the working capital with which immediate financial requirements are founded for smooth running of business.

3. Legal Obligations: Financial Statements, without value of Inventory cannot show true and fair view. Various pronouncements of ICAI including AS-2 and even Companies Act 1956 applicable to Companies require inventories to be valued and prescribes various disclosures of inventories so that Financial Statements show a clear picture and are not misleading.

7.3 INVENTORY VALUATION SYSTEMS

There are two Methods for determining Inventory.

(d) Periodic: It implies physical verification of Inventory. Under this method, no stock records are maintained. Thus, to determine the inventory in hand one has to do the physical verification and determine the quantity of inventory.

(e) Perpetual: It implies maintenance of stock records containing details of purchases, sales/issues and thus closing stock of each Inventory item. Stock registers are balanced to determine inventory in hand. Naturally, perpetual method is more reliable than periodic system, because under this method inventory levels can be determined at any time by just balancing stock register. However, it should be coupled with physical verification to determine any shortages. Thus perpetual system coupled with periodic system is best and a flawless method to keep inventory. However, the method used is also affected by nature of business. In a business, where no of items are very large and of low value, maintenance of stock records will be inconvenient e.g. for a chemist maintaining stock records of each and every medicine is not possible.

7.4 VALUATION OF INVENTORY FOR BALANCE SHEET PURPOSES

Valuation of Inventory as on Balance S Sheet Date if the Physical Inventory has been taken on a Date Prior to Balance Sheet Date :

To ascertain the value of inventory as on Balance Sheet date the cost of the items which are having effect of higher closing stock on Balance Sheet Date (for example, purchase made, Sales Return) after stock taking till Balance Sheet date should be added to and the cost of items which are having the effect of lower closing stock as on Balance Sheet date such as Sales, Purchase return should be subtracted from the value of physical inventory.

In addition the cost of unsold goods lying with others in our behalf, which were sent before the date of stock taking (for example, goods sent to customers before date of stock taking on approval basis but not yet approved till Balance Sheet date) is added to the value of physical inventory. Similarly, the cost of unsold goods lying with us on behalf of others, which were received before the date of stock taking (for ex ample, Goods received from Consignor before the date of stock taking on consignment basis but yet not sold till Balance Sheet date) is subtracted from the value of physical inventory.

Statement showing the Computation value of inventory if inventory is taken on a date (say 25th March, 2011) prior to the Balance Sheet date (say 31st March, 2011).

1. Statement Showing the Computation of Value of Inventory As on 31^{et} March, 2011		`
A.	Value of Inventory as per books as on 25.3 2011	XXX
B.	Less cost of goods sold and purchases returns after stock taking till March 31	XXX
	(Cost of Goods sold = Sales – Gross profit)	
C.	Add : Cost of unsold goods lying with others on our behalf (which we have sent before stock taking)	XXX
	(e.g.) (a) Cost of goods sent on Consignment basis	XXX
(b)	Cost of goods sent on Joint Venture basis	XXX
(c)	Cost of goods sent on Approval basis	XXX
(d)	Cost of goods sent on Hire purchase basis	XXX
(e)	Cost of goods sent to Branch	XXX
D.	Add : Cost of Sales Returns and purchases made after stock taking till 31st March	XXX
E.	Less : Cost of unsold goods lying with us on behalf of others	XXX
	(Which were received upto date of stock taking)	XXX
(e.g) (a)	Cost of goods received on Consignment basis	XXX
(b)	Cost of goods received on joint venture basis	XXX
(c)	Cost of goods received on Approval basis	XXX
(d)	Cost of goods received on Hire purchase basis	XXX
F.	Value of Inventory as per books as on 31.3.2011	XXX

2. Valuation of Inventory as on Balance Sheet Date in the physical Inventory has been Taken on a Date After the Balance Sheet Date.

To ascertain the value of inventory as on Balance Sheet date, the cost of items which are having the effect of higher closing stock as on Balance Sheet Date (for example, purchases retutn, Sales after balance sheet Date till stock taking) should be added and the cost of items, which are having the effect of lower closing stock as on Balance Sheet date (for example, Purchases made, sales returns after Balance Sheet Date till stock taking) should be subtracted from the value if physical inventory.

In addition, the cost of unsold goods lying with others on our behalf which were sent before the Balance Sheet Date (for example, Goods sent to Customers before Balance Sheet date on approval basis but not yet approved till Balance Sheet Date) is added to the value of physical inventory. Similarly, the cost of goods lying with us on bahalf of others which were received before the Balance Sheet date but not yet sold till Balance Sheet date (for example, Goods received from consignor before the Balance sheet da te but not yet sold till balance sheet date) is subtracted from the value of physical inventory.

Statements Showing the Computation of Value of Inventory if an Inventory is taken on a date (say 7[7th] April, 2011) after the Balance -sheet date (say March, 2011).

3. Statements showing the computation of value of inventory as on March 31, 2011	`
A. Value of Inventory as per books as on 7.4. 2011	XXX
B. Add : Cost of goods sold and purchases returns after 31st March till stock taking (Cost of Goods sold = Sales – Gross profit)	XXX
C. Add : Cost of the goods lying with others on our behalf as on 31.3.2011	XXX
(e.g.) (a) Cost of goods sent on Consignment basis	XXX
(b) Cost of goods sent on Joint Venture basis	XXX
(c) Cost of goods sent on Approval basis	XXX
(d) Cost of goods sent on Hire purchase basis	XXX
(e) Cost of goods sent to Branch	XXX
D. Less : Cost of Sales Returns and purchases made after 31st March till stock taking	XXX
E. Less : Cost of goods lying with us on behalf of others on 31.3.2011	XXX
(e.g) (a) Cost of goods received on Consignment basis	XXX
(b) Cost of goods received on joint Ventures basis	XXX
(c) Cost of goods received on Approval basis	XXX
(d) Cost of goods received on Hire purchases basis	XXX
F. Value of Inventory as per books as on 31.3.2011	XXX

7.5 ACCOUNTING STANDARD : 2 (REVISED)

The following is the text of the revised Accounting Standard (AS : 2), 'Valuation of Inventories', issued by the Council of the Institute of Chartered Accountants of India. The revised Standard supersedes Accounting Standard (AS : 2), Valuation of Inventories, issued in June, 1981. The revised standard comes into effect in respect of accounting periods commencing on or after April 1, 1999 and is mandatory in nature.

1. Objective : A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

2. Scope : This statement should be applied in accounting for inventories other than :

(a) work in progress arising under construction contracts, including directly related service contracts;

(b) work in progress arising in the ordinary course of business of service providers;

(c) shares, debentures and other financial instruments held as stock-in-trade; and

(d) producers of inventories of livestock, agricultural and forest products, and minerals oils, ores and gases to the extent that they are measured at net realizable value in accordance with well-established practices in those industries.

3. Definition of inventory valuation

AS-2 on Inventory Valuation defines Inventories as

: "Inventories are assets :

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

However, AS-2 excludes the following items as Inventories.

(a) Work in progress arising under construction contracts, including directly related service contracts.

(b) Work in progress arising in the ordinary course of business of service providers e.g. audit - in - progress for a Chartered Accountant.

(c) Shares, debentures and other financial instruments held as stock-in-trade (e.g., by stock traders, brokers); and

(d) Producers, inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

4. Valuation Rules : As per AS-2 on Inventory Valuation inventories are valued at cost or net realisable value whichever is less. As per Para 5 of AS-2 “Inventories should be valued at the lower of cost and net realisable value”.

The concept of such valuation is drawn from age old convention of prudence. Thus, if Net Realisable value is less than cost, the expected loss on inventory is recognized immediately, however if Net Realisable value is more, anticipated gain is not recognised. Both the elements Cost and Net Realisable value are discussed below :

Inventories are recognised as per MATCHING concept.

Inventories are valued at cost or net realisable value whichever is less, as per CONSERVATION/ PRUDENCE concept.

Para 6 of AS-2 clearly stipulates that “The cost of inventories should comprise all costs of purchas e, costs of conversion and other costs incurred in bringing the inventories to their present location a nd condition.

5. Cost of Purchase : The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities e.g. MODVAT recoverable, VAT on Purchase), freight inwards and other expenditure directly attributable to the acquisition clearing charges, octroi, import duty. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

6. Costs of Conversion: The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production t ha t very directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

Allocation of Cost **via-a-vis** Joint Products: A production process may result in more than one product being produced simultaneously. e.g. Crude Oil is used for the production of Diesel as well as Petrol. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production.

Allocation of Cost vis-a-vis By-Products : In certain cases production of main product also causes production of a subsidiary product which has its independent sale value. Such subsidiary product is called by-product e.g. for a **forging** unit, scrap of iron-ore is a by-product, similarly for a sugar manufacturing unit **molasses** is a by-product. This, by-product are secondary products produced from raw material used in producing main product without incurring any additional expenses.

By-product generally have insignificant value as compared to main product. Any sale value realised from by-product is not treated as a separate income, but as a reduction of total cost of production of main product. Most by-products as well as scrap or waste materials, by their nature, are immaterial. If t hey are not sold, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

7. Other Costs: Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Exclusions from the Cost of Inventories

In determining the cost of inventories, it is appropriate to exclude certain cost and recognise them as expenses in the period in which they are incurred. Examples of such costs are :

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage.

(c) Administrative overheads t ha t do not contribute to bringing t he inventories to t heir pres entlocation and condition; and

(d) selling and distribution costs.

Cost Formulas : Having understood the elements of cost, now let us understand how the cost is determined.

7.5.1 Distinction Between Periodic Inventory System and Perpetual Inventory System

Periodic Inventory System differs from Perpetual Inventory System in the following respects :

Basis of Distinction	Periodic Inventory System	Perpetual Inventory System
1.Basis of Ascertaining Inventory	Inventory is ascertained by taking by actual physical count.	Inventory is ascertained on the basis of records.
2. Calculation of Inventory	Inventory is directly calculated by applying the method of valuation of inventories.	Inventory is calculated as a residual figure as under : Closing Inventory – Opening Inventory + Purchases – Cost of Goods sold
3. Calculation of cost of goods sold.	Cost of Goods sold is calculated as a residual figure as under : Cost of Goods sold – Opening Inventory + Purchases – Closing Inventory	Cost of Goods sold is directly calculated by applying the method of valuation of inventories.
4. Lost Goods	Cost of Goods sold includes lost goods (if any).	Inventory includes lost goods (if any)
5. Closing Down of work Stock taking	It requires closing down of work for stock taking.	It does not require closing down of work for stock taking.
6. Continuous Stock Checking	It does not facilitate the continuous stock checking.	It facilitates the continuous stock checking.
7. Simplicity and cost.	It is simple and inexpensive.	It is elaborate and expensive.

7.6 METHODS OFVALUATION OF INVENTORIES

1. First in First Out [FIFO] (in AS-2)
2. Last in First Out {LIFO] (not in AS-2)
3. Cost method Average (in AS-2)
4. Specific Identification (in AS-2)
5. Standard Cost (in AS-2)
6. Adjusted Selling Price (in AS-2)
7. Base Stock Method (Not in AS-2)
8. Next in First Out [NIFO]
9. Height in First Out [FIFO]

1. FIFO: Method is also permitted as per AS-2. It implies that inventories are first issue from the oldest lot, i.e., goods received first, are issued first. Thus, inventories comprises of goods out of lates t purchases.

Illustration 7.6.1:

The following are the transactions relating to purchase and sale of a space part :

1st March 2001	Opening Stock	500 units @ ` 2 per unit
10th March 2001	Purchases	3,000 units @ `3 per unit
15th March 2001	Sold	1,000 units
25th March 2001	Purchases	1,750 units @ `4 per unit
30th March 2001	Sold	250 units

The value of inventory as on 31st March 2001 as per FIFO method is calculated as under :

		Receipts			Issues			Balance		
Date	**Particulars**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**
2001 Mar 1	Opening Bal.							500	2.00	1,000
10	Purchase	3,000	3.00	9,000				500 3,500	2.00 3.00	1,000 9,000
15	Issue			500	500 3.00	2.00 1,500	1,000 2,500	3.00	7,500	
25	Purchase	1,750	4.00	7,000				2,500 1,750	3.00 4.00	7,500 7,000
30	Issue				250	3.00	7.50	2,250 1,750	3.00 4.00	6,750 7,000

Value of Inventory as on 31st March 2001 = 2,250 units @ `3 each + 1,750 units @` 4 each = 6,750 +`7,000 = ` 13, 750.

Implication of FIFO Method in case of Rising or Falling Prices.

Periods	***Implications of FIFO Method***
1. In periods of Rising Prices	Since Inventories are issued at old, but lower cost, revenues are matched with lower cost, as a result, profits are more and consequently income tax liability is increased.
2. In periods of Falling Prices	Since Inventories are issued at old, but higher cost, revenues are matched with higher cost, as a result, profits are less and consequently income tax liability is increased.

Advantages

The advantages of FIFO Method are as follow:

1. This method is logical and has practical implications, i.e., issue of old inventories first. Thus it confirms to the physical flow of goods.
2. The value of closing stock tends to be nearer current market prices because it represents cost of recent purchases.
3. In periods of falling prices. Since inventories are issued at old, but higher cost, revenues are matched with higher cost, as a result, profits and loss and consequently, income tax liability is increased.
4. No unrealised inventory profits/losses are made by using this method because it is based on cost. 5.

This method is easy to operate if prices of materials do not fluctuate very frequently.

Dis -advantages

The dis-advantages of FIFO Method are as follow :

1. In a period of fluctuating prices, the cost of issues do not represent current market prices.
2. In periods of rising prices, since inventories are issued at old, but lower costs, revenues are matc hed with lower cost, as a result, profits are more and consequently income tax liability is increased.
3. This method involves a lot of calculation work in case there are violent fluctuations in the prices of materials.

2. LIFO (Last in First Out Method) : Method is not permitted as per AS-2. It implies that inventory are issued last. Thus, Inventory comprises goods out of oldest purchases.

Illustration 7.6.2

1st March 2001	Opening Stock	500 units @ ` 2 per unit
10th March 2001	Purchases	3,000 units @ ` 3 per unit
15th March 2001	Sold	1,000 units
25th March 2001	Purchases	1,750 units @ ` 4 per unit
30th March 2001	Sold	250 units

The value of inventory as on 31st March 2001 as per FIFO method is calculated as under :

		Receipts			Issues			Balance		
Date	**Particulars**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**
2001 Mar 1	Opening Bal.							500	2.00	1,000
Mar 10	Purchase	3,000	3.00	9,000				500	2.00	1,000
							3,000	3,00	9,000	
Mar 15	Issue				1000	3.00	3,000	500	2.00	1,000
						2,000	2,000	3.00		
Mar 25	Purchase	1,750	4.00	7,000				500	2.00	1000
							2000	3.00	6.000	
							1,750	4.00	7,000	
Mar 30	Issue				250	4.00	1000	500	2.00	1,000
								2,000	3.00	6,000
								1,500	4.00	6,000

Implication of FIFO Method in case of Rising or Falling Prices. Periods

	Implications of LIFO Method
1. In periods of Rising Prices	Since Inventories are issued at latest, but higher cost, revenues are matched with higher cost, as a result, profits are less and consequently income tax liability is decreased.
2. In periods of Falling Prices	Since Inventories are issued at latest, but lower cost, revenues are matched with lower cost, as a result, profits are more and consequently income tax liability is increased.

Advantages

The advantages of LIFO Method are as follow:

1. The cost of issues represent current market prices, thus it creates proper matching of sales with cost of goods sold.
2. In periods of rising prices, since inventories are issued, but higher cost, revenues are matched wit h higher cost, as a result, profits are less and consequently income tax liability is decreased.

Disadvantages

The disadvantages of LIFO Method are as follow :

1. This method is not logical and has impractical implications, i.e., issue of new inventories first. Thus it does not confirms to the physical flow of goods.
2. The value of closing stock does not tends to be nearer to current market prices because it represents cost of earlier purchases.
3. In periods of falling prices, since inventories are issued at latest, but lower cost, revenues are matched with lower cost, as a result, profits are more and consequently income tax liability is increased.
4. This method involves a lot of calculation work in case there are violent fluctuations in the prices of materials.

3. Average Cost Methods

(a) Simple Average Cost Method: Under this method issue will be values at an average price. Average price is calculated by adding up different prices and then dividing by the number of different prices. No weightage is given to the quantities purchased.

Illustration 7.6.3

The following are the transactions relating to purchase and sale of a spare part :

1st March 2001	Purchased	200 units @ ` 20 per unit
10th March 2001	Purchased	3,00 units @ ` 24 per unit
15th March 2001	Issued	250 units
25th March 2001	Purchased	250 units @ ` 26 per unit
30th March 2001	Issued	200 units

T he value of inventory as on 31s t March 2001 as per Simple Average Cost method is calculated a s under :

		Receipts			**Issues**			**Balance**	
Date	**Particulars**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Amt.**
2001 May 1	Purchases	200	20.00	4,000				200	4,000
10	Purchase	300	24.00	7,200				500	11,200
15	Issue				250	22.00*	5,000	250	5,700
25	Purchase	250	26.00	6,500				500	12,200
30	Issue				200	25.00*	5,000	300	7,200

Note : (a) Average Price on 15.03.2001 $= \dfrac{20+24}{2} =$ `22

(b) Average Price on 30.03.2001 $= \dfrac{24+26}{2} =$ `26

Value of closing Inventory (300 units) = ` 7,200.

(b) Weighted Average Cost Method : This method is also permitted by AS-2. According to this method, inventories are issued at weighted average price which is

$$= \frac{\text{Total Cost of inventory in hand}}{\text{Total Units}}$$

This method involves complex calculations at every time stock is issued, since cost per unit changes as new stock is purchased at **difference** price.

Under this method issues will be valued at weighted average price:

Illustration 7.6.4 :

The following are the transactions relating to purchase and sale of a spare part :

1st March 2001	Purchased	200 units @ ` 20 per unit
10th March 2001	Purchased	3,00 units @ ` 24 per unit
15th March 2001	Issued	250 units
25th March 2001	Purchased	250 units @ `26 per unit
30th March 2001	Issued	200 units

The value of Inventory as on 31st March 2001 as per Weighted Average Cost method is calculated as under:

		Receipts			Issues			Balance		
Date	**Particulars**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**	**Qty. Units**	**Rate Per Unit**	**Amt.**
2001 Mar 1	Purchase	200	20.00	4,000				200	20.00	4,000
Mar 10	Purchase	300	24.00	7,200				500	22.40	11,000
Mar 15	Issue				250	22.40*	5,600	250	22.40	5,600
Mar 25	Purchase	250	26.00	6,500				500	24.20	12,100
Mar 30	Issue				250	24.20*	4,840	300	24.20	7,260

Value of Inventory as on 31st March 2001 = 300 units @ ` 24.20 each = `7,260.

Note : (a) Weighted Average Price on 15.03.2001 = `11,200/500 = ` 22.40 (b) Weighted Average Price on 30.03.2001 = `12,100/500 = `24.50.

Advantages :

1. The cost of inventory and goods sold is averaged out in case of fluctuating prices, if prices show a n oscillating trend.
2. It is useful in case of process industries, i.e., when average cost calculation is a necessity.

Disadvantages :

The main disadvantages of Weighted Average Proice Method are as follows :

1. The closing stock does not correspond to the Conventional accounting of valuation of stock.

2. This method puts heavy burden on clerical staff because a new weighted average price is required to be calculated on receipt of a new lot.

3. This method cannot be used in job order industry where each individual order must be priced at each stage upto completion.

4. Specific Identification Method:

This method is also permitted by AS-2. Under this method, each cost incurred to bring inventory to its present location and condition is identified separately and taken as cost of that inventory. It is b est method to evaluate inventory when cost incurred an each item can be clearly identified and inventories can be segregated and inventory items are not interchangeable.

5. Standard Cost Method:

This method is also permitted by AS-2. Under this method, a standard cost per unit is calculated bas ed on past experience. Inventories are issued at that standard cost, but are adjusted for any variance between standard and actual. It is only recommended in cases where cost is stable and not changing.

6. Adjusted Selling Price Method/Retail Price Method:

This method is also permitted by AS-2. This method is commonly used under periodic system, where by inventory is physically counted and then valued at selling price. Afterwards, Standard Margin rat e i.e., Gross Profit % is deducted from Selling Price to arrive at cost. This method becomes a compulsion for various traders, when the number of items are very large and have standard Profit Rate e.g. a chemist.

Thus under this method Cost of Inventory = Selling Price – Gross Profit

7. Base Stock Method:

This method advocates a Minimum Level Stock approach, Accordingly a Minimum Level of stock is valued at its acquisitions cost and Stock over and above that level by any other method. The method has practical application in petrol pumps where minimum level of stock is to be compulsory maintained.

8. NIFO (Next in First Out) :

Under this method inventory are valued at cost they are expected to be purchased next. The method has no practical application and is against Cost Concept.

9. HIFO (Highest in First Out):

Under this method inventories purchased at highest cost are assumed to be issued first and thus stoc k comprises of inventories purchased at lower prices.

Illustration 7.6.5 :

The following are the transactions relating to purchase and sale of a spare part :

1st March 2001	Opening Stock	500 units @ `25 per unit
10th March 2001	Purchased	3,000 units @ `22 per unit
15th March 2001	Sold	1,000 unit
20th March 2001	Purchased	1,750 units @ ` per unit
25th March 2001	Sold	2,500 units

The value of Inventory as on 31st March 2001 as per HIFO method is calculated as under:

		Receipts			***Issues***			***Balance***		
Date	***Particulars***	***Qty.* Units**	***Rate* Per Unit**	***Amt.***	***Qty.* Units**	***Rate* Per Unit**	***Amt.***	***Qty.* Units**	***Rate* Per Unit**	***Amt.***
2001 Mar 1	Purchase Bal.							500	25.00	12,500
Mar 10	Purchase	3,000	22.00	66,000				500	25.00	12,500
								3,500	22.00	66,000
Mar 15	Issue				500	25.00	12,500			
					500	22.00	11,500	2,5000	22.00	55,000
Mar 25	Purchase	1,750	30.00	52,500				2,500	22.00	55,000
								1,750	30.00	52,500
Mar 30	Issue				1,750	30.00	52,500			
					750	22.00	16,500	1,750	22.00	38.500

Value of Inventory as on 31st March 2001 = 17,50 units @ ` 22 each = `38,500.

Net Realisable Value

AS-2 defines Net Realisable Value as "Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale."

According amount which will be realised from disposal of inventories after adjustment of direct selling expenses is Net Realisable Value. This, if inventories are valued at Cost or net realisable value, even expected loss on directly associated selling expenses is also provided for besides loss caused due to non-rec overy of Cost of Inventory.

A word of Caution : Net realisable value is calculated only in case of finished goods items of raw material or supplies held for production are valued at cost. This is because even if there Net Realisable value is less as compared to cost, the loss may not actually happen since they are not meant for sal e but to be used to produce final product which may be sold at profit. However, if it is expected that the finished product in which Raw Material is incorporated may not recover cost, then loss in Net Realisable value of Raw Material of Inventory is provided to the extent of such loss.

Illustration 7.6.6: Who was closing his books on 31.3. 1996 failed to take the actual stock, which he did only on 9th April 1996, when it was ascertained by him to be worth `25,000. It was found that sales are entered in the sales book in the same day of despatch and return in wards in the returns book as and when the goods are received back. Purchases are entered in the purchases daybook when the invoices are received.

It was found that sales between 31.03.1996 and 9.4.1996 as the sales daybooks are `1, 720. Purchases between 31.3.1996 and 9.4.1996 as per purchases daybook are `120, out of these goods amounting to `50 were not received until after the stock was taken.

Goods invoiced during the month of March 1996 but goods received only on 4th April 1996 amounted to ` 100. Rate of gross profit is $33^{1/3}$% on cost. Ascertain the value of physical stock as on 31.3.1996.

Solution : Statement of Valuation of Physical stock as on 31st March 1996.

Particulars	`	`
Value of stock as on 9th April, 1996		25,000
Add : Cost of Sales		
Sales made between 31.3.1996 and 9.4. 1996	1,720	
Less : Gross profit @ 25% on sales	– 430	+ 1,290
Less : Purchases actually received		26, 290
Purchased from 1.4.1996 to 9.4. 1996	120	
Less : Goods not received up to 9.4.1996	-50	- 70
		26,220
Less : Purchases during March, 1996 received on 4.4. 1996		100
Value of Physical stock as on 31.3. 1996		26, 120

Illustration 7.6.7.

From the following information ascertain the value of stock as 31.3.1997 :

	`
Value of stock on 1.4.1996	**70,000**
Purchases during the period from 1.4.1996 to 31.3.1997	3, 46,000
Manufacturing expenses during the above period	70, 000
Sales during the same period	5, 22, 000

At the time of valuing stock on 31.3.1996 a sum of`6, 000 was written off a particular item, which was originally purchased for `20, 000 and was sold for `16, 000, but for the above transaction the gross profit earned during the year was 25% on cost.

Solution:

Statements of valuation of stock as on 31st March 1997 :

Particulars		
Value of stock as on 9th April, 1996		70,000
Add : Puirchases during the period from 1.4.1996 to 31.3.1997		3, 46, 000
Add : Manufacturing expenses		70, 000
Less : Cost of sales during the period sales	5, 22, 000	4, 86, 000
Less : Gross Profit	– 1, 03, 200	– 4, 18, 800
Value of closing stock		67,200

Working Note :

Calculation of Gross Profit :

Gross Profit on normal sales (5, 22, 000 – 16, 000) × 20 /100	1, 01,200
Gross profit on the abnormal sales 16,000 – (20, 000 – 6, 000)	2, 000
	1, 03, 200

7.7 KEY TERMS

- **Inventory:** Inventories are unconsumed or unsold goods purchased or manufactured.
- **Historical Cost:** It is the aggregate of cost of purchase, cost of conversion, and other costs incurred in bringing the inventories to their present location and condition.
- **Periodic Inventory System:** A system where the quantity and value of inventory is found out only at the end of the accounting period after having a physical verification of the units in hand.
- **Perpetual Inventory System :** A system of records maintained by the controlling department, which reflects the physical movement of stocks and their current balance.

7.8 SUMMARY

- **Meaning of Inventory:** Inventories are unconsumed or unsold goods purchased or manufactured. According to the Accounting Standard: 2 (Revised), inventories are assets.
  (a) Held for sale in the ordinary course of business.
  (b) in the process of production for such sale, or
  (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
- **Objectives of Inventory Valuation :** Inventory has to be properly valued because of the following reasons:
  (i) Determination of income.
  (ii) Determination of financial position.
- **Inventory Systems :** Records pertaining to quantity and value of inventory-in-hand can be maintained according to any of the following two systems :
  (i) Periodic Inventory system
  (ii) Perpetual Inventory system
- **Method of Valuation of Inventories:** According to International Accounting Standard : 2 (IAS:2), the inventories should be valued at the lowest of 'historical cost' and 'net realized value'.
- **Historical Cost :** Historical cost of inventories is the aggregate of cost of purchase, cost of inventory valuation conversion, and other costs incurred in bringing the inventories to their present location and condition.

7.9 CHECK YOUR PROGRESS AND ANSWERS

1. State whether each of the following statements is 'True of False'.

(i) The valuation of inventory only affects the income statement.

(ii) Periodic inventory gives a continuous balance of stock in hand.

(iii) FIFO method correlates the current costs with the current market prices.

(iv) Inventory should be valued at the lower of historical cost and current replacement cost.

(v) LIFO method is suitable for items which are of non-perishable and bulky type.

(vi) Changes in the accounting policies relating to stock valuation are explained only to statutory auditors and not disclosed in the financial statements.

2. Indicate the correct answer :

(i) The test of objectivity and verifiability is satisfied by valuing inventory at

(a) Historical Cost. (b) Current Replacement Price. (c) Net Realizable Value.

(ii) Inventory is valued at lower of the cost or net realisable value on account of the accounting principle of

(a) Consistency. (b) Conservatism. (c) Realisation.

(iii) The system which gives a continuous information regarding quantum and value of inventory is known as

(a) Continuous Stock-taking. (b) Periodic Inventory. (c) Perpetual Inventory.

(iv) The value of inventory will be the least in case of

(a) Aggregate or Total Inventory method. (b) Item by Item Method. (c) Group or Category Method.

Ans. : 1. (i) False, (ii) False, (iii) False, (iv) False, (v) True, (vi) False.

2. (i) - (a), (ii) - (b), (iii) - (c), (iv) - (b).

7.10 QUESTIONS AND EXERCISES

1. Define Inventory. Why is proper valuation of inventory important ?
2. Discuss the different methods of inventory valuation with suitable examples.
3. Compare the LIFO and FIFO methods of inventory valuation.
4. Write a note on inventory valuation through the NIFO method.
5. State the salient features of AS:2 (Revised) regarding inventory valuation.

7.11 PRACTICAL PROBLEMS

1. From the following data, calculate the value of inventory on 31st January 2004 by (i) LIFO and (ii) FIFO methods :

2004		
1st Jan.	Opening Stock	200 pieces @ ` 2 each
4th Jan.	Purchases	100 pieces @`2.20 each
10th Jan.	Purchases	150 pieces @ ` 2.40 each
20th Jan.	Purchases	180 pieces @ `2.50 each
2nd Jan.	Issues	150 pieces
7th Jan.	Issues	100 pieces
12th Jan.	Issues	200 pieces

[**Ans.** Stock : LIFO 80 units of `172 and FIFO 80 units of `200]

2. Calculate the value of inventory using

(a) Weighted Average Method and

(b) the LIFO Method of pricing issues in connection with the following transactions :

April		Units	Value
1.	Balance in hand b/f	300	600
2.	Purchased	200	440
4.	Issued	150	
6.	Purchased	200	460
11.	Issued	150	
19.	Issued	200	
22.	Purchased	200	480
27.	Issued	250	

In a period of rising prices, as in the above case, what are the effects of each method ?

[**Ans.** (a) 150 units of `342, (b) 150 units of `300]

3. Purchases of a certain product during March, 2002 are set out below :

March	1	100 units	@ ` 10
	12	100 units	@ ` 9.80
	15	50 units	@ ` 9.60
	20	100 units	@ ` 9.40

Units sold during the month were as follows :

March 10 80 units
14 100 units
30 90 units

No opening inventories.

You are required to determine the cost of goods sold for March, under (i) FIFO, (ii) LIFO, and (iii) Weighted Average Cost Method.

[**Ans.** FIFO 270 units of `2648, LIFO 270 units of ` 2626, Weighted Average Cost Method 270 units of ` 2639]

4. A company started on 1st January, 2005 purchased raw material during 2005 as stated below :

January 2	800 kg	@ ` 62 per kg
February 26	1200 kg	@ ` 57 per kg
April 13	2500 kg	@ ` 59 per kg
July 10	3000 kg	@ ` 56 per kg
September 18	1500 kg	@ ` 60 per kg
November 29	1000 kg	@ ` 65 per kg

While preparing its final accounts on 31st December 2005, the company had 1300 kgs of raw material in its godown. Calculate the value of closing stock of raw material according to :

(i) First In First Out basis,
(ii) Last In First Out basis, and
(iii) Weighted Average basis.

[**Ans.** Value of closing stock (i) 83,000, (ii) ` 78,100 and (iii) `76,506].

5. From the following data, calculate the value of closing inventory according to Last in First out method on March 31, 2005, using :

(i) Periodic inventory system and
(ii) Perpetual inventory system.

March 1 Stock in Hand	400 units	@ 7.50 each
Purchases :		
March 5	600 units	@ 8.00 each
March 15	500 units	@ 9.00 each
March 25	400 units	@ 8.50 each
March 30	300 units	@ 9.50 each
Issues :		
March 3	300 units	
March 10	500 units	
March 17	400 units	
March 26	500 units	
March 31	200 units	

[**Ans.** Value of Closing Inventory : Periodic Inventory System ` 2250, Perpetual Inventory ` 2500].

6. Oil India is a bulk distributor of high octane petrol. A periodic inventory of petrol on hand is taken when the books are closed at the end of each month. The following summary of information is available for the month of June,

2007 :

Sale	`9,45,000
General Administration Cost	`25,000
Opening Stock : 1,00,000 litres @ ` 3 per litre	`3,00,000

Purchases (including freight in)

June 1	2,00,000 litres @ `2.85 per litre
June 30	1,00,000 litres @ ` 3.03 per litre
Closing Stock June 30	1,30,000 litres

Compute the following by the First In First Out, Weighted Average, and Last in First Out Methods of inventory costing:

(a) Value of inventory of June 30.

(b) Amount of the cost of goods sold for June.

(c) Profit and loss for June.

Ans.

Method	Value of Inventory `	Cost of Goods Sold `	Profit (Loss) `
FIFO	3,88,500	7,84,500	1,35,500
Weighted Average	3,90,000	7,83,000	1,37, 000
LIFO	3,93,000	7,80,000	1,50,000

[**Hints.** Administrative costs are not been included in the cost of goods sold.]

7. The following details relate to the value of inventories of different items as on 31st December 2004. You are required to calculate the value of inventory for balance sheet purposes on the basis of cost or net realizable value, whichever is less, by the following methods :

(i) Aggregate method, (ii) Group Method, and (iii) Item by Item Method

Articles	Group	Number of Items	Cost per Item (`)	Net Realisable Value per Item (`)
A	X	5	10	12
B	X	4	14	12
C	Y	6	10	8
D	Y	10	15	20
E	Y	5	20	15
F	Z	4	15	10
G	Z	5	20	16
H	P	4	6	4
I	P	3	4	5
J	P	3	3	2

[Ans. **(i) `588, (ii) `573, and (iii) `525]**

[**Ans.** (i) ` 588, (ii) ` 573, and (iii) ` 525]

7.12 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari

Financial Statement Analysis – John N. Meyer

Management Accounting – Khan and Jain.

Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.

Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

CHAPTER – 8 EQUITIES, ASSETS AND DEPRECIATION ACCOUNTING

Chapter Outlines

8.0 INTRODUCTION

The assets used by a business are usually of two types : (i) Current Assets, (ii) Fixed Assets. Current Assets are in cash form or can be converted into cash within a short period of time. Contrary to this, fixed assets provide benefits for a long period of time. Thus, the cost of the fixed assets is allocated over the periods during which the benefits are expected to be received from the use of such assets. The portion of cost of the fixed asset that expires during a particular accounting period is otherwise called "Depreciation" or "Expired Cost" which is charged to current year's revenue. Thus, depreciation plays a crucial role in the ascertainment of profit and to find out the real value of the fixed assets.

8.1 LEARNING OBJECTIVES

After studying this chapter, you should be able to :

- Understand the meaning, need for charging depreciation, and the factors affecting depreciation.
- Explain the two methods of charging depreciation, and the method of recording depreciation.
- Know the meaning and importance of provision and reserve.
- Explain the difference between provision and reserve, and the various types of reserve.

8.2 EQUITIES

Meaning: In broader sense, the term equity refers to all claims or rights against the assets of the enterprise. For every asset of the business, someone has paid for it or the amount is payable to someone for this the amount payable to such persons is called equity.

It is further divided into two categories :

(i) Owner's equity, (ii) Outsider's equity

Owner's equity is called capital and outsiders or creditor's equity is called liabilities.

Owner's equity + Outsider's equity = Assets or Capital + Liabilities = Assets.

Liabilities: It refers to an amount owing by one person (a debtor) to another (creditor) payable in money, goods or services. In general, liabilities are financial obligations to outside parties arising from events that have already happened. They can be divided into two categories :

(a) Current Liabilities: It refers to those liabilities which fall due for payment in a relatively short period. For example, creditors, bills payable short term loans, outstanding expenses etc.

(b) Fixed Liabilities: It refers to long term liabilities which are payable after a period of one year. For example, long term loans, public deposits, debentures etc.

Capital: It is the value of items invested by the proprietor into business. It may be in cash or in kind. Capital is increased with the amount of profits and is decreased with the amount of losses and drawings.

Capital = Assets – Liabilities

Capital may be classified into the following categories :

(a) Fixed capital: It is the capital invested in or represented by fixed assets.

(b) Working capital: It is the excess of current assets over current liabilities.

(c) Circulating capital: It is the capital in the form of current or floating assets.

8.3 ASSETS

The resources of an enterprise, i.e., things properties and rights of value owned by a business.

Fixed assets are used by a business firm for the purpose of producing or providing goods or services . The expense which results from the use of fixed assets is called depreciation. It is a diminution or a permanent fall in the value of fixed asset arising through wear and tear from the use of that asset in business. Thus, the cost of fixed asset is nothing but the price paid for a series of future services which should be sp read over a number of years during which benefit of the asset is derived. The process of changing the cost of fixed asset over its life is called depreciation. Thus, depreciation is an expense for each of the accounting years in which the asset provides service to the enterprise. It is an revenue expense just like rent, salary, etc.

Depreciation is the cost of diminution of service yield from a fixed asset. It is also the cost of lost usefulness of fixed assets.

8.4 CONCEPT OF DEPRECIATION

The value of asset shown in the accounting books is called book value. It is ascertained by deducting accumulated Depreciation from the original cost of the asset.

Book Value = Original Cost – Accumulated Depreciation

Accumulated Depreciation = Total Depreciation written off.

'Depreciation' has been defined by different accounting authorities as given below :

1. "Depreciation is the gradual and permanent decrease in the value of an asset from any cause."

   – Carter

2. "Depreciation may be defined as gradual deterioration in value due to use." – **R.G. Williams**
3. "Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a period." – **Spicer and Pegler**
4. "Depreciation represents the loss in value of the capital sunk in building, plant, machinery and other equipment, due to normal and inevitable deterioration during the life of these assets."

   – M. J.Wheldon.

5. "It is a matter of common knowledge that all fixed assets such as plant, machinery, tools, buildings, leaseholds, furniture etc, gradually 'diminish in value' as they get older and become work out by constant use in the business." **– J. R. Batlibio**
6. "Depreciation is the permanent and continuing diminution in the quality, quantity or value of assets.

8.5 CAUSES OF DEPRECIATION

The main causes of Depreciation are as follows :

1. Wear and Tear due to constant use : When fixed assets are put to use, the value of such assets may decrease on account of worn or torn out because of constant use as in case of Plant, Machinery, Furniture etc. used in a factory. A machine, when operated from day-to-day is bound to wear. This wearing out is in proportion to the number of hours of use in a day. Thus, primary cause of Depreciation is on account of loss of serviceability usually called ordinary wear and tear.

2. Lapse of Time: Certain assets decrease in value with the passage of time. This is true in case of assets like Leasehold properties, Patents, Copyrights etc.

3. Depletion: It is one of the internal causes of decrease in the value of wasting assets. An asset may get exhausted by working. This is in case of mineral mines. Due to continuous extraction of minerals or oil, a stage comes when time or well gets exhausted and nothing is left therein.

4. Obsolescence: It is an experience of every day life that due to new inventions and improved techniques, the old assets become obsolete (out of date). It may be discharded even if it could be p ut to use and is still in workable condition.

5. Accident : Sometimes an asset may be destroyed due to fire, flood etc. or a vehicle may be damaged due to an accident.

6. Exhaustion of Assets: Some assets completely lose their existence after some time. For example, live stock, trees etc. The value of such assets decrease due to lapse of their age.

8.6 BASIC FEATURES OF DEPRECTIATION

1. Depreciation is gradual diminution in the value of assets.
2. It decrease the book value of an asset.
3. Depreciation is a continuous process of diminution in value of fixed asset due to its use or lapse of time.
4. Depreciation is not a method of valuation of asset but it is a process of spread over of cost of ass et over its useful life.
5. Change in market value of an asset is not termed as Depreciation.
6. The term Depreciation is used only for diminution in value of tangible fixed asset due to its use.

8.7 CLASSIFICATION OF ASSETS

From the Depreciation point of view assets may be classified into the following two groups :

(A) Non-Depreciable Assets

(B) Depreciable Assets

Non-Depreciable Assets

The assets on which Depreciation is not provided for are called non-depreciable assets. Current assets and land are non depreciable assets. Current assets include stock, Debtors, Bills Receivable, investments, Cash and Bank balance, etc. Land is only the fixed asset on which Depreciation is not provided for because it does not depreciate due to use or its value is not reduced due to lapse of time.

Depreciable Assets

The assets which are depreciated due to their use or lapse of time are called Depreciable assets. These assets are expected to be used during more than the accounting period and have a limited useful life. These are held by the business entity for use and not for the purpose of sale in the ordinary course of business. Such assets may be classified into the following groups :

(i) Tangible Fixed Assets

(ii) Intangible Fixed Assets

(iii) Wasting Assets or Natural Resources

(iv) Assets with pre-determined time limit.

(i) Tangible Fixed Assets: Assets having physical existence are called tangible assets. For example : Buildings, Furniture, Machinery, etc. Land is tangible fixed asset but it is not a depreciable fix ed asset. The gradual reduction in value of tangible fixed asset is called Depreciations.

(ii) Intangible Fixed Assets: Asset not having physical existence is called intangible asset. Its value being limited by the rights and anticipative benefits that possession confers upon the owner. For example, Goodwill, patent, trade-mark, etc. are the intangible assets.

(iii) Wasting Assets or Natural Resources: Natural resources such as ore deposits, oilwells, timber stands, quarries, etc. are exhausted. Such assets are called wasting assets. The process of writing off the value of such assets is called depletion.

(iv) Assets with pre-determined time limit : Some assets are acquired for a limited period. For example, lease hold property is acquired for a pre-determined period. Depreciation of such asset should be written off properly.

8.8 METHODS OF RECORDING DEPRECIATION

Depreciation is provided at the end of each accounting year. There can be two methods of accounting for depreciation :

1 . When Provision for depreciation is not maintained :

In case the provision for depreciation is not maintained in the books, the fixed assets are shown in the books at their written down values. The following journal entries are passed to record depreciation :

(a)	For providing depreciation :	Depreciation A/c	Dr.
		To (Particular) Asset A/c	
(b)	For transfer of depreciation	Profit and Loss A/c	Dr.
	to Profit and Loss Account :	To depreciation A/c	
(c)	When an asset is sold or	Bank A/c	Dr.
	disposed off :	To Particular Asset A/c	
		(Sale proceed of asset sold)	
(d)	For profit on sale of an asset :	(Particular) Asset A/c	Dr.
		To Profit and Loss A/c	
(e)	For loss on sale of an asset :	Profit and Loss A/c	Dr.
		To (Particular) Asset A/c	

2. When Provision for depreciation is maintained :

Under this method, the Asset appears at original cost in the Balance Sheet and the accumulated depreciation, known as 'Provision for depreciation' is shown separately. The following journal entries are passed to record depreciation :

(a)	For providing depreciation :	Depreciation A/c	Dr.
		To Provision for Depreciation A/c	
(b)	For creation of provision :	Profit and Loss A/c	Dr.
	to Profit and Loss Account :	To depreciation A/c	
(c)	For sale of fixed asset :	(i) Provision for Depreciation A/c	Dr
		To (Particular) Asset A/c	
		(For transferring the accumulated dep. on asset sold)	
		(ii) Bank A/c	Dr.
		To (Particular) Asset A/c	
		(For Sale Proceed of Asset)	
(d)	For profit on sale of fixed	(Particular) Asset A/c	
	asset :	To Profit and Loss A/c	
(e)	For loss on sale of fixed asset :	Profit and Loss A/c	
		To (Particular) Asset A/c	
		(For loss on sale of Asset)	

8.9 OBJECTIVES OR NEED FOR PROVIDING DEPRECIATION

The need for providing Depreciation is accounting records arises due to any one or more of the following objectives to be attained:

1. To ascertain the profit or loss properly : For proper acertainment of profit or loss, it is necessary to charge the Depreciation (cost) against income (revenue) in each accounting period. Unless the Depreciation is charged against income, the result of operations would be overstated. As a result the Profit and Loss A/c would fail to present a true and fair view of the result of operations of a business entity. Moreover, a fixed asset is an important tool in earning revenue. The fall in the book value of asset reflects the cost of earning revenues from the use of asset in the current year. Hence, like other expenses it must also be provided for.

2. To show a true and fair view of the financial position: For presenting a true and fair view of the financial position, it is necessary to charge Depreciation . If Depreciation is not charged, the unexpired cost of the asset concerned would be overstated. As a result, the Positional Statement (i.e., the Balance Sheet) would not present a true and fair view of the financial position of an accounting entity.

3. To find out correct cost of production : For ascertaining the cost of production, it is necessary to charge Depreciation as an item of cost of production. If Depreciation on fixed assets is not charged, the cost records would not present a tur and fair view of the cost of production.

4. To comply with legal requirements: In case of companies, it is compulsory to charge Depreciation on fixed assets before it declares dividend [Sec. 205(A) of The Companies Act, 1956].

5. To accumulate funds for replacement of assets : A portion of profit is set aside in the form of Depreciation or in sinking fund and accumulated each year to provide a definite amount at a certain future date for the specific purpose of replacement of the asset at the end of its useful life. In the absence of such arrangement it may become difficult for the business enterprise to secure necessary funds for the replacement of assets, when large amount is needed for it.

6. To avoid payment of dividend from capital: If the Depreciation is not charged, the profit shown by the Profit and Loss Account will be in excess of the actual profits. Such an excess profit may be wholly withdrawn by proprietor or may be distributed among the shareholders as dividend. Hence, the amount of dividend distributed will also include the amount of Depreciation which is actually a part of capita l.

7. To get deduction from Income Tax: If Depreciation is not debited to Profit and Loss Account, the net profit shown by it will be in excess of actual profits. Thus, more tax would be payable by t he firm. Depreciation is an allowable expenditure under Income-Tax Act. It is essential to provide for Depreciation so that deduction may be claimed.

8. Other miscellaneous reasons: If proper amount of Depreciation is not charged, the net profit as revealed by Profit and Loss Account will be higher than the actual profit. As a result of which :

(a) Employees may demand higher wages and bonus.

(b) It may result in extravagance.

(c) Other parties will be attracted to establish the business which in turn will increase the competition.

(d) Manager of the firm will get higher commission if it is based on profit.

8.10 BASIC FACTORS OF PROVIDING DEPRECIATION

The measurement of Depreciation is based on the following factors :

1. Total cost of the Asset : Cost of a fixed asset is determined after adding all expenses incurred for bringing the asset to usable condition, such as freight, transit insurance, installation charges bes ides its purchase price. IF an old asset is purchased, the overhauling charges incurred will also be included in the cost of the asset. Interest on loan taken to purchase asset and other financing charges on credit terms should not be included in the cost of the asset. In short,

$$\boxed{\text{Original Cost} = \text{Price} + \text{Freight} + \text{Installation Expenses.}}$$

2. Estimated useful life of the Asset: Useful life of an asset is estimated in terms of number of years during which the asset can effectively be use for business operations. In case of longer useful life, amount of depreciation will be lower, while it will be higher in case of shorter useful life.

3. Estimated residual value of the Asset: It is the estimated sale value of the asset at the end of its useful life. It is called as residual value or break-up value. Depreciation is calculated after deducting estimated scrap value from the cost of the asset. In short,

$$\boxed{\text{Depreciation Base} = \text{Original Cost} - (\text{Scrap Value} - \text{Removal Charges})}$$

4. Provision for repairs and renewals: Suitable arrangements for repairs and renewals of an asset will automatically increases its useful working life. As a result of which less amount of depreciation shall be provided.

5. Possibility of new inventions: Obsolescence of an asset depends upon new inventions expected in future. If the new asset, because of inventions, is expected soon in future, the useful life of the old asset is shorten. Thus, higher amount of depreciation need to the provided.

6. Expansion of Asset: If any capital expenditure is incurred in connection with the expansion of the present asset, the same will be taken into consideration while providing for depreciation.

7. Legal Laws: If there are some legal laws in existence for making provision for depreciation, such laws are to be followed. For example, Company Law, Income Tax Law etc. are there for providing depreciation on fixed assets.

8. Interest on Capital Invested: Interest on capital invested for the purchases o construction of fixed asset should also be taken into consideration while making provision for depreciation.

9. Working conditions: The working conditions should also be kept in consideration while making provision for depreciation. For example: an asset may be used in one shift or in double or tripple shifts. The amount of depreciation shall be higher in case of its use in double or tripple shifts rather than it s use in one shift.

8.11 DEPRECIATION, DEPLETION AND AMORTIZATION DILAPIDATIONS

The terms are normally used in the same sense but there are some basic differences among them that are discussed below:

Depreciation: It is concerned with providing for the cost of tangible fixed asset due to its use or lapse of time. Depreciation is the gradual continuing reduction in the value of fixed assets while a temporary change in market value is called fluctuation.

Depletion; Reduction in the value of natural resources on account of exhaustion is termed as depletion. For example extracting coal from coal mine, minerals from its deposits, etc.

Amortization : The process of writing down the intangible asset is called Amortizations. For example, Goodwill, patent, lease hold property, trade-mark etc. are written off over their limited useful life. Such written off is called Amortization. In other words, amortization is the accounting process of converting intangible assets to expenses.

Obsolescence: The loss in usefulness of an asset occassioned through progress of the technology or changing law or social customs is called obsolescence.

Dilapidations: The term dilapidations refers to the damage done to a building or other property during tenancy.

It may be noted that the terms, Depreciation, depletion, amortizatioin and obsolescence should be used in the sense described above but there is a general tendency to use the work 'Depreciation' even for amoritzation and depletion.

Depreciation vs Maintenance: The expenses are incurred to maintain the efficiency of a machine. It does not mean that the machine will not be discarded but life of machine is limited. The maintenance expenses are incurred to maintain the machine during its useful life. Thus, cost of machine must be allocated to the products during the life time of the machine as Depreciation. Thus, Depreciation is spread over of cost of machine during its useful life whereas maintenance is the cost of maintaining limited useful life.

8.12 METHODS FOR PROVIDING DEPRECIATION

There are various methods for providing depreciation. Different methods may be suitable for different assets depending upon the nature and type of asset. These methods are enumerated as under :"

1. Fixed Installment Method.
2. Diminishing Balance Method
3. Annuity Method
4. Revaluation Method
5. Machine Hour Rate Method
6. Sum of Year's Digit Method
7. Depreciation Fund Method
8. Insurance Policy Method
9. Depletion Unit Method
10. Service Hours and Production Output Method.

1. *Fixed Instalment Method :*

This method is also called as original cost method or equal instalment method or straight line method. Under this method depreciation is charged at a fixed percentage on the original cost of the asset. Thus, the amount of depreciation remains equal from year to year, as such this method is called equal instalment or straight line or fixed instalment method. The amount of yearly depreciation is calculated by the following formula :

$$\boxed{\text{Annual depreciation} = \frac{\text{Original Cost of Asset - Estimated Scrap Value}}{\text{Estimated Life of Asset}}}$$

For example, if the purchase price of an asset is ` 90,000, ` 2000 are incurred for cartage and ` 8000 for the installment charges of the asset, estimated scrap value is likely to be ` 15,000 at the end of its useful life of 10 years, the amount of depreciation to be written off would be as follows :

$$\frac{(90,000+2000+8000-15,000)}{10 \text{ years}} = \text{` } 8,500 \text{ every year}$$

Rate of depreciation is calculated with the help of the following formula :

$$\boxed{\text{Rate of depreciation} = \frac{\text{Amount of Depreciation}}{\text{Original Cost}} \times 100}$$

Sale of Asset during the year

When an asset or a part of it being damaged is disposed off during the year, the following points should be kept in mind while preparing accounts :

(i) When the rate of depreciation is expressed as per annum, provide depreciation on the asset for the period it was used during the year. If the words 'per annum' are not given, no depreciation be provided in the year of disposal and full year depreciation should be charged during the year of purchase.

(ii) When there is a loss on sale of asset, it should be treated as loss of obsolescence and be debited t o Profit and Loss Account.

(iii) When there is a profit on sale of asset, it should be transferred to the credit of Profit and Loss Account. In case the profit is substantial, it should be treated as a Capital Profit.

Suitability : This method is suitable for those assets that do not require large investment and the amount of repairs and renewals required is also not large such assets have comparatively shorter lif e, such as Furniture, Patent, Copyright, Trademark, Leaseholds etc.

Merits : The main merits of this method are as follows :

(i) This method is simple to understand.

(ii) This method is easy to calculate and amount and the rate of depreciation.

(iii) Under this method the book value of the asset becomes zero or equal to its scrap value at the end of its useful life, which is not possible under some other methods.

(iv) Under this method, the original cost of the asset and total depreciation (upto date) is shown as a direct dedication in the Balance Sheet. Thus the information of original cost of the asset and the upto date depreciation is available at any time.

Demerits : The main demerits of this method are as follows :

(i) It is a well-known fact that the efficiency and usefulness of a machine is more in the earlier years as compared to later years. As such, more depreciation should be charged in earlier years than in the later years, whereas, depreciation remains constant from year to year under this method.

(ii) Repair charges go on increasing year after year as the asset becomes older but as the equal depreciation is charged under this method each year, the total burden charged on Profit and Loss Account in respect of depreciation and repairs put together will not be equal each yar. The total burden will b e lighter in earlier years and heavier during the later years.

(iii) When there are different machines having different life-span, the computation of depreciation becomes complicated because the depreciation on each machine will have to be calculated separately.

(iv) This method does not take into consideration the loss of interest on the amount invested for the ass et. The amount would have earned interest, had it been invested outside the business.

(v) Sometimes, even after the value of an asset is reduced to zero in the books, the asset continues to be used in the business of actual practice.

Important Note : Generally the rate of depreciation is expressed as "per annum" It means if furniture for ` 20,000 was purchased in the middle of the year and rate of depreciation is 10% per annum. The depreciation for the first year would be 10% on ` 20,000 for 6 months or `1000. On the other hand, if rate of depreciation is given as 10% and not 10% per annum, the depreciation on the asset for first year will be charged for the whole year i.e., 10% of 20,000 = `2,000. This is irrespective of the date of purchase of an asset. When the asset is disposed off in any year, no depreciation be provided for the period it was used before its disposal, if the rate is not given as annum.

Illustration - 8.1:

On 1st April, 2005 Anil and Co. purchased a Machine or `1,62,000 and incurred ` 3000 for freight, ` 2000 towards insurance and `3000 for installation charges. It was estimated that the machine will have a scrap value of ` 1,000 at the of its useful life which is 4 years. At the end of second year machine was sold for ` 32,000. Accounts are closed on 31st March every year.

I. Calculate :
   (1) Amount of depreciation, and
   (2) Rate of depreciation on the basis of Straight Line Method.

II. Pass necessary Journal entries when :
   (1) Provision for depreciation account is not maintained.
   (2) Provision for depreciation account is maintained.

Solution:

I. (1) Calculation of Amount of Depreciation :

$$\text{Amount of Depreciation} = \frac{\text{Cost of asset} - \text{Scrap value}}{\text{Useful life of the asset}}$$

$$= \frac{(1,62,000 + 3000 + 2000 + 3000) - 10,000}{4}$$

$$= \frac{1,60,000}{4} = \text{`}\ 40,000$$

I. (2) Calculate of Rate of Depreciation on the basis of Straight Line :

$$\text{Rate of Depreciation} = \frac{\text{Amount of Depreciation}}{\text{Original Cost of Asset}} \times 100$$

$$= \frac{₹\ 40{,}000}{₹\ 1{,}70{,}000} \times 100 = 23.53\%\ \text{p.a.}$$

II. (1) When Provision for Depreciation Account is not maintained.

Journal Entries

Books of Anil and Co.

Date	Particulars		LF.	Amount Debit	Amount Credit
2005				₹	₹
April 1	Machinery A/c	Dr.		1,62,000	
	To Cash A/c/Bank A/c				1,62,000
	(Being Machinery purchased)				
April 1	Machinery A/c	Dr.		8,000	
	To Cash A/c				8,000
	(Being Freight, Insurance and Installation charges paid).				
2006					
Mar. 31	Depreciation A/c	Dr.		40,000	
	To Machinery A/c				40,000
	(Being depreciation charged on machine)				
Mar. 31	Profit and Loss A/c	Dr.		40,000	
	To Depreciation A/c				40,000
	(Being depreciation transfer to P/L A/C				
2007					
Mar. 31	Depreciation A/c	Dr.		40,000	
	To Machinery A/c				40,000
	(Being depreciation charged on machine)				
Mar. 31	Profit and Loss A/c	Dr.		40,000	
	To Depreciation A/c				40,000
	(Being depreciation transferred to P & L A/c)				
Mar. 31	Bank A/c	Dr.		32,000	
	To Machinery A/c				32,000
	(Being amount released from Sale of Machine)				
Mar. 31	Profit and Loss A/c	Dr.		58,000	
	To Machinery A/c				58,000
	(Being loss on sale of machine transferred to P&L A/c)				

(2) When Provision for Depreciation Account is maintained :

Date	Particulars	LF.	Amount	
			Debit	Credit
2005			`	`
April 1	Machinery A/c	Dr.	1,62,000	
	To Cash A/c/Bank A/c			1,62,000
	(Being Machine purchased)			
April 1	Machinery A/c	Dr.	8,000	
	To Cash A/c			8,000
	(Being payment freight, Insurance and Installation charges).			
2006				
Mar. 31	Depreciatioin A/c	Dr.	40,000	
	To Provision for Depreciation A/c			40,000
	(Being provision made for depreciation on machine)			
Mar. 31	Profit and Loss A/c	Dr.	40,000	
	To Depreciation A/c			40,000
	(Being depreciation transferred to P & L A/c)			
2007				
Mar. 31	Depreciatioin A/c	Dr.	40,000	
	To Provision for Depreciation A/c			40,000
	(Being provision made for depreciation)			
Mar. 31	Profit and Loss A/c	Dr.	40,000	
	To Depreciation A/c			40,000
	(Being depreciation transferred to P & L A/c)			
Mar. 31	Bank A/c	Dr.	32,000	
	To Machinery A/c			32,000
	(Being amount released from Sale of Machine)			
Mar. 31	Provision for Depreciation A/c	Dr.	80,000	
	To Machinery A/c			80,000
	(Being provision for depreciation a/c transferred to machinery A/c)			
Mar. 31	Profit and Loss A/c	Dr.	58,000	
	To Machinery A/c			58,000
	(Being loss on sale of machine transferred to P & L A/c)			

Illustration - 8.2 :

Prepare 'Machinery Account' and 'Depreciation Account' on the basis of information given in Illustration-.

Solution :

Dr. **Machinery Account** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2005			`				`
April 1	To Cash A/c / Bank A/c		1,62,000	2006 March 31	By Depreciation A/c		40,000
April 1	To Cach A/c		8000	March 31	By Balance c/d		1,30,000

			1,70,000				1,70,000
2006				2007			
April 1	To Balannce b/d		1,30,000	March 31	By Depreciation A/c		40,000
April 1	To Cach A/c			March 31	By Cash A/c		32,000
				March 31	By Profit & Loss A/c		58,000
			1,30,000				1,30,000

Dr. **Depreciation Account** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2006			`	2006			`
March 31	To Machinery A/c		40,000	March 31	By Profit & Loss A/c		40,000
2007				2007			
March 31	To Machinery A/c		40,000	March 31	By Profit & Loss A/c		40,000

2. Diminishing Balance Method :

Under this method depreciation is provided on the written drown value of the asset. The value of the asset goes on diminishing year after year. The depreciation charge also goes on declining every year. For example, a machine was purchased for ` 20,000 and depreciation is to be charged @ 10% per annum. The depreciation according to this method will be as under :

For 1 year 10% on ` 30,000 `3000
For 2 year 10% on ` (30,000 – 3000) = 27,000 i.e., 2,700
For 3 year 10% on ` (27,000 – 2700) = 24,300 i.e., 2,430

and so on. As the value of the asset and also the depreciation charge on it goes on reducing year after year, the method is also known as Reducing Installment Method or Written Down Value Method.

The rate of depreciation may be ascertained with the help of following formula :

$$R\left(R\right)=1-\sqrt[n]{\frac{S}{C}}$$

Where, R = Rate of Depreciation; N/n = Useful life in years;
S = Scrap Value; C = Cost of the Assets.

Illustration - 8.3 :

A machine was purchased for` 1,29,000. Estimated life of the machine is 4 years. Its estimated scrap value at the end of the useful life is `8,100. Diminishing Balance method of depreciation is adopted. Find out annual rate of depreciation.

Solution :

$$R = 1-\sqrt[n]{\frac{S}{C}} = 1-\sqrt[4]{\frac{8,100}{1,29,600}} = 1-\sqrt[4]{\frac{81}{1296}} = 1-\sqrt[4]{\frac{3\times3\times3\times3}{6\times6\times6\times6}} = \left(1-\frac{3}{6}\right)$$

= 1 – .50 = .50 or 50%.

Hence, Depreciation Rate = 50% p.a.

Merits : The main merits of this method are as follows :

(i) It is easy to calculate depreciation.

(ii) The total charge (depreciation + repairs and renewals) remains almost uniform year after year, since the charge of depreciation in initial years is more and the amount of repairs and renewals is less; whereas in later years the amount of depreciation is less and the amount of repairs and renewals is more.

(iii) The efficiency and usefulness is more in the earlier years than in the later years. Hence, depreciation in earlier years be charged more than during the later years. This method ensures this principal.

(iv) Under this method the asset is never reduced to zero, so that some depreciation, however small is, debited to Profit and Loss Account so long as asset is in use.

(v) This methods of providing depreciation is permissible by the tax authorities in India also.

Demerits : The demerits of this method are as follows :

(i) It is difficult to calculate rate of depreciation.

(ii) It does not take into consideration the interest on capital invested for the asset.

(iii) It does not provide for the replacement of the asset on the expiry of its useful life.

(iv) It takes a very long time to write down an asset to its break-up value, unless a very high rate is used.

Suitability : This method is suitable for those assets in relation to which the amount of repairs and renewals goes on increasing as the asset grows older and the possibilities of obsolescence are more. This method is suitable for Plant, Machineries and Buildings etc.

Differences between Original Cost Method and Diminishing Balance Method :

The following are the main parts of differences between the two methods :

Basis of Difference	*Original Cost Method*	*Diminishing Balance Method*
1. Amount of depreciation	Equal depreciation is charged every year.	Depreciation goes on decreasing year after year.
2. Depreciation Charge	Depreciation is charged on the original cost of the asset.	Depreciation is charged on the reducing balance of the asset.
3. Zero level	The book value of the asset can be reduced to zero.	The book value of the asset can never be reduced to zero.
4. Combined effect on Profit & Loss Account	Combined burden on account of Depreciation and repairs will be lighter in earlier years and heavier during the later years.	Combined burden on account of Depreciation and repairs will be almost equal over different years.
5. Rate of depreciation	Rate of Depreciation is kept lower in comparison to diminishing balance sheet.	Rate of Depreciation is kept higher in comparison to original cost method.
6. Approval	This method is not approved by the Tax authorities in India.	This method is approved by Tax authorities in India.

In practice, the diminishing balance method is more widely used. This is because of the fact that the depreciation under this method goes on reducing according to the shrinking value of the Assets 6.

Illustration - 8.4 :

A firm purchased a second-hand Machinery on 1st April, 2004 for ` 74,000 and ` 4000 and ` 2000 were spent on its repairs and installation immediately. On 1st October, 2006 the Machinery was sold for ` 56,000, Prepare Machinery Account for three years charging Depreciation @ 10% per annum on diminishing balance of the asset assuming that the accounting year ends on 31st March each year : (a) when provision for Depreciation account is not maintained, (b) when provision for Depreciation account is maintained.

Solution : (a) When Provision for Depreciation A/c is not maintained :

Dr. **Machinery Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
				`	`
2004			2005		
April 1	To Bank A/c (Cost)	74,000	March 31	By Depreciation A/c	8000
April 1	To Cash A/c (Repairs)	4000	March 31	By Balance c/d	72,000

April 1	To Cash A/c (Installation)	2000			
		80,000			80,000
2005			2006		
April 1	To Balance b/d	72,000	March 31	By Depreciation A/c	7200
			March 31	By Balance c/d	64,800
		72,000			72,000
2006			2006		
April 1	To Balance b/d	64,800	October 1	By Depreciation A/c	
			October 1	(For 6 months)	3240
			October 1	By Bank A/c (Sale)	
				By Loss on Sale of	
				Machine A/c	5560
		64,800			64,800

Dr. **Depreciation Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
				`	`
2005			2005		
March 31	To Machinery A/c	8000	March 31	By Profit & Loss A/c	8000
2006			2006		
March 31	To Machinery A/c	7200	March 31	By Profit & Loss A/c	7200
2006			2007		
Oct. 1	To Machinery A/c	3240	March 31	By Profit & Loss A/c	3240
	(for 6 months)				

(b) When Provision for Depreciation Account is Maintained.

Dr. **Machinery Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
				`	`
2004			2005		
April 1	To Bank A/c (Purchase)	74,000	March 31	By Depreciation c/d	80,000
April 1	To Cash A/c (Repairs				
	and Installation)	6000			
		80,000			80,000
2005			2006		
April 1	To Balance b/d	80,000	March 31	By Balance c/d	80,000
		80,000			80,000
2006			2004		
April 1	To Balance b/d	80,000	October 1	By Provision for	
				Depreciation A/c	15,200
			October 1	By Depreciation A/c	3240
			October 1	By Bank A/c (Sale)	
			October 1	By Profit & Loss A/c	
				(Loss on Sale)	5560
		80,000			80,000

Provision for Depreciation Account

Date	Particulars	Amount	Date	Particulars	Amount
		`			`
2005			2005		
March 31	To Balance c/d	8000	March 31	By Depreciation A/c	8000
2006			2005		
March 31	To Balance c/d	15,200	April 1	By Balance b/d	8000
			2006		
			March 31	By Depreciation A/c	7200
		15,200			15,200
2006			2006		
Oct. 1	To Machinery A/c (Sale of Machinery)	15,200	April 1	By Balance b/d	15,200
		15,200			15,200

Depreciation Account

Date	Particulars	Amount	Date	Particulars	Amount
		`			`
2005			2005		
March 31	To Provision for Depreciation A/c	8000	March 31	By Profit & Loss A/c	8000
2006			2006		
March 31	To Provision for Depreciation A/c	7200	March 31	By Profit & Loss A/c	7200
2007			2007		
Oct. 1	To Machinery A/c (for 6 months)	3240	March 31	By Profit & Loss A/c	3240
		3240			3240

3. *Annuity Method :*

The annuity method is based upon the assumption that the business, besides losing the original cost of the asset also losses interest, on the amount being used for buying the asset, which he would have earned in case the same amount would have been invested in some other form of investment. So, the asset account should also be debited with interest, which is ultimately credited to Profit and Loss Account. Inter est is also credited to the asset account with amount of depreciation which remains fixed year after year. The a nnual amount of depreciation is determined with the help of Annuity Table. The amount of total depreciation is determined by adding the cost of the asset (i.e., purchase price) and interest thereon at an expected rate. The journal entries under this method are :

(i) Asset A/c ... . Dr.
To Bank A/c
(Being purchase of asset)

(ii) Asset A/c ... . Dr.
To Interest A/c
(Being charging interest to asset)

(iii) Depreciation A/c ... . Dr.
To Asset A/c
(Being depreciation charged on asset)

Purchase price of asset and interest thereon are charged as depreciation during its useful life under the Annuity Method of Depreciation.

An extract of annuity table is given below :

Year	3%	4%	5%	6%
3	.353530	.360349	.367208	.374110
4	.269027	.275490	.280212	.288591
5	.218355	.224628	.230975	.237396
10	.117231	.123291	0.129504	.135868
15	.083767	.089941	.096342	.102963
20	.067216	.073582	.080243	.087185

Example : A lease is acquired on 1-4-2000 costing ` 10,000 for 5 years. The amount of annual depreciation at 55 interest rate will be ascertained as follows :

Depreciation = (Original Cost × annuity value)

Here, annuity value for 5 years at the interest rate of 5% is 0.230975.

∴ Depreciation per annum = (10,000 × 0.230975) = ` 2309.75 ramnaour ` 2310.

Illustration - 8.5 :

Mr. Mohit acquired a lease costing ` 10,000 an April 1, 2002 for a terms of Five years. You find from t he Annuity Table t hat in order t o writ e off the depreciation on the basis of the annuity method a t 5% per annum interest, the amount to be written off annually works out to be ` 0.0230975 for every year. Pass necessary journal entries and prepare the Lease Account for all the five years. Books are closed on 31st March every year. Show the net annual charge to Profit and Loss Account during each of five years.

Solution :

Annual Depreciation = Original cost of asset × Annuity Table value

= ` 10,000 × 0.230975 = ` 2309.75 or ` 2310.

The amount of interest and original cost of the asset will be recovered if ` 2310 is charged per annum as Depreciation. It may be proved from the given table :

Table Showing Original Cost and Depreciation

Year	Opening Balance of Original Cost of Asset	Interest $ 5%	Depreciation	Original Cost recovered	Closing Balance of Original Cost of Asset
2000	10,000	500	2310	1810	8190
2003	8190	410	2310	1900	6290
2004	6290	315	2310	1995	4295
2005	4295	215	2310	2095	2200
2006	2200	110	2310	2200	NIL

The above table shows that the original cost ` 10,000 and interest @5% p.a. will be recovered as depreciation if ` 2310 is charged per annum.

The following Journal entries will be passed for depreciation under the Annuity Method :

Journal of Mr. Mohit

Date	Particulars	LF.	Amount Debit	Amount Credit
2002			`	`
April 1	Lease A/c Dr.		10,000	
	To Bank / Cash A/c			10,000
	(For purchase of Lease)			
2003				
March 31	Leas A/c Dr.		500	
	To Interest A/c			500

	(For charging interest on asset @ 5%)			
March 31	Depreciation A/c	Dr.	2310	
	To Lease A/c			2310
	(For depreciation charged on asset)			
March 31	Profit & Loss A/c	Dr.	2310	
	To Depreciation A/c			2310
	(For transfer to Depreciation)			
March 31	Interest A/c	Dr.	500	
	To Profit & Loss A/c			500
2004				
March 31	Lease A/c	Dr.	410	
	To Interest A/c			410
	(For Interest charged)			
	Depreciation A/c	Dr.	2310	
	To Lease A/c			2310
	(For depreciation charged on assets)			
	Profit & Loss A/c	Dr.	2310	
	To Depreciation A/c			2310
	(For transfer of Depreciation)			
	Interest A/c	Dr.	410	
	To Profit & Loss A/c			410
	(For transfer of interest)			
2005				
March 31	Lease A/c	Dr.	315	
	To Interest A/c			315
	(For Interest charged)			
2005				
	Depreciation A/c	Dr.	2310	
	To Lease A/c			2310
	(For depreciation charged on assets)			
	Profit & Loss A/c	Dr.	2310	
	To Depreciation A/c			2310
	(For transfer of Depreciation)			
	Interest A/c	Dr.	315	
	To Profit & Loss A/c			315
	(For transfer of interest)			
2006				
March 31	Lease A/c	Dr.	215	
	To Interest A/c			215
	(For Interest charged)			
	Depreciation A/c	Dr.	2310	
	To lease A/c			2310
	(For depreciation charged on assets)			
	Profit & Loss A/c	Dr.	2310	

	To Depreciation A/c			2310
	(For transfer of Depreciation)			
	Interest A/c	Dr.	215	
	To Profit & Loss A/c			215
	(For transfer of interest)			
2007				
March 31	Lease A/c	Dr.	110	
	To Interest A/c			110
	(For Interest charged)			
	Depreciation A/c	Dr.	2310	
	To Lease A/c			2310
	(For depreciation charged on assets)			
	Profit & Loss A/c	Dr.	2310	
	To Depreciation A/c			2310
	(For transfer of Depreciation)			
	Interest A/c	Dr.	110	
	To Profit & Loss A/c			110
	(For transfer of interest)			

Books of Mohit

Dr. **Lease Account** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2002			`	2003			` 2310
April 1	To Bank/Cash/ A/c		10,000	March 31	By Depreciation A/c		
2003				March 31	By Balance c/d		8190
March 31	To Interest A/c						
	(10,000 × 5%)		500				
			10,500				10,500
2003				2004			
April 1	To Balance b/d		8,190	March 31	By Depreciation A/c		2310
2004				March 31	By Balance c/d		6290
March 31	To Interest A/c						
	(8190 × 5%)		410				
			8600				8600
2004				2005			
April 1	To Balance b/d		6290	March 31	By Depreciation A/c		2310
2003				March 31	By Balance c/d		7295
March 31	To Interest						
	(5% on ` 6290)		315				
			6605				6605
2005				2006			
April 1	To Balance b/d		4295	March 31	By Depreciation A/c		2310
2006				March 31	By Balance c/d		2200

March 31	To Interest				
	(5% on ` 4295)	215			
		4510			4510
2006			2007		
April 1	To Balance b/d	2200	March 31	By Depreciation A/c	2310
2007					
March 31	To Interest				
	(5% on ` 2210)	110			
		2310			2310

Statement Showing the Net Annual Charges on the P & L A/c.

Year	Debit (Depreciation) `	Credit (Interest) `	Net Charges (Debit) `
2002-03	2310	500	1810
2003-04	2310	410	1900
2004-05	2310	315	1995
2005-06	2310	215	2095
2006-07	2310	110	2200

Merits of Annuity Method :

1. This method makes into account interest on capital invested in the asset.
2. The amount of depreciation charged per annum is constant.
3. It is most scientific method because it works out the amount of depreciation from Annuity Table.

Demerits of Annuity Method:

1. Too much calculations become combersome.
2. There is over-burden of calculation work when assets are acquired frequently.
3. There is a tendency to inequalise the charges to Profit and Loss Account in respect of depreciation and repairs put together because the amount of depreciation remains constant over the life of the asset whereas the amount of repairs increases in the latter years.

Suitability:

The annuity method is suitable to those assets that require considerable investment and where frequent additions are not made. It is suitable for lease properties i.e., Additions or extentions are frequently made in Plant and Machinery so this method is not suitable for them.

4. Depreciation Fund Method:

This method is also known as 'Sinking Fund Method' or 'Redumption Fund Method'. Under this method a fixed amount is appropriated in Depreciation Fund A/c from the Profit and Loss Account for a definite period. Such amount is invested outside the business in Gilt-edged securities or other securities. T he amount of interest received on such investments is also credited to the 'Depreciation Fund Account' and it is also re-invested in securities. at the end of the period, appropriate amount and interest received is not invested but the investments are sold. The sale proceed is utilised for acquiring of a new asset. The profit or loss on sale of investment is transferred to 'Depreciation Fund Account' and the balance of this account is transferred to (Particular) Asset Account.

The asset is shown at original cost in the Balance-Sheet and the 'Depreciation Fund Account' is not deducted from the asset a/c but it is shown on the liability side. The Investment A/c known as 'Depreciation Fund Investment Account' is shown on the 'Asset Side' of the Balance Sheet.

'Depreciation is charged at fixed amount for every year. The amount of annual appropriation for depreciation is ascertained with the help of present value table.

Amount of Depreciation = (Original Cost – Scrap value) × Present value of ` 1 for a given period at a given rate of interest.

Objectives of Depreciation Fund :

Depreciation fund is created for the following objectives :

1. To replace a wasting asset, for example : A mine or an oil well.
2. To replace a depreciable asset;
3. To renew a lease.

Accounting Entries :

(A) On Purchase of the asset :

Asset a/c Dr. (Cost of Asset)
To Bank A/c
(Being asset purchased)

(B) At the end of the first year

(i) For setting aside the amount of Depreciation :
P & L A/c Dr.
To Depreciation Fund A/c
(Being amount of Depreciation transferred to Depreciation Fund A/c)

(ii) For Investing the amount outside the business :
Depreciation Fund Investment A/c Dr.
To Bank A/c
(Being Investment made)

(C) At end of each year :

(i) Bank A/c Dr.
To Interest on Depreciation Fund Investment A/c
(Being Interest Received)

(ii) Interest on Depreciation Fund Investment A/c Dr.
To Depreciation Fund A/c
(Being interest transferred to Depreciation fund A/c

(iii) P & L A/c Dr.
To Depreciation Fund A/c
(Being amount of Depreciation transferred to Depreciation fund A/c)

(iv) Depreciation fund Investment A/c Dr.
To Bank A/c
(Being Investment made)

(D) At the end of Last Year:

(i) Bank A/c Dr.
To Interest on Depreciation Fund Investment A/c
(Being Interest Received)

(ii) Interest on Depreciation Fund Investment A/c Dr.
To Depreciation Fund A/c
(Being interest transferred to Depreciation fund A/c

(iii) P & L A/c Dr.
To Depreciation Fund A/c
(Being amount of Depreciation transferred to Depreciation fund A/c)

(iv) For Sale of Investments :

Bank A/c Dr.

To Depreciation Fund Investment A/c

(Being Investment sold)

(v) For transfer of Profit on Sale of Investments :

Depreciation fund Investment A/c Dr.

To P & L A/c

(Being profit transferred to P & L A/c).

(vi) For transfer of Loss on sale of Investments :

Profit & Loss A/c Dr.

To Depreciation Fund Investment A/c

(Being loss transferred to P & L A/c).

(vii) Depreciation Fund A/c Dr.

To Asset A/c

(Being Balance of Depreciation Fund Account transferred to Asset A/c)

(viii) For purchasing of the new asset :

(New) Asset A/c Dr.

To Bank A/c

(Being purchase of new asset)

Merits of Depreciation Fund Method :

1. This method enables a firm to purchase very costly assets without any difficulty in arranging cash resources. Thus, due provision is made for replacement of asset at the end of its working life.
2. Interest is also re-investment in securities which create resources for replacement of asset. This feature is not found in other methods.

De-merits of Depreciation Fund Method :

1. There is a tendency to inequalise the charges on Profit and Loss Account respect of depreciation and repairs put together because the amount of depreciation remains constant over the life of the asset whereas the amount of repairs increase in the latter years. The consequence is that the burden on Profit and Loss Account in earlier years is light while in latter years, it is heavy.
2. Too much calculations become combersome.
3. Assets are shown at original cost so book value are ascertained separately.
4. There is a risk of fluctuation in the price of securities which may disturb the business adversely.

Similarities Between Annuity Method of Depreciation Fund Method :

1. In both the methods interest is considered while deciding amount of depreciation.
2. The amount of depreciation for every year is fixed but not the same in both the methods.
3. Net charge to Profit and Loss Account is the same under both the methods.

Differences Between Annuity Method and Depreciation Fund Method :

	Annuity Method	Depreciation Fund Method
1.	Interest is theoretically computed and charged as depreciation. It is not actually recovered from outsiders.	Interest is actually received from outsides on amount invested.
2.	Due to reducing balance of asset, the amount of interest constantly decilines.	Due to increase in investment, the amount of interest constantly increases.

3.	This method does not arrange funds at the effective life of the asset because amount of depreciation and interest are not invested outside the business.	Funds are arranged at the end of the effective life of the asset because amount of depreciation and interest received thereon are invested outside the business.
4.	Interest is credited to the (particular) Asset Account and debited to the Profit and Loss Account.	Realised interest is credited to the 'Depreciation Fund Account and invested interest is debited to the 'Depreciation Fund Investment Account'.
5.	Annual net Charge on Profit and Loss Account constantly increases because the depreciation (a debit item) is constant but the interest (a credit item) is decreased every year.	Annual net charge on Profit and Loss Account is constant due to a fixed amount of depreciation being credited to the 'Depreciation Fund Account'.
6.	First entry for interest is made at the end of the first year.	First entry for interest is made at the end of second year because investment is made at the end of first year on which interest is received in second year.
7.	Asset is shown on its written down value of the asset side of the Balance Sheet.	Asset is shown at original cost and 'Depreciation Fund' is shown on liability side of the Balance Sheet.

Illustration - 8.6 :

Mr. Dinesh Gupta purchased a four year lease on April 1, 2002 for ` 1,00,000. It is decided to provide for the renewal of the lease at the end of the 4th year by setting up a Depreciation Fund. Investments are expected to fetch interest at 10% per annum. Sinking fund table shows that ` 0.2154708 invested each year will produce ` 1 at the end of fourth year at 10% p.a.

On 31st March, 2007, the investments were sold for ` 72,000. Pass necessary Journal entries and also prepair necessary ledger accounts.

Solution :

Annual Depreciation to be appropriated from P and L A/c = (` 1,00,000 × 0.2154708)

` 21547.08 or ` 21547.

Journal of Mr. Dinesh Gupta

Date	Particulars	LF.	Amount Debit	Credit
			`	`
2002				
April 1	Lease hold property A/c	Dr.	1,00,000,	
	To Bank A/c			1,00,000
	(Property taken on lease for 4 years)			
2004			21,547	
March 31	P & L A/c	Dr.		21,547
	To Depreciation fund A/c			
	(Amount transferred to depreciation fund)			
March 31	Depreciation Fund Investment A/c	Dr.	21,547	
	To Bank A/c			21,547
	(Investment made)			
2005				
March 31	Bank A/c	Dr.	2155	
	To Interest on Dep. Fund Inv/ A/c			2155
	(Interest Received)			

March 31	Interest on Dep. fund Inv. A/c	Dr.	2155	
	To Depreciation Fund A/c			2155
	(Interest transferred)			
March 31	P & L A/c	Dr.	21,547	
	To Depreciation Fund A/c			21,547
	(Amount transferred)			
March 31	Depreciation Fund Investment A/c	Dr.	23,702	
	To Bank A/c			23,702
	(Investment made)			
2006				
March 31	Bank A/c	Dr.	4525	
	To Interest on Dep. Fund Inv. A/c			4525
	(Interest Received)			
March 31	Interest on Dep. fund Inv. A/c	Dr.	4525	
	To Depreciation Fund A/c			4525
	(Interest Transferred)			
March 31	P & L A/c	Dr.	21,547	
	To Depreciation Fund A/c			21,547
	(Amount transferred)			
March 31	Depreciation Fund Investment A/c	Dr.	26,072	
	To Bank A/c			26,072
	(Investment made)			
2007				
March 31	Bank A/c	Dr.	7132	
	To Interest on Dep. Fund Inv. A/c			7132
	(Interest Received)			
March 31	Interest on Dep. fund Inv. A/c	Dr.	7132	
	To Depreciation Fund A/c			7132
	(Interest Transferred)			
March 31	P & L A/c	Dr.	21,547	
	To Depreciation Fund A/c			21,547
	(Amount transferred)			
March 31	Bank A/c	Dr.	72,000	
	To Dep. Fund Investment A/c			72,000
	(Investment sold)			
March 31	Depreciation Fund Investment A/c	Dr.	679	
	To P & L A/c			679
	(Profit on Investment transferred)			
March 31	Depreciation Fund A/c	Dr.	1,00,000	
	To Lease hold property A/c			1,00,000
	(Lease written off)			

Dr. ***Depreciation Fund Account*** ***Cr.***

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2004			`	2004			`
March 31	To balance c/d		21,547	March 31	By P & L		21,547
2005				2004			
March 31	To balance c/d		45,249	April 1	By Balance b/d		21,547
				2005			

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
				March 31	By Interest on Dep. Fund Inv. A/c		2155
				March 31	By P & L A/c		21,547
			45,249				45,249
2006				2005			
March 31	To balance c/d		71,321	April 1	By Balance b/d		45,249
				2006			
				March 31	By Interest on Dep. Fund Inv. A/c		4525
				March 31	By P & L A/c		21,547
			71,321				71,321
2007				2006			
March 31	To Lease hold. Property A/c		1,00,000	April 1	By Balance b/d		71,321
				2007			
				March 31	By Interest on Dep. Fund Inv. A/c		7132
				March 31	By P & L A/c		21,547
			1,00,000				1,00,000

Dr. Depreciation Fund Investment Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2004			`	2004			``
March 31	To Bank A/c		21,547	March 31	By Balance c/d		21,547
2004				2005			
April 1	To Balance b/d		21,547	March 31	By Balance c/d		45,249
2005							
March 31	By Bank c/d		23,702				
			45,249				45,249
2005				2006			
April 1	To Balance b/d		45,279	March 31	By Balance c/d		71,321
2006							
March 31	By Bank A/c		26,072				
			71,321				71,321
2006				2007			
April 1	To Balance b/d		71,321	March 31	By Balance c/d		72,000
2007							
March 31	By Bank A/c		679				
			72,000				72,000

Dr. Lease Hold Property Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2003			`	2004			`
April 1	To Bank A/c		1,00,000	March 31	By Balance c/d		1,00,000
2004			`	2004			`
April 1	To Balance b/d		1,00,000	March 31	By Balance c/d		1,00,000
2005			`	2004			`
April 1	To Balance b/d		1,00,000	March 31	By Balance c/d		1,00,000
2006			`	2004			`
April 1	To Balance b/d		1,00,000	March 31	By Dep. fund A/c		1,00,000

Profit and Loss Account

Dr. **(For the year ending ....)** **Cr.**

	Amount		Amount
	`		`
31st March 2004 :		31st March 2007	
To Depreciation Fund A/c	21,547	By Depreciation Fund	
31st March 2005 :		Investment A/c	679
To Depreciation Fund A/c	21,547		
31st March 2006 :			
To Depreciation Fund A/c	21,547		
31st March 2007 :			
To Depreciation Fund A/c	21,547		

Balance Sheet (as on ....)

Liabilities	Amount	Assets	Amount
	`		`
31st March 2004 :		31st March 2007	
Depreciation Fund A/c	21,547	Leasehold property	1,00,000
31st March 2005 :		Depreciation Fund Investment	21,547
Depreciation Fund A/c	45,249	31st March 2007	
31st March 2006 :		Leasehold property	1,00,000
Depreciation Fund A/c	71,321	Depreciation Fund Investment	45,249
		31st March 2006	
		Leasehold property	1,00,000
		Depreciation Fund Investment	71,321

5. Sum of Year's Digit Method (SYDM)

This is a method of calculating depreciation under which the rate of depreciation is determined by the fraction where the denominator is the sum of the digits representing the useful life of the asset and the numerators are individual digits used in the life of the asset taken in reverse order. The numerator does not change but the denominator changes every year. The amount of depreciation goes on decreasing in the coming years. For example, if the life of and asset is four years. The denominator will be (4 + 3 + 2 + 1) = 10 for all the four years. The numerator will be 4,3,2 and for I year, II year, III year and IV year respectively. If cost of this asset is ` 1,00,000 and scrap value is ` 5000 then, the amount of depreciation will be determined as follows :

Years	Amount of Depreciation
1	$\frac{4}{10}\times$ ` 95, 000 = ` 38, 000
2	$\frac{3}{10}\times$ ` 95, 000 = ` 28, 500
3	$\frac{2}{10}\times$ ` 95, 000 = ` 19, 000
4	$\frac{1}{10}\times$ ` 95, 000 = ` 9, 500

$$\text{Amount of depreciation} = \frac{\text{No. of years of the remaining life of asset}}{\text{Total of digits of life}} \times (\text{Cost Price} - \text{Scrap Value})$$

Illustration - 8.7 :

Cost price is a machine is ` 2,30,000 and its salvage value is estimated to be ` 10,000. If the expected useful life is 10 years, then calculate amount of depreciation on the basis of sum of year's digit method.

Solution :

Calculation of Amount of Depreciation (SYDM)

Year	Fraction	Cost less Salvages Value	Depreciation = Fraction × Cost less salvage value
1	$\frac{10}{55}$	(2,30,000 – 10,00)	
2	$\frac{9}{55}$	2,20,000	
3	$\frac{8}{55}$	2,20,000	
4	$\frac{7}{55}$	2,20,000	
5	$\frac{6}{55}$	2,20,000	
6	$\frac{5}{55}$	2,20,000	
7	$\frac{4}{55}$	2,20,000	
8	$\frac{3}{55}$	2,20,000	
9	$\frac{2}{55}$	2,20,000	
10	$\frac{1}{55}$	2,20,000	
Total	***55***		***`2,20,000***

Suitability : This method is suitable for charging depreciation on asset which provides more services in initial years in comparison to latter years. In the initial years, the amount of repairs is lower but the services are more effective so the depreciation should be comparatively higher. In the latter years the asset requires higher repair charges and provides lower services so the amount of depreciation should be lower. Thus, the method equalise the charges on Profit and Loss Account in respect of depreciation and repairs put together because the amount of depreciation decreases in the latter years of the life of the asset whereas the amount of repairs increases. The consequence is that the burden of Profit and Loss account in each year remains constant. This method is suitable for writing off depreciation on 'Photo Stat Machine', 'Computers', etc.

6. ***Machine Hour Rate Method :***

Machine hour rate means the cost of running a machine for an hour. Under this method, the life of a machine is estimated in hours (not in years). Proper records are maintained for machine running hour s and depreciation per hour is calculated as given below :

$$\text{Depreciation Per Machine Hour} = \frac{\text{Cost of Machine} - \text{Estimated Scrap Value}}{\text{Useful life of the machine (in hours)}}$$

Annual depreciation = (Actual working hours during the year and Machine Hour Rate).

Suitability :

Machine Hour Ra t e Method is a n idea l method for calculating depreciation where costly and different machines are used in production.

Illustration - 8.8:

At machine is estimated to have a useful life of 50,000 hours. The cost of machine acquired on April 1, 2005 was ` 20,50,000 and its salvage value is ` 50,000. If the machine has worked for 2000 hours in the year 2005-04 and 2500 hours in the year 2006-05, what will be the amount of depreciation for each of the accounting years. Prepare 'Machine Account' for the two years.

Solution :

Machine Hour Rate (For Depreciation) =

Depreciation for the year 2005-06 = ` (2000 × 40) = ` 80,000

Depreciation for the year 2006-07 = ` (2500 × 40) = ` 1,00,000

Dr. ***Machine Account*** ***Cr.***

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2005			`	2006			`
April 1	To Bank A/c		20,50,000	March 31	By Depreciation A/c		80,000
					By Balance c/d		19,70,000
			20,50,000				20,50,000
2006				2006			
April 1	To Balance b/d		19,70,000	March 31	By Depreciation A/c		1,00,000
					By Balance c/d		18,70,000
			19,70,000				19,70,000
2007							
April 1	To Balance b/d		18,70,000				

7. **Revaluation Method :**

When asset is represented by a large number of small and adverse items having small unit cost, it is not possible to depreciate each item. For example, Loose Tools. In such cases, depreciation is calculated by revoluation method adopting the following steps for calculating amount of depreciation :

First Step : At the end of each accounting period, all items of goods condition are valued at cost.

Second Step : The cost, calculated above, is compared with the opening balance and purchases made during the year. The difference is charged as depreciation.

Suitability :

This method is suitable for charging depreciation on 'Loose Tools', 'Live Stock', Trade Mark, Patent etc. This method is also referred to as the 'Appraisal System' or 'Inventory System'.

Illustration - 8.9 :

A company manufactures loose tools for its own use. At the end of each year depreciation is charged on revaluation method. From the following particulars, show the loose tools account :

Year ended 31.12.2002 - Loose tools manufactured : ` 5000 (revalued on 31.12.2003 : ` 4100)

Year ended 31.12.2004 - Loose tools manufactured : ` 2700 (revalued on 31.12.2004 : ` 5700)

Year ended 31.12.2005 - Loose tools manufactured : ` 1000 (revalued on 31.12.2005 : ` 6000)

Year ended 31.12.2006 - Loose tools manufactured : ` 1500 (revalued on 31.12.2003 : ` 5100)

The value as on 31.12.2006 is after considering the sale of old tools of the book value ` 1200 (as on 31.12.2006) for ` 950.

Solution :

Dr. **Lease Hold Property Account** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2002			`	2002			`
Dec. 31	To cost of			Dec. 31	By Depreciation A/c		
	Production A/c		5000		(Bal. fig.)		900
				Dec. 31	By Balance c/d		4100
			5000				5000
2004				2004			
Jan. 1	To Balance b/d		4100	Dec. 31	By Depreciation A/c		
Dec. 31	To cost of				(Bal. fig.)		1100
	Production A/c		2700	Dec. 31	By Balance c/d		5700
			6800				6800
2005				2005			
Jan. 1	To Balance b/d		5700	Dec. 31	By Depreciation A/c		
Dec. 31	To cost of				(Bal. fig.)		700
	Production A/c		1000	De. 31	By Balance c/d		6000
			6700				6700
2006				2001			
Jan. 1	To Balance b/d		6000	Dec. 31	By Bank A/c - Sale		950
Dec. 31	To cost of			Dec. 31	By Profit and Loss A/c		
	Production A/c		1500		– loss on sale		
					(1200 – 950)		250
				Dec. 31	By Depreciation A/c		
					(Bal. fig.)		1200
				Dec. 31	By Balance c/d		5100
			7500				5700
2007							
Jan. 1	To Balance b/d		5100				

Illustration - 8.10 :

On 1st April 2006, the stock of bottles of a soft drink company was valued at ` 1,50,000. During the year, the company purchased additional bottles amounting to ` 60,000 on 1st July, 2006. The stock was valued at ` 1,40,000 on March 31, 2007. Show the Bottle Account for the year 2006-05.

Solution :

Dr. Bottle Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2006			`	2007			`
April 1	To Balance b/d		1,50,000	March 31	By Depreciation A/c		
July 1	To Bank A/c		60,000		(Balancing Figure)		70,000
				March 31	By Balane c/d		1,40,000
			2,10,000				2,10,000

8. Change in Method of Depreciation :

The rate and method of providing depreciation should be uniform. Normally, it should not be changed. But in some cases a firm may decide to change the method of providing depreciation from 'Straight Line Method' to 'Reducing Balance Method' or vice versa from the method of depreciation it had adopted earlier. There will not be any problem if the firm decides to change the method with immediate or prospective effect. It would not have to make any adjustment in such a case. Depreciation will be charged on the basis of the new method just from the time it wants to change. But if it decides to change from retrospective effect it would be necessary to adjust the depreciation charged till date. The firm has to take the following steps for changing in the method of depreciation.

(i) Depreciation should be calculated at the old rates till the date of change in the method of providing depreciation.

(ii) Depreciation should be calculated at the new proposed depreciation rates till the date of change in the method.

(iii) Difference between (i) and (ii) should be calculated. If amount of depreciation under the new method is less than what was charged under the old method, such difference should be adjusted in the current year through passing the following journal entry :

(Particular) Assets A/c Dr.
To Profit & Loss A/c

(iv) If the amount of depreciation under new method is greater than what was charged under the old method, such difference should be adjusted in the current year through passing the following journal entry :

Profit and Loss A/c Dr.
To (Particular) Asset A/c

(v) In subsequent years, depreciation would be charged on the basis of new method on the adjusted value of the asset.

Change in the Method Depreciation from the Current Accounting year :

Illustration - 8.11 :

A Limited Company purchased on 1st Jan. 2001 a second-hand plant for ` 12,000 immediately spent ` 8000 on its overhauling. On 1st July in the same year additional plant costing ` 10,000 is purchased. On 1st July 2005 the plant purchased on 1st Jan. 2001 having become obsolete is sold for ` 4000 and on the same date fresh plant it purchased at a cost of ` 24,000.

Depreciation is provided @ 10% per annum on original cost on 31st Dec. every year. In 2006, however, the company changes the method of providing depreciation and adopts the method of writing off 15% p. a. on the diminishing balance method.

Show the Plant Account as it would appear at the end of each year from 2003 to 2006.

Solution:

(Books of .... Limited)

Plant Account

Dr. **Cr.**

Date 2003	Particulars	J.F.	Amount `	Date 2004	Particulars	J.F.	Amount `
Jan 1.	To Bank A/c (12,000 + 8000)		20,000	Dec 31	By Depreciation A/c 10% on ` ` 20,000 for 1 year 2000 10% on `10,000 for 6 months 500		2500
July 1	To Bank A/c		10,000				
				Dec. 31	By balance c/d		27,500
			30,000				30,000
2004				2004			
Jan. 1	To Balance b/d		27,500	Dec. 31	By Depreciation 10% on `30,000		3000
				Dec. 31	By Balance c/d		24,500
			27,500				27,500
2005				2004			
Jan. 1	To Balance b/d		24,500	July 1	By Bank A/c (sale)		4000
July 1	To Bank A/c		24,000	July 1	By Depreciation % 10% p.a. on `20,000 for 6 months		1000
				Dec. 31	By Profit and loss A/c Loss on Sale		11,000
				Dec. 31	By Depreciation A/c (on ` 10,000 for 1 year ` 1000 on ` 24,000 for 6 months ` 1200		2200
				Dec. 31	By Balance c/d		30,300
			48,500				48,500
2006				2006			
Jan. 1	To Balance b/d		30,000	Dec. 31	By Depreciation 15% on `30,3000		4545
					By Balance c/d		25,755
			30,300				30,000
2007							
Jan. 1	To Balance b/d		25,755				

Working Note :

	`
Loss on sale of plant has been computed as under :	
Cost on Jan. 1. 2003	20,000
Less : Depreciation for 2003	2000
Book value on Jan. 1. 2004	18,000

Less : Depreciation for 2004		2000
	Book value on Jan. 1. 2005	16,000
Less : Depreciation for 6 months up to July 1, 2005		1000
	Book value on Jan. 1. 2005	15,000
Less : Sale proceeds		4000
	Loss on sale	11,000

Change in the Method of Depreciation from Retrospective Effect (From Straight Line Method to W.D.V. Method)

Illustration - 8.12 :

Machine Account of Gupta Enterprises showed a debit balance of `3,50,000 as on January 2006. They have been charging depreciation at 10% on straight line method. They have now decided to change the method of depreciation from straight line method to written-down-value method with effect from January 1 2003 on which date they purchased the machine. You are required to prepare machine account up to December 31, 2006.

Solution :

In order to change the method of depreciation from the retrospective date, it is necessary to calculate the following :

(a) The value of asset on the date from which it is to be effective, i.e., January 1, 2003. In this case, the asset was purchased on this date.

(b) The balance of machine account as per the new method of depreciation on the date of decision, i.e., January 2006. This can be done by preparing a memorandum account with the balance as on January 1, 2003 (calculated as per (a) above) and the new rate of depreciation.

(c) The difference between the balances of machine accounts as per the old system of depreciation and the new system of depreciation. After knowing the difference, the entry will be passed through Profit and Loss Account :

The working is as under :

(a) Calculation of balance of machine account with old rate and old method of depreciation as on January 1, 2003:

If Machine is of `100 as on 1.1.2003, its balance on January 1, 2006 at 10% on straight line method will be:

	Balance on 1.1.2003	` 100
Less :	Depreciation @ 10% for 3 years viz., 10×3	`30
	Balance on 1.1.2006.	` 70

If on 1.1.2006 balance is `70 on 1.1.2003 it was ` 100. If

on 1.1.2006 balance is ` 2,80,000 on 1.1.2003 it was :

$$\frac{70}{100} \times 3,50,000 = \text{`}\ 5,00,000.$$

(b) Calculation of balance of Machine with new rate and new method of providing depreciation :

	`
Balance of Machine on 1.1.2003	5,00,000
Depreciation for 2003 @ 10% on written down value basis (W.D.V.)	50,000
	4,50,000
Depreciation for 2004 @ 10% on W.D.V.	45,000
	4,05,000

Depreciation for 2005 @ 10% on W.D.V.	40,500
Balance of Machine as on January 1, 2006	3,64,500

(c) Calculation of difference :

	`
Balance of Machine on 1.1.2006 at 10% on straight line method (given in the question)	3,50,000
Balance of Machine as on 1.1.2006 on W.D.V. basis (as per (b) above)	3,64,500
Balance to be increased in Machinery A/c	14,500

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2006			`	2006			`
Jan 1.	To Balance b/d		3,50,000	Dec. 31	By Depreciation A/c (10% on W.D.V.) of ` 3,64,500)		36,450
Jan 1.	To Profit & Loss A/c (Increase in value of asset due to change in method of Depreciation)		14,500	Dec. 31	By balance c/d		3,28,050
			3,64,000				3,64,500
2007							
Jan. 1	To Balance c/d		36,450				

Change in the Method of Depreciation with Retrospective Effect
(From W.D.V. Method to Straight Line Method)

Illustration - 8.13 :

Hanuman Enterprises purchased on April 1,2004 certain machinery for `72,800 and paid `2200 on its installation. On October 1, 2004 another machinery for `25,000 was acquired. On April 1, 2005, the first machinery was sold at `50,000 and on the same date a fresh machinery was purchased at a cost of ` 45,000.

Depreciation was annually provided on 31st March at 10% p.a. on written down value. On April 2, 2006, however, the firm decided to change the method of providing depreciation and adopted the method of providing depreciation @ 10% p.a. on the original cost, with retrospective effect. Ascertain the value of machinery on March 31, 2007.

Solution : **Books of Hanuman Enterprises**

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2006			`	2006			`
April 1	To Bank A/c (cost)		72,800	March 31	By Depreciation (7,500 + 1250)		8750
April 1	To Bank A/c (Installation charges)		2200	March 31	By Balance c/d (67,500 + 23,750)		91,250
Oct. 1	To Bank A/c		25,000				
			1,00,000				1,00,000
2005				2005			
April 1	To Balance b/d		91,250	April 1	By Bank A/c (Sale)		50,000
April 1	To Bank		45,000	April 1	By Profit & Loss A/c – Loss on sale		17,500
				2006			

			March 31	By Depreciation A/c (2375 + 4500)	6875
			March 31	By Balance c/d (21,375 + 40,500)	61,875
		1,36,250			1,36,250
2006			2007		
April 1	To Balance b/d	61,875	March 31	By Profit & Loss A/c – Adjustment	125
			March 31	By Depreciation (2500 + 4500)	7000
			March 31	By Balance c/d	54,750
		61,875			61,875
2007					
April 1	To Balance b/d	54,750			

Working Notes :

1. Book value of Machines — On the basis of old method (Written down value method)

	Machines I	Machines II	Machines III
	₹	₹	₹
Cost	75,000	25,000	45,000
Less : Depreciation for 2004-03	7500	1250	–
	67,500	23,750	45,000
Less : Sale proceeds	50,000	–	–
Loss on Sale	17,500	23,750	45,000
Depreciation foir 2005-04	–	2375	4500
W.D.V. as on 31.3.2006	17,500	21,375	40,500

2. Book value of Machines on the basis of new method (original cost method) :

	Machine II	Machine III
	₹	₹
Cost	25,000	45,000
Less : Depreciation	3750	4500
	$\left(\text{for } 1\frac{1}{2} \text{ years}\right)$	(for 1 year)
W.D.V. on 31.3.2006	21,250	40,500

3. Retrospective effect of change in depreciation method for machines II and III. (2004-03).

Depreciation under original cost method (3750 + 4500)	8250
Depreciation under W.D.V. method (1250 + 2375 + 4500)	8125
Deficiency to be debited to Profit and Loss Account	125

8.13 DEPRECIATION OFDIFFERENTASSETS

The following observations can be made regarding charging of depreciation assets :

1. **Goodwill :** Depreciation does not arise in the value of the goodwill of the business unless the profits of the firm are declining. Since goodwill is an intangible asset, it will be advisable to write off the value of the goodwill over a reasonable period. The amount written off should be shown separately in the Profit and Loss Account.
2. **Freehold land :** No depreciation need be charged in case of such properties.

3. **Freehold buildings, plants, machinery, ship, etc.** Fixed Instalment Method or Diminishing Balance Method may be used for charging depreciation on these assets. The endeavour should be to write off the asset during its effective life. In case of Plant and Machinery, the Machine Hour Rate Method can also be profitably used.
4. **Leasehold land and buildings.** The Fixed Instalment Method should generally be used for writting off depreciation in respect of such assets.
   However, the Depreciation Fund Method or Insurance Policy Method can also be used profitably for assets coming in the 3rd and 4th category discussed above.
5. **Loose tools, jigs, livestock, etc.** Revaluation Method is the most appropriate method for charging depreciation on these assets.
6. **Patents, Trademark etc.** These assets have a maximum legal life. However, their commercial life may be much shorter. Such assets should, therefore, be depreciated according to the Fixed Instalment Method in a way so that they are written off within the legal or commercial life, whichever is shorter.
7. **Mines, oil wells, quarries, etc.** Depreciation should be charged according to the Depletion Method in case of these assets.

It should be noted that the method of charging depreciation in respect of assets should be consistent year after year. In case the method of depreciation is changed, such facts together with the effect on profit on account 1of change in the method of depreciation has to be disclosed by way of a note in the final accounts of the business. Similarly, if it has not been possible to charge depreciation on assets on account of inadequacy of profits in any year, such facts should also be disclosed in the Final Accounts of the business for that particular year.

8.14 DEPRECIATION ON REPLACEMENT COST

In recent years, there has been a lot of controversy regarding charging of depreciation on historical vs. replacement cost of the asset. It is being argued by the promoters of 'replacement cost' that since one of the major objectives of providing depreciation is to provide enough funds for the replacement of an asset at the end of its useful life, it will be appropriate to provide for depreciation on the replacement cost of the asset rather than its historical cost. This is particularly true in the context of present inflationary conditions. If depreciation is charged on the basis of historical cost, there will not be enough funds to replace the asset at the end of its useful life of account substantial increase in the price of the new asset to be purchased for replacing the old asset. Thus, they argue that the very purpose of providing depreciation is completely defeated if the depreciation is charged on the basis of historical cost of the asset.

There is considerable strength in the arguments put forward by the protagonists of charging depreciation on the replacement cost. However, the following are the practical difficulties in adopting this approach.

1. It is difficult to estimate the replacement cost well in advance. The cost can be correctly known only when the asset is replaced.
2. The new asset purchased for replacing the old asset is always of a better type in respect of its quality as well as efficiency. Of course, one has to pay more for the new asset, but the profitability of the business also increases on account of new and better quality of the asset. In case depreciation is charged on replacement cost, depreciation is charged for the improved asset even when such asset has not been used for generating revenue during those years.
3. Income Tax Authorities do not give recognition to the concept of charging depreciation or replacement cost.
4. Under the Companies Act, depreciation is to be charged only on original cost of the asset. Any profit or loss made on scrapping the asset over its book value should be credited or debited to the Profit and Loss Account of the year in which the asset is scrapped.
5. Businessmen favour charging of depreciation on replacement cost under inflationary conditions. It is doubtful whether they would favour charging depreciation on the replacement cost of the asset in periods when the prices are falling.

8.15 DEPRECIATION OF POLICY

The management has to adopt a suitable depreciation policy keeping in view the following objectives :

(i) Recovery of the original investment, i.e., the acquisition cost of the asset, before the expiry of the economic life of the asset.
(ii) Ensuring a uniform rate of return on investments.
(iii) Generating sufficient funds for the replacement of the asset after the expiry of its economic life.
(iv) Deriving maximum tax benefit.
(v) Ascertainment of correct profit or loss.

The above objectives can be considerably achieved if the management takes care of the following aspects in framing its depreciation policy.

(i) **Selection of an appropriate method :** The management should select an appropriate method keeping in view the nature of asset and the prime objective of the management.

(ii) **Periodic review of provision :** The choice of the method determines the amount of the depreciation and the mode of its recording. However, the management must review periodically whether the provision for depreciation which is being made is proper or not. Any under or over provision in the context of changed circumstances should properly be adjusted in the books of accounts.

(iii) **Evaluation and disclosure of depreciation policy :** The depreciation policy being followed by the business should be evaluated in the context of tax, independence of price level changes, Government's regulations, etc. The effect of any change in the depreciation policy in an accounting period should be quantified and disclosed in the financial statements of the business.

8.16ACCOUNTING STANDARD (6 REVISED)

The following are the salient features of the Revised Accounting Standard on Depreciation Accounting issued by the Institute of Chartered Accountants of India in September, 1994.

1. The standard applies to all depreciable assets except the following items to which special considerations apply :
   (a) forests, plantations and similar regenerative natural resources;
   (b) wasting assets including expenditure on exploration for the extraction of minerals, oils, natural gas and similar non/regenerative resources;
   (c) expenditure on research and development;
   (d) goodwill;
   (e) livestock;
   (f) land unless it has a limited useful life for the enterprise.
2. The depreciable amounts of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.
3. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.
4. The useful life of a depreciable asset should be estimated after considering the following factors :
   (i) expected physical wear and tear;
   (ii) obsolescence;
   (iii) legal or other limits on the use of the asset.
5. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.
6. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.
7. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long-term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.

8. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.
9. If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disposed separately.
10. The following information should be disclosed in the financial statements:
   (i) the historical cost or other amount substituted for historical cost of each of depreciable assets;
   (ii) total depreciation for the period for each class of assets; and
   (iii) the related accumulated depreciation.
11. The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:
   (i) depreciation methods used; and
   (ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

The standard has become mandatory in respect of accounting periods beginning on or after 1 April, 1995.

8.17 KEY TERMS

Amortisation refers to the writing off the proportionate value of the intangible assets like copy rights, goodwill, patients etc.

Capital Reserve is the reserve created out of capital profits.

Depletion is used in respect to extraction of natural resources from wasting assets like mines, oil wells etc.

Depreciation is a permanent and regular reduction in the book value of a depreciable fixed asset during its estimated working life.

General Reserve is created out of profit to meet the future contingencies or to strengthen the financial position of the business organisation.

Obsolescence is a fall in the value of a fixed asset that results from the development of a better asset or due to technical change or change in customer's demand.

8.18 SUMMARY

- Depreciation is a permanent continuing and gradual reduction in the book value of a fixed asset. It is the allocation of the depreciable amount of a fixed asset over its estimated useful life. Depreciation arises due to use, obsolescence, passage of time and extraction etc.
- The various factors to be considered for the purpose of calculating the amount of depreciation are cost of the asset, estimated scrap value and estimated life period of the asset. The need for calculating depreciation arises in order to know the true amount of profit, to show the true financial position and to make provisions for replacement of assets.
- There are different methods of charging depreciation. The most important methods are :

Straight line method, and (b) Written down value method. There are two ways of recording depreciation in the books of account - with or without maintaining Provision for Depreciation Account.

- Business is full of risk and uncertainty. In order to protect the business from such untoward happenings in one hand and to win the confidence of all stakeholders on the other. It is necessary to make provisions and reserves in every business.

8.19 CHECK YOUR PROGRESS AND ANSWERS

1. Choose the most appropriate answer :

(a) A capital reserve is built out of :

(i) Recurring profit (ii) Non-recurring profit (iii) Revenue profit

(b) When a reserve is invested in outside securities, it is known as :

(i) Revaluation reserve (ii) Specific reserve (iii) Reserve fund

(c) A provision is created for :

(i) Unknown liability (ii) Known liability whose amount cannot be determined

(iii) Known liability whose amount can be determined.

(d) A reserve is created :

(i) Before calculation or profit (ii) After calculation of profit

(iii) After distribution of profit.

*(e) **Which of the following can be transferred to capital reserve ?***

(i) Profit on sale of asset (ii) P & L Account credit balance

(iii) Provision for depreciation.

[**Ans.** (a) - (ii), (b) - (iii), (c) - (ii), (d) - (ii), (e) - (i)]

8.20 QUESTIONS AND EXERCISES

1. State the characteristics of depreciation. Explain the causes of depreciation.
2. Why will you charge depreciation ? Discuss the two important methods of charging depreciation.
3. Distinguish between :
   (a) Depreciation and Depletion.
   (b) Amortisation and Obsolescence.
   (c) Provision and Reserve.
   (d) Straight Line method and WDV method.
   (e) Revenue Reserve and Capital Reserve.
   (f) General Reserve and Specific Reserve.

8.21 PRACTICAL PROBLEMS

1. On 1st January, 1998, a merchant purchased some furniture costing ` 55,000. It is estimated that its working life is 10 years at the end of which it will fetch ` 5000. Additions are made on 1st January, 1998 and 1st July 2001, to the value of ` 9,500 and ` 8,400 (residual values ` 500 and ` 400 respectively). Show the Furniture Account for the first four years, if depreciation is written off according to the straight line method.
   [**Ans.** Balance of Furniture Account on 1st January, 2002 ` 49,800]
2. A company provides depreciation under the straight line method at the rate of 10% p.a. The balance standing in the Plant and Machinery Account of 31 December 1995, after writing off depreciation for the year, was ` 1,95,150 (total cost price of the plant was ` 3,58,000).

   During January 1996 a new plant was purchased at a cost of ` 29,500 and one machine which had cost ` 5,500 in 1984 was sold as scrap for ` 400.

   During January 1997, there were additions costing `18,000 and a machine which had cost `7,000 in 1992 was sold for `3,500.

   Write up the Plant and Machinery Account for 1996 and 1997.

   [**Ans.** Balance as on 31st December, 1996 ` 1,85,900, Dec. 31, 1997, `1,60,550]

   [**Hints :** Profit of ` 400 on machinery sold as scrap will be taken direct to P & L Account.]

Diminishing Balance Method :

3. A plant is purchased for ` 20,000. It is depreciated at 5% per annum on reducing balance for five years when it becomes obsolete due to new method of production and is scrapped. The scrap produces `5,385. Show the plant account in the ledger.

   [**Ans.** Loss on sale `10,191; Depreciation 1st year ` 1,000; 2nd year ` 950, 3rd year `902; 4th year ` 857; 5th year ` 815.]
4. On January 1992 Bhola Nath Dutt & Sons purchased a machine costing ` 1,00,000. It working life is 10 years. It has been decided to depreciate it at the rate of 12½ per cent on the Diminishing Balance Method. Show the Machinery Account for first three years.
5. If an asset was purchased for ` 50,000 on 1st January, 1998. What would be its book value three years after if it was depreciated according to the following methods : (i) Straight Line Method, and (ii) Written Down Value Method. The rate of depreciation is 10% per annum. Show your answer by a tabular ledger account.

   [**Ans.** Straight Line Method ` 35,000; Written Down Value Method ` 36,450.]

Depreciation Fund Method :

6. A company purchased a four year's lease on 1st January, 1995 for `20,150. It is decided to provide for the replacement at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 4 per cent. Sinking Fund tables show that to provide the requisite sum at 4 per cent at the end of years, an investment of `4,745.02 is required. Investments are made to the nearest rupee.

   On December 31, 1998, the investments are sold for `14,830. On 1st January, 1999, the same lease is renewed for a further period of 4 years by payment of ` 22,000.

   Show journal entries and give the important ledger accounts to record the above.

   [**Ans.** Amount credited to the Profit and Loss Account at the end of December, 1998 `17.56]

Insurance Policy Method :

7. Chilies Ltd. acquired a long-term lease of property on payment of ` 60,000. A Leasehold Redemption Policy was taken out on which an annual premium of ` 1440 was payable. The surrender value of the policy on 31st March, 1997 was `12,896 to which amount the policy account stood adjusted. Next premium was paid on 20th December, 1997 and the surrender value on 31st March, 1998 was ` 14,444.

   (i) Show the Redemption Fund Account and the Policy Account for the year ended 31st March 1998.

   (ii) Assuming that on maturity, a sum of `60,100 was received and the balance in Policy Account then stood at ` 59,920 give the ledger accounts showing the entries necessary to close the accounts concerned.

   [**Ans.** (i) Balance at the end of 1998 Fund A/c and Policy A/c `14,444 each,

   (ii) Transfer to P & L A/c profit on maturity ` 100]

Depletion Method :

8. Burdwan Collieries Ltd. acquired the lease right for 20 years of a mine on 1st January, 1989 on a lump payment of `5,00,000 to the landlord. It was estimated by the expert that the coal deposit of the mine was `20,000 tonnes, 75 per cent, of which could be raised within the time period. The company decided to write off the Least Account under straight line method of depreciation. The Lease Account was shown accordingly for the first five years. On 31st October, 1994, the Board of Directors decided to depreciate the Lease on "Depletion" method with retrospective effect from 1st January, 1989. The annual raising were :

1989	20,000 tonnes
1990	30,000 tonnes
1991	1,00,000 tonnes
1992	2,00,000 tonnes
1993	2,00,000 tonnes
1994	2,00,000 tonnes

   You are required to show the Lease A/c from 1st January, 1989 to 31st January, 1994 showing clearly your calculations.

   [**Ans.** Arrears of depreciation in 1994 ` 58,333, Balance in the Lease Account at the end of 1994 `2,50,000]

Group Depreciation Method :

9. The valuation of a group of assets (plant and machinery), on 1st January, 1994 was ` 32,000 and the estimated life was 8 years. The following purchases and sales took place upto 31st December, 1996 :

   Purchases : March 31, 1994, Cost ` 15,000, estimated life 10 years.

   Sept. 30, 1995, Cost ` 12,000, estimated life 6 years.

   April 31, 1996, Cost `20,000, estimated life 8 years.

Sales : Out of initial group of assets, a machine (whose valuation on 1st January, 1994 was ` 5,000) sold for ` 4,700 on 30 June, 1996.

Assuming the break-up value of each asset to be 10 per cent of the initial valuation or original cost, prepare the Asset Account for the first three years.

[**Ans.** Balance on 31st December 1996, `57,424]

Change and Disposal :

10. A company purchased a second-hand machine on 1st January, 1994 for `37,000 and immediately spent ` 2,000 on its repairs and ` 1,000 on its erection. On 1 July, 1995 it purchased another machine for `10,000 and on 1 July, 1996 it sold off the first machine for ` 28,000 bought another for ` 25,000. On July, 1997, the second machine was also sold off for ` 2,000.

Depreciation was provided on machinery at 10 per cent on the original cost annually on 31 December. In 1995, however, the company changed the method of providing depreciation and adopted the written down value method, the rate of depreciation being 15 per cent per annum.

Give the Machinery Account for four years commencing from the acquisition of the machine. Amounts to be calculated to nearest ten ruppes.

[**Ans.** Balance in the Machinery Account on 31.12.1997 `19,650, Loss on sale of machine in 1995 `300, in 1997 `5,270]

11. A second-hand machinery was purchased on 1 January 1995, for ` 30,000 and ` 6,000 and ` 4,000 were spent on its repairs and erection immediately. On 1st July, 1996, another machinery was purchased for`26,000 and on 1st July, 1997, the first machinery having become obsolete was auctioned for `30,000. On the same date another machine was purchased for `25,000. On 1st July, 1998 the second machinery was also sold off and it fetched `23,000.

Depreciation was provided on machinery at the rate of 10 per cent on the original cost annually on 31st December. In 1997, the method of providing depreciation was changed to the written down (dimishing value) method, the rate of depreciation being 15 per cent.

You are required to prepare a machinery account for all the calendar years mentioned above.

[**Ans.** No Profit or Loss on machinery sold in 1997. Profit on sale of Machinery in 1998 ` 3,580, Balance in the Machinery Account ` 19,656].

8.18FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

❑

CHAPTER – 9 COMPANY FINANCIAL STATEMENT

Chapter Outlines

9.0 INTRODUCTION

Financial analysis is the process of using financial statements to enable the users to take economic and investment decisions. In this unit we are explaining the preparation and presentation of financial statements for a corporate entity.

9.1LEARNING OBJECTIVES

- To know the meaning of financial statements.
- Identify the Different types of Financial Statements.
- Understand the nature and limitations of Financial Statement.
- To know the requirements and the formats of Income Statement and Balance Sheet of a Company.

9.2 MEANING AND TYPES OF FINANCIAL STATEMENTS

According to Himpton John, "A financial statement is an organised collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show a position at a moment of time as in the case of a balance sheet, or may reveal a series of activities over a given period of time, as in the case of an income statement."

(i) Income statement: The income statement or profit and loss account is considered as a very useful statement of all financial statements. It depicts the expenses incurred on production, sales and distribution and sales revenue and the net profit or loss for a particular period. It shows whether the operations of the firm resulted in profit or loss at the end of a particular period.

(ii) Balance sheet: Balance sheet is a statement which shows the financial position of a business as on a particular date. It represents the assets owned by the business and the claims of the owners and creditors against the assets in the form of liabilities as on the date of the statement.

(iii) Statement of retained earnings: The statement of retained earnings is also called the Profit and Loss Appropriation Account. It is a link between the income statement and the balance sheet. Retained earnings are the accumulated excess of earnings over losses and dividends. The balance shown by the income statement is transferred to the balance sheet through this statement after making the necessary appropriations.

(iv) Funds flow statement: According to Anthony, "The Funds Flow Statement described the sources from which additional funds were derived and the use to which these funds were put". Funds flow stat ement helps the financial analyst in having a more detailed analysis and understanding the changes in the distribution of resources between two balance sheet periods. The statement reveals the sources of funds and their application for different purposes.

(v) Cash flow statement: A cash flow statement depicts the changes in cash position from one period to another. It shows the inflow and outflow of cash and helps the management in making plans for immediate future. An estimated cash flow statement enables the management to ascertain the availability of cash to meet business obligations. This statement is useful for short term planning by the management.

(vi) Schedules: These are the statements which explain the items given by income statement and balance sheet. Schedules are a part of financial statements which give detailed information about the financial position of a business organisation.

9.3 NATURE OF FINANCIAL STATEMENTS

Financial statements are prepared for the purpose of presenting a periodical review or report on the progress by the management and deal with the (a) status of the investments in the business and (b) results achieved during the period under review. Tha data exhibited in these financial statements are the result of the combined effect of (i) recorded facts : (ii) accounting conventions, (iii) postulates or assumptions made to implement conventional procedures; (iv) personal judgments used in the applications of conventions and postulates and (v) accounting standards and guidance notes. These factors are explained below :

(i) *Recorded Facts* : The term 'recorded facts' means, facts which have been recorded in the accounting books such as cash in hand, cash at bank, bills receivables, bills payable, debtors, creditors, fixed assets, sales, purchases, wages, capital and so forth. These items are listed on the basis of historical records of the transactions and valued at the price at which such transactions took place. Facts which have not been recorded in the accounting books are not depicted in the financial statements, however, material they might be.

(ii) *Accounting Conventions:* Accounting conventions have reference to certain fundamental accounting principles, the applications of which has been sanctified by long usage. For example, on account of the convention of conservation, provision is made for expected losses but expected profits are ignored. Those conventions are applied for the valuation of inventory, allocation of expenditure between capital and revenue for the purpose of assets valuations etc.

(iii) *Postulates :* Accountants make various assumptions for the conventions adopted. One of these assumptions or postulates is to the effect that the enterprise will continue in business beyond the period which is covered by the financial statements, i.e., business is a going concern. The assumption is referred to as the permanency postulate, and the assets of the business are valued under this assumption t cost less depreciation. In absence of this assumption, the assets may have to be valued at realisable value which may be negligible if the business is not a going concern. Another postulates which accountants make is the monetary postulate. It is the tacit assumption that the value of money, that is its purchasing power, remains constant over different periods. The accountants do not take into consideration the price-level changes while valuing various assets in different periods. Of late, however, accountants in the west have shown growing consciousness for incorporating price-level changes while preparing financial statements. A third postulate is the realisation postulate which takes cognizance of the time lag between production and sales affected. Under this postulate entire revenue is considered to be earned at the moment the sales take placed and not at the time when the production took place. This postulates forms the basis for the convention of matching costs with revenues, where under, the costs incurred in the past period are brought forward to be accounted for against the revenues earned at a later period.

(iv) *Personal Judgments:* It may be noted that the application of conventions, assumptions of postulates depends on the personal judgments of the accountant. For example, the choice of selecting methods of depreciation, the mode of amortisation of fictitious assets, the method of variation of stock, calculation of provision for doubtful debts etc. depend on the personal judgments of the accountant. However, the existence of consistency principle serves as a check on the power of the accountant to use his personal judgment. Since the accountant is guided by the past practices, the area of application of his personal judgment is reduced.

(v) *Accounting Standards and Guidance Notes :* Accountants are guided by various accounting standards and guidance notes in preparing the financial statement. Some of the accounting standards like, Disclosure of Accounting Policies, Revenue Recognition, Accounting for Fixed Assets etc. are mandatory in nature.

9.4 LIMITATIONS OF FINANCIAL STATEMENTS

- In Profit and Loss Account net profit is ascertained on the basis of historical costs.
- Profit arrived at by the Profit and Loss Account is of interim nature. Actual profit can be ascertained only after the firm achieves its maximum capacity.
- The net income disclosed by the Profit and Loss Account is not absolute but only relative.
- The Profit and Loss Account does not disclose factors like quality of product, efficiency of the management etc.
- The net income is the result of personal judgment and bias of accountants cannot be removed in the matters of depreciation, stock valuation, etc.
- There are certain assets and liabilities which are not disclosed by the Balance Sheet. For example t he most tangible asset of a company is its management force and a dissatisfied labour force is its liability which are not disclosed by the Balance Sheet.
- The book value of assets is shown as original cost less depreciation. But in practice, the value of the assets may differ depending upon the technological and economic changes.
- The assets are valued in a Balance Sheet on a going concern basis. Some of the assets may not realise their value on winding up.
- The accounting year may be fixed to show a favourable picture of the business. In case of sugar industry the Balance Sheet prepared in off season depicts a better liquidity position than in the crushing season.
- An investor likes to analyse the present and future prospects of the business while the balance sheet shows past position. As such the use of a Balance Sheet is only limited.
- Due to flexibility of accounting principles, certain liabilities like provision for gratuity etc. ar e not shown in the Balance Sheet giving the outsiders a misleading picture.
- The financial statements are generally prepared from the point of view of shareholders and their use is limited in decision making by the management, investors and creditors.
- Even the audited financial statements does not provide complete accuracy.
- Financial statements do not disclose the changes in management, loss of markets, etc. which have a vital impact on the profitability of the concern.
- The financial statements are based on accounting policies which vary from company to company and as such cannot be formed as a reliable basis of judgment.

9.5 PREPARATION OF COMPANY FINANCIAL STATEMENTS

The Financial statements, as discussed above, basically comprise of two statements v/z, income statement or profit and loss account and the balance sheet. They are usually prepared at the end of the accounting period, hence they are also termed as final accounts of the company. In case of companies, the final accounts have been termed as annual accounts and balance sheet. Section 210 of the Companies Act governs the preparation of the final accounts of a company. The important provisions regarding the preparation of the above accounts are as follows :

(i) At every annual general meeting of the company, the Board of Directors of the Company shall lay before the company :

(a) the balance sheet as at the end of the accounting period, and

(b) a profit and loss account for that period.

In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company as its annual general meeting instead of profit and loss account.

(ii) The profit and loss account (or the income and expenditure account) relate to the period -

(a) in the case of first annual general meeting of the company from the date of incorporation of the company to a date not more than 9 months before the meeting, and

(b) in the case of any subsequent annual general meeting from the date immediately after the period for which account was last submitted to not more than 6 months before the meeting.

The period for which the account has been prepared is called the financial year. It may be less or more than a calender year but it shall not exceed 15 months. However, with the permission of the Registrar, it may extend to 18 months.

According to Section 211, the profit and loss account and the balance sheet of a company must give a true and fair view of the state affairs of the company. The balance sheet should be in the form as given in Part I of Schedule VI or as near thereto as the circumstances admit. The form has been given latter in the unit. The profit and loss account should comply with the requirements of Part II of Schedule VI to the Companies Act. Part III to Schedule VI only interprets certain terms used in Schedule VI, Part I and Part II. Part IV has been added w.e.f. 15.5.1995. Part IV comprises of Balance Sheet Abstract as a Company's General Business Profile.

According to Companies (Amendment) Act, 1999 (w.e.f. 31.10.1998), every Profit and Loss Account and Balance Sheet has to comply with the accounting standards as issued by the Institute of Chartered Accountants of India a consulation with National Advisory Committee on Accounting Standards established under the Companies Act. Where the profit and loss account and balance sheet the following :

(a) deviation from the accounting standards,

(b) the reasons for such deviation, and

(c) the financial effects arising from such deviations.

The balance sheet and profit and loss account of the company have to be duly signed on behaf of the company by persons as per the provisions of Section 215 of the Companies Act. They should be accompanied with the Directors' and Auditors' report. The Directors' report should contain besides other prescribed particulars, the amount if any which the board recommends to be paid by way of dividend and a statement showing the name of every employee of company who has been paid remuneration for that year at a rate which is not less than ` 2,00,000 per month.

A copy of the final accounts (i.e., the profit and loss account and the balance sheet together with Directors' and Auditors' reports) should be sent not less than 21 days before the date of the annual general meeting to every member of the company, every debenture-holder and every trustee for the debenture holders. Three copies of such accounts and reports must be filed with the Registrar within 30 days from the date on which they were so laid in the meeting.

In the following pages, we are giving the particulars as required by Schedule VI both in respect of the profit and loss account and the balance sheet and the special points which the students must keep in mind while preparing them.

9.6 PROFIT AND LOSS ACCOUNT

Requirements of the Profit and Loss Account

The requirements of the profit and loss account can be put into two categories :

1. General Requirements; and 2. Special Requirements as per Schedule VI, Part II

1. General Requirements : These basically relate to three matters :

(i) **Heading :** In case of companies, it is not necessary split the profit and loss account into three sections viz.

Trading Account, Profit and Loss Account and Profit and Loss Appropriation Account. Of course splitting up of the account into three sections is not forbidden and should be done to give a better view about the profit earned and distributed by the company during a particular period.

The profit and loss account can be prepared under two headings :

(a) Profit and loss account giving details regarding the Gross profit and Net profit earned by the company during a particular period.

(b) Profit and loss appropriation account giving details regarding the balance of profit and loss account brought forward from the last year, the net profit (or loss) termed (or made) during the year and appropriations made during the year.

Items which are shown in the profit and loss account are popularly termed as items appearing "above the line". While the items which are shown in the profit and loss appropriation account are popularly termed as items appearing "below the line".

(ii) **Provision for Taxation :** Companies are charged income tax at a high rate. Usually the tax rate is about 40% or more of the taxable profits. Though provision for taxation is an appropriation of profits, yet the common practice is to show it "above the line" i.e., in the profit and loss section and not in profit and loss appropriation section. It other words, profit after tax is provided or refunded for is charged or credited to the profit and loss appropriation account.

(iii) **Accounting Year :** Though the Companies Act permits a company to select any period of 12 months as its accounting year, on account of tax laws it has become almost obligatory for every company to close its books of accounts on 31st March, every year.

2. Special Requirements as per Schedule VI, Part II. The profit and loss account of a company must be prepared in accordance with the requirement of Part II of Schedule VI of the Companies Act, 1956. These requirements are summarised as follows :

(i) The profit and loss account should clearly disclose the result of the working of the company during the period covered by the account. It should disclose separately incomes and expenses of a non-recurring nature and exceptional transactions. The profit and loss account should particularly disclose information in respect of the following items :

(a) The turn-over of the company.

(b) Commission paid to sole-setting agents.

(c) Commission paid to other setting agents.

(d) Brokerge and discount on sales other than the usual trade discount.

(e) Opening and closing of goods, purchases made or cost of goods manufactured or value of services rendered during the period covered by the account.

(f) Interest on company's debentures and other fixed loans.

(g) Amount charged as income tax.

(h) Remuneration payable to the managerial personnel.

(i) Amount paid to auditor for services rendered as - (a) auditor and (b) as advisor in any other capacity viz. taxation matters, company law matters, management services, etc.

(j) The details of licensed, installed and actual capacity utilized.

(k) Value of imports, earnings in foreign exchange and amounts remitted during the year in foreign currencies on account of dividends.

Formats of Financial Statements

The two main financial statements, viz. the Income Statement and the Balance Sheet, can either be presented in the horizontal form or the vertical form. Where statutory provisions are applicable, the statement has to be prepared in accordance with such provisions.

Income Statement

There is no legal format for the Profit and Loss Account. Therefore, it can be presented in the traditional 'T' form, or vertically, in statement form. An example of the two format is given as under.

(i) Horizontal, or 'T' form.

Manufacturing Trading and Profit and Loss Account of
.... for the year ending ....

Dr Cr.

Particulars	`	Particulars	`
To Opening Stock :		By Cost of Finished Goods e/d	xxx
Raw Materials	xxx	By Closing Stock	
Work-in-Progress	xxx	Raw Materials	xxx
To Purchases of Raw Materials	xxx	Work-in-Progress	xxx
To Manufacturing Wages	xxx		
To Carriage Inwards	xxx		
To Other Factory Expenses	xxx		
	xxxx		xxxx
To Opening Stock of finished goods	xxx	By Sales	xxx
To Cost of Finished Goods b/d	xxx	By Closing Stock of finished goods	xxx
To Gross Profit c/d	xxx	By Gross Loss c/d	xxx
	xxxx		xxxx
To Gross Loss b/d	xxx	By Gross Profit b/d	xxx
To Office and Admn. Expenses	xxx	By Miscellaneous Receipts	xxx
To Interest and Financial Expenses	xxx	By Net Loss c/d	xxx
To Provision for Income-tax	xxx		
To Net Profit c/d	xxx		
	xxxx		xxxx
To Net Loss b/d	xxx	By Balance b/d	
To General Reserve	xxx	(from previous year)	xxx
To Divident	xxx	By Net Profit b/d	xxx
To Balance c/f	xxx		
	xxxx		xxxx

(ii) Vertical Form

Income statement of .... for the year ending ....

Particulars		`	`
Sales			xxxx
Less : Sales Returns		xxx	
Sales Tax/Excise Duty		xxx	xxxx
Net Sales	(1)		xxxx
Cost of Goods Sold			
Materials Consumed			xxxx
Direct Labour			xxxx
Manufacturing Expenses			xxxx
Add/Less Adjustment for change in stock			xxxx
	(2) xxxx		
			xxx
Gross Profit	(1) - (2)		
Less : Operating Expenses			
Office and Administration Expenses		xxx	
Selling and Distribution Expenses		xxx	xxx

Operating Profit	**xxxx**
Add : Non-Operating Income	xxx
	xxxx
Less : Non-Operating Expenses (including Interest)	xxx
Profit Before Tax	xxxx
Less : Tax	xxx
Profit After Tax	**xxxx**
Appropriations	
Transfer to reserves	xxxx
Dividends declared/paid	xxx
Surplus carried to Balance Sheet	xxx
	xxxx

9.7 BALANCE SHEET

The Companies Act, 1956 stipulates that the Balance Sheet of a joint stock company should be prepared as per Part I of Schedule VI of the Act. However, the statement form has been emphasised upon by accountants for the purpose of analysis and interpretation. The permission of the Central Government is necessary for adoption of the 'Statement' form.

(i) Horizontal Form :

Balance Sheet of .... as on ....

Liabilities	`	Assets	`
Share Capital	xxx	**Fixed Assets**	
(with all particulars of Authorised,		1. Goodwill	xxx
Issued, Subscribed Capital)		2. Land and Buildings	xxx'
Called-up Capital	xxx	3. Leasehold Property	xxx
Less : Calls in Arrears	xxx	4. Plant and machinery	xxx
Add : Forfeited Shares	xxx	5. Furniture and Fittings	xxx
Reserves and Surplus :		6. Patents and Trade Marks	xxx
1. Capital Reserve	xxx	7. Vehicles	xxx
2. Capital Redemption Reservd	xxx	**Investments**	xxx
3. Share Premium	xxx	**Current Assets, Loans and Advances**	
4. Other Reserves	xxx	**(A) Current Asses**	
Less : Debit balance of Profit &		1. Interest accured on Investments	xxx
Loss : A/c (if any)	xxx	2. Loose tools	xxx
5. Profit and Loss Appropriation A/c	xxx	3. Stock in Trade	xxx
6. Sinking Fund	xxx	4. Sundry Debtors	xxx
Secured Loans		Less : Provision for doubtful debts	
Debentures	xxx	5. Cash in hand	xxx
Add : outstanding Interest	xxx	6. Cash at Bank	xxx
Loans from Banks	xxx		
Unsecured Loans		**(B) Loans and Advances**	
Fixed Deposits	xxx	7. Advances to subsidiaries	xxx
Short-term loans and advances	xxx	8. Bills Receivable	xxx
		9. Prepaid expenses	xxx

Current Liabilities and Provisions		Miscellaneous Expenditure (to the extent not written off or adjsted)	
(A) Current liabilities		1. Preliminary Expenses	xxx
1. Bills Payable	xxx	2. Discount on Issue of shares and debentures	xxx
2. Sundry Creditors	xxx	3. Underwritting Commission	xxx
3. Income received in advance	xxx	Profit and Loss Account (loss), if any	xxx
4. Unclaimed Dividents	xxx		
5. Other liabilities	xxx		
(B) Provisions			
6. Provisions for Taxation	xxx		
7. Proposed Dividends	xxx		
8. Providend Fund and Pension Fund Contingent Liabilities not provided for	xxx		
	xxx		xxx

(ii) Vertical Form :

Balance Sheet of .... as on ....

Particulars	Schedule No.	Current Year `	Previous Year `
I. Source of Funds			
1. Shareholders' Funds			
(a) Capital		xxxx	xxxx
(b) Reserves and Surplus		xxxx	xxxx
2. Loan Funds			
(a) Secured Loans		xxxx	xxxx
(b) Unsecured Loans		xxxx	xxxx
Total			
II. Application of Funds			
1. Fixed Assets			
(a) Gross Block		xxxx	xxxx
(b) Less Depreciation		xxxx	xxxx
(c) Net Block		xxxx	xxxx
(d) Capital work-in-progress		xxxx	xxxx
2. Investments		xxxx	xxxx
3. Current Assets, Loans and Advances			
(a) Inventories		xxxx	xxxx
(b) Sundry Debtors		xxxx	xxxx
(c) Cash and Bank balances		xxxx	xxxx
(d) Other Current Assets		xxxx	xxxx
(e) Loans and Advances		xxxx	xxxx
		xxxx	xxxx
Less : Current Liabilities and Provisions			
(a) Current Liabilities		xxxx	xxxx
(b) Provisions		xxxx	xxxx
		xxxx	xxxx

Net Current Assets		
4. (a) Miscellaneous Expenditure to the extent not written off or adjusted	xxxx	xxxx
(b) Profit and Loss Account (debit)	xxxx	xxxx
Total	xxxx	xxxx

(iii) Vertical Form for Analysis :

Balance Sheet of .... as on ....

Particulars		`
ASSETS		
Current Assets		
Cash and Bank Balances		xxxx
Debtors		xxxx
Stock		xxxx
Other Current Assets		xxxx
	(1)	xxxxx
Fixed Assets		xxxx
Less : Depreciation		xxxx
Investment	(2)	xxxx
	TOTAL (1) + (2)	xxxxx
LIABILITIES		
Curent Liabilities :		
Bills Payable		xxxx
Creditors		xxxx
Other Current Liabilities	(3)	xxxx
Long Term Debt		
Debentures		xxxx
Other Long-term Debts		xxxx
		(4) xxxxx
Capital and Reserves		
Share Capital		xxxx
Reserves and Surplus		xxxx
		(5) xxxx
	(4) + (5)	xxxx
Total Long-term Funds	TOTAL (3) + (4) + (5)	xxxxx

Statement of Retained earnings :

Profit and Loss Appropriation Account

Particulars	`	Particulars	`
To Transfers to Reserves	xxx	By Last year's balance	xxx
To Dividends Paid (Interim or Final)	xxx	By Current year's net profit (Transferred ferred from Profit and Loss (A/c)	xxx
To Dividends Proposed	xxx	By Excess Provisions (which are no longer required	xxx
To Surplus carried to Balance Sheet	xxx		
		By Reserves withdrawn (if any)	xxx
	xxx		xxx

Illustration - 9.1 :

From the following information, prepare a vertical income statement.

	(`)
Sales	2,00,000
Opening Stock	10,000
Closing Stock	15,000
Purchases	40,000
Operating expenses	12,000
Non-operating expenses	4,000

Rate of Tax 50%

Income Statement

Particulars		`
Sales		2,00,000
Less : Cost of goods sold :		
Opening Stock	10,000	
Add : Purchase	40,000	
	50,000	
Less : Closing Stock	15,000	35,000
Gross Profit		1,65,000
Less : Operating expenses		12,000
Operating Profit		1,53,000
Less : Non-operating expenses		4,000
Profit before tax		1,49,000
Less : Income tax (50%)		74,500
Net Profit after tax		74,500

Illustration - 9.2 :

From the following particulars pertaining to Mohan Ltd. you are required to prepare a comparative Income Statement and interpret the changes.

Particulars	2000 `	2001 `
Sales	58,000	65,200
Cost of Goods Sold	47,600	49,200
Administration Expenses	1,016	1,000
Selling Expenses	1,840	1,920
Non-operating Expenses	140	155
Non-operating Incomes	96	644
Sales Returns	2,000	1,200
Tax rate	43.75%	43.75%

Comparative Income Statement of Mohan Ltd. for the years 2000 and 2001

Particulars	2000 `	2001 `
Sales	58,000	65,200
Less : Returns	2,000	1,200

Net Sales		56,000	64,000
Less : Cost of Goods sold		47,600	49,200
Gross Profit	(A)	8,4000	14,800
Less : Operating Expenses			
Administration Expenses		1,016	1,000
Selling Expenses		1,840	1,920
Total Operating Expenses	(B)	2,856	2,920
Operating Profit	(A – B)	5,544	11,880
Add : Non-operating Incomes		96	644
		5,640	12,524
Less : Non-operating Expenses		140	155
Net Profit Before Tax		5,500	12,369
Less : Tax		2,406	5,411
Net Profit After Tax		3.094	6,958

Illustration - 9.3 :

The following balances have been extracted from the books of Rama Ltd. on 31.12.2006 :

Share Capital ` 10,00,000; Share Premium `1,00,000; 12% ` 5,00,000; Creditors ` 2,00,000; Proposed Dividend ` 50,000; Profit and Loss Account (Dr.) ` 50,000; Livestock `9,00,000; Government Bonds ` 4,00,00; Work-in-progress ` 4,00,000; and Discount on Issue of 12% Debentures `1,00,000.

Prepare the Balance Sheet of the Company as per Schedule VI Part I of the Companies Act, 1956.

Solution :

Rama Ltd.
Balance Sheet, As on 31st December, 2006.

Liabilities	Amount `	Assets	Amount `
Share Capital :		**Fixed Assets :**	
Authorised, Issued and Subscribed	10,00,000	Livestock	9,00,000
Reserve and Surplus :		**Investments**	
Share Premium	1,00,000	Government Bonds	4,00,000
Secured Loans :		**Current Assets, Loans**	
12% Debentures	5,00,000	**and Advances**	
Current Liabilities		(A) Current Assets	
and Provisions :		Work-in-progress	4,00,000
(A) Current Liabilities :		(B) Loans and Advances	–
Creditors	2,00,000	**Miscellaneous Expenditures**	1,00,000
(B) Provisions	50,000	**Profit and Loss Account**	50,000
	18,50,000		18,50,000

9.8 KEY TERMS

- **Balance Sheet.** A statement of financial position of business at a specified moment of time.
- **Company Final Accounts.** The term includes the profit and loss account (or income and expenditure account in cash of a company not carrying on business for profit) and balance sheet of a company prepared as per the requirements of Schedule VI to the Companies Act.
- **Financial Statement.** Organised collection of data according to logical and consistent accounting procedures.

- **Income Statement.** A financial statement which presents the revenues and expenses of an enterprise for an accounting period and shows the excess of revenues over expenses (or vice-versa). It is also known as Profit and Loss Statement/Account.
- **Profit and Loss Appropriation Account.** An account showing distribution of earning during a particular period.

9.9 SUMMARY

- Final acounts of a corporate entity include an Income Statement (Profit and Loss Account), Profit and Loss Appropriation Account, Cash Flow Statement and Balance Sheet.
- The profit and loss account is to be prepared as per the requirements of Schedule VI Part II, while a balance sheet is to be prepared as per Schedule VI Part I to the Companies Act.

9.10. CHECK YOUR PROGRESS AND ANSWERS

1. True or False :

(i) A company's Profit and Loss Account is to be prepared as per the requirements of Schedule VI, Part II.

(ii) In case of companies gross profit and net profits are required to be computed separately.

(iii) The Profit and Loss Account should give separate details regarding remuneration paid to the auditors for audit and other services.

(iv) Loose tools are shown as an item of current assets in a company's balance sheet.

(v) Debit balance of the Profit and Loss Account is shown on the assets side of the company's balance sheet.

(vi) Provision for taxation is shown below the line in the company's Profit and Loss Account.

2. Select the most appropriate answer :

(i) The Director's Report must give details of employees who have been paid a monthly remuneration of not less than -

(a) `2,00,000 (b) `60,000 (c) ` 1,00,000

(ii) Balance Sheet of a company is to be prepared in the format given in -

(a) Schedule VI, Part I. (b) Schedule VI, Part II. (c) Table A.

(iii) The companies now prefer to close their account for the accounting year ending on -

(a) 31st December (b) 31st March (c) 30th June.

Ans. : 1. (i) True, (ii) False, (iii) True, (iv) True, (v) True, (vii) ....

2. (i) - (a), (ii) - (a), (iii) - (a)

9.11 QUESTIONS AND EXERCISES

1. Explain the terms 'financial statements'. Discuss their various types.
2. Explain the requirements of Schedule VI, Part II of the Companies Act. 1956.
3. Give in a summarized form, the horizontal form of company's balance sheet as per Schedule VI, Part I of the Companies Act. 1956.
4. Give the main heads under which the various items appear in case of vertical form of a company's balance sheet.
5. Draw up a pro forma Balance Sheet of a Company.
6. Name the major heading into which the liabilities side of a company's balance sheet is organized and presented.
7. Name the major heads (in the required serial order) under which various assets of a company are to be presented as per the requirements of the Indian Companies Act.
8. Prepare a layout of information required to be given under the heading "Share Capital" on the liabilities side of a company's Balance Sheet.
9. State the major heads on the assets side of Balance Sheet of a company as per Schedule VI, Part I of the Indian Companies Act. 1956.

10. What is Contingent Liability ? Where is it shown in the Balance Sheet ? Give three example of Contingent Liabilities.
11. State any five items which are shown under the heading 'Miscellaneous Expenditure' in the Balance Sheet of a Company as per Schedule VI, Part I of the Companies Act. 1956.
12. State any five items which are shown under the heading 'Reserves and Surplus' in the Balance Sheet of a company as per Schedule VI, Part I of the Companies Act. 1956.

9.12 PRACTICAL PROBLEMS

1. Under what headings of Balance sheet of a company will you classify the following items:

   (i) Sundry Debtors (ii) Share Premium

   (iii) Goodwill

   [**Ans.** (i) Current Assets, Loans and Advances; (ii) Reserves and Surplus, (iii) Fixed Assets]

2. How would you disclose the following items in the Balance Sheet of a limited company :

   (i) Loose Tools (ii) Stock

   (iii) Goodwill (iv) Discount on issue of debentures not yet written off

   (v) Bills Payable (vi) Preliminary Expenses

   (vii) Unclaimed Dividends (viii) Share Premium Account

   [**Ans.** (i) Current Assets, Loans and Advances; (ii) Current Assets, Loans and Advances; (iii) Fixed Assets; (iv) Miscellaneous Expenditure; (v) Current Liabilities and Provisions; (vi) Miscellaneous Expenditure; (vii) Current Liabilities and Provisions; (viii) Reserves and Surplus.]

3. Under what headings will you show the following items in the Balance sheet of a company :

   (i) Securities premium account (ii) Preliminary expenses

   (iii) Bills receivable (iv) Goodwill

   (v) Authorised capital

   [**Ans.** (i) Reserves and Surplus; (ii) Miscellaneous Expenditure; (iii) Current Assets, Loans and Advance; (iv) Fixed Assets; (v) Share capital]

4. State the relevant main headings under which the following items would be disclosed in the balance sheet of a limited company :

   (i) Goodwill (ii) Bills Receivable

   (iii) Authorised capital (iv) Preliminary expenses

   (v) Provision for tax

   [**Ans.** (i) Fixed Assets; (ii) Current Assets, Loans and Advance, (iii) Share Capital, (iv) Miscellaneous Expenditure; (v) Current Liabilities and Provisions.]

5. Under what headings you will show the following items in the Balance Sheet of a joint stock company :

   (i) Authorised capital (ii) Share forfeiture account

   (iii) Capital reserve (iv) Secured debentures

   (v) Provision for Tax

   [**Ans.** (i) Share Capital (ii) Share Capital, (iii) Reserves and Surplus, (iv) Second Loans, (v) Current Liabilities and Provisions.]

6. Compute the amount of contingent liabilities from the following details :

   (i) A customer of the company has filed a claim of `10,000 for the alleged loss suffered by him on account of faulty quality of the company's goods. The company has challenged the claim in the Court of Law.

   (ii) The company holds 1000 equity shares of `10 each in X Ltd. ` 6 per share has been called up so far.

   (iii) The company's share capital consists of 10% cumulative preference shares of `1,00,000. On account of heavy losses the company could not declare dividends on these shares for the last two years.

   (iv) The company has to pay to its retired employees `20,000 on account of pension and gratuity.

   (v) The estimated amount of contracts to be executed on capital account is `50,000. No provision has yet been made for these contracts.

   (vi) The company has given its acceptance in favour of its creditors `20,000.

   [**Ans.** ` 84,000]

7. Y Udyog Ltd. has the authorized capital of `1,00,000 divided into `10,000 equity shares of `10 each. The

company invited applications for 5000 shares. Applications for 4000 shares were received. All calls were made and were duly received except the final call of `2 per share on 100 shares. Out of the shares on which the final call was not received 75 shares were forfeited. Show how the share capital will appear in the Balance Sheet of the company as per Schedule VI, Part I of the Companies Act, 1956.

[**Ans.** Total of B/S ` 39,800]

8. The following balances have been extracted from the books of Ramesh & Company :

Share Capital ` 5,00,000; Share Premium ` 50,000; 12% Debentures ` 2,50,000; Creditors `1,00,000; Proposed Dividend ` 25,000; Profit and Loss (Dr.) ` 25,000; Freehold Property `4,50,000; Share in ICICI ` 2,00,000; Work-in-Progress ` 2,00,000; Discount on Issue of Debentures ` 50,000.

Prepare the Balance Sheet of the Co. as per Schedule VI, Part I of the Companies Act, 1956.

[**Ans.** Balance Sheet Total ` 9,25,000]

9. Prepare a Balance Sheet of V.T. Ltd. as on March 31, 1995 as per provision of Part I, Schedule VI under Section of the Companies Act, 1956 from the following information:

	`
General Reserve	3000
Debentures	3000
Profit and Loss A/c (Cr.)	1200
Depreciation on Fixed Assets	700
Gross Fixed Assets	9000
Current Liabilities	2500
Preliminary Expenses	300
Preference Share Capital	5000
Current Assets	6100

[**Ans.** Balance Sheet Total `14,700]

10. The following balances are supplied, on the basis of which you may required to show the major appropriate heads under which the items given below will appear in the Balance Sheet of Veekay Ltd. as on 31st March, 1995:

	`
Plant and Machinery	5,60,000
Building	10,00,000
Equity Share Capital	(Authorized) 20,00,00
0 Equity Shares of `100 each `70 called and	paid up 14,00,00
0 10% Debentures	55,000
Discount on issue of 10% Debentures	5,500
Furniture & Fixture	15,000
Long-term Bank Loan (Secured)	1,25,00

0 [**Ans.** Balance Sheet Total `1,58,000]

9.13 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari

Financial Statement Analysis – John N. Meyer

Management Accounting – Khan and Jain.

Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.

Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

CHAPTER – 10 CORPORATE DISCLOSURE AND FINANCIAL REPORTING

Chapter Outlines

10.0 INTRODUCTION

Today corporates occupy a special place in the economy of every country. The company does not exist for itself. There are various stakeholders. These stakeholders must be continuously informed about the financial affairs of the corporate world. This chapter can only initiate a student into the world of corporate reporting. This unit deals with different aspects of financial reporting and disclosures with an suitable example

10.1 LEARNING OBJECTIVES

- Understand the meaning and objectives of Corporate Disclosure and Financial Reporting.
- Annual Reports and its Contents
- Familiarisation with the contents of Annual Report.
- Objective of Financial Reporting.

10.2 MEANING OF CORPORATE DISCLOSURE AND FINANCIAL REPORTING

Corporate Disclosure Financial Reporting is concerned with providing useful information or disclosur e to the user groups of financial statements, i.e., shareholders, creditors, potential investors etc. Financial reporting, thus includes "not only the financial statements but also other means of communicating information that relates directly or indirectly to the information provided by the accounting system, i.e., information about an enterprise's resources, obligations, earnings, etc.

The management of an enterprise may communicate information to external parties by means of financial statements and other financial information. The corporate annual reports form one of the most common means of financial reporting. Such reports incorporate not only income statement, balance sheet and statement of retained earnings but also important accounting ratios, graphs, diagrams, etc., all meant for providing useful information to the interested parties.

Objectives of Corporate Disclosure and Financial Reporting

The basic objective of financial reporting is to provide information useful for making economic decisions. According to SFAC-1, Financial Reporting should provide the following information :

1. *Information for investment and credit decisions :* Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.
2. *Information for assessing cash flow prospects :* Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing and

uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected b y an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations and to pay cash dividends and may also be affected by perceptions of investors and creditors generally about the ability, which affect market prices of the enterprise's securities. Thus, financial reporting should provide information to help investors, creditors and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.

3. *Information about economic resources, etc.* Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterpris e to transfer resources to other entities and owner's equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
4. *Information about financial performance.* Financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investor 's and creditors expectations about future enterprise performance, those expectations are commonly based at least partly on evaluation of past enterprise performance.
5. *Information about liquidity, solvency and funds flow.* Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect in enterprise's liquidity or solvency.
6. *Information about management performance:* Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
7. *Information useful to management.* Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners.

On the basis of the above, the main objectives of the financial reporting can be summarised as follows:

(i) To provide informations which if useful to investors, creditors and others in making rational decisions.

(ii) To assist investors and creditors in assessing future net cash flows to the enterprise in respect of amount, timing and uncertainty.

(iii) To identify entity resources (assets) and claims against resources, both creditor's claims (liabilities) and owner's claims (owners' equity).

(iv) To show how an enterprise obtains resources and what it uses them for.

(v) To provide information about enterprise performance and earnings potential.

In conclusion it may be said that financial reporting is not end in itself. It is only a means of providing informations which may be useful in making business and economic decisions. The objectives of financial reporting are not immutable. They are affected by the economic, legal, political and social environment in which financial reporting takes place. Moreover the objectives are also affected by the characteristics and limitations of the kind of information that financial reporting can provide. Since management knows more about the enterprise and its affairs than investors, creditors or other outsiders, it can increase t he usefulness of financial information by identifying certain events and circumstances and expanding their financial effects on the enterprise.

10.3 ANNUAL REPORTS: CORPORATE FINANCIAL REPORTING IN INDIA

As mentioned in the preceding unit, not corporate entities in India are not subject to much or legislative or statutory requirements for financial reporting. However, corporates in India, whether public or private, are subject to regulation due to various enactments viz., the Companies Act, 1956 and regulatory bodies viz., the Securities and Exchange Board of India (SEBI), the Institute of Chartered Accountants of India (I CAI), the concerned stock exchange where the company is going to have its securities listed.

10.3.1 Annual Report

Every company is required to submit at its Annual General Meeting the report regarding the activities of the company during the preceding financial year, such a report is termed as "Annual Report" of the company. It basically comprises of the following documents relating to the company :

10.3.1.1 Balance Sheet

10.3.1.2 Profit and Loss Account

10.3.1.3 Auditor 's Report

10.3.1.4 Board of Directors Report

According to Section 210 of the Companies Act, at every Annual General Meeting, the Board of Directors of the Company will have to lay before the members a Balance Sheet as at the end of the period specified and profit and loss account for that period. According to Section 211, every Profit and Loss Account and Balance Sheet of the company has to be in the prescribed format and comply with the prescribed accounting standards. It has to be accompanied with a Board of Directors Report and the Auditors Report. Moreover, in case of listed companies, the cash flow statement is also to be prepared and presented. According to Section 212, the balance sheet of a holding company has to include certain particulars as to its subsidiaries also.

Thus, the following are the key components of the corporate financial statements required for effect ive financial reporting :

1. **Profit and Loss Account:** As mentioned above, Section 210 of the Companies Act requires every company carrying business for profit, to submit before its members at its annual general meeting Profit and Loss Account disclosing the profit or loss made during the specified period. It may be noted that the Profit and loss account is usually prepared in 3 sections showing gross profit, net profit and appropriation out of profit separately. It is prepared as per the requirements of Schedule VI (Part II) of the Companies Act, 1956.

2. **Balance Sheet :** According to Section 210, a company is also required to place before its members, at every annual general meeting, a Balance Sheet at the end of a specified period giving a true and fair view of the state of affairs of the companies. The Balance Sheet is to be prepared in the forma t given in the Part I of Schedule VI of the Companies Act., 1956.

   A detailed explanation about both the above statements has already been given in the preceeding pages.

   According to Section 212, a copy of each of the following documents relating to each of its subsidiaries is to be attached with the Balance Sheet of a holding company.

   (a) Balance Sheet

   (b) Profit and Loss Account

   (c) Broad of Directors' Report

   (d) Auditor 's Report

   (e) Statement of Holding Company's interest in the subsidiary company.

3. **Cash Flow Statement :** It is a statement reporting cash flows during the period for which the financial statements are prepared, classified by operating, investing and financial activities. It is to be prepared by every listed company or every business enterprise whose annual turnover exceeds to ` 50 crores as per AS 3 (Revised) "Cash Flow Statement" issued by ICAI.

4. **Consolidated Financial Statements :** Every listed company or a business enterprise whose turnover exceeds Rs. 50 crores per annum has to prepare consolidated financial statements of the group besides independent financial statements of each enterprise. They are to be prepared in accordance with AS 21 and AS 24, issued by ICAI.

5. **Auditors' Report :** Accounts of all the companies, whether public or private are to be audited by the qualified auditors. According to Section 227 of the Companies Act, 1956, the auditors should make a

report to the members of the company regarding the Balance Sheet and Profit and Loss Account, and all documents annexed with it should be laid before the members at the Annual General Meeting. The report of the auditors shall state as under:

(a) Whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts (i) give the information required by the Act in the manner so required, and (ii) give a true and fair view of the state of affairs of the company as at the end of its financial year and of the profit and loss for the period.

(b) Whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purpose of his audit.

(c) Whether in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purpose of his audit have been received from branches not visited by him.

(d) Whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns, and

(e) Whether the auditor has received and considered the report on the accounts of the branch office.

6. **Board of Director's Report :** According to section 217 of the Companies Act, 1956 the Board of Directors report should contain details regarding the following matters :

1. There shall be attached to every Balance Sheet laid before a company in general meeting, a report by its Board of Directors, with respect to :
   (a) the state of the company's affairs;
   (b) the amounts, if any, which it proposes to carry to any reserves in such balance sheet.
   (c) the amount, if any, which it recommends should be paid by way of dividend.
   (d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the Balance Sheet relat es and the date of the report.
   (e) the conservation of energy, technology absorption, foreign exchange earnings and out go, in such manner as may be prescribed.
2. The Board's report shall, so far as is material for the appreciation of the state of the company's affairs by its members, not in the Board's opinion be harmful to the business of the company or of a ny of its subsidiaries, deal with any changes which have occurred the financial year -
   (a) in the nature of the company's business;
   (b) in the company's subsidiaries or in the nature of the business carried on by them; and
   (c) generally in the classes of business in which the company as an interest.
3. The name of every employee of the company who has been paid remuneration for that year at a rate which is not less than such sum as may be prescribed.
4. The Board's report shall also include a Director 's Responsibility Statement indicating therein
   (a) that in the preparation of the annual accounts, the applicable accounting standards have been followed along with proper explanation relating to material departures;
   (b) that the directors have selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period.
   (c) that the directors have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
   (d) that the directors have prepared the annual accounts on a going concern basis.

5. The Board's report shall also specify the reasons for the failure, if any, to complete the buy-back within the time specified in sub-section (4) of Section 77A.
6. The Board shall also be bound to give the fullest information and explanations in its report aforesaid, or in case falling under the provision to Section 222, in an addendum to that report, on every reservation, qualification or adverse remark contained in the auditors' report.
7. The Board's report and any addendum thereto shall be signed by its chairman if he is authorized on that behalf by the Board; and where he is not so authorized, shall be signed by such number of directors as are required to sign the Balance Sheet and the Profit and Loss Account of the company by virtue of sub-sections (1) and (2) of Section 215.
8. The Board's report shall be signed by its Chairman.

7. Report on Corporate Governance: Corporate governance requires by corporations, timely and accurate disclosure on all matters relating to them, viz., financial position, performance, ownership and governance of the corporation etc.

The objective of the corporate governance is compliance with corporate laws and rules on the legislative side and proper accounts to the stakeholders legally and morally. Corporate governance is essential not only for gaining credibility and trust but also as a strategy for survival, consolidation and growth.

The main constituents of the corporate governance are the Shareholders, Board of Directors and the Management. SEBI now requires every listed company to have a separate section on corporate governance in the Annual Report of the company with a detailed compliance report on corporate governance. In order to make the report really meaningful and informative to the shareholders, the suggested list of items to be included in the corporate governance report has been made pretty exhaustive. These include the following

(a) Board of Directors : The board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than 50% of the Board comprising non-executive directors. While the Board with a non-executive chairman is to have at least one-third as independent directors, the Board with in Executive Chairman is to have at least half of the Board as independent directors.

(b) Audit Committee: Every company is required to set up a qualified and independent Audit Committee, consisting of minimum 3 members, all being non-executive directors, and majority of them being independent and with at least one having financial and accounting knowledge. The Chairman of the Committee shall be one independent director. The Finance Director, Head of Internal Audit and when required, a representative of the External Auditor are to be present as invites for the meetings of the Audit Committee. The Audit Committee shall meet at least thrice a year and once in every six months. The clause also defines the powers and the role of the Committee fairly extensively.

(c) Remuneration of Directors: The remuneration of non-executive directors is to be decided by the Board of Directors and there is a requirement for adequate disclosure of the same in the annual report. This is bound t o act as a deterrent to ma ny promoters in remunerating the directors disproportionately.

(d) Board Meetings : There have to be at least four meetings of the Board of Directors each year. The clause requires same minimum information to be made available to the Board as per an exhaustive Annexure. Some of the information which is to be made available to the Board relates to the following : Annual Operating Plans, Capital Expenditure, Budgets and Updates, Joint Venture or Collaboration Agreements, Investments, Show-cause Notices, Demands, Non-compliances, Accidents, Effluent on Pollution Problems, Labour Problems etc. The Boards are, therefore, expected to be more well-informed and effective as a result of this requirement.

(e)) Director's Report : As part of the Director's Report or as an addition thereto, there is a need for a Management Discussion and Analysis Report which should discuss the Industry Structure and Developments, Opportunities and Threats, Segment - view or Product-wise performance, Outlook and such other matters. All pecuniary relationships or transactions of the non-executive directors vis-a-vis the company should be disclosed in the Directors' report.

(f) Disclosure to Shareholders : In case of the appointment of a new Director or re-appointment of a Director, the shareholders must be provided with a brief resume of the Director like the nature of his expertise in specific functional areas, names of companies in which he holds directorships and committee memberships.

(g) Shareholders' / Investors' Grievances Committee : A Board Committee designated as 'Shareholders/Investors Grievance Committee' should be constituted under the chairmanship of a Non-executed Director to look into the redressing of shareholder and investor complaints like transfer of shares, non-receipts of dividends, warrants etc.

(h) Compliance Certificate : The Company is required to obtain a certificate from the Auditors of the company regarding compliance of conditions of corporate governance as stipulated in the Clause. This certificate is required to be not only annexed to the Directors' report but also sent to the Stock Exchanges along with the annual returns of the company.

In order to encourage the companies to give meaningful information to the investors, the Institute of Chartered Accountants of India gives the annual awards for excellence in financial reporting. While making its choice of Institute looks into the information given by the companies in respect of t he following matters :

1. Disclosure of Accounting Policies.
2. Statement of Changes in the Financial Position.
3. Disclosure of Unusual and Prior Period Items.
4. Use of vertical form as against conventional 'T' form.
5. Use of charts, graphs, diagrams, etc.
6. Computation of important accounting ratios.
7. Providing all other useful information, viz., value added statements, current cost accounts; social cost benefit analysis; human resources, etc.
8. The extent to which the director's report is informative regarding operations of their organization, financial and otherwise, employer-employee relations, etc.

The discussion in the preceding pages is indicative of the fact that the accountants these days are making constant efforts to make the financial statements more informative and intelligible to the end-users.

10.4 ILLUSTRATIVE EXAMPLE

We are giving below the extracts from the Annual Report of HCL Office Automation Ltd. for giving an exhaustive understanding of the mode of financial reporting in case of a corporate enterprise.

HLC OFFICE AUTOMATION LTD.

REGD. OFFICE : 806, SIDDHARTH, 96, NEHRU PLACE, NEW DELHI, 110019.

Director's Report :

To the Members,

The Directors of your Company here with present the Thirteenth Annual Report together with the Audited Accounts for the financial year ended 31st March, 2003.

Financial Highlights :

	(` in lacs)	
	2004-2005	2003-2004
Sales and other income	67.67	45.50
Profit before interest,		
Depreciation and Tax	12.05	(0.12)
Finance Charges	0	0
Depreciation	12.30	13.57

Profit/(Loss) before Tax	(0.25)	(13.69)
Provision for Taxation	0	0
Net Profit/(Loss) (After Tax)	(0.25)	(13.25)
Balance of Profit/(Loss) carried forward to next year	(2441.88)	(2441.63)

Performance :

The other income of the Company was `Lacs as against ` 45 Lacs in the previous year. The loss for the year ended 31st March, 2005 was `0.25 Lacs as against loss of `13.25 Lacs in the previous year. No business could be transacted during the year by the Company.

Fixed Deposits :

As on 31st March, 2005, 92 nos. of deposit aggregating to `10.15 Lakh was unclaimed.

Directors :

In accordance with the Articles of Association of the Company, Mr. S. Murali, Director will retire b y rotation at the forthcoming Annual General Meeting and being eligible, offers himself for re-appointment. Mr. K.R. Vasudevan has been appointed as an Additional Director by Board at their meeting held on July 29, 2005 who will hold office till the conclusion of the forthcoming Annual General Meeting.

Directors' Responsibility Statement :

Pursuant to Section 217(2AA) of the Companies Act, 1956, The Directors hereby confirm :

(i) That in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explaining relating to material departures.

(ii) That the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit or loss of the Company for that period.

(iii) That the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of his Act for safeguards the assets of the Company and for preventing and detecting fraud and other irregularities.

(iv) That the directors had prepared the annual accounts on a going concern basis.

Auditors's Report :

The Auditors of the Company, M/s, S.D. Chopra and Associates, Chartered Accountants, retire at the forthcoming Annual General Meeting and being eligible offer themselves for re-appointment. The clause 3 referred to in the Auditor 's Report are explained in Schedule 16 and, therefore, do not call for further comments.

Personnel :

Inter-personnel relations in the Company during the period under review continued to be harmonious. The Board wishes to place on record their appreciation of the contribution made by all the employees to the operations of the Company during the year under review.

During the year, there were no employees covered under Section 217 (2A) of the Companies Act., 1956 read with the Companies (Particulars of Employees) Rules, 1975.

Additional Information Relating to Conservation of Energy, Technology Absorption and Foreign Exchange Earnings and Outgo.

As there has been no business activities in the Company during the year under review, the additional information required under Section 217(1) (e) of the Companies Act, 1956, read with the Companies (Disclosure of particulars in the Report of the Board of Directors) Rules, 1988, is not provided.

Corporate Governance:

A separate report on "Corporate Governance" is annexed hereto as part of Annual Report.

Acknowledgement:

Your Directors wish to thank the Government authorities, financial institutions, bankers and shareholders for their co-operation and assistance extended to the Company.

On behalf of the Board of Directors
K.R. Vasudevan
Manager

29th July, 2005
Noida

Report on Corporate Governance:

1. Company's Philosophy on Corporate Governance :

The company continues to believe that it is necessary to be fair, transparent and equitable treatment to all shareholders comprising shareholders, creditors, financiers and the like to achieve the goals of the company. The company complies with the requirements of Corporate Governance as introduced in Clause 49 of the Listing Agreement.

2. Composition Category and Directorship in other Companies :

(i) Board of Directors :

Name of the Director	Category	Designation
Mr. K.R.Vasudevan	Executive	Manager
Mr. S.Murali	Non – Executive, Independent	Director
Mr.K.R.Radhakrishnan	Non – Executive, Independent	Director

(ii) Directors' Attendance Record :

During the financial year 2004-05, 4 meetings of the Board were held on 30th June, 2004, 30th July, 2004, 29th October, 2004 and 28th January, 2005.

Detail of Directors' attendance and other particulars are given below :

Name of the Director	No. of Board Meetings held	No. of Board Meetings attended	Last AGM attended (Yes / No)
Mr.J.V.Ramamurthy	4	4 (Resigned w.e.f . July 29, 2005)	Yes
Mr. K.R.Vasudevan	4	Appo int ed on July 29, 2005	No
Mr. S.Murali	4	4	Yes
Mr.K.R.Radhakrishnan	4	4	Yes

(iii) Directorship in other companies and board committees :

S.N. Name of the Director	Directorship in Public Limited Companies	Membership in Board Committees
1. Mr. K.R.Vasudevan	1	NIL
2. Mr. S.Murali	1	NIL
3. Mr.K.R.Radhakrishnan	6	NIL

3. Audit Committee : The Company constituted the audit committee to review various areas of Committee, chaired by Mr. S. Murali, comprises of Mr. J.V. Rammurthy and Mr. K.R. Radhakrishnan. The Committee met 4 times during the financial year 2004-05 on the following dates 30th June, 2004,
30th July, 2004, 29th October, 2004 and 28th January, 2005. All the members were present in all the four meetings.

4. Remuneration Committee :

As neither remuneration nor sitting fees is paid to the Directors, no remuneration committee has been set up.

5. Investor's Grievance Committee :

(i) The Company has constituted a 'Shareholders/Investors Grievance Committee' headed by Mr. K.R. Radhakrishnan, a Non-Executive Director to specifically look into redressal of Shareholders' and Investors' complaints. The Committee met four times during the year. The Company Secretary has been designated as the compliance officer of the Company in compliance with the Listing Agreement.

(ii) There were two complaint received during the year and there are no complains not solved to the satisfaction of the shareholder. There was no share transfer pending as on 31st March, 2005.

6. Shareholder's Meetings :

Detail of the last three AGMs held

Year	Date	Venue	Time
2001– 02	18th September, 2002	Air Force Auditorium, Subroto Park, New Delhi	4.00 P.M.
2002 – 03	8th September, 2002	Air Force Auditorium, Subroto Park, New Delhi	3.00 P.M.
2003 – 04	4th September, 2004	Air Force Auditorium, Subroto Park, New Delhi	10.00 P.M.

No special resolutions were put through Postal Ballot last year. At present, there are no resolution which are required to be passed by postal ballot.

7. Disclosures : Related Party Transactions :

There are no related party transactions of the Company of material nature, with Promoters, the Directors or the Management, their subsidiaries or relatives etc., that may have potential conflict with the interest of the Company at large.

Non Compliance by the Company, Penalties, Strictures :

The Company has complied with the requirements of the Stock Exchange/SEBI/any Statutory Authority on all matters related to capital markets during the last three years. There are no penalties or strictures imposed on the Company by Stock Exchange or S EBI or any statutor y authorities relating to the above.

8. Means of Communication :

(a) At present quarterly/half yearly reports are not being sent to each household of shareholders.

(b) The quarterly/half yearly annual accounts results are published in the English and Hindi Newspapers.

– which newspaper normally published in — The Statement (English), Veer Arjun (Hindi)

– any website where displayed — No

– whether it also displays official news release — No

– whether presentations made to institutional investors or to analyst — No

(c) The Management Discussion and Analysis forms a part of the Annual Report.

9. General Shareholders Information :

(i) Annual General Meeting :

Day and Date	Time	Venue
Saturday, September 10, 2005	3.00 P.M.	Air Force Auditorium Subroto Park, New Delhi - 100010

(ii) Financial Calender (tentative) for the year 2005-06.

Financial Reporting for the quarter ending 30th June, 2005	29th July, 2005.
Financial Reporting for the quarter ending 30th September, 2005	28th October, 2005.
Financial Reporting for the quarter ending 31th December, 2005	27th January, 2006
Audited Results for the financial year ended 31th March, 2006	26th June, 2006

(iii) Next dates of Book Closure — 1st September, 2005 to 10th September, 2005 (Both days inclusive)

(iv) Dividend Payment Date — Not Applicable

(v) Listing on Stock Exchanges

The Shares of the Company are listed on the Stock Exchange at Mumbai. Listing fees for the period April 2006 to March 2006 has been paid to the Stock Exchange, Mumbai.

(vi) Stock Code — 523519

Trading Symbol of 'The Stock Exchange'. Mumbai.

(vii) Stock Market Data (Rs.) :

MONTH	HIGH	LOW
APRIL, 2004	4.24	2.51
MAY, 2004	3.45	2.32
JUNE, 2004	3.50	1.74
JULY, 2004	3.55	1.90
AUGUST, 2004	4.00	2.30
SEPTEMBER, 2004	6.94	2.56
OCTOBER, 2004	10.56	4.10
NOVEMBER, 2004	17.10	11.61
DECEMBER, 2004	12.30	9.15
JANUARY, 2005	11.48	8.10
FEBRUARY, 2005	10.50	6.71
MARCH, 2005	9.75	5.41

(Source : Closing share prices at Mumbai Stock Exchange)

(viii) Registrar and Share Transfer Agents :

As per the provisions of the Listing Agreement entered with The Stock Exchange, Mumbai, the Company has appointed M/s Skyline Financial Services Private Limited as a Common Registrar and Share Transfer Agents for the shares of the Company held in both physical as well as electronic modes. All correspondence with regard to share transfers and matters related therewith may directly be addressed to the Share Register and Transfer Agents at the address given below :

M/s. Skyline Financial Services Private Limited
123, Vinoba Puri, Lajpat Nagar II, New Delhi - 110024.
Tel : 011-29833777, 011-29847136; Fax : 011-29848352

(ix) Share Transfer System : The shares received in physical mode by the Company's Registrar and Share Transfer Agents are transferred within a period of 25 days from the date of receipt.

(x) Distribution of Shareholding as on 31st March, 2005 :

	Category	No. of Shares	% holding
A.	Promoter's holding		
1.	Promoters		
	– Indian Promoters	9,836, 207	67.13
	– Foreign Promoters	Nil	
2.	Persons acting in concert	Nil	
	Sub Total (A)	9,836, 207	67.13
B.	Non-Promoters' holding		
3.	Institutional Investors		
	a. Mutual Funds and UTI	10,878	0.07
	b. Banks, Financial Institutions, Insurance Companies (Central/State Government Institutions/Non-government Institutions)	62,918	0.43
	c. FIIs	Nil	
4.	Others		
	a. Private Bodies Corporate	2,737,838	16.68
	b. Indian Public	2,002,057	13.66
	c. NRI/OCBs	2,788	0.02
	d. Any other (Please specify)	Nil	–
	Sub Total (B)	4,742,683	32.37
	Grand Total (A + B)	1,46,52,686	100.00

(xi) Dematerialisation of shares and liquidity.

The shares of the Company are compulsorily traded in dematerialised form with effect from 29th January, 2001. As on 31st March, 2005, 16.85% shares of t he Company are held in demater ialised form.

(xii) There are no outstanding GDRs/ADRs/Warrants or any Convertible Instruments.

(xiii) Plant Locations : The Company does not have any manufacturing unit.

(xiv) Address for Correspondence.

The shareholders may send their communication/grievances/queries to the Registrar and Share Transfer Agents at their address mentioned above or to Secretarial Department, HCL Office Automation Ltd, E-4, 5, 6, Sector XI, Noide - 201301 (Tel No. : 0120-2520977, Fax : 0120-2551519).

Management Discussion and Analysis Report :

As the Company could not undertake any business activities during the year under review there is nothing significant to be reported as Management Discussion and Analysis.

Auditor's Certificate on Compliance with the Conditions of Corporate Governance under clause **49 of the Listing Argument(s) :**

To the Members of HCL Office Automation Ltd.

1. We have received the implementation of Corporate Governance procedures by HCL Office Automation Ltd. during the year ended 31st March, 2005 with the relevant records and documents maintained by the Company, furnished to us for four review and the report on Corporate Governance as approved by the Board of Directors.

2. The compliance of conditions of Corporate Governance is the responsibility of the management, Our examination was limited to procedures and implementation thereof, adopted by the Company for ensuring the compliance of the conditions of Corporate Governance. It is neither an audit or an expression of opinion of the financial statements of the Company.

   We further state that such compliance is neither an assurance as to the future viability of the Comp any nor the efficient or effectiveness with which the management has conducted the affairs of the Company.

3. On the basis of our review and according to the information and explanations given to us, the condition of Corporate Governance as stipulated in clause 49 of the listing agreement(s) with the stock exchange(s) have been complied with the Company.

S.D. Chopra
Proprietor
For and on behalf of
S.D.Chopra and Associates
Chartered Accountants

New Delhi
Date 29th July, 2005.

Auditor's Report

To
The Members of HCL Office Automation Limited.

1. We have audited the attached Balance Sheet of HCL Office Automation Limited, as at 31st March, 2005 the Profit and Loss Account and also the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.
2. Except as matters stated in paragraph 3 below, we conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting, the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation., We believe that our audit provides a reasonable basis for our opinion.
3. We draw attention to :

   (a) Note 5 on schedule - 16 regarding deferred tax assets.

   (b) Note 9 on schedule - 16 through the company has incurred losses far in excess of paid up capital and reserves, since the director 's are looking for right opportunity to explore the similar line of business of activity, the directors consider that it is appropriate to prepare, the financial statements on going concern basis.
4. As required by the Companies (Auditor 's Report) order, 2003 issued by the Central Government of India in terms of sub-section (4A) of Section 227 of the Companies Act, 1956, we enclose in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the said order.
5. Further to our comments in the Annexure referred in paragraph 4 above, we report that :

   (i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purpose of our audit.

   (ii) In our opinion, proper books for account as required by law have been kept by the company so far as appears from our examination of those books.

   (iii) The Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by this report are in agreement with the books of account.

   (iv) In our opinion, the Balance Sheet, Profit and Loss Account and Cash Flow Statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of Section 211 of the Companies Act, 1956.

(v) On the basis of written representations received from the directors, as on 31st March, 2005 and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March, 2005 from being appointed as a director in terms of clause (g) of sub-section (1) of Section 274 of the Companies Act, 1956.

(vi) Subject to the matters stated in paragraph 3, in our opinion and to the best of our information and according to the explanations given to us, the said accounts read together with the Accounting Policies and Notes thereon and attached thereto, give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India :

(a) in the case of the Balance Sheet, of the state of affairs of the Company as on 31st March, 2005;

(b) in the case of the Profit and Loss Account, of the loss for the year ended on that date;

(c) in the case of the Cash Flow Statement, of the cash flow for the year ended on that date.

For S.D. Chopra and Associates
Chartered Accountants

Place : New Delhi
S.D. Chopra
Date : 27th June, 205
Proprietor

Annexure to the report of the Auditor's to the members of HCL Office Automation Limited on the Accounts for the year ended 31st March, 2005.

[Referred to in paragraph 4 of our report even date]

1. (i) The company has maintained proper records to show full particulars including quantitative details and situation of its fixed assets.

(ii) The physical verification of the fixed assets has not been carried out during the year.

(iii) None of the fixed assets have been disposed off during the year.

2. (i) The inventory has been physically verified during the year by the management. In our opinion, the frequency of verification is reasonable.

(ii) The procedure of physical verification of inventories followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business.

(iii) The company is maintaining proper records of inventory. The discrepancies noticed on verification between the physical stocks and the book records were not material.

3. (i) The company has not taken any loans secured or unsecured from the firms or other parties listed in the register maintained under Section 301 of the Companies Act, 1956.

(ii) The company has not granted any loans secured or unsecured from the firms or other parties listed in the register maintained under Section 301 of the Companies Act, 1956.

4. In our opinion and according to the information and explanations given to us, there are adequate internal control procedures commensurate with the size of the company and the nature of its business with regard to purchases of inventory, fixed assets and for the sale of goods and services. During the course of our audit, no major weakness has been noticed in the internal controls.

5. (i) According to the information and explanations given to us, we are of the opinion that the particulars of contracts or arrangements that need to be entered into the register maintained under Section 301 of the Companies Act, 1956 have been so entered.

(ii) In our opinion and according to the information and explanations given to us, the transactions made in pursuance of contracts or arrangements have been made at price which are reasonable having regard to prevailing market prices at the relevant time.

6. The company has not accepted fixed deposits from the public during the year and the balance outstanding is only on account of unclaimed deposits.

7. There were no internal audit systems in operation during the year. However, the company has internal control procedures which, in our opinion, are adequate in relation to the size of the company.

8. The Central Government has not prescribed the maintenance of cost records by the company under section 209 (i) (d) of the companies Act, 1956 for any of its products.

9. (i) According to the records of the company, the company is regular in depositing with appropriate authorities undisputed statutory dues including provident fund, investor education protection fund, employees state insurance, income tax, sales tax, wealth tax, service tax, cess and other statutory dues applicable to it.

(ii) According to the information and explanations given to us, no undisputed amounts payable in respect of income tax, sales tax, wealth tax, service tax, custom duty and excise duty were outstanding, as at 31st March, 2005 for a period of more than six months from the date they become payable.

(iii) According to the information and explanations given to us, the dues of Sales Tax, Custom Duty, Excis e Duty, which have not been deposited on account of any dispute and the forum where the dispute is pending are as under :

Nature of the statute	Nature of the dues	Amount (` in lacs)	Forum where dispute is pending
Central Excise Act. 1944	Excise Duty	520.7	Dy. Commissioner / Commissioner Central Excise
Cusoms Act. 1962	Custom Duty	241.00	Supreme Court
		46.96	Collector of Custom
Central Sales Tax.Act and Sales Tax Act of various states.	Sales Tax	38.81	Sales Tax Tribunal
		20.99	Dy. Commissioner / Commissioner (Appeal)

10. In our opinion the accumulated losses of the company are more than fifty percent of its net worth. The company has not incurred cash losses during the financial year covered by our audit and has incurred cash losses in the immediately preceding financial year.

11. In our opinion and according to the information and explanations given to us, the company do not-have any borrowings from financial institutions, bank or debenture holders.

12. The company has not granted any loans, and advances on the basis of security by way of pledge of share etc.

13. Provisions of any special statute applicable to chit funds are not applicable to the company.

14. The company is not dealing or trading in shares, securities, debentures and other investments.

15. The company has not given any guarantee for loans taken by others from the banks or financial institutions.

16. The company has not raised any term loan during the year.

17. Based on our examination and in our opinion the company has not raised any short-term / long -term funds during the year.

18. The company has not made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act.

19. The company has not issued any debentures during the y e a r .

20. The company has not made any public issue during the year.

21. According to the information and explanations given to us, no fraud on or by the company has been noticed or reported during the course of our audit.

For and on behalf of

S.D.Chopra and Associates
Chartered Accountants

Place : New Delhi — S.D. Chopra
Date 27th June, 2005. — Proprietor

Balance Sheet as at March 31, 2005

	Schedule	As at 31.03.2005 `/Lacs	As at 31.03.2004 `/Lacs
SOURCES OF FUNDS			
Shareholder's Funds :			
Share Capital	1	1465.27	1465.27
Reserve and Surplus	2	658.40	658.40
Loans Funds :			
Unsecured Loans	3	324.04	325.21
Total		2447.71	2448.88
Applications of Funds			
Fixed Assets :			
Gross Block		262.40	262.40
Less : Depreciation		190.48	178.18
		71.92	84.22
Investments	5	1.15	4.63
Current Assets, Loans and Advances :			
Inventories	6	–	3.70
Sundry Debtors	7	12.27	5.86
Cash and Bank Balances	8	130.29	134.61
Other Current Assets	9	14.75	14.75
Loans and advances	10	16.47	17.39
		173.78	176.31
Less : Current Liabilities and Provisions :	11		
Current Liabilities		238.83	256.05
Provisions		2.19	1.86
		241.02	257.91
Net Current Assets		–67.24	–81.60
Profit and Loss Account		2441.88	2441.63
Total		2448.88	2447.71
Accounting Policies	15		
Notes to Accounts	16		

This is the Balance Sheet referred to in our report of even date.

The Schedules referred to above form an integral part of the Balance Sheet.

S.D.Chopra	K.R. RADHAKRISHNAN	S.MURALI	J.V. RAMAMURTHY
Proprietor	Director	Director	Managing Director

For and on behalf of

New Delhi — S.D. Chopra and Associates — M.MUTHUKUMARASWAMY
27th June, 2005 — Chartered Accountants — Company Secretary

Profit and Loss Account for the year ended March 31, 2005.

	Schedule	Year Ended 31.03.2005 `/Lacs	Year Ended 31.03.2004 `/Lacs
INCOME :			
Other Income	12	67.67	45.50
		67.67	45.50
Expenditure :			
Finished Goods Stock Written Off		3.70	–
Personnel	13	3.59	3.19
Administration, Selling and Distribution	14	48.33	42.43
Depreciation		12.30	13.57
Profit (Loss) Before Taxation		67.92	59.19
		(0.25)	(13.69)
Excess provision of Income Tax of earlier year written back		–	0.44
Profit(Loss) After Tax		(0.25)	(13.25)
Loss Brought Forward		(2441.63)	(2428.38)
Balance carried over		(2441.88)	(2441.63)
Basic and Diluted Earning/(Loss) Per Equity Share of ` 10/- each (Schedule 16, Note 11)		(0.002)	(0.09)
Accounting Policies	15		
Notes to Accounts	16		

This is the Profit and Loss Account referred to in our Report of even date.

The Schedules referred to above form on integral part of the Profit and Loss Account

S.D.Chopra
Proprietor
For and on behalf of

K.R. RADHAKRISHNAN
Director

S.MURALI
Director

J.V. RAMAMURTHY
Managing Director

New Delhi
27th June, 2005

S.D. Chopra and Associates
Chartered Accountants

M.MUTHUKUMARASWAMY
Company Secretary

Cash flow statement for the year ended March 31, 2005

	Year Ended 31.03.2005	`/Lacs	Year Ended 31.03.2004	`/Lacs
(A) Cash Flow from Operating Activities				
Net Profit/Loss (–) before tax		(0.25)		(13.69)
Adjustment for :				
Depreciation	12.30		13.57	
Interest and dividend income	(7.53)		(8.39)	
Credit balance written back	(13.85)		–	
Sales Tax/Excise claim received	(9.68)	(18.76)	(0.70)	4.48
Operating Profit/Loss (–) before working capital changes		(19.01)		(9.21)

Adjustments for :				
Trade and Other receivables	(11.40)		2.08	
Inventories	3.70		–	
Trade payable and other liabilities	(16.89)	(24.59)	4.02	6.10
Cash generated from/used in (–) operations		(43.60)		(3.11)
Direct tax paid	(1.25)		(1.18)	
Income tax refund	–	(1.25)	4.96	3.78
Cash flow before extra-ordinary items	(44.85)		0.67	
Credit balances written back		13.85		–
Sales tax/Excise claim received		9.68		0.70
Bad debts/debit balances w/off		8.84		–
Net Cash from/used in (–) Operating Activities		(12.48)		1.37
(B) Cash flow from Investing activities				
Interest and dividend received	5.85		10.17	
Purchase of fixed assets	–		(0.29)	
Sale of Investments	3.48	9.33	–	9.88
Net cash from/used in (–) investing activities		9.33	–	9.88
(C) Cash flow from Financing activities				
Un-secured loans paid	(1.17)	(1.17)	(2.59)	(2.59)
Net cash from/used in (–) Financing Activities		(1.17)		(2.59)
Opening balance of Cash & Cash equivalents		134.61		125.95
Closing balance of Cash & Cash equivalents		130.29		134.61
Net Increase/Decrease (–) in Cash and Cash equivalents		(4.32)		8.66
Total (A) + (B) + (C)		(4.32)		8.66

This is the Cash Flow Statement referred to in our report of even date

S.D.Chopra K.R. RADHAKRISHNAN S.MURALI J.V. RAMAMURTHY
Proprietor Director Director Managing Director
For and on behalf of
New Delhi S.D. Chopra and Associates M.MUTHUKUMARASWAMY
27th June, 2005 Chartered Accountants Company Secretary

Schedules to the Balance Sheet :

	As at 31.03.2005	As at 31.03.2004
1. Share Capital		
AUTHORISED		
5,00,00,000 Equity Shares of `10/- each	5000.00	5000.00
10,00,000 Preference Shares of `10/- each	1000.00	1000.00
	6000.00	6000.00
Issued, Subscribed and Paid up		
1,46,52,686 (Previous Year : 1,46,52,686)		
Equity Shares of ` 10/- each fully paid up		
Our of the total above, 83,65,246		
Equity Shares (2004-83,65,246) are held by		
HCL Peripherals Ltd., the holding company.	1465.27	1465.27
1465.27	1465.27	

Of the above equity shares :

(i) 49,64,529 (Previous Year : 49,64,529) of `10/- each were allotted as fully paid up pursuant to a contract without payment being received in cash.

(ii) 47,23,6214 (Previous Year : 47,23,614) of `10/- each were allotted as fully paid up pursuant to the scheme of Amalgamation between erstwhile Sandarbh Properties Private Limited and the Company (Schedule 16, Note 2(a)).

2. Reserves and Surplus

(Schedule 16 Note 4)

	As at 31.03.2005 `/Lacs	As at 31.03.2004 `/Lacs
General Reserve	27.40	27.40
Capital Reserve	297.63	297.63
Security Premium	333.37	333.37
	658.40	658.40

3. Unsecured Loans

	As at 31.03.2005 `/Lacs	As at 31.03.2004 `/Lacs
Fixed Deposits (Including unclaimed deposits Rs. 10.15 lacs (Previous Year : Rs. 11.32 lacs)	10.15	11.32
Short-Term Loans from Corporates	313.89	313.89
	324.04	325.21

4. Fixed Assets :

(Scehedule 16 Note 3)

	Gross Block				Depreciation			Net Block		
	As at 01.4.04	Addition during the year	Deduction during the year	As at 31.3.05	As at 01.4.04	Addition during the year	Deduction during the year	As at 31.3.05	As at 31.3.05	As at 31.3.04
Land - Freehold	1.07	–	–	1.07	–	–	–	–	1.07	1.07
Plan & Machinery & Equipments	27.04	–	–	27.04	27.01	–	–	27.04	–	–
Furniture & Fixtures % Office Equipments	216.34	–	–	216.34	140.01	11.03	–	151.04	65.30	76.33
Vehicles	17.95	–	–	17.95	11.13	1.27	–	12.40	5.55	6.82
	262.40	–	–	262.40	178.18	12.30	–	190.48	71.92	84.22
Previous Year	262.11	0.29	–	262.40	164.62	13.57	–	178.18	84.22	–

5. Investments :

Long term (Non -trade) Government Securities : 370 units (Previous Year : 370 units) of ` 100/ – each of Unit Trust of India under Vecaus -II scheme fully paid up*	0.37	0.37
	0.37	0.37

Quoted Securitis :		
(Schedule 16, Note 2 (b)}		
Nil (Previous Year : 8700) Equity		
shares of `10/ - each of		
HCL Infosystems Ltd. fully paid up		
(Sold during the year 8700 shares)	–	3.48
1933 (Previous Year : 1933)		
equity shares of `2/ -each of		
HCL Technologies Ltd. fully paid up		
(Shares received in pursuant to scheme		
of arrangement between HCL		
Infosystems Ltd., HCL Technologies Ltd.		
and their respective shareholders and creditors.)		
	–	–
960 (Previous Year : 960) Equity shares of ` 10/ -		
each of IDBI fully paid up. (Includes 360 bonus shares)	0.78	0.78
	0.78	4.26
Unquited securities :		
10 (Previous Year : 10) Equity shares of ` 10/ -each		
of Hinduja HCL singtel Communications private Limited.		
fully paid up (Value `100/ -	0.00	0.00
	0.00	0.00
	1.15	4.63
6. Inventories :		
Finished Goods	3.70	3.70
Less : written off	3.70	–
	0.00	3.70
7. Sundry Debtors :		
(Unsecured -Considered good)		
Debts exceeding six months :	9.13	5.86
Less : Bad debts written off	5.89	–
Other debts	3.27	5.86
	3.27	5.86
	9.00	–
	12.27	5.86
8. Cash and Bank Balances :		
Cash in hand		
Balance with Scheduled Banks	0.08	0.17
– On Current Accounts	1.51	6.83
– On Margin Accounts	128.70	127.61
	130.29	134.61
9. Other Current Assets :		
Deposits		
	14.75	14.75
	14.75	14.75

Schedules to the Balance Sheet (Contd.)

	As at 31.03.220 `/ Lacs	As at 31.03.2005 ` / Lacs
(Unsecured - considered Good)		
Advances recoverable in cash or in kind or for value to be received)	11.36	13.53
Advance Tax (net of provision)	5.11	3.86
	16.47	17.39
10. Current Liabilities And Provisions		
(Schedule 16 Note 6)		
Current liabilities :		
Sundry Creditors	184.72	201.49
Sundry Deposits	5.37	5.37
Advance from Customers	48.74	49.19
	238.83	256.05
Provisions :		
For Gratuity and other employee benefits	2.19	1.86
	2.19	1.86
	241.02	257.91

The company is in the process of obtaining duplicate certificate in its name as the original certificate which was sent for endorsement, was lost in transit.

Note : Market value of quoted securities `8.17 lacs.

10.5 KEY TERMS

- **Financial Reporting :** A mechanism evolved for providing useful information to the user-group of financial statements, i.e., share-holders, creditors, potential investors etc.
- **Corporate Governance :** A mechanism requiring by corporations, timely and accurate disclosure on all matters relating to them, viz., financial position, performance, ownership and governance of the corporations etc.

10.6 SUMMARY

- Financial reporting is basically concerned with providing useful information about the affairs of the organization concerning its performance, financial position, earnings potential etc. and which can help them in taking rational decisions.
- Corporate Annual Reports form the most common means of financial reporting.
- In India, the main constituents of corporate annual reports are Profit and Loss Account, Balance Sheet, Cash Flow Statement, Auditor's Reports, and the Report on Corporate Governance.

10.7 CHECK YOUR PROGRESS AND ANSWERS

Select the Most appropriate answer:

1. Corporate governance requires, by corporations, timely and adequate disclosures on all matters concerning:

   (a) Financial position

   (b) Financial position and performance

   (c) Financial position, performance, ownership and governance of the corporation.

2. SEBI has tried to make corporate governance effective by :

   (a) Amending Clause 49 in the Listing Agreement of the Stock Exchanges.

(b) Making the Institute of Chartered Accounts of India (ICAI) to issue requisite Accounting Standards.

(c) Bringing amendments in the Companies Act. 1956.

3. According to Clause 40, the non-executive directors should not be less than :

   (a) 50% (b) 1/3 (c) 2/3

   of the total strength of the Board.

4. According to Clause 49, the Audit Committee should compare a minimum of :'

   (a) 5 members (b) 3 members (c) 2 members

5. The format of the balance sheet in the Companies Act has been prescribed by :

   (a) Schedule VI, Part I. (b) Schedule VI, Part II. (c) Schedule VI, Part III.

   Ans. 1. (c), 2. (a), 3. (a), 4. (c), 5. (a)

10.8 QUESTIONS AND EXERCISES

1. Define Financial reporting. State its objective.
2. Explain the key components of the corporate financial statements required by various authorities in India for effective corporate Financial reporting.
3. Explain the concept of Corporate Governance. State the main provisions of Clause 49 relating to corporate governance.
4. What is the basis formulated by ICAI for granting Annual Awards for Excellence in Corporate Reporting ?

10.9 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari

Financial Statement Analysis – John N. Meyer

Management Accounting – Khan and Jain.

Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.

Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHAPTER - 11 FINANCIAL STATEMENTS : ANALYSIS AND INTERPRETATION

Chapter Outlines

11.0 INTRODUCTION

Financial Statement Analysis is an analysis which highlights important relationship between items in the financial statements. Financial statements are prepared with the objective of knowing the profitability and financial soundness of the business. This requires proper analysis and interpretation of financial statements.

11.1 LEARNING OBJECTIVES

- To know the concept of Financial Statement Analysis.
- Differentiate between Analysis and Interpretation of Financial Statement.
- To know the steps involved in Financial Analysis.
- Limitations of Ratio Analysis.
- Different Types of Ratios and the Method of Computing them.

11.2 RELATIONSHIP BETWEEN ANALYSIS AND INTERPRETATION

Financial statements, as stated earlier, are indicators of the significant factors :

1. Profitability
2. Financial soundness.

Analysis and interpretation of financial statement, therefore, refers to such a treatment of the information contained in the Income statement and the Balance Sheet so as afford full diagnosis of the profitability and financial soundness of the business.

A distinction here can be made between the two terms -'Analysis' and 'Interpretation'. The term 'Analysis' means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help one unless they are put in a simplified form. For example, all items relating to ‘Current Assets’ are put at one place while all items relating to ‘Current Liabilities’ are put at another place. The term ‘Interpretation’ means ‘explaining the meaning and significance of the data so simplified’.

However, both ‘Analysis’ and ‘Interpretation’ are complementary to each other. Interpretation requires Analysis while Analysis is useless without Interpretation . Most of the authors have used the term ‘ Analysis’ only to cover the meanings of both analysis and interpretation, since analysis involves interpretation. According to Myers. “Financial statement analysis is largely a study of the relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these f actors as shown in a series of statements.” For the sake of convenience, we have also used the term ‘Financial Statement Analysis’ throughout the unit to cover both analysis and interpretation.

11.3STEPS INVOLVED IN THE FINANCIAL STATEMENTS ANALYSIS

The analysis of the financial statements requires :

(1) Methodical classification of the data given in the financial statements.

(2) Comparison of the various inter-connected figures with each other which is popularly termed as “Ratio Analysis.”

Each of the above steps has been explained in the following pages :

(1) Methodical classification: In order to have a meaningful analysis it is necessary that figures should be arranged properly. Usually instead of the two-column (T form) statements as ordinarily prepared, the statements are prepared in single (vertical) column form “which should throw up significant figures by adding or subtracting.” This also facilities showing the figures of a number of firms or number of years side by side for comparison purposes.

OPERATING (INCOME) STATEMENT

for the year ending

	Particulars		`	`
	Gross Sales		......	......
Less :	Sales Returns			
	Sales Tax/Excise		......	......
	Net Sales (or sales) for the year	(1)		......
Less :	Cost of Sales :	(2)		
	Raw Materials consumed			
	Direct wages		......	......
	Manufacturing Expenses		......	......
Add :	Opening Stock of Finished Goods		......	......
Less :	Closing Stock of Finished Goods		......	......
	Gross Profit	(1) – (2) = (3)		......
Less :	Operating Expenses :	(4)	......	......
	Administration Expenses		......	......
	Selling and Distribution Expenses		......	......
	Net Operating Profit (OPBIT)	(3) – (4) = (5)		......
Add :	Non-trading Income			......
	(such as dividends, interest received, etc.)			......
Less :	Non-trading Expenses (such as discount on			
	issue of shares written off)		......	......
	Income or Earnings before Interest and Tax (EBIT)	(6)		......
Less :	Interest on Debentures	(7)		......
	Net Income or Earning before Tax (EBIT)	(8)		......
Less :	Tax	(9)		......
	Income or Profit After Tax (PAT)	(1)		......

BALANCE SHEET

as on ....

Particular		`
Cash in Hand		......
Cash at Bank		......
Bills Receivable		......
Book Debts (less provision for bad debts)		......
Marketable Trade Investments		......
Liquid Assets	(1)	......
Inventories (stock of raw materials, finished goods, etc)		......
Prepaid Expenses		......
Current Assets	(2)	......
Bills Payable		......
Trade Creditors		......
Outstanding Expenses		......
Bank Overdraft		......
Other Liabilities payable within a year		......
Current Liabilities	(3)	......
Provision for Tax		......
Proposed Dividends		......
Other Provisions		......
Provisions	(4)	....
Current Liabilities and Provisions	(3) + (4) = (5)	......
Net working Capital		
(Current Assets - Current Liabilities and Provisions (2) – (5)	(6)	......
Goodwill at cost		......
Land and Building		......
Plant and Machinery		......
Loose Tools		......
Furniture and Fixtures		......
Investments in Subsidiaries		......
Patents, Copyright, etc.		......
Fixed Assets	(7)	......
Capital Employed	(6) + (7) = (8)	......
Other Assets	(9)	......
Investment in Government Securities, Unquoted Investment, etc.		......
Other Investments (non-trading)		......
Advances of Directors		......
Company’s Net Assets	(8) + (9) = (10)	......
Debentures		......
Other Long-term Loans (payable after a year)		......

Long term loans	(11)	......
Shareholders' Net worth	(10) – (11) = (12)	......
(or total tangible net worth)		......
Reference Share Capital	(13)	......
Equity Shareholders' Net worth	(12) – (13) = (14)	......
Equity Shareholders' Net worth is represented by :		......
Equity Share Capital		......
Forfeited Shares		......
Reserves		......
Surplus		......
Equity Shareholder's Claims		......
Less : Accumulated Losses		......
Miscellaneous Expenditure		......
(such as preliminary expenses, discount on issue of share or debentures not written off)		......
Equity Shareholders' Net worth		......

11.3.1.1 Goodwill to be included only when it has been paid for and has the value.

11.3.1.2 Patents, Copyright, etc., should be shown only when they have the value. In case these assets are valueless, they should not be included here but should be written off against shareholder 's claims with other losses.

The process of methodical classification of the data will be clear with the help of the following illustration

Illustration - 11.3.1 :

Below is, given the Balance Sheet of Prospective Ltd. as on 31st March, 2006, together with the Profit and Loss Account.

BALANCE SHEET

as on 31st March, 2006

Liabilities	`	Assets		`
Equity share capital	500	Trade Investments		200
Dividend Equilisatioin Reserve	70	Patents		30
General Reserve	110	Land and Building (at cost)		320
Profit and Loss A/c	190	Plant and Machinery (at cost)		650
6 per cent Debentures	250	Cash in Bank		88
Bank Overdraft	150	Stock :		
Staff Provident Fund	80	Materials	90	
Creditors	210	Finished goods	160	
Unpaid Dividend	10	Work-in-progress	60	310
Proposed Dividend	60	Sundry Debtors	230	
Provision for Taxation	170	Less : Provision for		
Provision for Depreciation	250	doubtful debts	8	222
		Bills Receivable		30
		Staff providend fund investment		80
		Deposits with Customs Authorities		20
		Advance for Purchase of Machinery		60
		Preliminary Expenses		30
	2050			2050

PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2006 (Rs. in thousands)

Particulars		`	Particulars		`
To Stock :			By Sales	2000	
Materials	90		By Stock :		
Finished goods	120		Materials	90	
Work-in-progress	40	250	Finished goods	160	
To Purchase of Materials		850	Work-in-progress	60	310
To Wages		280	By Dividend on Investment		30
To Power		40	By Sales of Scrap		8
To Miscellaneous Factory Expenses		110			
To Office Salaries		80			
To Miscellaneous Expenses		90			
To Selling and Distribution Expenses		120			
To Advertisements		80		—	
To Preliminary Expenses		5			
To Debenture Interest		15		—	
To Depreciation :					
Plant	60				
Land and Building	12	72			
To Provision for Taxation		170			
To Proposed Dividend		60			
To Balance of Profit		126			
		2348			2348

You are required to present the information suitably summarised in Single-Column Statements (Vertical Form) showing distinctly the following :

(i) Total Capital employed

(ii) Shareholder's Funds

(iii) Gross Profit

(iv) Net Operating Profit

(v) Cost of goods sold.

Solution :

Prospective Limited

BALANCE SHEET

as on 31st March, 2006 (` in thousands)

Cash at Bank			88
Book Debts (net)			222
Bills Receivable			30
Liquid Assets	(1)		340
Deposit with Customs			30
Stock :			
Materials		90	
Finished goods		160	
Work-in-progress		60	310

Current Assets	(2)		680
Bank Overdraft			150
Creditors			210
Unpaid Dividend			10
Current Liabilities	(3)		370
Proposed Dividend			60
Provision for Taxation			170
Current Liabilities and Provisions	(4)		600
Net working Capital	(2) – (4) = (5)		80
Land and Building (at cost)		320	
Plant and Machinery (at cost)		650	
Patents		30	
Fixed Assets		1000	
Less : Provision for Depreciation	(6)	250	
Net Fixed Assets		750	
Advance against Machinery		60	
Trade Investments		200	
Total Fixed Investments			
Staff Providend Funds Investments	(7)		1010
Less : Staff Providend Funds		80	
		80	Nil
Total Capital Employed	(8)		1090
Less : 6 per cent debentures	(9)		250
Shareholder's Funds	(10)		840
Represented by :			
Equity Share Capital			500
General Reserve			110
Dividend Equalisation Reserve			70
Profit and Loss A/c (Less : Preliminary Expenses)			160
			840

PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2006 (` in thousands)

Sales			2000
Less :	Cost of goods sold		1284
	Gross Profit		716
Less :	Operating Expenses :		
	Salaries	80	
	Miscellaneous Expenses	90	
	Selling and Distribution Expenses	120	
	Advertisements	80	370
	Net Operating Profit		346

Add :	Non-operating Income (Dividends on Investments)	30	
Less :	Non-operating Expenses (Interest on debentures)	15	15
			361
Less :	Preliminary Expenses written off		5
	Profit before Tax		356
Less :	Income Tax payable		170
	Profit after Tax		186
Less :	Proposed Dividend		60
	Profit retained in the business		126

STATEMENT OF COST OF GOODS SOLD

for the year ended 31st March, 2006 (` in thousands)

Cost of goods manufactured :			
Work-in-progress on 1 April, 1995			40
Materials consumed :	Opening stock	90	
	Purchases	850	
		940	
Less : Closing Stock		90	850
Wages			280
Power			40
Miscellaneous Factory Expenses			110
Depreciation			72
			1392
Less : Sale of Scrap			
Work-in-progress on 31 March, 2006		8	
Cost of goods manufactured		60	68
Add : Opening stock of Finished Goods			1324
			120
			1444
Less : Closing Stock of Finished Goods			160
Cost of goods sold			1284

11.4 RATIO ANALYSIS

An absolute figure often does not convey much meaning. Generally, it is only in the light of other information that significance of a figure is realised. A weights 70 kg. is he fat ? One cannot answer this question unless one knows A's age and height. Similarly, a company's profitability cannot be known unless together with the amount of profit and the amount of capital employed. The relationship between the two figures expressed arithmetically is called a ratio. The ratio between 4 and 10 is 0.4 or 40% or 2:5. "0.4", "40%" and "2 :5" are ratios. Accounting ratios are relationships, expressed in arithmetical terms, between figures which have a cause and effect relationship or which are connected with each other in some ot her manner.

Accounting ratios are a very useful tool for grasping the true message of the financial statements and understanding them. Ratios naturally should be worked out between figures that are significantly related to one another. Obviously no purpose will be served by working out ratios between two entirely unrelated figures, such as discount on debentures and sales. Ratios may be worked out on the basis of figures contained in the financial statements.

Ratios provide clues and symptoms of underlying conditions. They act as indicators of financial soundness, strength, position and status of an enterprise.

Interpretation of ratios form the core part of ratio analysis. The computation of ratio is simply a clerical work but the interpretation is a taste requiring art and skill. The usefulness of ratios dependent on the judicious interpretations.

Uses of Ratios

A comparative study of the relationship, between various items of financial statements, expressed as ratios, reveals the profitability, liquidity, solvency as well as the overall financial position of the enterprises. Ratio analysis helps to analyse and understand the financial health and trend of a business, its past performance makes it possible to have forecast about future state of affairs of the business, Interfirm comparison and intrafirm comparison becomes easier through the analysis. Past performance and future projections could be reviewed through ratio analysis easily. Management uses the ratio analysis in exercising control in various areas viz. budgetary control, inventory control, financial control etc, and fixing the accountability and responsibility of different departmental heads for accelerated and planned performance.

It is useful for all the constituents of the company as discussed under :

1. **Management:** Management is interested in ratios because they help in the formulation of policies, decision-making and evaluating the performances and trend of the business and its various segments.
2. **Shareholders:** With the application of ratio analysis to financial statements, shareholders can understand not only the working and operational efficiency of their company, but also the likely effect of such efficiency on the working and operational efficiency of the their company, but also the likely effect of such efficiency on the net worth and consequently the price of their shares in the Stock Exchange. With the help of such analysis, they can form opinion regarding the effectiveness or otherwise of the management functions.
3. **Investors:** Investors are interested in the operational efficiency, earning capacities and 'financial health' of the business. Ratios regarding profitability, debt-equity, fixed assets to net worth, ass ets turnover, etc., are some measures useful for the investors in making decisions regarding the type of security and industry in which they should invest.
4. **Creditors:** Creditors can reasonably assure themselves about the solvency and liquidity position of the business by using ratio-analysis. Such analysis helps to throw light on the repayment policy and capability of an enterprise.
5. **Government:** The Government is interested in the 'financial health' of the business. Carefully worked ratios will reflect the policy of the management and its consistency of otherwise with the overall regional and national economic policies. Such ratios help in better understanding of cost-structures and may justify price controls by the Government to save the consumers.
6. **Analysis:** Ratio analysis is the most important techniques available to the financial analysis to study the financial statements to compare the progress and position of various firms with each other and vis-a-vis the industry.

11.5 CLASSIFICATIOIN OF RATIOS

Different ratios calculated from different financial figures carry different significance for different purposes. For example, for the creditors liquidity and solvency ratios are more significant than the profitability ratios, which are of prime importance for an investor. This means that ratios can be grouped on different basis depending upon their significance. The classification is rather crude and unsuitable to determine the profitability or financial position of the business. In general, accounting ratios may be classified on the following basis leading to overlap in many cases.

A . According to the statement upon which they are based :

Ratios can be classified into three groups according to the statements from which they are calculated

(i) *Balance Sheet Ratios:* They deal with relationship between two items appearing in the balance sheet, e.g., current assets to current liability or current ratio. These ratios are also known as financial position ratios since they reflect the financial position of the business.

(ii) *Operating Ratios or Profit and Loss Ratios:* These ratios express the relationship between two individual or group of items appearing in the income or profit and loss statement. Since they reflect the operating conditions of a business, they are also known as operating ratios, e.g., gross profit to s ales, cost of goods sold to sales, etc.

(iii) *Combined Ratios :* These ratios express the relationship between two items, each appearing in different statements, i.e., one appearing in balance sheet while the other in income statement, e.g., return on investment (net profit to capital employed). Assets turnover (sales) ratio, etc. Since both the statements are involved in the calculation of each of these ratios, they are also known as inter-statement ratios.

Since the balance sheet figures refer to one point of time, while the income statement figures refer to events over a period of time, care must be taken while calculating combined or inter-statement ratios. For example while computing assets turnover ratio, average assets should be taken on the basis of opening and ending balance sheets.

B . Functional Classification

T he classification of ratios according to the purpose of its computation is known as functional classification. On this basis ratios are categorised as follows:

(i) *Profitability Ratios*: Profitability ratios gives some yardstick to measure the profit in relative terms with reference to sales, assets or capital employed. These ratios highlight the end result of business activities. The main objective is to judge the efficiency of the business.

(ii) *Turnover Ratios or Activity Ratios:* These ratios are used to measure the effectiveness of the use of capital/assets in the business. These ratios are usually calculated on the basis of sales or cost of goods sold and are expressed in integers rather than as percentages.

(iii) *Financial Ratios or Solvency Ratios :* These ratios are calculated to judge the financial position of the organisation from short-term as well as long-term solvency point of view. Thus, it can be sub-divided into :

(a) Short-term Solvency Ratios (Liquidity Ratios) and (b) Long-term Solvency Ratios (Capital Structure re Ratios).

(iv) *Market Test Ratios :* These are of course, some profitability ratios, having a bearning on the market value of the shares.

C . Classification according to "Importance" :

T his classification has been recommended by the British Institute of Management for inter-firm comparisons. It is based on the fact that some ratios are more relevant and important than others in the process of comparisons and decision-making. Therefore, ratios may be treated as primary or secondary.

(a) *Primary Ratios:* Since profit is primary consideration in all business activities, the ratio of profit to capital employed is termed as 'Primary Ratio'. In business world this ratio is known as 'Return on Investment'. It is the ratio which reflects the validity of otherwise of the existence and continuat ion of the business unit. In case if this ratio is not satisfactory over long period, the business unit cannot justify its existence and hence, should be closed down. Because of its importance for the very existence of the business unit it is called 'Primary Ratio.

(b) *Secondary Ratios :* These are ratios which help to analyse the factors affecting 'Primary Ratio'. These may be sub-classified as under :

   (i) *Supporting Ratios :* These are ratios which reflect the profit-earning capacities of the business and thus support the 'Primary Ratio'. For example sales to operating profit ratio reflects the capacity of contribution of sales to the profits of the business. Similarly, sales to assets employed reflects the effectiveness in the use of assets for making sales, and consequently profits.

(ii) *Explanatory Ratios :* These are ratios which analyse and explain the factors responsible for the size of profit earned. Gross profit to sales, cost of goods sold to sales, stock-turnover, debtors turnover are some of the ratios which can explain the size of the profits earned. Where these ratios are calculated to highlight the effect of specific activity, they are termed as 'Specific Explanatory Ratios'. For example, the effect of credit and collection policy is reflected by debtors turnover ratio.

The classification of the structure of ratio analysis cuts across the various bases on which it has been made. The determination of activity and profitability ratios are drawn partly from the balance sheet and partly from the profit and loss account. Ratios satisfying the test of liquidity or solvency partake the items of both the balance sheet and income statement, some activity ratios coincide with those satisfying the test of liquidity, some leverage ratios belong to the category of income statement. This clearly indicates t hat one basis of classification crosses into other category. However, for the purpose of consideration of individual ratios, a classification of ratio on functional basis is discussed hereunder :

11.6 PROFITABILITY RATIOS

A measure of 'profitability' is the overall measure of efficiency. In general terms efficiency of business is measured by the input-output analysis. By measuring the output as a proportion of the input, and comparing result of similar other firms or periods the relative change in its profitability can be established.

The income (output) as compared to the capital employed (input) indicates profitability of a firm. Thus the chief profitability ratio is :

$$\frac{\text{Operating Profit}\left(\text{net margin}\right)}{\text{Operating Capital Employed}}\times 100$$

Once this is known, the analyst compares the same with the profitability ratio of other firms or periods. Then, when he finds some contrast, he would like to have details of the reasons. These questions are sought to be answered by working out relevant ratios. The main profitability ratio and all the other sub ratios are collectively known as 'profitability ratios'.

Profitability ratio can be determined on the basis of either investments or sales. Profitability in relation to investments is measured by return on capital employed, return on shareholders' funds and return on assets. The profitability in relation to sales are profit margin (gross and net) and expenses ratio or operating ratio.

(i) Return on Investment :

This ratio is also known as overall profitability ratio or return on capital employed. The income (output) as compared to the capital employed (input) indicates the return on investment. It shows how much the company is earning on its investment. This ratio is calculated as follows :

Operating profit means profit before interest and tax. In arriving at the profit, interest on loans is treated as part of profit (but not the interest on bank overdraft or other short-term finance) because loans themselves are part of the input, i.e., the capital employed and hence, the interest on loans should also be part of the output and should not be excluded there from. All non-business income or rather income not related to normal operations of the company should be excluded. Thus profit figure shall be IBIT, i.e., income Before Interest and Taxation (excluding non-business income).

The income figure is reckoned before taxation because the amount of tax has no relevance to the operational efficiency. Both interest and taxation are appropriations of profit and do not reflect operational efficiency. Moreover, to compare the profitability of two different organisations having different sources of finance and different tax burden, the profit before interest and taxation is the best measure.

Capital employed comprises share capital and reserves are surplus, long-term loans minus non-operating assets and fictitious assets. It can also be represented as net fixed assets plus working capital (i.e., current assets minus current liabilities). Thus capital employed may comprise:

Share Capital + Reserve and Surplus + Long term Loans – Non-Operating Assets
– Fictitious Assets

In using overall profitability ratio as the chief measure of profitability, the following two notes of caution should be kept in mind. First, the figure of operating profit shows the profit earned throughout a period. The figure capital employed on the other hand refers to the values of assets as on a balance sheet date. As the values of assets go on changing throughout a business period it may be advisable to take the average assets throughout a period, so that the profits are compared against average capital employed during a period.

Secondly, in making comparison between two different units on the basis of the overall profitability ratio, the time of incorporation of the two units should be taken care off. If a company incorporated in 1980 is compared with that incorporated in 1995, the first company's assets will be appearing at a much lower figure than those of second company. Thus the former will show a lower capital base and if profits of both the companies are the same, the former will show a higher rate of return. This does not indicate higher efficiency; only the capital employed is lower because of the reason that it started 15 years earlier. Hence, in such cases the present value of the fixed assets should be considered for calculating the capital employed. In the end, it may be stated that the limitations of the ratio should be kept in mind while forming an opinion. The 'profits' and 'capital employed' figures are the result of a number of approximations (example, depreciation) and human judgment (valuation of assets). The purpose of calculation of the ratio should be kept in view and appropriate figures should be selected having regard to impact of changing price levels. "Return on capital employed" is an instrument to be used cautiously with clear understanding of its limitations.

Suppose a company has the following items on the liabilities side and it shows underwriting commission of `1,00,000 on the assets side :

	`
10% Preference capital	10,00,000
Equity capital	30,00,000
Reserves	26,00,000
Loans @ 15%	30,00,000
Current Liabilities	15,00,000

Its profit, after paying tax @ 50% is `14,00,000. Profit before interest and tax will be `32,50,000 as shown below :

Profit after tax	14,00,000
Tax	14,00,000
Interest @ 15% on `30,00,000	4,50,000
	32,50,000

The operating capital employed is `95,00,000 i.e., total of all the items (excluding current liabilities) less ` 1,00,000, a fictitious asset. The ROI comes to

$$\frac{32,50,000}{95,00,000}\times 100 \text{ or } 34.21\%$$

The overall profitability ratio has two components. These are the net profit ratio (operating profit / sales × 100) multiplied by turnover ratio (sales/capital employed). Therefore, ROI, in terms of percentage:

$$\frac{\text{Operating Profit}}{\text{Capital Employed}}\times 100 = 100\times\frac{\text{Operating Profit}}{\text{Sales}}\times\frac{\text{Sales}}{\text{Capital Employed}}$$

If a management wants to maximise its profitability, it could do so by improving its net profit ratio and turnover ratio. The former refers to the margin made in each sale in terms of percentage whereas, the latter shows the utilisation, i.e., rotation of the capital in making the sale. If the selling price of an article is ` 10 whose cost is ` 6, there is a margin of ` 4 or 40%. This shows the gap between selling price and cost price in the percentage form. The overall profitability is also dependent upon the effectiveness of employment of capital. If in this case, sales `200 were made with a capital of `100 then the rotation, i.e., the turnover is 200/100 or 2 times. Thus the business has earned a total profit of ` 80 with a capital of `100, profitability ratio being 80%, i.e., Net profit ratio × Turnover ratio = 40% × 2 = 80%.

(ii) Return on Shareholders' Funds :

It is also referred to as return on net worth. In this cases it is desired to work out the profitability of the company from the shareholders' point of view and it is computed as follows :

$$\frac{\text{Net profit after Interest and Tax}}{\text{Shareholders Funds}} \times 100$$

Modifications of the 'return on capital employed' can be made to adopt it to various circumstances. Thus if it is required to work out the profitability from the shareholders' point of view, then the profit figure should be after interest and taxation and the capital employed should be after deducing the long-term loans. This ratio would reflect the profitability for the shareholders. To extend the idea further, the profitability from equity shareholders' point of view can also be worked out by talking the profits after preference dividend and comparing against capital employed after deducing both long-term loans and preference capital.

(iii) Return on Assets :

Here the profitability is measured in terms of the relationship between net profits and assets. It shows whether the assets are being properly utilised or not. It is calculated as :

$$\frac{\text{Net profit after Tax}}{\text{Total Assets}} \times 100$$

This ratio is a measure of the profitability of the total funds or investment of the organisation.

(iv) Profit Ratios

(a) Gross Profit Ratio or Gross Margin.

Gross profit ratio expresses the relationship of gross profit to net sales or turnover. Gross profit is the excess of the proceeds of goods sold and services rendered during a period over their cost, before taling into account administration, selling and distribution and financing charges. Gross profit ratio is expressed as follows:

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

This ratio is important to determine general profitability since it is expected that the ratio would b e quite high so as to cover not only the remaining costs but also to allow proper returns to owners.

Any fluctuation in the gross profit ratio is the result of a change either in 'sales' or the 'cost of goods sold' or both. The rise or fall in the selling price may be an external factor over which the management may have little control, especially when prices are controlled. The management, however, must try to keep the other end of the margin (i.e., cost) at least steady, if not reduce it. If the gross profit ratio is lower than what it was previously, when the selling price has remained steady, it can be reasonably concluded that there is an increase in the manufacturing cost. Since manufacturing overheads include a fixed element as well as, a fall in the volume of sales will also lower the rate of gross profit and vice-versa.

(b) Net Profit Ratio :

One of the components of return on capital employed is the net profit ratio (oir the margin on sales) calculated as :

$$\text{Net Profit Ratio} = \frac{\text{Operating Profit}}{\text{Sales}} \times 100$$

It indicates the get margin earned in a sale of ` 100. Net profit is arrived at from gross profit after deducting administration, selling and distribution expenses; non-operating incomes, such as dividends received and non-operating expenses are ignored, since they do not affect efficiency of operations.

If the expenses met out of the gross profit are disproportionately heavy, the net profit ratio will go down. If gross profit ratio is 40%, but the net profit ratio is 15% it means the expenses ratio is 25%. Thus

a complement of the net profit ratio is $\frac{\text{Administration expenses} + \text{Selling expenses}}{\text{Sales}} \times 100$ Proceedings

upwards from net profit, we can arrive at gross profit if administrative and selling expenses are added back. Similarly, if we add administrative and selling expenses ratio to the net profit ratio we can get the gross profit ratio.

(c) Operating Ratio

The ratio of all operating expenses (i.e., materials used, labour, factory overheads, office and selling expenses) to sales is the operating ratio.

A comparison of the operating ratio would indicates whether the cost content is high or low in the figure of sales. If the annual comparison shows that the sales has increases, the management would b e naturally interested and concerned to know as to which element of the cost has gone up.

It is not necessary that the management should be concerned only when the operating ratio goes up. If the operating ratio has fallen, though the unit selling price has remained the same, still the position needs analysis as it may be the sum total of efficiency in certain departments and inefficiency in others. A dynamic management should be interested in making a fuller analysis.

It is, therefore, necessary to break up the operating ratio into various cost ratios. The major components of cost are : material, labour and overheads. Therefore, it is worthwhile to classify the cost ratio as :

Material cost ratio $= \frac{\text{Material consumed}}{\text{Sales}} \times 100$

Labour cost ratio $= \frac{\text{Labour cost}}{\text{Sales}} \times 100$

Factory overheads cost ratio $= \frac{\text{Overhead cost}}{\text{Sales}} \times 100$

Administrative expenses ratio $= \frac{\text{Administrative expenses}}{\text{Sales}} \times 100$

Selling and distribution expenses ratio Sales $= \frac{\text{Selling and distribution expenses}}{\text{Sales}} \times 100$

Generally all these ratios are expressed in terms of percentage. They total upto the Operating Ratio. This deducted from 100 will be equal to the Net Profit Ratio.

If possible, the total expenditure for effecting sales should be divided into two categories, viz., fixed and variable and then ratios should be worked out. The ratio of variable expenses to sales will be generally constant; that of fixed expenses should fall if sales increase; if will increase it sales fall.

11.7ACTIVITY RATIOS OR TURNOVER RATIOS

The ratios used to measure the effectiveness of the employment of resources are termed as activity ratios. Since these ratios relate to the use of assets for resources are termed as activity ratios. Since these ratios relate to the use of assets for generation of income through turnover they are also known as turnover ratios, as we have seen already, the overall profitability of the business depends on two factors i. e., (i) the rate of return on sales and (ii) the rate of return on capital employed i.e., the speed at which the capital employed in the business relates. More efficient the operations of an undertaking, the quicker and more number of times the rotation is. Thus the overall profitability ratio is calculated as - Net Profit Ratio × Turnover Ratio. The net profit ratio has already been discussed. Now the important turnover ratios as regards capital employed and assets are discussed below :

(i) *Capital Turnover* (Sales to Capital Employed) Ratio

This ratio shows the efficiency of capital employed in the business and is calculated as follows :

$$\text{Capital Turnover Ratio} = \frac{\text{Net Sales}}{\text{Capital Employed}}$$

The higher the ratio the greater are the profits.

(ii) Total Assets Turnover Ratio :

This ratio is ascertained by dividing the net sales by the value of total assets. Thus,

$$\text{Total Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Total Assets}}$$

A high ratio is an indicator of overtrading of total assets while a low ratio reveals idle capacity. This total Assets Turnover Ratio can be segregated into :

(a) Fixed Assets Turnover Ratio :

This ratio indicates the number of times fixed assets are being turned over in a stated period. It is calculated as:

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Fixed Assets}}$$

This ratio is an indicator of the extent to which investment infixed assets contributes to generate sales. The fixed assets are to be taken net of depreciation. The higher is the ratio the better is the performance.

(b) Working Capital Turnover Ratio :

This ratio shows the number of times working capital is turned-over in a stated period. This ratio is calculated as :

$$\text{Working Capital Turnover Ratio} = \frac{\text{Net Sales}}{\text{Working Capital}}$$

It indicates to what extent the working capital funds have been employed in the business towards sales.

(iii) Stock Turnover Ratio (Inventory Turnover Ratio)

This ratio is an indicator of the efficiency of the use of investment in stock. It is calculated as :

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \text{ or } \frac{\text{Sale}}{\text{Average Inventory}}$$

Too large an inventory will depress the ratio; control over inventories and active sales promotion will increase the ratio. If desired this ratio may be split into two ratios, for raw materials and for finished goods.

(i) $\frac{\text{Material consumed}}{\text{Average raw material stocks}}$; and

(ii) $\frac{\text{Sale or Cost of goods sold}}{\text{Average stocks of finished goods}}$

Average inventory is calculated on the basis of the average inventory at the beginning and at the end of the accounting period.

(iv) Debtors Turnover Ratio (Debtor 's Velocity)

These days some amount of sales always locked up in the form of book debts. Efficient credit control and prompt collection of amounts due will mean lower investments in book debts. This ratio measures the net credit sales of a firm to the recorded trade debtors thereby indicating the rate at which cash is generated by turnover of receivable or debtors. This ratio is calculated as:

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Sale}}{\text{Average debtors}}$$

Average debtors refer to the average of opening and closing balance of debtors for the period. Debtors include bills receivables but exclude debts which arise on account of transactions other than sale of goods. While calculating debtors turnover, it is important to note that provision for bad and doubtful debt s are not deducted from total debtors in order to avoid the impression that a larger amount of receivables have been collected.

Debt Collection Period : This ratio indicates the extent to which the debts have been collected in time. This ratio is infact, interrelated with and dependent upon the debtors turnover ratio. It is calculated by dividing the days in a year by the debtors turnover. This ratio can be computed as follows :

(i) $$\frac{\text{Months / Days in a year}}{\text{Debtors Turnover}}$$

O R $$\frac{\text{Average Debtors} \times \text{Months / Days in a year}}{\text{Net Credit Sales for the Year}}$$

O R $$\frac{\text{Average Debtors}}{\text{Average Monthly / Daily Credit Sales}}$$

Debtor's collection period shows the quality of debtors since it measures the speed with which money is collected from them. It is rather difficult to specify a standard collection period for debtors. It depends upon the nature of the industry, seasonal character of the business and credit policy of the firm et c.

(v) Creditors Turnover Ratio (Creditors' Velocity)

Like debtors' turnover ratio, this ratio indicates the speed at which the payments for credit purchases are made to creditors. This ratio is computed as follows :

$$\text{Creditors Turnover Ratio} = \frac{\text{Credit purchases}}{\text{Average Creditors}}$$

The term 'creditors' include, trade creditors and bills payable. In case the details regarding credit purchases, opening and closing balances of creditors are not available, then instead of credit purchases, total purchases may be taken and in place of average creditors, the balance available may be substituted.

Debt Payment Period : This ratio gives the average credit period enjoyed from the creditors. It can be computed as under :

(i) $$\frac{\text{Months /Days in a Year}}{\text{Creditors Turnover}}$$ or

(ii) $$\frac{\text{Average Creditors} \times \text{Months / Days in a Year}}{\text{Credit Purchases in the year}}$$ or

(iii) $$\frac{\text{Average Creditors}}{\text{Average Monthly / Daily Credit Purchases}}$$

Both above ratios determine the average age of payables, on the basis of which it can be compensated as to how prompt or otherwise the company is making payments for credit purchases effected by it. A high creditors' turnover ratio or a low debt payment period shows that creditors are being paid promptly, hence enhancing the credit worthiness of the company. However, a very favourable ratio to this effect also shows that the business is not taking full advantage of credit facilities allowed by the creditors.

11.8 FINANCIAL RATIOS

Financial statements of a firm are analysed for ascertaining its profitability as well as financial position. A firm is said to be financially sound provided if it is capable of meeting its commitments both short-term and long -term. Accordingly, the ratios to be computed for judging the financial position are also known as solvency ratios and those are computed for short-term solvency are known as liquidity ratios.

(i) Liquidity Ratio :

In a short period, a firm should be able to meet all its short-term obligations i.e. current liabilities and provisions. It is current assets that yield funds in the short period-current assets are those asset s which the firm can convert it into cash within one year or short run. Current assets should not only yield suf ficient funds to meet current liabilities as they fall due but also to enable the firm to carry on its day t o day activities. The ratios to test the short-term solvency or liquidity position of an enterprise are ma inly the following :

(a) *Current Ratio:* Current ratio also known as the working capital ratio, is the most widely used ratio. It is the ratio of total current assets to current liabilities and is calculated by dividing the current assets by current liabilities.

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

Current assets are those assets which can be converted into cash in the short -run or within one year. Likewise, current liabilities are those which are to be paid off in the short run. Current assets normally include cash in hand or at bank, inventories, sundry debtors, loans and advances, marketable securit ies, pre-paid expenses, etc. while current liabilities consist of sundry creditors, bills payable, outstanding and accrued expenses, provisions for taxation, proposed and un-claimed dividend, bank overdraft etc.

Current ratio indicates the firms commitment to meet its short-term obligations. It is a measure of testing short-term solvency or in other words, it is an index of the short-term financial stability of an enterprise because it shows the margin available after paying off current liabilities.

Generally 2 :1 ratio is considered ideal for a concern. If the current assets are two times of the current liabilities, there will be no adverse effect on the business operations when the payment of liabilities is made. In fact a ratio much higher than 2:1 may be unsatisfactory from the angle of profitability, though satisfactory from the point of view of short-term solvency. A high current ratio may be taken as adverse on account of the following reasons:

(i) The stock might be pilling up because of poor sales.

(ii) The amount might be looked up in debtors due to slack collection policy.

(iii) The cash or bank balances might be lying idle because of no proper investment.

(b) *Liquid Ratio :* This ratio is also known as quick ratio or Acid Test Ratio. This ratio is calculated by relating liquid or quick assets to current liabilities. Liquid assets means those assets which are immediately converted into cash without much loss. All current assets except inventories and prepaid expenses are categorised as liquid assets. The ratio can be computed as :

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Liquidity ratio may also be computed by substituting liquid liabilities in place of current liabilities. Liquid liabilities means those liabilities which are payable within a short period. Bank overdraft and cash credit facilities, if they become a permanent made of financing are to be excluded from current liabilities to arrive at liquid liabilities. Thus :

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$$

This ratio is an indicator of the liquid position of an enterprise. Generally, a liquid ratio of 1 :1 is considered as ideal as the firm can easily meet all current liabilities. The main difference in current ratio and liquid ratio is an account of inventories and therefore a comparison of two ratios lead to important conclusions regarding inventory holding up.

(ii) Long-term Solvency Ratios :

Long -term sources and uses of funds form the basic input for computation of long-term solvency ratios. The investors both present and prospective i.e. shareholders and debenture holders are interested in knowing the financial status of the company so that they can take decisions for long-term investment of their funds. The following are the main ratios in this category.

(a) Debt-Equity Ratio :

Debt -equity ratio is the relation between borrowed funds and owners' capital in a firm, it is also known as external- internal equity ratio. The debt-equity ratio is used to ascertain the soundness of long- term financial policies of the business. Debt means long-term loans i.e. debentures or long-term loans from financial institutions. Equity means shareholders' funds i.e., preference share capital, equity share capital, reserves less loss and fictitious assets like preliminary expenses. It is calculated in the following ways :

(i) $$\frac{\text{Debts}}{\text{Equity}\left(\text{Shareholders' Funds}\right)} \text{ OR}$$

(ii) $$\frac{\text{Debts}}{\text{Long} - \text{term Funds}\left(\text{Shareholders' Funds} + \text{Debts}\right)}$$

The main purpose of this ratio is determine the relative stakes of outsiders and shareholders.

Normally in India a debt equity ratio of 2:1 if it is calculated as (i) above or 0.67 :1 if calculated as (ii) above is considered as ideal. This means that a company may borrow upto twice the amount of its capital and reserves or it may raise two-thirds of its long-term funds by way of loans. Generally loans are very profitable for shareholders since interest at a fixed rate only is payable whereas the yield generally is much higher and income -tax authorities allow interest as a deductible expenses, thus effectively reducing the interest burden of the company. A higher proportion would be risky because loans carry with them for obligation to pay interest at a fixed rate which may become difficult if profit is reduced. However a lower proportion of long-term loans would indicate an undue conservation and unwillingness to take every normal risks. Both these affect the image of the company and the value placed by the market on shares.

(b) Proprietary Ratio :

This ratio is a variant of debt-equity ratio which establishes, the relationship between shareholders funds and total assets. Shareholders' fund means, share capital both equity and preference and reserves and surplus less losses. This ratio is worked out as follows :

$$\text{Proprietory Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

This ratio indicates the extent to which shareholders' funds have been invested in the assets.

(c) Fixed Assets Ratio :

The ratio of fixed assets to long-term funds is known as fixed assets ratio. It focuses on the proportion of long-term funds invested in fixed assets. The ratio is expressed as follows:

$$\text{Fixed Assets Ratio} = \frac{\text{Fixed Assets}}{\text{Long} - \text{term Funds}}$$

Fixed assets refer to net fixed assets (i.e., original cost-depreciation to date) and trade investments including shares in subsidiaries. Long-term funds include share capital, reserves and long-term loans.

This ratio should not be more than 1. It is the principle of financial management that not merely fixed assets but a part of working capital also should be financed by long-term funds. As such it is desirable to have the ratio at less than one i.e., say, 0.67 to indicate the fact that the entire fixed capital plus a portion of the working capital are financed by long-term funds.

(d) Debt Service Ratio :

This ratio is also known as Fixed Charges Cover or Interest Cover. This ratio measures the debt servicing capacity of a firm in so far as fixed interest on long-term loan is concerned. It is determined by dividing the net profit before interest and taxes by the fixed charges on loans. Thus:

$$\text{Debt Service Ratio} = \frac{\text{Net Profit before interest and Tax}}{\text{Interest Charges}}$$

This ratio is expressed as 'number of times' to indicate that profit is number of times the interest charges. It is also a measure of profitability. Since higher the ratio, higher the profitability. The ideal ratio should be 6 to 7 times.

(e) Capital Generating Ratio :

The proportion between fixed interest or dividend bearing funds and non-fixed interest or dividend bearing funds in the total capital employed in the business is termed as capital gearing ratio. Debentures, long-term loans and preference share capital belong to the category of fixed interest/dividend bearing funds. Equity shares capital, reserves and surplus constitute non-fixed interest or dividend bearing funds. This ratio is calculated as follows :

$$\text{Capital Gearing Ratio} = \frac{\text{Fixed Interest Bearing Funds}}{\text{Equity Shareholders' Funds}}$$

In case the fixed income bearing funds are more than the equity shareholders' funds, the company is said to be highly geared. A low capital gearing implies that equity funds are more than the amount of fixed interest bearing securities. This ratio indicates the extra residual benefits accruing to equity shareholders. Whether the concern is operating in trading on equity can be judged by this ratio.

11.9 MARKET TEST RATIOS

These ratios are calculated generally in case of such companies whose shares and stocks are traded in the stock exchanges. Shareholders, present and probable, are interested not only in the profits of the company but also in the appreciation of the value of their shares in the stock market. The value of shares in the stock market, besides other factors, also depends upon factors like dividends declared, earning per share, the payout policy, etc. of the companies. The following ratios reflect the effect of these factors on the market value of the shares.

(i) *Earning Per Share (EPS) :* This is calculated as under :

$$\text{EPS} = \frac{\text{Net profit}}{\text{Number of equity shares}}$$

This ratio measures the profit available to the equity shareholders on a per share basis. Suppose, the net income of company after preference dividend is ` 40,000 and the number of equity shares is 6,000 then,

$$\text{EPS} = \frac{\text{` }40,000}{6,000} = \text{` }6.66 \text{ per shares.}$$

It should be noted that net income here is the net income in income statement for the period, after taking into consideration operating, non-operating, and other items like income-tax. It should be remembered that if any dividend is payable to the preference shareholders, it has to be deducted before arriving at net income for this purpose. This ratio is of considerable importance in estimating the market price of the shares. A low E.P.S. means lower possible dividends and so lower market value, while a high EPS has a favourable effect on the market value of the shares.

However, the EPS alone does not reflect the effect of various financial institutions of the business. Also, its calculation may be affected, to a considerable extent, by different accounting practices and policies relating to valuation of stocks, depreciation, etc. Therefore, this ratio should be cautiously interpreted.

(ii) *Price Earning Ratio:* This ratio establishes relationship between the market price of the shares of a company and it's earning per share (EPS). It is calculated as under :

$$\text{Price Earning Ratio}\left(\text{PER}\right) = \frac{\text{Market value per equity share}}{\text{Earning per share}}$$

Assuming the market value of a share to be Rs. 40 and the EPS ` 6.66 per share as calculated in (i) above, then the PER comes to $\frac{40}{6.66}$ or 6 times . This ratio helps in predicting the future market value of the shares within reasonable limits. It also helps in ascertaining the extent of under and over-valuation in the market price, thus pointing to the effect of factors generated by the company's financial position. This can be illustrated by the following illustration :

Suppose, the actual market value per share is ` 45 while on the basis of PER and EPS it should be 6 times of EPS, i.e., `6.66 × 6 = `40. The excess of `5 between anticipated and actual market price reflects the effect of general economic and political conditions, the image of the company, etc..... which cannot be make out from company's financial statements. A reciprocal of this ratio gives the capitalisation rate of current earnings per share.

(iii) *Pay-out Ratio :* The ratio expression the relationship between what is available as earnings per share and what is actually paid in the form of dividends out of available earnings. It is a good mea sure of the dividend policy of the company. A higher payout ratio may mean lower retention and ploughing back of profits, a deteriorating liquidity position and little or not increase in the profit-earning capacity of the company. This ratio is calculated with the help of the following formula :

$$\text{Pay}-\text{out Ratio} = \frac{\text{Dividend per equity shares}}{\text{Earnings per share}}$$

(iv) *Dividend Yield Ratio :* This ratio establishes the relationship between the market price and the dividend paid per share. It is expressed as a percentage and gives the rate of return on the market value of the shares and helps in the decision of investors who are more concerned about returns on their investment rather than its capital appreciation. This ratio is calculated as under :

$$\frac{\text{Dividend per shares}}{\text{Market price per share}} \times 100$$

Since dividends are declared on paid-up value of shares, they do not reflect the actual rate of earning if the shares are purchased at market price, which is generally different from paid-up value. This ratio removes this ambiguity by relating the dividends to the market value of shares. For example, if a company declares 20% dividend on its share of ` 20 each, having a market value of rs. 40 each, then the real rate of return is not 20% but is 10% as calculated below:

$$\frac{\text{Dividend per shares}}{\text{Market value per share}} \times 100 = \frac{4}{40} \times 100 = 10\%$$

It should be noted that in the calculation of all the above four ratios (market test) preference shares are ignored and their dividend is adjusted against income, before it is considerable for these ratios.

11.10 ADVANTAGES OF RATIO ANALYSIS

Ratio analysis is a powerful tool of financial analysis. An absolute figure generally conveys no meaning. It is seen that mostly figure assumes importance only on background of other information. Ratios bring together figures which are significantly allied to one another to portray the cause and effect relationship.

From a study of the various ratios and their practical applications, the following advantages can be attributed to the technique of ratio analysis :

1. It helps to analyse and understand financial health and trend of a business, its past performance, and makes it possible to forecast the future state of affairs of the business. They diagnose the financial health by evaluating liquidity, solvency, profitability etc. This helps the management to assess the financial requirements and the capabilities of various business units. It serves as a media to link the past with the present and the future.
2. It serves as a useful tool in management control process, by making a comparison between the performance of the business and the performance of similar types of business.
3. Ratio analysis play a significant role in cost accounting, financial accounting, budgetary control and auditing.
4. It helps in the identification, tracing and fixing of the responsibilities of managerial personnel at different levels.
5. It accelerates the instituionalisation and specialisation of financial management.
6. Accounting ratios summarise and systematise the accounting figures in order to make them more understandable in a lucid form. They highlight the inter-relationship which exists between various segments of the business expressed by accounting statements.

11.11 LIMITATIONS OF RATIO ANALYSIS

Ratio analysis is a widely used technique to evaluate the financial position and performance of a business. But these are subject to certain limitations :

(i) Usefulness of ratios depend on the abilities and intentions of the persons who handle them. It will be affected considerably by the bias of such persons.

(ii) Ratios are worked out on the basis of money-values only. They do not take into account the real values of various items involved. Thus, the technique is not realistic in its approach.

(iii) Historical values (specially in balance sheet ratios) are considered in working out the various ratios. Effects of changes in the price levels of various items are ignored and to that extent the comparisons and evaluations of performance through ratios become unrealistic and unreliable.

(iv) One particular ratio, in isolation is not sufficient to review the whole business. A group of ratios are to be considered simultaneously to arrive at any meaningful and wroth while opinion about the affairs of the business.

(v) Since management and financial policies and practices differ from concern to concern, similar ratios may not reflect similar state of affairs of different concerns. Thus comparisons of performance on the basis of ratios may be confusing.

(vi) Ratio analysis is only a technique for making judgments and not a substitute for judgment.,

(vii) Since ratios are calculated on the basis of financial statements which are themselves affected great ely by the firm’s accounting policies and changes therein, the ratios may not be able to bring out the r eal situations.

(viii) Ratios are at best, only symptoms; they may indicate what is to be investigated only a careful investigation will bring out the correct position.

(ix) Ratios are only as accurate as in accounts on the basis of which these are established. Therefore, unless the accounts are prepared accurately by applying correct values to assets and liabilities, the statements prepared there from would not be correct and the relationship established on that basis would not be reliable.

11.12 COMPUTATION OF RATIOS

Illustration - 11.1

From the following statements, calculate the various ratios :

Condensed Income Statement of Juliet and Company for year ending March 31, 1997

(In ` '000)

	`	% sales
Net Sales	600	100.0
Less : Cost of goods sold	360	60.0
Gross Profit	240	40.0
Operating expenses	156	26.0
Operating Profit	84	14.0
Interest	8	1.3
Income before tax	76	12.7
Income tax provision	38	6.4
Net Income after tax for the year	38	6.3

Balance Sheet of Julient and Company (as on March 31, 1996 and 1997)

(In ` '000)

	March 31, 1996	March 31, 1997
Assets :		
Current Assets :		
Cash	60	80
Account receivables (net)	60	60
Inventories	100	120
Pre-paid expenses	20	20
Total Current Assets	240	280
Fixed Assets :		
Land	60	60
Building and structures	240	240
Less : Accumulated depreciation	120	140
Net Building structures	120	100
Total Fixed Assets	180	160
Other Assets :		
Goodwill and patents	–	20
Total Assets	420	460
Liabilities and Equities		
Current Liabilities :		
Accounts payable	50	60
Wages and taxes outstanding	30	20
Income-tax payable	20	40
Total Current Liabilities	100	120
Long-term Liabilities:		
10% Mortgage Debentures	80	80
Total Liabilities	180	200
Share holders Equity :		
Share capital (6,000 shares of ` 20 each fully paid)	120	120
Retained earnings	120	140
Total Shareholders' Equity	240	260
Total Liabilities and Equities	420	460

Solution:

(i) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

$$1995-96 = \frac{2,40,000}{1,00,000} = 2.4$$

$$1996-97 = \frac{2,80,000}{1,20,000} = 2.3$$

It is clear from the above calculations that liquidity has slightly deteriorated in 1996-97. However, it is still above the ideal current ratio which is suggested as 2 : 1.

(i) Debt-Equity Ratio (Debt/Equity)

$$1995-96 = \frac{80,000}{2,40,000} = 0.33$$

$$1996-97 = \frac{80,000}{2,60,000} = 0.31$$

The position has improved.

(ii) Acid Test Ratio or Quick Ratio

$$= \frac{\text{Liquid or Quick Assets}}{\text{Current Liabilities}}$$

$$1995-96 = \frac{1,20,000}{1,00,000} = 1.2$$

$$1996-97 = \frac{1,40,000}{1,20,000} = 1.17$$

This means that there has been a slight change in the quick ratio for the two periods. The ideal or standard acid test ratio is often taken to be 1 : 1 (or 100%) for a safe current financial position.

(iii) Debtor's Turnover Ratio

$$= \frac{\text{Net Sales}}{\text{Average Debtors}}$$

$$= \frac{6,00,000}{60,000} = 10 \text{ times}$$

It means that 10% of sales effected always remain to be realised.

(iv) Debt Collection Period :

$$= \frac{\text{Average Debtors} \times \text{Days in a year}}{\text{Net Credit sales}}$$

$$= \frac{60,000 \times 365}{6,00,000} = 36.5 \text{ days.}$$

This shows that the company's debts are collected after an average of 36.5 days.

(v) Inventory Turnover Ratio :

This ratio is an important indication of the speed with which inventories are converted into sales. In other words, it reflects the degree of liquidity of inventories and their relationship with the turnover. It is calculated as :

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory at Cost}}$$

Average inventory is calculated by adding opening and closing inventory figures and dividing the total by 2. Thus, inventory turnover for 1996-97.

$$= \frac{3,60,000}{1,10,000} = 3.27 \text{ times.}$$

(vi) Sales Ratios :

(i) Sales to fixed assets or fixed assets turnover ratio.

$$\frac{\text{Net Sales}}{\text{Net Fixed Assets}} = \frac{6,00,000}{1,60,000} = 3.75 \text{ times}$$

(ii) Sales to net worth :

$$\frac{\text{Sales}}{\text{Capital Net Worth}} = \frac{6,00,000}{2,60,000} = 2.3 \text{ times}$$

(iii) Sales to
working capital or working capital turnover ratio :

$$\frac{\text{Sales}}{\text{Working Capital}} = \frac{6,00,000}{1,60,000} = 3.75 \text{ times}$$

(vii) Operating Ratio :

$$\text{Operating Ratio} = \frac{\text{Cost of Goods Sold} + \text{Operating Expenses} \times 100}{\text{Sales}}$$

$$= \frac{3,60,000 + 1,56,000}{6,00,000} \times 100 = 86\%$$

(viii) Profit Ratios

(i) $$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{2,40,000}{6,00,000} \times 100 = 40\%$$

(ii) $$\frac{\text{Net Operating Profit}}{\text{Net Sales}} \times 100 = \frac{84,000}{6,00,000} \times 100 = 14\%.$$

It should be noted that fixed interest charges are not considered as a charge against net operating profits. Some writes calculate this ratio with net income (including non-operating items). In both cases income tax is ignored.

Illustration - 11.2

Determine which company is more profitable.

	A.Ltd.	B.Ltd.
Net Profit Ratio	3%	4%
Sales/Capital Employed	5 times	3 times

Solution

Judging from the net margin ratio B Ltd. appears to be more profitable. But the criteria for determining profitability is return on capital employed which in this case works out to 15% and 12% respectively for A Ltd. and B.Ltd. Hence A. Ltd. is undoubtedly more profitable.

Return on investment is a good measure of profitability in as much as it is an extension of the input- output analysis. Moreover, it aids in comparing the performance efficiency of dissimilar enterprises .

Illustration - 11.3 :

From the following information, calculate, debtors turnover ratio and average collection period.

	`
Total debtors (on 1.4. 1996)	
Cash sales	2,00,000
Credit sales	1,50,000
Cash collected	10,00,000
Sales returns	7,80,000
Bad debts	60,000
Discount allowed	40,000
Provision for bad debts	20,000
No. of days in a year -360	25,000

Calculation of Closing Balance of Total Debtors

Total Debtors Account

Debtors Turnover Ratio = $= \dfrac{\text{Credit sales}}{\text{Average Debtors}}$

Average Debtor $= \dfrac{\text{Opening Debtors} + \text{Closing Debtors}}{2} = \dfrac{2,00,000 + 3,00,000}{2}$ = `2,50,000

Debtors Turnover Ratio $= \dfrac{\text{Days in the year}}{\text{Debtors Turnover Ratio}} = \dfrac{10,00,000}{2,50,000} = 4 \text{ times}$

Average Collection Period $= \dfrac{360}{4} = 90 \text{ days}$

Illustration - 11.4 :

You are given the following figures :

Current ratio	2.5	Fixed assets turnover ratio (on cost of sales)	2 times
Liquidity ratio	1.5		
Net working capital	`3,00,000	Average debt collection period	2 months
Stock turnover ratio (cost of sales/ closing stock)	6 times	Fixed assets/shareholders net worth	0.80
Gross profit ratio	20%	Reserve and surplus/capital	0.50

Draw up the balance sheet of the company.

Solution : **Balance Sheet as on ....**

	`		`
Share capital	5,00,000	Fixed Assets	6,00,000
Reserves and surplus	2,50,000	Stock	2,00,000
Long-term borrowings (balancing figure)	1,50,000	Debtors	2,50,000
		Bank	50,000
Current liabilities	2,00,000		
	10,00,000		***11,00,000***

Workings :

If current liabilities	=	1
Current assets	=	2.5
It means the difference or working capital	=	1.5
Working capital or 1.5	=	` 3,00,000
$\therefore$ Current assets	=	` 5,00,000
Current liabilities	=	` 2,00,000
Liquid ratio	=	1.5
And current liabilities	=	` 2,00,000
Liquid assets (bank and debtors) (2,00,000 × 1.5)	=	` 3,00,000
Stock (5, 00,000 – 3, 00,000 , i.e. current assets – liquid assets)		
Cost of sales (as stock turnover ratio is 6)	=	` 2,00,000
Sales (as G.P. ratio is 20%,	=	` 12, 00,000
$12,00,000 + \frac{20}{80} \times (12,00,000)$	=	` 15,00,000
Fixed assets, $\frac{12,00,000}{6}$ as fixed assets turnover is 6	=	` 6,00,000
Debtors, $\frac{15,00,000}{2}$ Debt collection		
Period being 2 months	=	` 2,50, 000
Sharaholders' net worth, $\frac{6,00,000 \times 1}{0.80}$	=	` 7,50, 000
Out of shareholders' net worth, reserves and surplus	=	` 2,50, 000
$\therefore$ Share capital	=	` 5, 00, 000

Illustration 11.5 :

From the following information make out a statement of proprietors' funds with as much details as possible :

			`
Current ratio	2.5	Working capital	60, 000
Liquidity ratio	1.5	Reserves and surplus	40, 000
Proprietory ratio (fixed assets / Proprietory fund)	0.75	Bank overdraft	10, 000

There is no long-term loan or fictitious asset.

If we take proprietory fund as x, then fixed assets = 0.75 x

Proprietory fund + Current liabilities = Fixed assets + Current assets.

$\therefore$ x + 40, 000 = 0.75x + 1, 00, 000

$\therefore$ x – 0.75 x = `60, 000

0.25x = ` 60, 000 or x = 2, 40, 000

Out of ` 2, 40, 000, reserves and surplus = ` 40, 000

$\therefore$ Capital is `2, 00, 000.

Illustration 11.6 :

From the final accounts of Prudent Ltd, given below, calculate the following :

(i) gross profit ratio ;

(ii) current ratio ;

(iii) liquid ratio ; and

(iv) return on investment ratio.

Trading and Profit and Loss Account for the year ended 31st March, 1997

	`		`
To Material consumed		By sales	
Opening stock 9, 050		By Profit	85, 000
Purchases 54, 525		By interest on investment	600
63, 575			300
Less : Closing stock 14, 000	49, 575		
To Carriage inwards	1, 425		
To Office expenses	15, 000		
To Sales expenses	3, 000		
To Financial expenses	1, 500		
To Loss on sales of fixed assets	400		
To Net profit	15, 000		
	85, 900		85,900

Balance Sheet as on 31st March, 1997

Liabilities		`	Asset	`
Share capital :			Fixed assets :	
2, 000 equity shares of			Buildings	15,000
Rs. 10 each, fully paid			20, 000 Plant	6,000 23, 000
General reserve			9, 000	
Profit and loss account			6, 000 Current assets :	
Bank overdraft			3, 000 Stock - in -trade	14, 000
Sundry creditors			Debtors	7,000
For expenses	2,000		Bills receivable	1, 000
For others	8, 000	10, 000	Bank balance	3,000 25, 000
			48, 000	48,000

Solution :

(i) Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$

(ii) Gross profit= Sales – Material consumed – Carriage inwards

= ` 85, 000 – ` 49, 575 – ` 1, 425

= ` 34, 000

Sales = ` 85, 000

Gross Profit Ratio = $= \frac{34,000}{85,000} \times 10 = 40\%$

(iii) Current Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Assets = Stock + Debtors + Bills Receivable + Bank Balance

= ` (14,000 + 7,000 + 1,000 + 3,000)

= `25,000

Current Liabilities = Sundry Creditors + Bank Overdraft

= ` (10,000 + 3,000)

= `13,000

Current Ratio $= \frac{25,000}{13,000} = 1.92:1$

(iv) Liquid Ratio $= \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$

Liquid Assets = Debtors + Bills Receivable + Bank Balance

= ` (7,000 + 1,000 + 3,000)

= `11,000

Current Liabilities = Sundry Creditors + Bank Overdraft

= ` (10,000 + 3,000)

= `13,000

Liquid Ratio $= \frac{11,000}{13,000} = 0.84:1$

N.B. Bank overdraft is treated as current liability.

(v) Return on investment

Ratio $= \frac{\text{Operating Profit} \times 100}{\text{Capital Employed}}$

Operating Profit = Net Profit + Non-operating expense/loss – Non-operating income.

= Net Profit + Loss on sale of fixed assets

+ Financial expenses – (Profit + interest on investment)

= 15,000 + 400 + 1,500 – 900 = `16.000

Capital Employed = Share Capital + General Reserve + Profit and Loss Account

= (20,000 + 9,000 + 6,000) = ` 35,000

$$= \frac{16,000 \times 100}{35,000} = 45.71\%$$

Note : Its assumed that 'profit' `600 as an item of non-operating income and financial expenses as an item of non-operating expense. Since details are not given, these two items are excluded while calculating operating profit.

Illustration - 11.7 :

Syntex Limited's financial statements contain the following information :

	31.3.1996	31.3.1997
Cash	2,00,000	1,60,000
Sundry debtors	3,20,000	4,00,000
Temporary investments	2,00,000	3,20,000
Stock	18,40,000	21,60,000
Prepaid expenses	28,000	12,000

Total current assets	25,88,000	30,52,000
Total assets	56,00,000	64,00,000
Current liabilities	6,40,000	8,00,000
10% debentures	16,00,000	16,00,000
Equity share capital	20,00,000	20,00,000
Retained earnings	4,68,000	8,12,000

Statement of Profit for the year ended 31st March, 1997

	`
Sales	40,00,000
Less : Cost of goods sold	–28,00,000
Less : Interest	– 1,80,000
Net profit	10,40,000
Less : Taxes @ 50%	– 5, 20, 000
Profit after taxes	5,20,000
Dividends declared on equity shares	2,20,000

From the above, appraise the financial position of the company from the points of view of : (i) liquidity, (ii) solvency, (iii) profitability, and (iv) activity.

Solution:

1995-96 1996-97

(i) Liquidity Ratios :

(a) Current ratio : $\dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{25,88,000}{6,40,000} = 4.04 = \dfrac{30,52,000}{8,00,000} = 3.81$

(b) Acid test ratio : $\dfrac{\text{Quick Assets}}{\text{Current Liabilities}} = \dfrac{7,20,000}{6,40,000} = 1.13 = \dfrac{8,80,000}{8,00,000} = 1.10$

(ii) Solvency Ratios :

(a) Debt equity ratio : $\dfrac{\text{Total outsiders' debts}}{\text{Equity funds}} = \dfrac{22,40,000}{24,68,000} = 0.91 \quad \dfrac{24,00,000}{28,12,000} = 0.85$

$$\frac{\text{Long – term debts}}{\text{Equity funds}} = \frac{16,00,000}{24,68,000} = 0.65 = \frac{16,00,000}{28,12,000} = 0.57$$

(b) Interest coverage ratio : $\dfrac{\text{EBIT}}{\text{Interest charges}} = \dfrac{12,00,000}{1,60,000} = 7.5 \text{ times}$

(iii) Profitability Ratios :

(a) Gross profit ratio $= \dfrac{\text{Gross profit} \times 100}{\text{Sales}} = \dfrac{12,00,000 \times 100}{40,00,000} = 30\%$

(b) Net profit ratio $= \dfrac{\text{Net profit} \times 100}{\text{Sales}} = \dfrac{5,20,000 \times 100}{40,00,000} = 13\%$

(c) Return on total assets $= \dfrac{\text{Net profit} \times 100}{\text{Total assets}} = \dfrac{5,20,000 \times 100}{64,00,000} = 8.13\%$

(d) Return on capital employed $= \dfrac{\text{Net profit before interest and taxes} \times 100}{\text{Total capital employd}}$

Capital Employed :	`
	20,00,000
Equity Capital	8,12,000
Retained Earnings	16,00,000
10%Debentures	44,12,000

$$= \frac{12,00,000 \times 100}{44,12,000} = 27.2\%$$

(e) Return on equity funds

$$= \frac{\text{Net profit after taxes} \times 100}{\text{Equity funds}} = \frac{5,20,000 \times 100}{88,12,000} = 18.5\%$$

(iv) Activity Ratios :

(a) Debtors turnover ratio :

$$= \frac{\text{Credit sales}}{\text{Average accounts receivable}} = \frac{40,00,000}{3,60,000} = 11.11 \text{ times}$$

Note : In the absence of any information, all sales have been treated as credit sales.

(b) Stock turnover ratio :

$$= \frac{\text{Cost of sales}}{\text{Average stock}} = \frac{28,00,000}{20,00,000} = 1.4 \text{ times}$$

(c) Total assets-turnover ratio :

$$= \frac{\text{Cost of goods sold}}{\text{Total assets}} = \frac{28,00,000}{64,00,000} = 0.4375 \text{ times}$$

(The sales figures can also be used).

The company's position is quite sound from the point of view of liquidity, solvency and profitability. However, its activity ratios particularly in terms of the utilisation of total assets and holding of stock do not seem to be adequate.

Illustration - 11.8

The balance sheet of Major Ltd. as on 31st March, 1997 is as under :

Liabilities	`	Assets		`
Share capital :		Fixed assets :		
2,000 equity shares of		At cost	5,00,000	
Rs. 100 each fully paid	2,00,000	Less : Depreciation	1,60,000	3,40,000
7-1/2% preference shaes	1,00,000			
General reserve	60,000	Current assets :		
12% debentures	60,000	Stock		80,000
Current liabilities :		Debtors		80,000
Sundry creditors	80,000	Bank		20,000
	5,00,000			5,00,000

The company wishes to forecast balance sheet as on 31st March, 1998. The following additional particulars are available :

(i) Fixed assets costing Rs. 1,00,000 have been installed on 1st April, 1997 but the payment will be made on 31st March, 1998.

(ii) The fixed assets turnover ratio on the basis of gross value of fixed assets would be 1.5.

(iii) The stock turnover ratio would be 14.4 (calculated on the basis of average stock).

(iv) The break up of cost and profit would be as follows :

Material	40%
Labour	25%
Manufacturing expenses	10%
Office and selling expenses	10%
Depreciation	5%
Profit	10%
	100%

The profit is subject to interest and taxation at 50%.

(v) Debtors would be 1/9 of sales.

(vi) Creditors would be 1/5 of material consumed.

(vii) In March 1998 a dividend @ 10% on equity capital would be paid.

(viii) 12% debentures for ` 25,000 have been issued on 1st April, 1997.

Prepare the forecast balances sheet as on 31st March, 1998 and show the following resultant ratios :

(a) Current ratio;

(b) Fixed assets/net worth ratio, and

(c) Debt equity ratio.

Solution :

Forecast Balance Sheet of Major Ltd. as on 31.3.1998

Liabilities	`	Assets		`
Share Capital :		Fixed assets :		
2,000 Equity shares of		Cost	6,00,000	
Rs. 100 each	2,00,000	Less : Depreciation		
7-1/2% preference shares	1,00,000		2,05,000	3,95,000
Reserves and Surplus :		Current assets :		
General Reserve	60,000	Stock		40,000
Profit and Loss A/C	12,400	Debtors		1,00,000
		Cash at bank		34,300
Secured Loans :				
12% Debentures	85,000			
Current Liabilities :				
amd Provisions :				
Sundry creditors	72,000			
Provision for taxation	39,900			
	5,69,300			5,69,300

Ratios:

$$(a)\ \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1,74,300}{1,11,900} = 1.56$$

$$(b)\ \text{Fixed Assets / Net Worth Ratio} = \frac{\text{Fixed Assetes}}{\text{Net worth}} = \frac{3,95,00}{3,72,400} = 1.06$$

$$(c)\ \text{Debt / Equity Ratio} = \frac{\text{Debt}}{\text{Equity}} = \frac{85,000}{3,72,400} = 0.23$$

$$(\text{OR}) \quad \frac{\text{Debt}}{\text{Debt} + \text{Equity}} = \frac{85,000}{4,57,400} = 0.19$$

Working Notes :

1. Fixed Assets as on 31.3.1998

			`
Balance as on 31.3.1997		5,00,000	
Additions during the year		1,00,000	6,00,000
2. Sales = Fixed assets × Fixed assets turnover ratio			
Sales = ` 6,00,000 × 1.5 (turnover stands for sales)			9,00,000
3. Cost of goods sold :			
Material	40%	3,60,000	
Labour	25%	2,25,000	
Manufacturing expenses	10%	90,000	
Depreciation	5%	45,000	7,20,000
4. Total Depreciation			
Opening ` 1,60,000 + ` 45,000 (for the year)			2,05,00

5. $$\text{Average Stock} = \frac{\text{Cost of goods sold}}{\text{Stock turnover ratio}} = \frac{7,20,000}{14.4} = \text{Rs. } 50,000$$

6. Stock as on 31.3.1998 = (2 × Average stock) – Opening stock = (2 × 50,000) – 60,000 = ` 40,000

7. Debtors on 31.3.1998 = 1/9th of sales : $\frac{9,00,000}{9}$ = `1,00,000

8. Creditors on 31.3.1998 = 1/5th of material consumed $= \frac{3,60,000}{5}$ = `72,000

9. Cash and Bank Balance

Cash and Bank Account

Dr.	`		Cr. `
To Opening Balance	20,000	By Debtors (increases)	20,000
To Debentures	25,000	By Creditors (decreases)	8,000
To Profit - 15% on sale		By Interest-debentures	10,200
before depreciation		By Fixed assets	1,00,000
(Depreciation 45,000		By Preference-dividend	7,500
Profit 90,000	1,35,000	By Equity dividend	20,000
		By Closing balane	
To Stock (decrease)	20,000	(balancing figure)	34,300
	2,00,000		2,00,000

10. Provision for Taxation : `

Profit - 10% of Sales	90,000	
Less - Debenture interest	10,200	
	79,800	
Provision @ 50%	39,900	

11. Profit and Loss A/c:

Profit - 10% of Sales		90,000
Less : Debenture interest	10,200	
Provision for tax	39,900	
10% dividend on equity shaers	20,000	
7-1/2% Dividend on preferences shares	7,500	77,600
Net profit to Balance Sheet		12,400

Note :

(i) Stock turnover ratio has been calculated with reference to cost of goods sold.

(ii) Debentures interest has been assumed to be paid.

5. Explain the significance of ratio analysis in financial management.
6. Explain briefly the different ratios that are commonly used and show how they are useful in financial analysis.
7. By taking a hypothetical example, calculate different ratios.
8. Explain different ratios coming under :
   (a) Profit ratios
   (b) Overall measures ratio
9. (a) Explain the uses of ratio analysis.
   (b) What are the limitations of ratio analysis.
10. Write short notes on :
    (a) Liquidity test ratio
    (b) Acid test ratio
    (c) Profitability test ratios
    (d) Turnover ratios.
11. Imagine you are a Financial Executive of a company which is intending to raise a short-term loan from a Bank. What ratios would you choose to highlight the performance to the Bank ?
12. On the basis of the following figures derived from the accounts of a company, prepare a report on the level of efficiency of financial and operational management of the company.

Years	Capital Turnove Ratio	Net Profit On Sales (%)	ROI (%)	Current Ratio
1	1.0	8	8	6.0
2	2.0	10	20	4.0
3	3.0	11.5	34.5	2.0
4	5.0	13	65	0.5

13. The profit and loss and balance sheet of Happy Ltd. is given beloiw :

P & L Account for the year ended 31st March, 1997

	`		`
To Opening stock	90,000	By Sales	9,00,000
To Purchases	5,60,000	By Closing stock	90,000
To Wages	2,14,000		

To Gross profit	1,26,000		
	9,90,000		9,90,000
To Salaries	16,000	By Gross profit	1,26,000
To Electricity	10,000		
To Miscellaneous expenses	10,000		
To Depreciation	30,000		
To Net profit	60,000		
	1,26,000		1,26,000

Balance Sheet as on 31.3.1997

	`			`
Share capital :		Fixed assets	5,40,000	
Equity shares	1,80,000	Less : Depreciation	1,50,000	3,90,000
Reserve and surplus	1,20,000			
Secured loans	2,10,000	Current assets :		
		Stock	90,000	
Current liabilities :		Sundry debtors	1,05,000	
Sundry creditors	90,000	Cash	15,000	2,10,000
	6,00,000			6,00,000

Discuss under the following important functional groupings the usual ratios and comment on the financial strength of the company :

(i) Liquidity and solvency test ratios;
(ii) Profitability test ratios, and
(iii) Overall measures ratios.

14. Prepare Balance Sheet and Profit and Loss Account from the following information :

	`
Capital	4,00,000
Working capital	1,80,000
Bank overdraft	30,000

There is no fictitious asset. Current assets contain only stock, debtors and cash. The following additional data is also available :

(i) Closing stock is 20% higher than opening stock
(ii) Current ratioh -2.5
(iii) Quick ratio -2.0
(iv) Proprietary ratio -0.6 (Fixed assets : Proprietary fund)
(v) Gross profit ratio -20% (of sales)
(vi) Stock velocity -5
(vii) Debtor's velocity -73 days
(viii) Net profit ratio -10% (to average capital employed).

15. The following are the summarised profit and loss account and balance sheet of Waldo company Limited for the year ending 31st March, 1997..

Profit and Loss Account

	`		`
To Opening stock	9,950	By Sales	85,000
To Purchases	54,525	By Closing stock	14,900
To Incidental	1, 425		

To Gross profit	34,000		
	99,900		99,000
To Operating expenses :		By Gross profit	34,000
Selling and distribution	3,000	By Non-operating	
Administration	16,5000	income -interest	300
To Non-operating expenses :		By profit on sale of shares	600
Loss on sale of assets	400		
To Net Profit	15,000		
	34,900		34,900

Balance Sheet

Issued Capital		Land and building	15,000
2,000 equity shares of		Plant and machinery	8,000
` 10 each	20,000	Stock in trade	14,900
Reserves	9,000	Sundry debtors	7,100
Profit and loss account	6,000	Cash and bank balance	3,000
Current liabilities	13,000		
	48,000		48,000

Your are required to calculate :

(a) Current ratio

(b) Operating ratio

(c) Stock turnover ratio

(d) Return on total resources.

(e) Turnover of fixed assets.

11.13 KEY TERMS

- **Accounting Ratio:** It is the relationship expressed in mathematical terms between two accounting figures related with each other.
- **Balance Sheet:** A statement of financial position of business at a specified moment of time.
- **Balance Sheet Ratios:** Ratios calculated on the basis of figures of balance sheet only.
- **Composite Ratios:** Ratios based on figures of profit and loss account as well as the balance sheet. They are also known as Inter-Statement Ratios.
- **Financial Analysis:** Critical evaluation of data given in the financial statements.
- **Financial Ratios:** Ratios disclosing the financial position or solvency of the firm. They are also known as Solvency Ratios.
- **Financial Statement:** An organized collection of data according to logical and consistent accounting procedures conveying an understanding of some financial aspects of a business firm.
- **Interpretation:** Explaining the meaning and significance of the financial data.
- **Profitability Ratios:** Ratios which reflect the final results of business operations.
- **Turnover Ratios:** Ratios measuring the efficiency with which the assets are employed by a firm. They are also known as Activity or Efficiency Ratios.

11.14 SUMMARY

- Accounting ratio is a mathematical relationship expressed between two inter-connected accounting figures. It may be expressed in "time" or "percentage".
- Ratios are useful only when they are given in a comparative form. Moreover, ratios are only indicators. They cannot be taken as final regarding good or bad financial position of the business. Other things have also be seen.

- No fixed standards can be laid down for ideal ratios. Moreover, a particular ratio may be calculated in more than one way without violating any basic principle of accounting. It is, therefore, advisable for a student to give the basis for computing a particular ratio.
- While making inter-firm (comparison of one firm with another) or intra-firm (comparison within the firm itself) comparison on the basis of accounting ratios, it must be seen that the different firms or departments, which are being compared, have the same accounting policies and adopt the same accounting procedures.

11.15 CHECK YOUR PROGRESS AND ANSWERS

1. True or False :
   - (a) Equity to fixed interest-bearing securities is Acid Test Ratio.
   - (b) Debt equity ratio is a 'Solvency Ratio'.
   - (c) Ratio analysis is a technique of planning and control.
   - (d) A firm's ability to meet the interest charge and repayment dues on long-term obligations.
   - (e) Rate of return on capital employed is a turnover ratio.
   - (f) 'Acid Test' denotes liquidity.
   - (g) For Stock Turnover Ratio, average stock is to be calculated.
   - (h) A decreased Stock Turnover Ratio usually indicates expanding business.
2. The current ratio of a company is 2 : 1. Which of the following suggestions would improve the ratio, which would reduce it and which would not change it ?
   - (a) To pay a current liability.
   - (b) To sell a motor car for cash at a slight loss.
   - (c) To borrow money on an interest-bearing promissory note.
   - (d) To purchase stocks for cash.
   - (e) To give interest-bearing promissory note to a creditor to whom money was owed on current account.
3. Assuming the current ratio is 2, state in each of the following cases whether the ratio will improve or decline or will have no change.
   - (a) Payment of a current liability.
   - (b) Purchase of fixed assets.
   - (c) Cash collected from customers.
   - (d) Bills receivable dishonoured.
   - (e) Issue of new shares.
4. Which accounting ratio will be useful in indicating the following symptoms :
   - (a) Low capacity utilisation.
   - (b) Falling demand for the product in the market.
   - (c) Inability to pay interest.
   - (d) Borrowing for short-term and investing in long-term assets.
   - (e) Large inventory accumulation in anticipation of price rise in future.
   - (f) Inefficient collection of debtors.
   - (g) Inability to pay dues to financial institutions.
   - (h) Return of shareholder's funds being much higher than the overall return on investments.
   - (i) Liquidity crisis.
   - (j) Increase in average credit period to maintain sales in view of falling demand.
5. Indicate the important accounting ratios that would be used by each of the following :
   - (i) A long-term creditor interested in determining whether his claims is adequately secured;
   - (ii) A Bank who has been approached by a company for short-term loan/overdraft; and
   - (iii) A shareholder who is examining his portfolio and who is to decide whether he should hold or sell his shares in a company.

Answers to 'Check Your Progress'

1. (a) False; (b) True; (c) False; (d) True; (e) False; (f) True; (g) True; (h) False
2. (a) Improve the ratio; (b) Improve the ratio; (c) Reduce the ratio; (d) No change in the ratio; and (e) No change in the ratio.
3. (a) Improve; (b) decline; (c) no change; (d) no change; (e) improve.
4. (a) Fixed Assets Turnover Ratio; (b) Finished Goods Turnover Ratio; (c) Interest Coverage Ratio; (d) Fixed Assets Ratio; (e) Inventory Turnover Ratio, (f) Debtors Turnover Ratio; (g) Debt Service Coverage Ratio; (h) Debt-Equity Ratio, Return on Investment; (i) Current Ratio, Quick Ratio; (j) Debtor's Turnover Ratio, Debt Collection Period.
5. (i) Debt Service Coverage Ratio; (ii) Current Ratio and Quick Ratio; (iii) Earning per Share.

11.16 QUESTIONS AND EXERCISES:

1. Discuss the concepts regarding financial statements and limitations of financial statements.
2. How do you analyse and interpret financial statements of a company for reporting on the soundness of its capital structure and solvency.
3. What is the need for financial analysis ? How does the ratio analysis technique help in the financial analysis ?
4. What do understand by analysis of financial statements ? Describe the uses of such analysis ?
5. Explain the significance of ratio analysis in financial management.
6. Explain briefly the different ratios that are commonly used and show how they are useful in financial analysis.
7. By taking a hypothetical example, calculate different ratios.
8. Explain different ratios coming under :
   (a) Profit ratios
   (b) Overall measures ratio
9. (a) Explain the uses of ratio analysis.
   (b) What are the limitations of ratio analysis.
10. Write short notes on :
    (a) Liquidity test ratio
    (b) Acid test ratio
    (c) Profitability test ratios
    (d) Turnover ratios.
11. Imagine you are a Financial Executive of a company which is intending to raise a short-term loan from a Bank. What ratios would you choose to highlight the performance to the Bank ?

11.17 PRACTICAL PROBLEMS

1. From the following information, you are required to prepare a Balance Sheet :
   1. Current Ratio – 1.75 2. Liquid Ratio – 1.25
   3. Stock Turnover Ratio (Cost of Sales/Closing Stock) – 9
   4. Gross Profit Ratio – 25 per cent 5. Debt Collection period – 1½ months
   6. Reserves and Surplus to Capital – 2 7. Turnover to Fixed Assets – 1.2
   8. Capital Gearing Ratio – 0.6 9. Fixed Assets to Net Worth – 1.25
   10. Sales for the year `12,00,000.

		`		`
[**Ans.**	Share Capital	5,00,000	Stock	1,00,000
	Long-term Liabilities	3,00,000	Debtors	1,50,000
	Reserve and Surplus	1,00,000	Cash and Bank balance	1,00,000
	Current Liabilities	2,00,000	Balance Sheet Total	11,00,000]
	Fixed Assets	7,50,000		

2. You are given the following information pertaining to the financial statement of AYZ Ltd., as on 31 December, 1997. On the basis of the information supplied, you are required to prepare the Trading and Profit and Loss Account for the year ended and a Balance Sheet as on that date.

	`		`
Net Current Assets	2,00,000	Ratio of Gross Profit on Turnover	25 per cent
Issued Share Capital	6,00,000	Net Profit to Issued Shares Capital	20 per cent
Current Ratio	1.8	Stock Turnover Ratio (cost of goods sold/closing stock)	5 times
Quick Ratio (Ratio of debtors and bank balance to current liabilities)	1.35	Average of Outstandings for the years	36½ days
Fixed Assets to Shareholder's Equity	80 per cent		

On 31 December, 1998, the current assets consisted only of Stock, Debtors and Bank Balance, Liabilities consisted of Share Capital and Current Liabilities and Assets consisted of Fixed Assets and Current Assets.

		`		`
[**Ans.**	Gross Profit	1,87,000	Stock	12,500
	Net Profit	1,20,000	Bank balance	2,62,500
	Current Assets	4,50,000	Fixed Assets	8,00,000
	Current Liabilities	2,50,000	Balance Sheet total	12,50,000]
	Debtors	75,000		

3. Based on the following information of the financial ratios prepare Balance Sheet of Star Enterprises Ltd., as on December 31, 2005. Explain your working and assumptions :

Current Ratio	25
Liquidity Ratio	1.5
Net Working Capital	`6,00,000
Stock Turnover Ratio	5
Ratio of Gross Profit to Sales	20%
Turnover Ratio to Net Fixed Assets	2
Average Debt Collection Period	2.4 months
Fixed Assets to Net worth	0.80
Long-term debt to Capital and Reserve	7/25

[**Ans.** Fixed Assets – ` 10,00,000; Current Assets – ` 10,00,000; Share Capital and Reserves – `12,50,000;

Long-term Deposits – ` 3,50,000; Current Liabilities – ` 4,00,000]

4. From the following information, prepare a summarised balance sheet as on 31st March, 1997 :

	`
(i) Working Capital	
(ii) Reserves and Surplus	1,20,000
(iii) Bank Overdraft	80,000
(iv) Assets (fixed)-Proprietory Ratio	20,000
(v) Current Ratio	0.75
(vi) Liquidity Ratio	2.5

[**Ans.** Current Liabilities `80,000; Current Assets `2,00,000; Fixed Assets `3,60,000; Stock `1,10,000; Balance Sheet Total `5,60,000]

5. Following are the ratios relating to the trading activities of an Organisations :

Debtor's Velocity	3 Months
Stock Velocity	6 Months
Creditor's Velocity	2 Months
Gross Profit Ratio	20%

Gross profit for the year ended 31st December, 2006 was `5,00,000. Stock at the end of 1996 was ` 20,000 more than what it was at the beginning of the year. Bills Payable and Receivable were `36,667 and ` 60,000 respectively. You are to ascertain the figures of :

(a) Sales ; (b) Sundry Debtors;
(c) Sundry Creditors; and (d) Stock.

[**Ans.** (a) ` 25,000,000; (b) 5,65,000; (c) `3,00,000; and (d) `10,10,000

6. From the following information, relating to a limited company, prepare a Statement of Proprietors' Funds :

(i) Current Ratio	2
(ii) Liquid Ratio	1.5
(iii) Fixed Assets/Proprietory Funds	3/4
(iv) Working Capital	`75,000
(v) Reserves and Surplus	50,000
(vi) Bank Overdraft	10,000

There were no long-term loans or fictitious assets.
All working must form part of your answer.

[**Ans.** Proprietor's Funds : Sources `3,00,000; Applications; (a) Fixed Assets `2,25,000, (b) Working Capital ` 75,000]

7. From the following information relating to Wise Limited, you are required to prepare its summarised Balance Sheet :

(a) Current Ratio	2.5
(b) Acid Test Ratio	1.5
(c) Gross Profit/Sales Ratio	0.2
(d) Net Working Capital/Net worth Ratio	0.3
(e) Sales/Net Fixed Assets Ratio	2.0
(f) Sales/ Net worth Ratio	1.5
(g) Sales/Debtors Ratio	6.0
(h) Reserves/Capital Ratio	1.0
(i) Net worth/Long-term Loan Ratio	20.0
(j) Stock velocity	2 Months
(k) Paid up Share Capital	`10 lakhs

[**Ans.** In ` Laksh; Fixed Assets `15; Stock 4, Debtors `5, Other Current Assets `1, Reserves `10, Long-term Loans ` 1 and Current liabilities ` 4].

Analysis of Financial Statements :

8. Following is the Profit and Loss A/c and Balance Sheet of A Limited for the year ended 31 December, 1998 and Balance Sheet as on that date. Calculate the different ratios and comment on the financial position of the company.

Particulars			`
Net Sales			3,00,000
Less : Cost of goods sold			2,58,000
	Gross Profit		42,000
Operating Expenses :			
Selling		2,200	
General and Administration		4,000	
Rent of Office		2,800	9,000
Gross Operating Profit			33,000
Depreciation			10,000
			23,000
Other Income:			
Interest on Government Securities			1,500
	Gross Income		24,500
Other Expenses :			
Interest on Bank Overdraft		300	
Interest on Debentures		4,200	4,500
Net Income before Tax			20,000
Tax @ 50 per cent on Net Income			10,000
	Net Income after Tax		10,000

BALANCE SHEET

as on 31st December, 1998

Liabilities	`	Assets		`
Net Worth :		Fixed Assets		
Sundry Creditors	6,000	Cash		5,000
Bills Payable	10,000	Investments (Government securities)		15,000
Outstanding Expenses	1,000	Sundry Debtors		20,000
Provision for Taxation	13,000	Stock		30,000
Total Current Liabilities	30,000	Total Current Assets		70,000
6% Mortgage Debentures	70,000	Fixed Assets	1,80,000	
7% Preference Shares	10,000	Less : Provision for		
Equity Shares	50,000	depreciation	50,000	1,30,000
Reserve and Surplus	40,000			
Total Claims on Assets	2,00,000			2,00,000

[**Ans.** Gross Profit Ratio 14 per cent, Net Profit Ratio (after considering interest on bank overdraft) : 7.56 percent, ROI 13.53 per cent, Stock Turnover Ratio 8.6, Debt Collection Period 24 days, Fixed Assets Turnover 2.3, Fixed Assets Ratio. 76, Debt equity ratio 70/1000 = 0.7, Current Ratio 2.3].

9. The following items appear in the accounts at 31 December, 2006 of Operations Ltd. :

Particulars	`
Cash	48,600
Land and Buildings at Cost	8,00,000
Deposits and Payments in Advance	62,000
Stock	2,72,800
Trade Creditors	4,05,750
General Reserve	1,00,000
Debtors	5,23,000
Bills Receivable	22,600
Plant and Machinery at cost less depreciation	5,44,000
Debentures - repaybale 2000 (secured)	2,50,000
Bank Overdraft	52,000
Ordinary Stock, ` 10 units	10,00,000
Profit and Loss Account balance	2,17,000
Proposed ordinary stock Dividend for 1996, net	86,250
Trade Investments	20,000
Advance payment of Tax	1,00,000
Provision for Taxation	2,64,000
Bills Payable	18,000
Net Sales for the year 1996	21,82,400
Net Profit for the year 1996 before taxation and dividends	3,27,830

Note : The values of all fixed assets reflect current price levels and adequate depreciation has been provided.

You are required :

(i) to arrange the above items in the form of a financial statement to show the following accounting ratios, which should be stated : (a) return on capital employed, (b) stock : fixed assets, (c) current assets: current liabilities; (d) sales : debtors and bills receivable;

(ii) to indicate briefly the significance of these ratios and how they may be used to compare the efficiency of the business with others in the same industry.

[**Ans.** Ratios (a) ROI on shareholder's funds in 24.9 per cent, (b) 1 : 4.93, (c) 1.25 : 1, (d) 4 : 1]

[**Hints :** Working Capital ` 2,03,000; Shareholder's Equity `13,17,000]

10. India International Limited has been in existence for two years. The following particulars are extracted from its published accounts.

BALANCE SHEET
as on 31st December, 1998

Liabilities	First Year	Second Year	Assets	First Year	Second year
	`		`	`	
Equity Capital	1,00,000	1,00,000	Fixed Assets	2,08,000	1,98,000
Reserve	10,000	20,000	Stock	30,000	60,000
Profit & Loss A/c	14,000	2,000	Book Debts	40,000	80,000
Loan	1,10,000	80,000	Cash at Bank	30,000	2,000
Bank Overdraft	–	20,000			
Creditors	30,000	90,000			
Provision for Taxation	34,000	13,000			
Proposed Dividend	10,000	15,000			
	3,08,000	3,40,000		3,08,000	3,40,000

PROFIT AND LOSS ACCOUNT

Particulars	`	`	Particulars	`	`
Interest on Loan	2,400	4,800	Balance b/d		14,000
Directors' Remuneration	10,000	30,000	Profit for the year	80,400	60,800
Provision for Taxation	34,000	13,000			
Dividend		15,000			
Transfer to Reserve	10,000	10,000			
Balance c/d	14,000	2,000			
Total	80,400	74,800		80,400	74,800

Sales amounted `6,00,000 in the first year and `5,00,000 in the second year. Examine in detail from the point of (i) Profitability, (ii) Solvency and (iii) Sales. Make such other computations as seen expedient to you and write on overall internal analysis of this company.

[**Ans.**	1st Year	2nd Year
Net Profit Ratio	11.73%	6.16%
ROI (based on Capital at end)	30.08%	15.25%
Current Ratio	1.35	1.03
Stock Turnover	20	8.33
Debtors Turnover	15	6.25]

11. On the basis of the following figures derived from the accounts of a company, prepare a report on the level of efficiency of financial and operational management of the company.

Years	Capital Turnover Ratio	Net Profit On Sales (%)	ROI (%)	Current Ratio
1	1.0	8	8	6.0
2	2.0	10	20	4.0
3	3.0	11.5	34.5	2.0
4	5.0	13	65	0.5

12. The profit and loss and balance sheet of Happy Ltd. is given beloiw :

P & L Account for the year ended 31st March, 1997

	`		`
To Opening stock	90,000	By Sales	9,00,000
To Purchases	5,60,000	By Closing stock	90,000
To Wages	2,14,000		
To Gross profit	1,26,000		
	9,90,000		9,90,000
To Salaries	16,000	By Gross profit	1,26,000
To Electricity	10,000		
To Miscellaneous expenses	10,000		
To Depreciation	30,000		
To Net profit	60,000		
	1,26,000		1,26,000

Balance Sheet as on 31.3.1997

	`			`
Share capital :		Fixed assets	5,40,000	
Equity shares	1,80,000	Less : Depreciation	1,50,000	3,90,000
Reserve and surplus	1,20,000			
Secured loans	2,10,000	Current assets :		
		Stock	90,000	
Current liabilities :		Sundry debtors	1,05,000	
Sundry creditors	90,000	Cash	15,000	2,10,000
	6,00,000			6,00,000

Discuss under the following important functional groupings the usual ratios and comment on the financial strength of the company :

(i) Liquidity and solvency test ratios;

(ii) Profitability test ratios, and

(iii) Overall measures ratios.

13. Prepare Balance Sheet and Profit and Loss Account from the following information :

	`
Capital	4,00,000
Working capital	1,80,000
Bank overdraft	30,000

There is no fictitious asset. Current assets contain only stock, debtors and cash. The following additional data is also available :

(i) Closing stock is 20% higher than opening stock

(ii) Current ratio -2.5

(iii) Quick ratio -2.0

(iv) Proprietary ratio -0.6 (Fixed assets : Proprietary fund)

(v) Gross profit ratio -20% (of sales)

(vi) Stock velocity -5

(vii) Debtor's velocity -73 days

(viii) Net profit ratio -10% (to average capital employed).

14. The following are the summarised profit and loss account and balance sheet of Waldo company Limited for the year ending 31 st March, 1997..

Profit and Loss Account

	`		`
To Opening stock	9,950	By Sales	85,000
To Purchases	54,525	By Closing stock	14,900
To Incidental	1, 425		
To Gross profit	34,000		
	99,900		99,000
To Operating expenses :		By Gross profit	34,000
Selling and distribution	3,000	By Non-operating	
Administration	16,5000	income -interest	300
To Non-operating expenses :		By profit on sale of shares	600
Loss on sale of assets	400		
To Net Profit	15,000		
	34,900		34,900

Balance Sheet

Issued Capital		Land and building	15,000
2,000 equity shares of		Plant and machinery	8,000
` 10 each	20,000	Stock in trade	14,900
Reserves	9,000	Sundry debtors	7,100
Profit and loss account	6,000	Cash and bank balance	3,000
Current liabilities	13,000		
	48,000		48,000

Your are required to calculate :

(a) Current ratio

(b) Operating ratio

(c) Stock turnover ratio

(d) Return on total resources.

(e) Turnover of fixed assets.

11.18 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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CHPTER – 12 CHSH FLOW STATEMENT

Chapter Outlines

12.0 INTRODUCTION

In a competitive market it is important for a company to generate sufficient cash for its survival. The liability to earn profits may not be enough to maintain solvency and goodwill of business. The commitment of a company to various parties can be ensured if there is adequate flow of cash and cash equivalents during the years. For this purpose a financial statement known as cash flow statement (C/F Statement) is prepared every year to ascertain the flow of cash and cash equivalent during a particular accounting period.

Cash flow statement analyse or explains the reasons for changes in balance of cash between the dates of two balance sheets. This document includes only those items which are responsible or which affects cash. This document helps the management of cash in cases of (a) Deficiency or Shortage (b) Surplus during the period.

12.1 LEARNING OBJECTIVES

After going through this unit, you should be able to :

- Explain the meaning of cash flow statement.
- Understand the concept of funds in cash flow analysis.
- Identify the sources and applications of cash.
- Differentiate between cash flow analysis and funds flow analysis.
- Explain the utility and limitations of cash flow analysis.
- Prepare cash flow statement.

12.2 MEANING OF CASH FLOW

It means inflow or outflow of cash or cash equivalent during the given specified period. This flow (Inflow or Outflow) is divided into three parts under AS-3 (Revised). These are :

1. Operating Activities
2. Investing Activities
3. Financing Activities

Operating Activities

These are related to Sales and Purchases. Operating activities are the main revenue producing activities of any business organisation.

Investing Activities

These activities are related to purchase and sale of Fixed Assets (long term assets) or productive assets and other Investment. These activities help to generate future income (profits) and cash flow.

Financing Activities

Those activities which relates to change in owners capital and borrowing of the business enterprise.

12.3 PROCEDURE OF PREPARING CASH FLOW STATEMENT

Mandatory (Compulsory) Preparing of Cash Flow Statement:

As per the notification of ICAI (Institute of Chartered Accountants of India) preparing Cash Flow Statement as per AS-3 (Revised) it is mandatory in case of following companies w.e.f. 1.4.2001.

(i) Companies whose Equity or Debt Securities are listed on a Recognised Stock Exchange in India.

(ii) All other Commercial, Industrial and Business Enterprises whose turnover for the accounting period is more than ` 50 crores.

As per AS-3 (Revised) a cash flow statement is inflow and outflow of cash. It is to be divided into following three categories as per the given order :

(a) Operating Activities

(b) Investing Activities

(c) Financing Activities

The information will establish the relationship among these three activities.

(A) Cash Flow from Operating Activities:

These activities are related to purchases and sales of goods and are main revenue generating items resulting into net profit or loss of organisation (unit).

These items may be :

1. Cash receipts from sale of goods and services (like transport, communication, health, services etc.
2. Cash receipts from royalty, fees, commission and other revenues.
3. Cash receipts from Debtors and B/R.
4. Cash payments to workers and employees like wages, salaries and various other payments.
5. Cash payments for purchase of goods and services.
6. Cash payments to creditors and B.P.
7. Cash payments or refunds of income tax unless and until these are specifically mentioned for investing or financing activities.

Note : In case of Financial Company like Banks, Insurance and Mutual funds the operating activities includes :

(a) Cash receipts and cash payments for policy premiums and claims, annuties and other policy benefits.

(b) Cash advances and loans made by Banks and Financial Institutions as these are the main operating activities for the banks.

(c) Purchase and sale of shares and other securities and other related activities.

(d) Interest paid and interest received.

(e) Dividend paid and Dividend received are also operating activities for these type of enterprises.

Note :

Thus, it is very very important to keep in mind whether the enterprise for which cash flow statement is prepared, is a Trading, Manufacturing, Service Provider, Financial or Real Estate Business.

(B) Cash from Investing Acivities :

These activities are related to purchase and sale of Fixed Assets (long term assets) or productive assets and other Investment. These activities help to generate future income (profits) and cash flow. These activities as per AS- 3 (Revised) includes :

1. Cash payments to purchase fixed assets including intangible assets (Goodwill, Patents, Copyrights or Trade mark etc.)
2. Cash receipts from sale of fixed assets including intangible assets.
3. Cash payments to purchase Shares, Warrants, Debentures of other companies (excluding those instruments included in cash equivalent).
4. Cash receipts from sale of shares, warrants or Debt Instruments (Excluding those Instruments included in cash Equivalent).
5. Cash advances and loans made to third parties (in case of financial companies these items are taken as operating activities).
6. Cash receipts from repayment of loans and advances by third parties (in case of financial companies these are included in operating activities).
7. Cash receipts of insurance claim for property involved in accidents.
8. Cash receipts of dividends and interest on investment in shares and debt instruments. (in case of financial company these will be included in operating activities.
9. Cash receipts from future contract and forward contract.
10. Cash payments for future contract and forward contract.

(C) Cash Flow from Financing Activities:

Those activities which relates to change in owners capital and borrowing of the business enterprise. Examples may be Share Capital, Debentures, Mortgage Loan and Other Loans.

As per AS-3 (Revised) the following items are included in this activity.

1. Cash receipts (Net amount) from issuing shares or other similar instruments.
2. Cash receipts from issuing debentures, loans, notes, bonds and other short-term or long-term borrowings.
3. Cash payments for Buy-back of equity shares.
4. Cash payments of amount borrowed.
5. Cash payment for redemption of the redeemable preference shares or redemption of debentures, bonds, bank loans or mortgages.
6. Cash payments of dividends on Equity and Preference shares.
7. Cash payments for interest on long-term borrowing (Debentures, Loans, Mortgages or Borrowings).
8. Cash payments for Share Issue Expenses and Preliminary Expenses, etc.

Classification of Activities for the purpose of Cash Flow Statement :

Illustration - 12.1 :

Classify the following activities as : (i) Operating Activities, (ii) Investing Activities, (iii) Financing Activities in case of (a) manufacturing enterprise, (b) a financial enterprise.

1. Purchase of Investments.
2. Receipt of interest on loan and advances made to third parties.
3. Brokerage paid on purchase and sale of investments.
4. Receipts from the repayments of loan and advances made to third parties.
5. Interest received on Debentures held as Investments.
6. Loan and advances made to third parties.
7. Proceeds from Sale of Investments.
8. Dividend received on shares held as Investments.

Solution:

(a) In case of a Manufacturing Enterprise, all the given activities are Investing Activities since they are related to acquisition and disposal of long-term assets.

(b) In case of a Financial Enterprise, all the given activities are Operating Activities since they are related to the main revenue producing activities of the enterprise.

Illustration - 12.2:

Classify the following activities as : (i) Operating Activities, (ii) Investing Activities, (iii) Financing Activities in case of (a) manufacturing enterprise, (b) a Real Estate enterprise.

1. Purchase of Land.
2. Payment of Construction Cost of a Building.
3. Purchase of Building.
4. Sale of Building.
5. Sale of Land.
6. Brokerage paid on purchase and sale of Land and Building.
7. Rent received from a Building.

Solution :

(a) In case of a Manufacturing Enterprise, all the given activities are Investing Activities since they are related to acquisition and disposal of long term assets.

(b) In case of a Real Estate Enterprise, all the given activities are Operating Activities since they are related to the main revenue producing activities of the enterprise.

Illustration - 12.3:

(i) Give one example of an activity which is classified as Operating Activity in case of all enterprises.

Ans. Payments made to employees.

(ii) Give one example of an activity which is classified as Investing Activity in case of all enterprises.

Ans. Purchase of Goodwill.

(iii) Give one example of an activity which is classified as Financing Activity in case of all enterprises.

Ans. Payment of dividend on shares.

(iv) Give two examples of an activity which is classified as Operating in case of one enterprises and investing in case of another enterprise.

Ans. (a) Purchase of shares of other companies and

(b) Receipt of dividend on shares by a manufacturing enterprise are investing activities since these relate to the acquisition of long term assets but are operating activities in case of a financial enterprise since these relate to the main revenue producing activity of the enterprise.

Format of Cash Flow Statement:

Cash Flow Statement of .... Ltd.

for the year ended .... (Direct Method)

Particulars	`	`
A. Cash flow from / Used in Operating Activities		
Cash sales		
Cash Collection from Debtors		
Cash purchases		
Cash paid to Suppliers		
Payment of Expenses		
Cash Generated from Operating Activities		
Income Tax paid / Refund		
Cash Flow before Extra ordinary Items		
(+) or (–) Extra ordinary Receipts/Payments		
Net Cash Flow from / (used in) Operating Activities (A)		xxx
B. Cash Flow from / Used in Investing Activities		
Proceeds from sale of Fixed Assets		
Proceeds from sale of Investments		

Proceeds from sale of Patents/Trademark/Copyrights	
Rent / Dividend / Interest / Received	
Purchase of Fixed Assets	
Purchase of Investments	
Purchase of Intangible Assets	
Net Cash Flow from / (used in) Investing Activities (B)	xxx
C. Cash Flow from / Used in Financing Activities	
Proceeds from Issue of Shares	
Proceeds from Issue of Debenture	
Redemption of Preference Shares	
Redemption of Debentures	
Repayment of Borrowings	
Interest / Dividend paid	
Net Cash Flow from / (used in) Financing Activities (A)	xxx
D. Net increase (Decrease) in Cash and Cash Equivalents (A + B + C)	xxx
E. Add : Cash and Cash equivalents at the beginning of the period	xxx
F. Cash and Cash Equivalents at the end of the Period (D + E)	xxx

Cash Flow Statement of .... Ltd.

for the year ended .... (Indirect Method)

Particulars	`	`
1. Cash flow from Operating Activities		
A. Net profit as per P&L A/c or Difference between Closing and Opening Balance of Statement of P&L.		
Add: Proposed Dividend for the current year.		
Add: Interim Dividend paid during the current year.		
Add: Transfer to Reserve.		
Add: Provision for Tax made during the year.		
Less: Refund of Tax credited to Statement of P&L.		
Less: Extra-ordinary items credited to Statement of P&L.		
A. Net Profit Before Taxation and Extra-ordinary items		
B. Add : Items to be added (Non-cash and Non-operating expenses)		
Depreciation		
Interest on Borrowings		
Preliminary Expenses / Under writing Commission / Discount on Issue of Debentures / Shares Written off		
Goodwill / Patents / Trademarks / Copyrights Amortised		
Loss on Sale of Fixed Assets, Investments, etc.		
Premium payable on Redemption of Preference Shares / Debentures.		
C. Less : Items to be deducted (Non-cash and Non-operating income)		
Interest / Dividend / Rent Received		
Profit on Sale of Fixed Assets, Investment, etc.		
D. Operating Profit before Working Capital Changes (A + B + C).		
E. Add : Decrease in Current Assets and Decrease in Current Liabilities. (Fall in Net WorkingCapital)		

F.	Less : Increase in Current Assets and Decrease in Current Liabilities. (Rise in Net Working Capital)	
G.	Cash Generated from Operations (D + E – F)	
H.	Less : Income Tax Paid / Add: Refund	
I.	Cash Flow before Extra ordinary items (G ± H)	
J.	Extra ordinary items (Receipt / Payment)	
K.	Net Cash flow from / (used in) Operating Activities (I ± J)	xxx
	II. Cash Flow from / Used in Investing Activities.	
	Proceeds from sale of Fixed Assets	
	Proceeds from sale of Investments	
	Proceeds from sale of Patents/Trademark/Copyrights	
	Rent / Dividend / Interest / Received	
	Purchase of Fixed Assets	
	Purchase of Investments	
	Purchase of Intangible Assets	
	Net Cash Flow from / (used in) Investing Activities	xxx
	III. Cash Flow from / Used in Financing Activities	
	Proceeds from Issue of Shares	
	Proceeds from Issue of Debenture	
	Redemption of Preference Shares	
	Redemption of Debentures	
	Repayment of Borrowings	
	Interest / Dividend paid	
	Net Cash Flow from / (used in) Financing Activities	xxx
	IV. Net increase (Decrease) in Cash and Cash Equivalents (I + II + III)	xxx
	V. Add : Cash and Cash equivalents at the beginning of the period	xxx
	VI. Cash and Cash Equivalents at the end of the Period (IV + V)	xxx

Note : In both the methods, Cash Flow from Investing Activities and Financing Activities are same.

Miscellaneous Illustrations

Illustration - 12.4 :

Calculate Cash from Operating Activities from the following :

Particulars	Amount (`)
Net Loss after adjustment	1,00,000
Depreciation	30,000
Preliminary expenses written of	7,000
Goodwill written off	10,000
Provision for Doubtful Debts	5,000
Commission accrued	14,000
Dividend Received	24,000
Outstanding Wages	9,000

Solution :Calculation of Cash from Operating Activities

Particulars	Amount (`)	Amount (`)
Net Loss :		(1,00,000)

Add : Depreciation	30,000	
Provision for Doubtful Debts	5,000	
Preliminary expenses written off	7,000	
Goodwill written off	10,000	
Outstanding Wages	9,000	61,000
		(39,000)
Less : Dividend Received	24,000	
Commission accrued	14,000	38,000
Fund lost in Operation		**(77,000)**

Illustration - 12.5 :

Calculate Cash from Operating Activities from the following :

Particulars	31st March, 2015 (`)	31st March, 2016 (`)
Statement of Profit and Loss	1,45,000	2,99,000
General Reserve	70,000	1,00,000
Workmen Compensation Fund	50,000	30,000
Goodwill	1,40,000	1,25,000
Discount on Issue of Debentures	40,000	30,000
Stock	50,000	64,000
Debtors	42,000	30,000
Outstanding salaries	11,000	70,000
Sundry Creditors	24,000	33,000
Bills payable	12,000	15,000

Solution :

Calculation of Cash from Operating Activities

Particulars	Amount (`)	Amount (`)
Closing Balance of Statement of Profit and Loss		2,09,000
Opening Balance of Statement of Profit and Loss		1,45,000
Net profit for the year		64,000
Add : Provision for General Reserve (1,00,000 – 70,000)	30,000	
Goodwill Written off (1,40,000) – 1,25,00)	15,000	
Discount of issue of Debentures written off (40,000 – 30,000)	10,000	55,000
		1,19,000
Less : Reduction of Workmen Compensation fund (50,000 – 30,000)		20,000
Fund from Operations		99,000
Add : Increase in Current Liabilities :		
Sundry Creditor (33,000 – 24,000)	9,000	
Bills Payable (15,000 – 12,000)	3,000	
Decrease in Current Asset :		
Debtors (42, 000 – 30,000)	12,000	24,000
		1,23,000
Less : Increase in Current Assets		
Stock (64,000 – 50,000)	14,000	
Decrease in Current Liabilities :		
Outstanding salary (11,000 – 7,000)	4,000	18,000

Cash from Operations	1,05,000

Illustration - 12.6 :

Calculate Cash from Investing Activities from the following :

Particulars	31st March, 2015 (`)	31st March, 2016 (`)
Plant and Machinery Account	5,00,000	5,40,000
Accumulated Depreciation Account	70,000	95,000
Investment Account	3,00,000,	2,60,000

During the year a machine worth of `50,000 was solf for `65,000. Accumulated depreciation of the machine is ` 10,000. Loss on sale of investment is `7,000.

Solution:

Calculation of Cash from Investing Activities

Particulars	(`)
Cash flow for Plant Machinery	
Sale of Machinery	65,000
Purchase of Machinery	90,000
Net Cash Outflow	(25,000)
Cash flow from sale of Investment (3,00,000 – 2,60,000 – 7,000)	33,000
Net cash inflow from Investing Activities	8,000

The treatment of Plant and Machinery Account is stated as follows .

Dr. Plant and Machinery Account Cr.

Particular	`	Particulars	`
To Balance b/d	5,00,000	By Accumulated Depreciation A/c	10,000
To Adjusted P&L (Profit on Sale)	25,000	By Cash A/c (States)	65,000
To Cash Purchase (B/F)	90,000	By Balance c/d	5,40,000
	6,15,000		6,15,000

Dr. Accumulated Depreciation Account Cr.

Particulars	`	Particulars	`
To Plant and Machinery Account	10,000	By Balance b/d	70,000
To Balance c/d	95,000	By Profit and Loss A/c	35,000
	1,05,000		1,05,000

Illustration - 12.7 :

Calculate Cash from Financing Activities from the following :

Particulars	31st March, 2015 (`)	31st March, 2016 (`)
Preference Share Capital	5,00,000,	7,00,000
Debentures	3,00,000,	2,00,000
Loan	2,50,000,	3,25,000

Solution :

Calculation of Cash from from Financing Activities

Particulars	(`)
Inflow :	
Issue of preference share capital (7,00,000 – 5,00,000)	2,00,000
Raising of Loan (3,25,000 – 2,50,000)	75,000
	2,75,000
Outflow :	
Redemption of Debentures (3,00,000 – 2,00,000)	1,00,000

Cash flow from Financing Activities	1,75,000

Illustration - 12.8 :

X Ltd. provides the following information and calculate net cash flows from financing activities.

Particulars	31st March, 2015 (`)	31st March, 2016 (`)
Equity Share Capital	5,00,000	6,00,000
14% Debentures	1,00,000	–
12% Debentures	–	2,00,000

Additional information :

1. Interest paid on debentures ` 14,000.
2. Dividend paid ` 50,000.
3. During the year 2016, X Ltd. Issued bonus shares in the ratio of 5 : 1 by capitalizing reserves.

Solution :

Calculation of Net Cash flows from Financing Activities

Particulars	Amount (`)	Amount (`)
Cash proceeds from the issue of 12% Debentures	–	2,00,000
Cash proceeds from equity shares		1,00,000
Cash payment of 14% Debentures	–	(1,00,000)
Interest paid	(14,000)	–
Dividends paid	(50,000)	(64,000)
Net cash flows from Operating Activities		1,36,000

Note : Bonus share will not be shown in the Cash Flow Statement because there will be no cash inflow.

Illustration - 12.9 :

From the following Balance Sheets, prepare cash flow statement of A & Co. Ltd. :

Particulars	Note No.	31st March, 2015 (`)	31st March, 2016 (`)
I. Equity and Liabilities			
1. Shareholders' Funds			
(a) Share capital			
Equity Share Capital		4,05,000	5,72,500
12% Preference Share Capital		2,70,000	1,35,000
(b) Reserves and Surplus		1,48,000	3,64,000
2. Non-Current Liabilities			
(a) Long term Borrowings (14% Debentures)		1,35,000	2,70,000
3. Current Liabilities (1,08,000)		1,08,000	2,16,000
Total		10,66,500	15,58,000
II. Assets			
1. Non-Current Assets			
(a) Fixed Assets :			
Tangible		6,88,500	8,37,000
(b) Non-Current Investment		40,000	1,08,000
2. Current Assets			
Other current assets		2,70,000	4,05,000
Discount on issue of debentures		13,500	6,750
Cash		54,000	2,01,250
Total		10,66,500	15,58,000

Additional information:

1. Depreciation charged on fixed assets was ` 81,000.
2. An interim dividend of 15% was paid on equity shares. Additional shares was issued on 31.03.2016.
3. Preference shares were redeemed at a premium of 15%.
4. Fixed assets with a book value of `54,000 were sold at ` 33,750 on April 1, 2015.
5. Preference dividend paid during the year `32,400.
6. Debentures interest paid during the year `18,900.

Solution:

A & Co. Ltd Cash Flow Statement for the year ended 31st March. 2016

Particulars	Amount (`)	Amount (`)
Cash Flows from Operating Activities		
Net Profit (` 3,64,000 – `1,48,500	2,16,000	
Add :		
Depreciation of Fixed Assets	81,000	
Loss on Sale of Fixed Assets (Note 1)	20,250	
Premium on redemption of preference shares (Note 3)	20,250	
Discount on Issue of Debentures	6,750	
Preference Dividend paid	32,400	
Interest on Debentures paid	18,900	
Interim Dividend	60,750	
Cash generated from Operations before Working Capital Changes	4,56,300	
Increase in Other Current Assets (4,05,000 – 2,70,000)	(1,35,000)	
Increase in Current Liabilities (2,16,000 – 1,08,000)	1,08,000	
Net cash flow from Operating Activities (A)		4,29,300
Cash Flows from Investing Activities		
Cash payment to acquire Fixed Assets (Note - 1)	(2,83,500)	
Cash receipts from sale of Fixed Assets	33,750	
Cash payment to acquire investments	(67,500)	
Net cash used in Investing Activities (B)		(3,17,250)
Cash Flows from Financing Activities		
Cash proceeds from Issue of Shares	1,67,500	
Cash proceeds from Issue of Debentures	1,35,000	
Cash paid for redemption of Preference Shares (Note - 2)	(1,55,250)	
Interim Dividend paid	(60,750)	
Preference Dividend paid	(32,400)	
Interest on Debentures paid	(18,900)	
Net Cash from Financing Activities (C)		35,200
Net Increase in Cash and Cash Equivalents (A + B + C)		1,47,250
Add : Cash and Cash Equivalents in the beginning		54,000
Cash and Cash Equivalents at the end of the Period		2,01,250

Working Notes:

(1) Dr. Fixed Assets Account Cr.

Date	Particulars	`	Date	Particulars	`
2015			2015		
Apr. 1	To Balance b/d	6,88,500	Apr. 1	By Bank A/c	33,750
	To Bank A/c (Purchased) B/F	2,83,000		By Profit and Loss Acc. (Loss)	20,250
			2016		
			Mar. 31	By Depreciation A/c	81,000
				By Balance c/d	8,37,000
		9,72,000			9,72,000

(2) Dr. 12% Preference Share Capital Account Cr.

Date	Particulars	`	Date	Particulars	`
31.3.16	To Bank A/c (` 1,35,000 + ` 20,250)	1,55,000	1.4.15	By Balance c/d	2,70,000
31.3.16	To Balance c/d	1,35,000		By Premium on Redemption [15% (2,70,000 – 1,35,000)]	20,250
		2,90,250			2,90,250

(3) Premium paid on redemption of preference shares was charged against Statement of Profit and Loss at the time of calculating profit. Therefore, it will be added back to calculate cash flows from operating activities.

Illustration - 12.10:

From the following details relating to the accounts of Sourav Ltd.

Credit Balances	31.3.17	31.3.16	Debit Balances	31.3.17	31.12.16
Share Capital	10,00,000	8,00,000	Plant and Machinery	7,00,000	5,00,000
Reserve	2,00,000	1,50,000	Land and Building	6,00,500	4,00,000
Statement of Profit & Loss	1,00,000	60,000	Investments	1,00,000	–
Debentures	2,00,000	–	Sundry Debtors	5,00,000	7,00,000
Provision for Taxation	1,00,000	70,000	Stock	4,00,000	2,00,000
Proposed Dividend	2,00,000	1,00,000	Cash in Hand/Bank	2,00,000	2,00,000
Sundry Creditors	7,00,000	8,20,000			
	25,00,000	20,00,000		25,00,000	25,00,000

1. Depreciation @ 25% was charged on the opening value of Plant and Machinery.
2. During the year one old machine costing ` 50,000 (WDV `20,000) was sold for ` 35,000.
3. ` 50,000 was paid towards income tax during the year.
4. Building under construction was not subject to any depreciation.

Prepare Cash Flow Statement.

Solution:

Sourav Ltd. Cash Flow Statement for the year ended 31st March. 2017

Particulars	Amount (`)	Amount (`)
Cash Flows from Operating Activities		
Net Profit (` 1,00,000 – ` 60,000	40,000	
Add Back :		
Transfer to Reserve	50,000	
Provision for Taxation (Note - 1)	80,000	
Proposed Dividend (Note - 3)	2,00,000	
Depreciation Written off	1,25,000	
	4,95,000	

Less : Profit on Sale of Machinery (Note - 4)	15,000	
Cash generated from Operations before Working Capital Changes	4,80,000	
Decrease in Debtors	2,00,000	
Increase in Stock	(2,00,000)	
Decrease in Creditors	(1,20,000)	
Cash Generated from Operations	3,60,000	
Income Tax paid	(50,000)	
Net Cash from Operating Activities (A)		3,10,000
Cash Flows from Investing Activities		
Purchase of Plant and Machinery	(3,45,000)	
Addition to Building	(2,00,000)	
Purchase of Investment	(1,00,000)	
Sale of Old Machine	35,000	
Net cash used in Investing Activities (B)		(6,10,000)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares	2,00,000	
Proceeds from Issue of Debentures (Note - 5)	2,00,000	
Dividends paid (Note - 3)	(1,00,000)	
Net Cash from Financing Activities (C)		3,00,000
Net Increase in Cash and Cash Equivalents		Nil
Add: Cash and Cash Equivalents in the beginning of the period		2,00,000
Cash and Cash Equivalents at the end of the Period		2,00,000

(1) Provision for Taxation Account

Date	Particulars	`	Date	Particulars	`
	To Cash A/c	50,000	1.4.2016	By Balance b/d	70,000
31.3.17	To Balance c/d	1,00,000	31.3.2017	By Statement of Profit & Loss (B/F)	80,000
		1,50,000			1,50,000

(2) Plant and Machinery Account

Date	Particulars	`	Date	Particulars	`
1.4.2016	To Balance b/d	5,00,000	31.3.2017	By Depreciation A/c	1,25,000
31.3.2017	To Profit on Sale of Machinery A/c	15,000		By Cash A/c (Sale of Machinery)	
	To Cash A/c (B/F)	3,45,000		By Balance c/d	7,00,000
		8,60,000			8,60,000

3. It is assumed that proposed dividend of 2015-16 was paid in 2016-17. Dividend proposed for 2016-17 was debited to Statement of Profit and Loss ` 2,00,000.

4. Profit on Sale of Machinery = (` 35,000 – ` 20,000) = ` 15,000.

5. It is assumed that no interest has been paid for new debentures issued.

Illustration - 12.11:

Following are the liabilities and assets of

PVC. Ltd. as on 31st March 2016 and 2017

Particulars	Note No.	31.03. 2016 (`)	31.03.2017 (`)
I. Equity and Liabilities			
1. Shareholders' Funds			
(a) Share capital		2,00,000	2,50,000
(b) Reserves and Surplus:			
General Reserve		50,000	60,000
Surplus A/c		30,500	30,600
2. Non-Current Liabilities			
(a) Long term Borrowings (Bank Loan)		70,000	–
3. Current Liabilities			
(a) Sundry Creditors		1,50,000	1,35,200
(b) Short term Provisions (Provision for Taxation)		30,000	35,000
Total		5,30,500	5,10,800
II. Assets			
1. Non-Current Assets			
(a) Fixed Assets :			
Land and Building		2,00,000	1,90,000
Machinery		1,50,000	1,69,000
Goodwill		–	5,000
2. Current Assets			
Stock		1,00,000	74,000
Sundry Debtors		80,000	64,200
Cash		500	800
Bank		–	7,800
Total		5,30,500	5,10,800

Additional information:

During the year ended 31st March, 2017.

(i) Dividend of ` 23,000 was paid.

(ii) Assets of another company were purchased for a consideration of `50,000 payable in shares. Following assets were purchased:

Stock: `20,000; Machinery `25,000;

(iii) Machinery was further purchased for ` 8,000.

(iv) Depreciation written off on machinery `12,000; and

(v) Income tax provided during the year ` 33,000; Loss on the sale of machinery ` 200 was written of against general reserve.

You are required to make the Statement of Cash Flow by Indirect Method.

Solution :

Cash Flow Statement for the year ended 31st March, 2017

Particulars		Amount (`)	Amount (`)
(A)	Cash Flows from Operating Activities:		
	Net Income before tax and extra-ordinary items (Note - 1)	66,300	
	Adjustment for Depreciation [(12,000 + 10,000 (Land& Building)]	22,000	

	Operating profit before working capital changes	88,300	
	Decrease in Stock (1,20,000 – 74,000)	46,000	
	Decrease in Debtors	15,800	
	Decrease in Sundry Creditors	(14,800)	
	Payment of Tax (Note - 3)	(28,000)	
	Net cash used in Operating Activities (A)		1,07,300
(B)	**Cash Flows from Investing Activities**		
	Sale of Machine	1,8000	
	Purchase of Machinery for Cash (Note - 2)	(8,000)	
	Net cash used in Investing Activities (B)		(6,200)
(C)	**Cash Flows from Financing Activities**		
	Payment of Bank Loan	(70,000)	
	Payment of Dividend	(23,000)	
	Net Cash from Financing Activities (C)		(93,000)
	Net changes in Cash and Cash Equivalents (a + b + c)		8,100
	Cash and Cash Equivalents as 31.3.2016		500
	Cash and Cash Equivalents as on 31.3.2017		8,600

Working Notes :

Adjusted Surplus A/c

Particulars	`	Particulars	`
To General Reserve	10,200	By Profit before tax and extra-ordinary items	66,300
To Profit & Loss (` 30,600 – ` 30,500)	100		
To Provision for Taxation	33,000		
To Dividend	23,000		
	66,300		66,300

Machinery A/c

Particulars	`	Particulars	`
To Balance b/d	1,50,000	By General Reserve	200
To Share Capital	25,000	By Depreciation	12,000
To Cash	8,000	By Cash (Sale of Machine) B/F	1,800
		By Balance c/d	1,69,000
	1,83,000		1,83,000

Provision for Taxation A/c

Particulars	`	Particulars	`
To Bank (Tax paid) B/F	28,000	By Balance b/d	30,000
To Balance c/d	35,000	By Adjusted Surplus A/c	33,000
	63,000		63,000

Share Capital A/c

Particulars	`	Particulars	`
To Balance c/d	2,50,000	By Balance b/d	2,00,000
		By Stock	20,000
		By Machinery	25,000
		By Goodwill	5,000
	2,50,000		2,50,000

12.4 Difference between Cash Flow Statement and Funds Flow Statement :

o.	Basis	Cash Flow Statement	Funds Flow Statement
1.	Disclosure	It discloses the inflow and outflow of cash and cash equivalents under the heading of operating. Investing and Financing activities.	It discloses the magnitude, direction and changes of net working capital.
2.	Basis of accounting	It is prepared under cash basis.	It is prepared under accrual basis.
3.	Usefulness/Range of financial planning	It is for short term planning.	It is for long term planning.
4.	Distinct Heading	Inflows and outflows of cash under three distinct headings - Operating, Investing and Financing activities.	It shows sources and applications of funds without any heading.
5.	Prescribed format	It is prepared as per prescribed format of AS-3 (revised).	There is no such prescribed format.
6.	Scope	It's scope is narrow as only cash and cash equivalents are considered.	It's scope is wide as the concept of fund is net working capital i.e., total current assets minus total current liabilities.
7.	Changes of working capital	It shows the changes in working capital more clearly.	It shows the changes of working capital at a glance.

12.5 UTILITY / USES, IMPORTANCE OR SIGNIFICANCE OF CASH FLOW STATEMENT

The main uses and importance of cash flow statement can be summarised as follows:

1. **Evaluation of Liquidity Position :** This statement helps to analyse whether short period liabilities like creditors, bank overdrafts, B/P, O/S expenses can be paid easily with the regular receipts (Inflow) of cash or not. There should be balance in inflow and outflow to keep liquidity and smooth working conditions in business.
2. **Comparison in Intra-firm and Inter-firm:** With the help of cash flow statement, intra firm (within the firm) and inter firm (with other firms) can be carried out to know whether the liquidity position is improving or deteriorating over the period of time.
3. **Arrangement of Future Needs:** The requirement of cash and availability of cash can be calculated easily after a specified period regularly to know deficit or surplus of cash to make timely arrangement.
4. **Cash Generated by various Activities Separately:** Cash flow statement is divided into three separate activities and cash generated by each activity, there may be positive or negative generation of cash by any of the activity but in the end total of all these three activities shows the ultimate cash position. These activities are (a) Operating (b) Investing (c) Financing.
5. **Calculation of the Position of Repayments of Liabilities on Time:** Cash flow statement helps to find out whether the business has sufficient cash to pay or plan to pay its liabilities and fulfill its other needs like (a) Repayment of loans (b) funds for replacement of plant, machinery, vehicles or other fixed assets or not on time.
6. **Useful to Outsiders :** Cash flow statement is very useful to outsiders like Bankers, Investors, Lenders, Debenture-holders, Creditors to judge and analyse the long-term as well as short-term liquidity and cash position of the business and taking decisions regarding financial position.
7. **It Provides Test for Managerial Decision:** For the long-term success of the business and generating higher profits, the most important rule for the management should be "Maximum Fixed Assets should be purchased from funds generated from long-term sources of funds like (a) Shares (b) Debenture (c) Mortgages (d) Ploughing back of profits etc. and these liabilities should be repaid out of cash generated from operating activities of the business.

8. **Explains Causes of Change in Cash:** Cash flow statement explains the reasons for change or deviation in cash or cash equivalent between the two Balance Sheets which provide useful tips and reasons for change in cash over the period.
9. **Explanation Regarding Net Profit and Cash Balance:** Sometime a very funny position arises in the organisation like profits are very high while each balance is very very low even there may be situation that cash is not sufficient to pay salary bill, or power bill or for purchase of raw material. On the other hand sometimes profits are very low but large amount of cash balance either in hand or in bank. The reason for this situation may be issuing shares, raising loans or selling fixed assets etc.
10. **Working Capital and Operating Activities Relation:** The success of the business lies in the fact that maximum needs of the working capital should be fulfilled through the cash flow from operating activities. Funds from long period sources should be used for fixed assets and other profit generating activities to provide strength/ stability, soundness and liquidity to business.
11. **Dividend Payment and Cash Resources:** Regular payment of dividend is a positive sign of growing and progressive business year by year. Payment of dividend increases Goodwill, Credibility among investors and better public image of organisation as well as of management. But these dividends should be paid out of the profits and reserves and not from borrowed funds or funds raised on sale of fixed assets.

12.6 LIMITATIONS OF CASH FLOW STATEMENT

These can be summarised as follows:

1. **It ignores Non-cash Transactions:** While preparing cash flow statement, non-cash transactions are not included or are not considered. These transactions may be :
   (a) Issue of Bonus Shares
   (b) Conversion of Debentures into shares.
   (c) Purchase of Fixed assets by issuing shares or consideration other than cash.
2. **Closing Cash Balance can be Manipulated or Window Dressing by Management :** If management wants cash balance can be easily manipulated by :
   (a) Postponing payments
   (b) Postponing cash purchases
   (c) Fast collection from debtors around closing dates of final accounts.
3. It is not a substitute for an Income Statement (Profit and Loss Account/Statement of Profit and Loss) **:** In Profit and Loss Account, non-cash items like depreciation, writing off goodwill, preliminary expenses etc. are included which reduces the profits while in cash flow these are ignored which results into difference in Net Income (profits) and cash flow during the same period.
4. **It ignores the Accrual Concept of Accounting:** Cash flow statement is prepared on cash basis (Actual Inflow or outflow, while in the accounting system the accounts are prepared on accrual basis (means income earned whether received or not and expenditure incurred whether paid or not) are to be considered for True and Fair calculation of the results of business at the end of accounting year as salary outstanding, wages outstanding, Rent outstanding, insurance prepaid etc.
5. **No True Judgment of Liquidity:** Liquidity of a business cannot be judged solely upon cash or bank balance but other current assets like debtors, stock, bills receivable etc. which can be converted into cash easily in a short period. Thus, ability to pay current liabilities cannot be judged by cash and bank balance alone.
6. **It is a Historical Document:** Cash flow statement is prepared on the basis of two consecutive Balance Sheets taking into account the various information provided in those documents. So this is related to past period and thus a historical document. For expansion and growth future planning is needed.
7. **It is Based on Secondary Data:** This document is based on already prepared Income Statement and Balance Sheet thus for preparing cash flow statement secondary data are used.

12.7AS 3 (REVISED): CASH FLOW STATEMENTS

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.

1. 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 needs of the enterprise to utilise 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 timings 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.

2. 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 an be viewed as the product of the enterprise, as maybe 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.

3. 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.

4. 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 results 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.

12.8 KEY TERMS

- **Cash :** The term stands for cash and demand deposits with bank.
- **Cash Equivalents:** The term includes short-term highly liquid investments that are readily convertible into known amount of cash which is subject to insignificant risk or change in values.
- **Cash Flow Analysis:** A technique involving analysis of the causes of flows of cash from one period to another.
- **Cash Flow Statement:** A statement depicting the change in cash position from on period to another.

12.9 SUMMARY

- Cash flow statement describes the inflows (sources) and outflows (uses) of cash and cash equivalents during a specified period of time.
- AS 3 (Revised) classifies the cash flows in a period in the following three categories :
  (a) cash flows from operating activities;
  (b) cash flows from investing activities, and
  (c) (deducting) cash flows from financing activities.
- Net increase (decrease) in cash and cash equivalents is arrived at by adding (deducting) the cash inflows (outflows) during a particular period. The cash and cash equivalents at the beginning of the accounting period is added to the amount computed as above to ascertain the amount of cash or cash equivalents at the end of the accounting period.

12.10 CHECK YOUR PROGRESS AND ANSWERS:

1. True or False:

(a) A Cash flow statement reveals the effects of transactions involving movement of cash.
(b) The term 'Funds' mean 'Current Assets' in case of a Cash Flow Analysis.
(c) A 'Cash flow statement.' can very well be equated with an 'Income Statement'.
(d) A company should keep large balances of cash in hand so it can meet all contingencies.
(e) Increase in provision for doubtful debts should be added back in order to find cash from equations.
(f) Funds flow statements and cash flow statement are one and the same.

2. Choose the correct answer:

(i) Cash from operation is equal to :
  (a) Net profit plus increase in outstanding expense.
  (b) Net profit plus increase in debtors.
  (c) Net profit plus increase in stock.

(ii) Increase in the amount of debtors results in :
  (a) Decrease in cash,
  (b) Increase in cash,
  (c) No change in cash.

(iii) Increase in the amount of bills payable results in :
  (a) Decrease in cash,
  (b) Increase in cash,
  (c) No change in cash.

3. State the effect of the following transactions, considered individually, on funds (working capital concept) and funds (cash concept) :
  (a) Purchases of goods for cash.
  (b) Purchase of building against a long-term loan payable.
  (c) Bonus paid in the form of fully paid shares.

Ans. 1. (a) True, (b) False, (c) False, (d) False, (e) True, (f) False

2. (i) - (a), (ii) - (a), (iii) - (a)

3. When funds denote working capital, none of the items will affect working capital. When funds denotes 'Cash' items. (a) will result in decrease of cash while items (b) and (c) will have no effect on cash.

12.11 QUESTIONS AND EXERCISES

1. What is Cash Flow Statement? State the procedure for preparing Cash Flow Statement.
2. Discuss the advantages and limitations of Cash Flow Statement.
3. Discuss the managerial use of Cash Flow Statement.
4. What are the different methods of calculating 'Net cash flow from operating activities'?
5. Explain the Direct method and Indirect method of determining 'Net cash flow from operating activities'.
6. What do you meant by Cash Flow Statement? Give a specimen of Cash Flow Statement as per Accounting Standard - 3 (Revised).
7. What are the uses of Cash Flow Statement?
8. What are the limitations of Cash Flow Statement?
9. What are the objectives of Cash Flow Statement?
10. Distinguish between Cash Flow Statement and Funds Flow Statement.
11. Distinguish between Cash Flow Statement and Cash Budget.
12. Distinguish between Cash Flow Statement and Balance Sheet.
13. Write Short Notes on :
    (a) Cash and Cash equivalents.
    (b) Cash flow from operating activities.
    (c) Cash flow from investing activities.
    (d) Cash flow from financing activities.
    (e) What is Cash Flow Statement ?

12.12 PRACTICAL QUESTIONS

1. From the following Balance Sheets, prepare a Cash Flow Statement for the year ended 31.03.2016.

Particulars	Note No.	31.03. 2016 (`)	31.03.2017 (`)
I. Equity and Liabilities			
1. Shareholders' Funds			
(a) Share Capital		2,00,000	2,50,000
(b) Reserves and Surplus:			
General Reserve		50,000	60,000
Surplus A/c		30,500	30,600
2. Non-Current Liabilities			
(a) Long term Borrowings (Bank Loan)		70,000	–
3. Current Liabilities			
(a) Sundry Creditors		1,50,000	1,35,200
(b) Short term Provisions (Provision for Taxation)		30,000	35,000
Total		5,30,500	5,10,800
II. Assets			
1. Non-Current Assets			
(a) Fixed Assets :			
Land and Building		2,00,000	1,90,000
Machinery		1,50,000	1,69,000
Goodwill		–	5,000

2. Current Assets		
Stock	1,00,000	74,000
Sundry Debtors	80,000	64,200
Cash	500	800
Bank	–	7,800
Total	5,30,500	5,10,800

Additional Information :

1. Dividend of `23,000 was paid.
2. Income Tax paid during the year `28,000.
3. Machinery was purchased during the year `33,000.
4. Depreciation written off on building ` 10,000 : Machinery ` 14,000.

2. The following account balances and Profit and Loss Account have been prepared by Chief accountant of Mahalaxmi Ltd.

Balance as at 31st December ....

Credit Balances	31.12.13 (`)	31.12.14 (`)	Debit Balances	31.12.13 (`)	31.12.14 (`)
Equity Share Capital	1,40,000	2,20,000	Plant and Machinery	1,00,000	1,82,000
Profit & Loss Account	14,000	20,000	Stock-in-trade	30,000	80,000
Sundry Creditors	28,000	78,000	Sundry Debtors	10,000	40,000
Provision for Tax	2000	6000	Cash-in-hand	40,000	14,000
			Prepaid Expenses	4000	8000
	1,84,000	3,24,000		1,84,000	3,24,000

Dr. Profit and Loss Account for the year ended 31st December 2014 Cr.

Particulars	`	Particulars	`
To Opening Stock	30,000	By Sales	2,00,000
To Purchases	1,96,000	By Closing Stock	80,000
To Gross Profit c/d	54,000		
	2,80,000		2,80,000
To General Expenses	22,000	By Gross Profit	54,000
To Depreciation	16,000		
To Provision for Tax	8,000		
To Net Profit c/d	8,000		
	54,000		54,000
To Dividend	2000	By Balance b/d	14,000
To Balance c/d	20,000	By Net Profit	8,000
	22,000		22,000

(i) Draw up a Cash Flow Statement as per AS-3

(ii) Interpret the company's result.

3. From the following details relating to the accounts of Umakanta and Co. Ltd., Prepare Cash Flow Statement.

Credit Balances (Liabilities)	2015 (`)	2014 (`)	Debit Balances (Assets)	2015 (`)	2014 (`)
Share Capital	4,00,000	3,00,000	Goodwill	90,000	1,00,000
Reserve	1,00,000	80,000	Plant and Machinery	4,29,250	2,98,000
Profit & Loss Account	50,000	30,000	Investments (in Shares)	60,000	1,00,000

10% Debenture	1,00,000	1,50,000	Prepaid Expenses	5,750	4,000
Provision for Taxation	40,000	50,000	Sundry Debtors	1,10,000	1,60,000
Trade Creditors	70,000	90,000	Stock	80,000	50,000
Proposed Dividend	40,000	30,000	Cash and Bank	24,000	10,000
Dividend Payable	4,000	–	Debenture Discount	5,000	8,000
	8,04,000	7,30,000		8,04,000	7,30,000

The following further information are also given.

1. 15 % depreciation has been charged in the accounts on Plant and Machinery.
2. Old machines costing ` 50,000 (WDV ` 20,000) have been sold for ` 35,000.
3. `45,000 income tax has been paid and adjusted against Income Tax Provision Account.
4. A machine costing `10,000 (WDV ` 30,000) have been discarded.
5. `10,000 profit has been earned by sale of Investments.
6. Debentures have been redeemed at 5% premium as at 31.03.2015.

4. Gobardhan Ltd. provided the Balance Sheet on 31st March 2006 and 2007 as follows.

Particulars	2006 (`)	2007 (`)
I. Equity and Liabilities		
Equity Share Capital	10,00,000	11,00,000
Pref. Share Capital	3,00,000	2,00,000
Statement of Profit and Loss Balance	2,40,000	1,50,000
General Reserve	47,000	59,000
Debentures	2,00,000	1,00,000
Long-term Loan	3,00,000	3,40,000
Provision for Tax	70,000	85,000
Proposed Dividend	49,000	53,000
Sundry Creditors	32,000	25,000
Bills payable	12,000	15,000
Bank Overdraft	20,000	23,000
Total	22,70,000	21,50,000
II. Assets		
Land and Building	10,20,000	10,95,000
Plant and Machinery	9,85,000	7,50,000
Furniture and Fittings	55,000	65,000
Stock	42,000	37,000
Debtors	33,000	43,000
Cash	84,000	1,10,000
Outstanding Income	17,000	15,000
Rent paid in advance	14,000	20,000
Discount on issue of shares	20,000	15,000
Total	22,70,000	21,50,000

The following further information are also given.

1. Provision for depreciation on Land and Building is @4% on ` 1,00,000.
2. An old Plant was sold and a new one was purchased for `70,000. Profit on sale of Plant was `15,000. Depreciation on Plant and Machinery is provided @ 5% on `7,00,000.
3. Depreciation on Furniture was provided as ` 7,000.

4. Furniture worth `15,000 (accumulated depreciation ` 5,000) was sold for `8,000. The loss on sale is adjusted with the General Reserve.
5. Dividend paid for the year is `50,000.
6. Provision for Tax during the year is ` 40,000.

5. ABC provided the Balance Sheet on 31st March 2006 and 2007 as follows :

Liabilities		2006 (`)	2007 (`)
I. Equity and Liabilities			
Equity Share Capital		3,00,000	4,00,000
Statement of Profit and Loss Balance		1,15,000	1,90,000
General Reserve		50,000	65,000
Mortgage Loan		3,00,000	20,000
Provision for Tax		1,07,000	1,29,000
Proposed Dividend		85,000	99,000
Sundry Creditors		27,000	33,000
Bills payable		15,000	20,000
Bank Overdraft		31,000	24,000
	Total	10,30,000	9,80,000
II. Assets			
Fixed Assets		6,00,000	7,50,000
Addition		1,20,000	90,000
Less : Accumulated Depreciation		2,30,000	2,90,000
		4,90,000	5,50,000
Investments		1,50,000	–
Goodwill		70,000	50,000
Stock		90,000	1,00,000
Debtors		55,000	40,000
Cash		1,75,000	2,40,00
	Total	10,30,000	9,80,000

The Company earned a profit of ` 3,00,000 after tax during the year. The profit was further adjusted as follows :

Particulars	`	`
Statement of Profit and Loss Balance as on 31st March 2006		1,15,000
Profit of the current year		3,00,000
		4,15,000
Provision for Tax	1,10,000	
Provision for Dividend	1,00,000	
Provision for General Reserve	15,000	2,25,000
Balance of Profit transferred to Balance Sheet		1,90,000

Adjustments :

1. Profit on sale of Investments is ` 30,000.
2. A plant costs ` 74,000 (Accumulated depreciation `11,000) was sold for a loss of ` 10,000.

Prepare a Cash Flow Statement by Indirect Method.

12.13 FURTHER READING

Cost and Management Accounting – S.N. Maheshwari
Financial Statement Analysis – John N. Meyer
Management Accounting – Khan and Jain.
Maheshwari, S.N. and S.K. Maheshwari, An Introduction to Accountancy.
Maheshwari, S.N. and S.K. Maheshwari, A Text Book for Accounting for Management.

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