BAOU
Education for All

DR. BABASAHEB AMBEDKAR
OPEN UNIVERSITY

MBA01C103
Semester 1

ACCOUNTING FOR MANAGERS

Message for the Students

Dr. Babasaheb Ambedkar Open (University is the only state Open University, established by the Government of Gujarat by the Act No. 14 of 1994 passed by the Gujarat State Legislature; in the memory of the creator of Indian Constitution and Bharat Ratna Dr. Babasaheb Ambedkar. We Stand at the seventh position in terms of establishment of the Open Universities in the country. The University provides as many as 54 courses including various Certificate, Diploma, UG, PG as well as Doctoral to strengthen Higher Education across the state.

On the occasion of the birth anniversary of Babasaheb Ambedkar, the Gujarat government secured a quiet place with the latest convenience for University, and created a building with all the modern amenities named ‘Jyotirmay’ Parisar. The Board of Management of the University has greatly contributed to the making of the University and will continue to this by all the means.

Education is the perceived capital investment. Education can contribute more to improving the quality of the people. Here I remember the educational philosophy laid down by Shri Swami Vivekananda:

> ***“We want the education by which the character is formed, strength of mind is Increased, the intellect is expand and by which one can stand on one’s own feet”.***

In order to provide students with qualitative, skill and life oriented education at their threshold. Dr. Babaasaheb Ambedkar Open University is dedicated to this very manifestation of education. The university is incessantly working to provide higher education to the wider mass across the state of Gujarat and prepare them to face day to day challenges and lead their lives with all the capacity for the upliftment of the society in general and the nation in particular.

The university following the core motto ‘स्वाध्याय: परमम् तप:’ does believe in offering enriched curriculum to the student. The university has come up with lucid material for the better understanding of the students in their concerned subject. With this, the university has widened scope for those students who are not able to continue with their education in regular/conventional mode. In every subject a dedicated term for Self Learning Material comprising of Programme advisory committee members, content writers and content and language reviewers has been formed to cater the needs of the students.

Matching with the pace of the digital world, the university has its own digital platform Omkar-e to provide education through ICT. Very soon, the University going to offer new online Certificate and Diploma programme on various subjects like Yoga, Naturopathy, and Indian Classical Dance etc. would be available as elective also.

With all these efforts, Dr. Babasaheb Ambedkar Open University is in the process of being core centre of Knowledge and Education and we invite you to join hands to this pious *Yajna* and bring the dreams of Dr. Babasaheb Ambedkar of Harmonious Society come true.

Prof. Ami Upadhyay
Vice Chancellor,
Dr. Babasaheb Ambedkar Open University,
Ahmedabad.

MBA

SEMESTER-1

ACCOUNTING FOR MANAGERS

BLOCK: 1

Authors' Name: Dr. Butalal Ajmera
Dr. Parth Bhatt

Review (Subject): Prof. (Dr.) Manoj Shah
Dr. Shankarsinh Sodha
Dr .Sanjay Bhayani

Review (Language): Dr. Ketan Gediya

Editor's Name: Prof. (Dr.) Manoj Shah,
Professor and Director,
School of Commerce and Management,
Dr. Babasaheb Ambedkar Open University, Ahmedabad.

Co-Editor's Name: Dr. Dhaval Pandya
Assistant Professor,
School of Commerce and Management,
Dr. Babasaheb Ambedkar Open University, Ahmedabad.

Publisher's Name: Registrar,
Dr. Babasaheb Ambedkar Open University,
'JyotirrmayParisar', opp. Shri Balaji Temple,Chharodi,
Ahmedabad, 382481,
Gujarat, India.

Edition: 2022 (First Edition)

ISBN: 978-93-5598-338-1

Dr. Babasaheb Ambedkar Open University

(Established by Government of Gujarat)

ACCOUNTING FOR MANAGERS

SEMESTER-1

Block

1

BLOCK

2

UNIT: 1 INTRODUCTION TO ACCOUNTING

1.1 INTRODUCTION

What is accounting?

Accounting is a very interesting subject and it has been taught in colleges and universities across India/ across the globe. The knowledge of accounting offers very promising career opportunities. Now a day Institute of Charted Accountant of India is very famous body which designs the syllabus and provides training to the aspiring chartered accountants. Business organizations need information for taking crucial decisions and an accountant provides information which becomes the base for taking decision. Accounting is also called the language of business. The language of accounting helps the society to understand the financial affairs of business house. With the help of the accounting knowledge stakeholders can understand what is going on inside the business house. It is better for other stakeholders like bankers, investors, government, suppliers and employees to know about the principals and techniques of accounting so that they can understand the financial performance of the firms better.

Accounting provides information that is useful in making business and economic decisions for making reasoned choices among alternative uses of scare resources in the conduct of business and economic activities Accounting is the language which helps different stakeholders to understand about company’s financial matters.

It is also said that accounting is a system which comprises of three parts –

input, process and output. Input means recoding transaction in the books of journal. Business transaction means transitions like purchase, sales, and cash receipts and cash payment. All these transactions are quantified in term of money. But there are also transactions which are not quantified in term of money for example, events like fire, earthquake and change in tax law etc. All these transactions are also entered in the book of journal. The book of journal is called the first book in which first transactions are entered. The transactions are processed with the help of accounting principles, accounting standard, management estimate, conventions and law and regulations. The outputs are profit and loss accounts, balance sheets, statement of cash flows, tax returns and explanatory note etc. The output is very much useful to shareholders, bankers, credit rating agencies, employees, suppliers, government, regulators, newspaper and television channels etc. The accounting is called accounting information system.

1.2 USERS OF ACCOUNTING INFORMATION

Accounting information system is useful to stockholders. Most importantly investors and bankers use accounting information. Investors before investing in any security of any firms analyze the accounting information and then they take decision. Lenders also can know the financial capacity of the firm by analyzing the accounting information.

Investors: There are two types of investor - individual investors and institutional investors. Both types of investors need financial information about a firm. Investors are interested in knowing the risk and return associated with the security in which they are investing. Accounting information provides detailed information about risk and return existing in a business house. Investors can take decision about long term investment or short term investment on the basis of this information. They can also know the time and market pulse and whether to buy or to sell any security. Even investors can know about the quality of governance. Investors can know that whether the assets of the firm are being utilized for the business or for the personal use. Efficiency of the management can also be judged. Majority of the investors are interest in dividend.Thus accounting information is very important for investors.

Lenders: Bankers who are giving loan to the firm are also interested in the financial information of a firm. Lenders can know the financial soundness of the firm. Even the bank can also know whether the borrower firm can pay installment and interest on time or not. Many a time firms seem financially sound in the initial period but later on firms show inability to return the amount. Many times bank can change its norms on the basis of accounting information. In many instances, firm or it should be banks can terminate the loan on the basis of bad financial performance.

Security analyst and advisors: Investors invest their hard earned savings in the capital market. Educated investors can study market indicators very well but less educated or uneducated investors cannot know about financial information of the firm. Uneducated investors invest on the basis of the expert's advice. Thus expert gives tips or analytical views on the market. Experts are known as analysts who analyze the financial statement of the companies and gives expert advice to the investors. Many television channels have morning shows on expert advice. Particularly NDTV has a channel called NDTV profit. Experts predict the trend of stock during the day. They forecast about opening price, closing price, high price and low price of the stock during the day.

Managers: Manager is also interested in accounting information because he can make planning regarding business properly on the basis of this information. Management functions like planning, controlling and staffing decision can be easily taken on the basis of accounting information. He can also close those projects which are not profitable. Managers can the competitive position of the firm and he can also know where his firm can stand against the competitors in the same industry. A manager's remuneration is linked with financial performance of the organization. Management can demand more remuneration if the financial performance is increased. Moreover manager's performance is also connected with financial performance. Good financial performance reflects in stock price.

Employees and trade union: There are categories of employees- past employees, present employees and aspirant employees. Past employees are more concerned with the retirement benefits that they are receiving from the firm. Their retirement benefits are based on the financial performance of the firm. Present employees are also interested in the increment in their salary which is also based on financial performance of the firm. They are also eager to get more perquisites from the employer. New aspirant employees are willing to join the organization but before joining any organization they study financial performance of the firm. They do not join those firms which are not having good financial performance. Trade unions always believe that the employers are always doing injustice to the employees. So they always fight with management to get more benefits and salary rise. It is better for trade union to fight with management if the financial performance is good.

Suppliers and other trade creditors: Suppliers provide raw material to the firms to continue the production uninterrupted. Suppliers are also interested in financial information of the firm because on the basis of this information they can know whether they will get back the amount that is owned by the firm. A firm can make payment regularly only if the financial performance is good. Suppliers supply raw material for shorter period. So they are interested in liquidity of the firm.

Customers: customers want good quality goods at reasonable price. Customers also want warranty on product they buy. Firms with good financial performance can produce a product with good quality and affordable to sell at reasonable price.

Government and regulatory agencies: Government plays the role of a regulator. A company is operated within the framework laid down by the company act. Central government, state government and local government provide infrastructural facilities against which government collect tax. The amount of tax is decided on the net profit which comes from financial information of the company. On the basis of the information, the Government can know whether the company is following the rules and regulations or not. Government can take appropriate action if the reporting practices in not up to the mark. Even ministry of finance, ministry of commerce and ministry of corporate affairs are also interested in the accounting information of the company. Regulatory author like SEBI and IRDA are also interested in financial affairs of the company that can know that the company is complying with rules and regulations or not. Penalty is imposed on those firms which are not adhering to the rules and regulations and are not abide by regulatory authority.

The public: A company cannot run in isolation. It is part and parcel of the society. Company receives input and resources from the society and in response to that company is doing some for Society. Each Company has to spend some amount on social activities. The concept of social responsibility increases the prestige of the company. For example, TATA had donated millions of rupees for those who were affected by corona virus. Financial information of the company provides information to the general public about those resources which taken from the society are utilized properly or not. Society can know the inside activities of the company through accounting information. They can know the cost of the product being sold to them. Society is also always concerned for environment on the planet and they would see to it whether the company is protecting environment or not. If the company is not caring for environment then company is penalized by appropriate regulatory authority.

After the detailed discussion on the definition of Accounting, now let us understand the functions of Accounting. The following are the functions of Accounting:

1.3 FUNCTIONS OF ACCOUNTING

1) **Recording:** Economic transactions are recorded in the book of journal. Economic transactions are recorded in chronological order and in a systematic way. Thus journal is the primary book of accounting in which transactions are entered for the first time. There are also subcategories of journals like cash journal where only cash transactions are recorded, purchase journal where credit purchase related transaction are recorded and sales journal where credit sales related transactions are recorded.
2) **Classifying:** Transactions are classified according to their nature and then they are recorded in the book of ledger. Those transactions which are similar in nature are put at one place. Ledger book contains different types of accounts. In each account similar types of transactions are recorded. For example different accounts are prepared for different types of expenses like stationery expenses, traveling expenses and advertisement expenses. All expenses related to traveling are recorded in traveling expense account of respective financial year.
3) **Summarizing:** recorded data are summarized in a systematic way so that user of data can understand it easily. The transactions are summarized in profit and loss and balance sheet and trial balance.
4) **Dealing with financial transaction:** Only those transaction are recorded which are expressed in term of money. The transactions which are not expressed in term of money cannot be recorded. Even event which is not quantified cannot be recorded. For examples company has very good and honest employees who are doing good work for company but the honesty and trustworthiness of employees cannot be expressed in term money and also will not be mentioned in balance sheet.
5) **Analysis and interpretation:** Analysis and interpretation of data is very important. User can understand the data properly when the data are analyzed and interpreted well. Thus analysis and interpretation of data helps the users to know about the financial position of the company. They can know the profitability and future plans of the company with proper analysis and interpretation.
6) **Communicating:** At the end, financial information should be communicated to the users. Communicating result is almost important for investors because they are waiting for the outcome of the company**.** The result is reported in proper and prescribed format. Generally, income statement, balance sheet, cash flow statement, ratio analysis and chart and graphs are prepared and communicated to the stakeholders.

7) **Book keeping and Accounting:** People many a time, misunderstand the words book keeping and accounting and use them interchangeably. But there are a difference between book keeping and accounting. Book keeping is mainly concerned with recording financial data and other business activities in an appropriate manner. Book keepers maintain all types of records of business operation. Book keeping is a clerical type of work. It can be done mechanically also. Accounting is mainly concerned with recording, classifying, and summarizing the recorded data and interpreting them for internal and external users. Book keeper does only routine work. For example when salary is paid, book keeper debits salary and credit the cash. He knows only dual aspect of the transaction. But beyond that accountant knows basic principles, concept and adjustment required to different types of transactions.

1.4 IS ACCOUNTING A SCIENCE OR AN ART?

Accounting is a kind of science because the process of accounting is based on principles. The body of knowledge of accounting has been acquired through study and experience. Principles and concepts of accounting are also made out of study and experience by the experts. But Accounting is not pure science as physics or chemistry. In pure science, principles are developed on the basis of experiments and their outcomes. Accounting is social science because it is related to human behavior. The principles and concepts of accounting are developed on the basis of study of human behavior. As per the definition of The American Institute of Certified Public Accountants, “Accounting is the art of recording, classifying and summarizing the financial transactions”. Accounting helps us to know the profitability and financial position of a firm.

1.5 BRANCHES OF ACCOUNTING

There Are Various Branches of Accounting which have developed over the years which areas under:

1) **Financial accounting:** This branch of accounting is mainly concerned with preparation of income statement, balance sheet, cash flow statement, statement of retained earnings and other explanatory note and material which are very important part of the financial statements. Now a days chairman’s speech, ratio analysis, corporate governance report and reports of direct are attached but there are not necessary.
2) **Cost accounting:** Cost accounting is useful to know the total cost or per unit cost of the product or service. Management can take decision on the basis of cost accounting. Cost accounting is useful to ascertain the cost of product or service. Cost accounting is also important for

management to reduce the cost. Standard costing, marginal costing, process costing, differential costing are parts of cost accounting. The Chartered Institute of Management accountants (CIMA) defines a s "The establishment of budgets, standard cost and actual cost costs of operation, processes, activities or products and the analysis of variance, profitability or the social use of funds".

3) **Management accounting:** Management accounting helps management in planning, controlling and organizing. Management can take decision based on management accounting. Thus management accounting does not have any separate principles but it collects the information from cost accounting and financial accounting and presents in a systematic way so as to help the management to take decision regarding business. The Institute of Cost and Management accountant of U.K. defines Management Accounting as "The application of professional knowledge and skill in the preparation of accounting information is such a way as to assist the management in the formulation of policies and in the planning and controlling of the operation of the undertakings."
4) **Tax accounting:** This branch of accounting deals with corporate tax, income tax and goods and services tax. The tax accountant plans to reduce the tax liabilities in a legitimate way. The tax accountant also keeps watch on whether the firm is conforming the statutory requirement or not.
5) **Social Responsibility Accounting**: This is a very interesting branch of accounting. It is mainly concerned with social cost and benefits. It keeps records of all activities done for the society and also records the money spent on different activities as per the company act-2013. Now it is mandatory for company to have a fund for corporate social responsibility of 2% of net profit**.** The social responsibility account keeps watch whether the firm is spending as per norms or not.
6) **Other branches:** other branches of accounting include human resource accounting, computerized accounting, creative accounting, EXBRL (Extensible business reporting language), lean accounting, forensic accounting and inflation accounting.

Objectives of financial accounting: The Institute of Chartered Accountants of India (ICAI) explains that financial statements are prepared for the following objectives

1) To give information about financial position, changes in financial position andperformance of the company.
2) To provide all financial information to support the decision makers.
3) To evaluate the performance of management – whether management is efficiently utilizing resources of not.

1.6 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Financial statements have very good quality because investors are investing money on the basis of financial statements. Even foreign investors expect that quality of financial statement should be good. Following are the good quality of financial statement.

1. **Understandability:** The language of the financial statement should be easy to understand. The investors should be able to understand the financial statements prepared in simple and understandable language. It does not mean that necessary complex information is excluded. Sometimes it is necessary for decision maker to use complex information. But in short too much use of technical terminologies should be avoided.
2. **Relevance:** Financial information should be useful to users only when it is relevant. Irrelevant information is not useful to decision makers. Fact and figure shown in the financial statement increases the quality of financial information. Moreover, true and fair information shown in balance sheet also enhances the predictability. Quality of the financial statement also dependents on those important unknown items explained in financial statements.
3. **Materiality:** Material information means such information which is highly required for decision making. Material information cannot be removed or omitted. Material information directly influences the quality of the financial statement. It is also said that relevant information is affected by the nature and materiality of the information.
4. **Reliability:** Investors also always rely on the information presented in the form of financial statements. They believe that financial statement provides reliable information. Information with errors and mistake cannot be reliable which misleads the readers or users of the information.
5. **Comparability:** Inter-firm comparison and comparison with previous year is very significant aspect to sustain in the competitive market. Financial statement should be prepared in such a way that the comparison becomes possible. There should be consistent conformation in the financial statements which makes the comparison meaningful. Consistency means not changes methods of accounting every year. For example, if accounting method is switched over year to year then comparison is not possible. There is method for evaluating inventory like LIFE, FIFO and weighted average, once LIFE is selected for valuation of inventory then next year this

method cannot be changed. Otherwiseno comparison is possible.

1.7 ACCOUNTING PROCESS–JOURNAL, LEDGER & TRIAL BALANCE

Business Transactions: The transactions happen between two or more people and the transactions are related to exchange of goods and service which are expressed in term of money. Every business transaction has two effects- one party receives benefits in cash of kind and another party also gives benefits in form of cash or kind. In short, each transaction has two effects which are recorded in accounting.

There are three types of business transactions

1. Cash transaction (service or goods are sold on cash only)
2. Credit transactions(services or goods are on credit)
3. Non-Cash transaction (there are transaction in which no money or cash is involved For Example Depreciation and loss due to natural calamities)

Meaning of Accounting: Every business transaction has two effects and each aspect has an account. In short, account is a summary of related transactions recorded at one place to a particular head. “It is a summary of accounts of business transaction relating to following persons.

1) Individuals, firm, companies
2) Properties, goods or cash
3) Items of revenue (income, profit or gain), and expenses (loss)

Classification of accounts: There are two classifications

1) Personal account includes natural, artificial and representative account.
2) Impersonal account includes real and nominal)

Personal account: Transaction happens between business entity and person are recorded in “personal Accounts” The examples are given below

For example – Rajesh and Suresh trading Co., Charitable trusts, XYZ Bank Ltd, C companyLtd, etc.

There can be personal representative accounts as well.

For example – In the case of salary, when it is payable to employees, it is known how much amount is payable to each of the employee. But collectively it is called as “Salary payable A/c”.

Rules for this Account:

Debit the receiver.

Credit the Giver.

Impersonal Accounts

Impersonal accounts are those that do not relate to persons.

There are of two types:

1. Real accounts (or permanent accounts)
2. Nominal accounts (or temporary accounts)

Real Accounts

Real accounts exist even after the end of accounting period. For the next accounting period, these accounts start with a non-zero balance, which is carried forward from the previous accounting period. Examples of such accounts include machinery accounts, land accounts, furniture accounts, cash accounts, and accounts payable accounts. Usually, real accounts are listed in the balance sheet of the business. For this reason, they are sometimes referred to as balance sheet accounts.

Nominal Accounts

Nominal accounts are closed at the end of the accounting period. For the next account period, these accounts start with a zero balance. Nominal accounts typically cover issues such as income, gains, expenses, and losses.

Normally, nominal accounts are used to accumulate income and expense data. In turn, these data can be used to prepare income statements or trading and profit and loss accounts. For this reason, nominal accounts are sometimes referred to as income statement accounts. Examples of nominal accounts include sales, purchases, and gains on asset sales, wages paid, and rent paid.

Classification of Accounts

Specifically, under the modern approach, accounts are classified into the following fivegroups:

Asset accounts: Examples include land accounts, machinery accounts, accounts receivable accounts, prepaid rent accounts, and cash accounts.

Liability accounts: Examples include loan accounts, accounts payable accounts, wages payable accounts, salaries payable accounts, and rent payable accounts.

Revenue accounts: Examples include sales accounts, service revenue accounts, rent revenue accounts, and interest revenue accounts.

Expense accounts: Examples include wage expense accounts, commission expense accounts, salary expense accounts, and rent expense accounts.

Capital/owner’s equity accounts: An example is an individual owner’s account (e.g., Mr. X’s account).

Example

Consider the list of accounts shown below. Our task is to classify these accounts using both the traditional and modern approaches.

Plant and machinery, Purchases, Sales, Rent, Land and building, Cash, Sam's capital Loan from city bank

Journal: The word "journal" has been derived from the French word "jour". Jour means day. So journal means daily. Transactions are recorded daily in journal and hence it has been named so. It is a book of original entry to record chronologically (i.e. in order of date) and in detail the various transactions of a trader. It is also known Day Bookbecause it contains the account of every day's transactions.

CHARACTERISTICS OF JOURNAL:

Journal has the following features:

1. Journal is the first successful step of the double entry system. A transaction is recorded first of all in the journal. So the journal is called the book of original entry.
2. A transaction is recorded on the same day it takes place. So, journal is called Day Book.
3. Transactions are recorded chronologically, So, journal is called chronological book for each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger-posting easy. That is why journal is called "Assistant to Ledger" or "subsidiary book"
4. Narration is written below each entry. The amount is written in the last two columns debit amount in debit column and credit amount in credit column.

ADVANTAGES OF JOURNAL:

The following are the advantages of journal:

1. Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.
2. Since the transactions are kept recorded in journal, chronologically with narration, it can be easily ascertained when and why a transaction has taken place.
3. For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in journal. So, there is no possibility of committing any mistake in writing the ledger.
4. Since all the debits of transaction are recorded in journal, it is not necessary to repeat themin ledger. As a result, ledger is kept tidy and brief.
5. Journal shows the complete story of a transaction in one entry.

6. Any mistake in ledger can be easily detected with the help of journal.

OBJECTIVE OF AN ENTRY:

While recording transactions in journal the following two objects must be aimed at:

1. That each entry in the journal should be so clear that at any future time we may, without the aid of memory, perceive the exact nature of the transactions.
2. That each transaction should be so classified that we may easily obtain the aggregate effect of such transactions at the end of a certain period.

NARRATION OF AN ENTRY:

It is the remark or explanation put below each entry in the journal. The journal is a book of original entry and all possible details have to be recorded in connection with each and every transaction entered there. The details are laid out in the form of a remark at the end of each journal entry, which is called narration.

FORM OF JOURNAL:

Date	Particulars	L.F.	Dr. Amount	Cr. Amount

Column (1) is meant for writing the date of the transaction.

Column (2) is used for recording the names of the two accounts affected by transactions.

Column (3) is meant for noting the number of the page of the ledger on which the particular account appears in that book.

Column (4) shows the amount to be debited to the account named. Column (5) shows the amount to be credited to the account stated.

RULES OF JOURNALISING:

The act of recording transactions in journal is called journalizing. The rules may be summarized as follows:

1. Use two separate lines for writing the names of the two accounts concerned in eachtransaction.
2. Write the name of the debtor or account to be debited in the first line and the name of the creditor or the account to be credited in the next line.
3. Write the name of the account to be debited close to the line starting the particularscolumn and that of the account to be credited at a short distance from this line.
4. Use "Dr" after each debit item and "To" before each credit. The term "Cr." after acredit item is unnecessary, as one account is debtor, the other must be creditor.

5. To separate one entry from another a line is drawn below every entry to cover particulars column only. The line does not extend to amount column.

Ledger

In Journal all the financial transactions are recorded for the first time. Companies will maintain individual accounts to know transactions in short time. Those individual accounts are known as Ledger. Example: Sale of goods takes place number of times in a year. All those transactions can be seen at one place i.e.., Sales Account Ledger. So, Ledger is a book of account in which all types of accounts relating to assets, liabilities, capital, expenses and revenues are maintained.

Features of Ledger

1. Ledger is an account book that contains various accounts
2. Ledger is a book of final entry because all transactions in journal are posted intoledger.
3. Ledger maintains accounts relating to Assets, Liabilities, Capital, Revenue andExpenses.
4. It is permanent record of all business transactions.
5. It is the reference book of accounting system. It is used to prepare financialstatements.
6. At the end of the accounting period each account will contain the entire informationof all the transactions.

Format of a Ledger Sheet:

Title of an Account

Date	Particulars	J. F.	Amount (₹)	Date	Particular	J. F	Amount (₹)

Advantages of Ledger

1. Ledger provides instant information regarding different transactions.
2. It provides detailed information about revenues and expenses.
3. It provides value of every asset and liability separately.
4. It provides useful information to the management in preparing budgets and policies.
5. It provides information for the preparation of financial statements.
6. It helps in knowing the health of the business with the help of financial statements.

Types of Ledger

Based on kind of business transaction ledger can be classified into seven major categories.These are –

1. **Assets Ledger**: It contains accounts relating to assets only e. g.

Machinery accounts,Building account, Furniture account, etc.

2. **Liabilities Ledger**: It contains the accounts of various liabilities e. g. Capital (Owneror partner), Loan account, Bank overdraft, etc.
3. **Revenue Ledger**: It contains the revenue accounts e. g. Sales account, Commission earned account, rent received account, interest received account, etc.
4. **Expenses Ledger**: It contains the various accounts of expenses incurred, e. g. Wages account, Rent paid account, Electricity charges account, etc.
5. **Debtors Ledger**: It contains the accounts of the individual trade debtors of the business. Individuals, firms and institutions to whom goods and services are sold on credit by business become the "trade debtors" of the business.
6. **Creditors Ledger**: It contains the accounts of the individual trade Creditors of the business. Individuals, firms and institutions from whom a business purchases goods and services on credit are called "trade creditors" of the business.
7. **General Ledger**: It contains all those accounts which are not covered under any of the above types of ledger. For example, Landlord A/c prepaid insurance A/c etc.

Posting of Journal Proper into Ledger

All the transactions which are recorded in Journal will be carried to different individual accounts i.e.., ledger. The transfer of entries from journal to relevant account in the ledger is called as posting of journal entries into ledger. The procedure for posting into ledger is –

1. Firstly, identify the accounts of the journal entry. Open those accounts in the ledger.
2. All the transactions associated with that particular account will be posted in ledger
3. Enter the date, particulars and amount.

Trial Balance

A trial balance is a report that lists the balances of all general ledger accounts of a company at a certain point in time. The accounts reflected on a trial balance are related to all major accounting items, including assets, liabilities, equity, revenues, expenses, gains, and losses.

It is primarily used to identify the balance of debits and credits entries from the transactionsrecorded in the general ledger at a certain point in time.

Features of trial balance

1. It is a summary of debit and credit balances which are extracted from various ledgeraccounts

2. It is a summary of debit and credit balances
3. The motive behind the preparation of Trial balance is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts
4. Trial balance does not prove any arithmetical accuracy of accounts which can onlybe determined by the audit
5. It is not an account. It is only a statement of account
6. It is not a part of the final statements
7. A Trial balance at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly
8. It acts as a bridge between books of accounts and the Profit and LossAccount and Balance sheet
9. How to prepare a trial balance?
10. Preparing trial balance is one of the first steps towards preparing final accounts andother financial statements. Following are the steps to prepare trial balance:
11. Preparing ledger accounts to determine the closing balance of each account.
12. Post the ledger Accounts into trial balance and place the balance in the debit or credit column. The format of the trial balance is explained in the next section.
13. All the assets and expenses should have debit balance while liabilities and incomeshould have a credit balance.
14. Calculate the total of the debit balance
15. Similarly, compute the total of the credit column
16. Finally, the sum of debit balance should match the sum of credit balance.
17. If there is any difference, the process of error rectification should be started. Errors could be of commission errors, errors or omissions, errors of principle, compensatingerror and so on…

Advantages of Trial Balance

Trial balance has several advantages:

1. To check the debits, equal the credits
2. To find the uncover errors in journalizing
3. To find the uncover errors in posting
4. To locate the errors in ledger accounts
5. To make financial statements
6. To list the accounts at a single place
7. To know the ending balance of each account at a glance
8. To make the adjustments for unrecorded transactions

9. To find the missing amount of an account in the special case
10. To test the mathematical accuracy of recording process

Disadvantages of trial balance

1. It does not prove that all transactions have been recorded
2. It does not prove that the ledger is correct
3. Numerous errors may exist even though the trial balance columns agree
4. It cannot find the missing entry from the journal
5. It cannot find the missing entry from the ledger
6. It cannot protect the repeated postings
7. It cannot protect the offsetting errors
8. It cannot protect the errors of principles
9. It cannot protect the errors of commission
10. It cannot protect the errors of omission

Errors and Preparation of Trial Balance

Here are the four types of errors in preparation of trial balance, i.e., (i) Errors ofOmission, (ii) Errors of Commission, (iii) Errors of Principle, and (iv) Compensating Errors.

Types of Error

1. **Errors of Omission:** Errors of omission may be caused at the time of recording the transactions in the books of original entry or at the time of posting to the ledger. Errors of omission arise when a business transaction is completely or partially omitted to be recorded in the books of accounts
2. **Complete Omission:** Complete omission means the transaction which is completely omitted to be recorded in the books of original entry and thus cannot be posted in ledger or though recorded in the journal/journal proper but omitted to be posted in the ledger completely. These errors do not affect the agreement of trial balance.
3. **Partial Omission:** Errors of partial omission mean errors of omission other than the errors of complete omission. In other words, when a transaction is partly recorded in the books of accounts, it is known as error of partial omission. These errors hamper the agreement of trial balance.
4. **Errors of Commission:** Errors of commission mean and include errors caused due to wrong recording of transactions, wrong casting of the subsidiary books, wrong totaling or balancing of the accounts, wrong posting and wrong carry forward. These errors may or may not hamper the agreement of trial balance.
5. **Error of Recording:** Error of recording arises when a transaction is recorded in the booksof original entry incorrectly. These errors do not

hamper the agreement of trial balance.

6. **Error of Totaling or Balancing of Accounts:** Error of balancing arises due to wrong balancing of some ledger accounts. These errors hamper the agreement of trial balance
7. **Error of Posting:** Error of posting arises when a transaction is correctly recorded in the books of original entry including journal but posted wrongly in ledger accounts. These errors may or may not hamper the agreement of trial balance.
8. **Posting to the wrong side but correct account:** In this case, posting is made in the correct account but on the wrong side. These types of errors hamper the agreement of trial balance.
9. **Posting to the wrong account but correct side:** In this case, posting is made to the wrong account but on the correct side. These errors do not hamper the agreement of trial balance.
10. **Posting of wrong amount**: In this case, posting is made with the wrong amount but in the correct account and correct side. These errors hamper the agreement of trial balance. Example: Goods sold to Shiva for Rs. 10,000. Instead of posting an amount of Rs. 10,000 on the debit side of Shiva's Account, the amount has been posted as Rs. 1,000 on the debit side of Shiva's Account. Due to this error, Shiva's Account shall show a reduced debit balance of Rs. 9,000 (i.e., difference between Rs. 10,000 and Rs. 1,000). Resultantly, total of trial balance shall not agree.
11. **Posting twice in an account:** In this case, posting is made twice in the correct account and correct side. These errors hamper the agreement of trial balance. Example: A sum of Rs. 5,000 is paid to Rohan. Instead of posting an amount of Rs. 5,000 once on the debit side of Rohan's Account, the amount has been posted twice on the debit side of Rohan's Account. Due to this error, Rohan's Account shall show an excess debit balance of Rs. 5,000. Resultantly, total of trial balance shall not agree.
12. **Error in Carrying Forward:** Error in carrying forward arises when a mistake is occurredin carrying forward a total from one to the next page. These errors hamper the agreement of trial balance.
13. **Errors of Principle:** Errors of principle mean and include, errors caused due to violation of generally accepted accounting principles viz. incorrect allocation between capital and revenue items. It is worth mentioning that proper allocation between these two items is very important in the sense that improper allocation would lead to wrong and misleading results through financial statements. These errors would lead to understatement/overstatement of assets or expenses or liabilities or incomes. These errors do not disturb the agreement of

trialbalance.

14. **Compensating Errors:** When two or more errors are committed in such a way that the effect of one error is compensated by the effect of other, it is known as compensating errors. It is worth mentioning that the net impact of these errors on the debits and credits of an account is nil. These errors do not disturb the agreement of trial balance. Example 1: A sum of Rs. 1,000 was paid to Rohit on 1.1.2011 but was posted in Rohit's Account as Rs. 100. Similarly, a sum of Rs. 100 paid to Rohit on 31.3.2011 was posted in Rohit's Account as Rs. 1,000. In this case, it can be observed that error of 1.1.2011 was compensated by the error of31.3.2011.

❖ Check Your Progress

1. Explain GAAP.
2. Explain the meaning and significance of entity concept.
3. Explain the meaning and significance of going concern concept.
4. Explain the meaning and significance of cost concept.
5. Explain the meaning of matching concept.
6. Explain conversion of consistency.
7. Explain convention of conservatism.
8. Explain conversion of materiality.
9. Define double entry system.
10. How are accounts classified?
11. Write short notes on personal accounts.
12. What do you mean by "entry"? What is an opening entry?
13. What is journal?
14. What are special journals?
15. What is ledger?
16. "Ledger is the book of final entry" why?
17. Explain the utilities of a ledger.
18. What is posting?
19. What is debit balance?
20. Explain credit balance?
21. Distinguish between journal with ledger.

Long Questions

1. What is accounting information system? Elucidate the salient features of an accountingsystem.
2. Explain the information needs of different types of user group in detail.
3. What are the qualitative characteristics of accounting information? Explain them in detail.

4. What are the functions of financial accounting? What are its advantages? Explain its limitations.
5. Distinguish between management accounting and financial accounting.
6. “Revenue is recognized when a sales transaction is made or when services are rendered.” Do you agree with this statement? Give reasons for your answer with suitable illustrations and exceptions, if any, to this statement.
7. Explain the terms “Accounting concepts” and “Accounting conventions” Do you agree that both the terms represent the same meaning? Explain.
8. Define journal. “What are its special characteristics? What are the advantages of a journal?
9. Explain the term “Journalizing”. Explain with a simple illustration, the procedure to befollowed for making entry in the general rule.
10. Explain the steps involved in “posting”.
11. Explain the procedure for balancing a ledger account.
12. Explain the significance of debt and credit balances of various types of accounts withexamples

UNIT : 2 ACCOUNTING CONCEPTS AND STANDARDS

2.1 INTRODUCTION

If I ask you – why do you do the business? The essential reason is to earn profit, right? of course. To get the exact idea of profitability, the business man should keep proper record of each transaction carried out in business. That's when accounting comes into picture. The accounting process starts with a transaction and ends with financial statements. Each business is part of an industry and collectively, industries make an economy – financial market. To record all the transactions accurately and make financial statements relevant, there are set accounting standards and concepts that need to be followed by the entity.

2.2 ACCOUNTING PRINCIPLES

Principle is a rule which explains the concept and stats the process to be followed in order to bring more clarity for stakeholders. They also define do's and don'ts.

Accounting principles are defined as:

"Accounting principles are a 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 wherealternatives exist."

The accounting principles are also known as Generally Accepted Accounting Principles (GAAP).

Following are the characteristics of accounting principles:

a. They should be based on real assumptions
b. They must be simple, understandable and explanatory
c. They must be followed consistently

d. They should be able to reflect future predictions and
e. They should be informational for the users.

2.3 ACCOUNTING CONCEPTS

Accounting concepts is the base for evolving a set of rules and guidelines to record business transactions. It is a recognized presumption that business is an accounting entity, separate from its owners, it is a sole proprietorship, or partnership firm or limited companies (private as well as public). Despite the fact that accounting concept is not a fact, its role in the preparation of financial statements or any accounting process is well recognized by the accountants. Hence, to define accounting concepts, we can say that, *"Accounting concepts are the assumptions on the basis of which financial statements of a business entity are prepared."* Thus, these accounting concepts lay the foundation on the basis of which the accounting principles are formulated.

1) Entity Concept –
Let us say, your father is starting a business. For recording the transactions, will he record personal expenses (household expenses) along with business transactions? Of course, no! Because then it will not reveal true financial position of the business. That's the entity concept. As per this concept, the business enterprise and owner – both have separate identity. Business transactions will be recorded in the book of

business and personal transactions of owner will be recorded in his personal set of books of accounts.

As per the business as an entity concept, the owner of business enterprise will be treated as a creditor of the company to the extent of his capital contributions. That is the reason why capital fund introduced by the owner is considered like any other liability.

Thus, important points for entity concept are:

a) Personal transactions of the owners will not be recorded in business books of accounts and only business transactions are to be recorded to arrive at the accurate result (profit/loss) pertaining to business.
b) The capital fund introduced by the owner(s) will be treated as a liability of the business, which it due to the owners by business entity.

2) Money Measurement Concept –

Money is the reason and result of any business. The transactions recorded in the business are mainly involving cash inflow and cash outflow except few non cash transactions such as depreciation, amortization, etc. Money is the medium of exchange and the standard of economic value. The money measurement concept highlights the fact that in accounting, all transactions of any type of enterprise are recorded in terms ofmoney. According to this concept, transactions, which cannot beexpressed in terms of money, are not recorded in the books of account. The transactions are recorded at the value of the date of transaction.

Value of money is not constant and it varies from time to time. Hence it becomes challenging for accountant to measure assets and liabilities at correct value by following revaluation standards. At times, change in the value of money is ignored. Further, since this concept does not consider non-monetary transactions, at times only financial result might mislead management for taking decision. Many qualitative factors affect the business but due to its non-monetary nature, they are not being recorded in the books of account such as quality of the products marketed, working conditions of employees, sales policy etc. However, few companies have started adopting HR accounting, carbon credit accounting (to monetize the impact on environment), CSR accounting, etc.

Despite the above mentioned limitations, money measurement concept holds its utmost relevance.

3) Periodicity Concept –

Periodicity concept is also known as 'Accounting period concept'. When we start a business, we normally assume the life span as indefinite period for the business. Durable and seasonal businesses are exceptions, though.

Now, when we are doing business and say, the business is about to last for 50 years; we will not measure financial results at the end of 5 years. We will decide one interval will review the financial matter of the business. That's exactly the meaning of periodicity concept.Depending on the type of business and industry norms, business adopts convenient time to measure income, expense and ultimately reviews the net profit/loss for the period.

As per Generally Accepted Accounting Principles (GAAP) twelve months' period is followed for the purpose of preparing and reporting financial statements. Normal accounting period as well as reporting period is either financial year, which starts from Apr 1 and ends on Mar 31 of the following year or calendar year i.e. from Jan 1 to Dec 31.

Public companies as well as big corporates also follow the shorter period of 3 months (quarterly financial statements) or 6 months (half yearly financial statements); apart from annual accounts. Public companies are liable to present quarterly financial statements to various authorities like SEBI. Such accounts and/or financial statements are known as interim accounts and/or financial statements.

Periodicity concept facilitates:

I. Comparing of financial statements of different periods
II. Uniform and consistent accountix treatment for ascertaining the profit and assets of the business
III. Matching periodic revenues with expenses for getting correct results of the business operations

4) Accrual Concept –

To record the transactions, two basis can be followed:

a) Mercantile basis (Accrual basis) or
b) Cash basis.

In cash basis, the transaction is recorded as and when there is cash inflow or outflow in the business.

Whereas, as per accrual concept, the revenue is recognized when the sales is completed or service is rendered and the right to receive has been established. E.g. when company A has given loan to company B and the interest is to be received at every six months; then right to receive is established at every six months and company A will record interest receivable irrespective of actual cash inflow in the business.

Similarly, when the obligation to payment arises, the expense is recorded in the books of accounts. The provision for expense is created in the circumstances when payments are made later on. E.g., outstanding electricity expense.

"Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities."

Let's summarize various circumstances and its treatment in books of accounts:
Timing of revenue and expense booking could be different from cash receipt or paid.

i.	when cash received before revenue is booked	a liability is created when cash is received in advance
ii.	when cash received after revenue is booked	an asset called Trade receivables is created
iii.	when cash paid before expense is booked	creates an asset called Trade Advance when cash is paid in advance
iv.	when cash paid after expense is booked	creates a liability called payables or Trade payables or outstanding liabilities

5) Matching Concept –
Rationally, the books of accounts will reflect true and correct results only when all the expenses and revenue transactions are recorded. When the revenue is recorded for the period then the corresponding expense shall also be recorded and recognized in the same accounting period. This is the basic understanding of matching concept.

"*After revenue recognition, all costs (expenses) that were incurred to earn the revenue of the period will be charged against that revenue earning during that accounting period to determine the net income of the business enterprises.*"

All the expense and revenue transaction pertaining to the relevant accounting/reporting period; must be recorded in the same period. Due to this, matching concept can be correlated with accrual concept as well. Let us understand the concept with the help of an equation:

Where π = Profit
ΣR = Sum Of Revenues
ΣE = Sum of Expenses (Costs Incurred)

$$\pi = \Sigma R - \Sigma E$$

In other words, Periodic profit = Periodic Revenue – Matched expense
Now let's understand matching and accrual concept with the help of a constructive/concrete example.
Illustration: Ram started business of Boxes. He purchased 20,000 boxes @ Rs. 130 per box and sold 15,000 boxes @ Rs. 200 per box during the financial year of 1st April, 2020 to 31st March, 2021. He also paid godown rent @ 5,000 per month for 11 months and paid Rs. 5,00,000 to

the suppliers. He also received 12,00,000 from the customers.

Answer

Particulars	Ans (₹)
Revenue [15.000 * ₹ 200]	30,00,000
Less: Cost of sale [15,000 * 20 *₹ 130]	(19,50,000)
Gross Profit	10,50,000
Less: Rent expense [5000*12]	(60,000)
Net Profit	9,90,000

Assets:

1)	Inventory [5,000*130]	6,50,000
2)	Trade receivables	18,00,000
3)	Cash [12,00,000 – 5,00,000-55,000	6,45,000
		30,95,000

Liabilities:

1)	Trade Paybles	21,00,000
2)	Outstanding rent	5,000
3)	Profit [Capital]	9,90,000
		30,95,000

6) Going Concern Concept –

When we start business, we always have an intention to continue it for indefinite period. We assume that the business will be carried on forever. This assumption is considered as a going concern concept. A fundamental decision the management makes, while preparing financial statements, is to apply the going concern basis.

Accounting standard 1, dealing with the disclosure of accounting policies mentions that *"the enterprise is normally viewed as a going concern,that is, 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."*

While preparing the financial statements, if the entity is not following the going concern or the management has significant doubt for the application of going concern or the management has the intention for indefinite continuity of the business, the disclosure of the same needs to be given in the notes to accounts of financial statements with the fact and reasons for the same.

If the financial statements are audited by the external/statutory/internal auditor and the auditor has significant doubt on the going concern of the entity, the same is mentioned by the auditor in the audit report considering his professional judgment.

For example, the business is continuously incurring losses but the management still believes that the business will be carried on and going concern will be followed, then the same can be disclosed: "As at March 31, 20XX the entity had total assets at Rs. XXX/-, and total liabilities at Rs. XXX/-, and accumulated losses Rs. XXX/-. In addition, the entity has incurred a net loss of Rs. XXX/-, during the current financial year, and also suffered recurring losses during the past previous years. However, the entity's management is currently committed to continue the business as a going concern and would introduce additional funds to the business as and when required to meet its obligations as they fall due in the foreseeable future."

7) Cost concept –

When you purchase a machine for your business for Rs. 4,00,000/-, then the amount paid to acquire the asset is the cost of the asset for you. This is the basic understanding of cost concept. The assets are recorded at the Historic cost i.e. the cost at which you acquired the asset in the beginning.

This concept is highly objective and free from the bias and any type of subjectivity. This concept is applicable and preferred for the entities where fixed assets are purchased for use in production or manufacture and not for resale. There is few exception of the concept too. Say, conservatism concept. For inventory – it is recorded at the lower value of cost or net realizable value.

Despite its relevance, there are few drawbacks of the concept such as:

a) Real value of the capital employed in the business is ignored since the same is not shown in the balance sheet.
b) Market value of the assets keeps on varying frequently. Since the assets are recorded at historic cost, unrealized gains are ignored.
c) There are few significant assets of the entity whose acquisition cost is not measurable. For example – human resources or the corporate relations. Considering this concept, such valuable assets are not recorded in the books of accounts. Further, the assets for which the entity did not pay acquisition cost, those are also not recorded. The proper justification for the same can be quoted as: *"thus the knowledge and skill, that is built up as the business, operates a team work that grows up within the organization, a favorable location that becomes of increasing importance as time goes by, a good reputation with its customers, none of these appears as an asset in the accounts of the company."*

8) Realization concept –

Realization concept also follows moreover the same approach as of cost concept. The realization concept comes into picture at the time of revenue recognition.When the asset is recorded at historic cost and as at the date of financial Statement, if the business has the certainty of realizing the gain, the same shall be recorded in the balance sheet. Let's understand the same through an example.

Illustration: An entity had purchased the land for Rs. 2,00,000/- as on August 5, 2017. As on March 31, 2021, the market value of the land is Rs. 5,50,000/-. Then in such case, instead of showing financial position as:

Particulars	Ans (₹)
Capital	2,00,000
	2,00,000
Non. Current Assets:	
Land	2,00,000
	2,00,000

The correct presentation of financial position would be as under:

Particulars	Ans (₹)
Capital	2,00,000
Reserves & Sarplus Unrealized Gain	3,00,000
	5,00,000
Non. Current Assets:	
Lord	5,00,000
	5,00,000

Hence, we can say that, going concern concept, cost concept and realization concept go hand-in-hand and give us the correct criteria of evaluation as well as revaluation of the assets.

9) Dual aspect concept –

Since we are now acquainted with the basics of accounting, on its basis we can derive three golden rules of accounting:

a) Debit the receiver, credit the giver
b) Debit what comes in, credit what goes out
c) Debit expenses and losses, credit incomes and gains

That means, each transaction has two effects. This is the basic and core idea of double entry book keeping accounting system.

Hence, we see various combinations, we can say that each transaction either

(1) It increases one Asset and decreases other Asset;
(2) It increases an Asset and simultaneously increases Liability;
(3) It decreases one Asset, increases another Asset;
(4) It decreases one Asset, decreases a Liability.
Alternatively:
(5) It increases one Liability, decreases other Liability;
(6) It increases a Liability, increases an Asset;
(7) It decreases Liability, increases other Liability:
(8) It decreases Liability, decreases an Asset.

Based on the above effects, we can derive at following equations:

Equity (E) + Liabilities (L) = Assets (A)

Or

Equity (E) Assets (A)- Liabilities(L)

Or, Equity+Long Term Liabilities + Current Liabilities Fixed Assets + Current Assets

Or, Equity+ Long Term Liabilities = Fixed Assets + (Current Assets - Current Liabilities)

Or, Equity Fixed Assets + Working Capital - Long Term Liabilities

Let's understand the implication through the following example:

Particulars	March 31,2019 (₹)	March 31, 2020 (₹)
Capital	1,00,000	?
12% bank Loan	1,00,000	1,00,000
Trade Payables	75,000	70,000
Fixed Assets	1,25,000	1,10,000
Trade Receivables	75,000	80,000
Inventory	70,000	80,000
Cash & Bank	5,000	6,000
Required Find the profit for the year & the Balance sheet as on 31/3/2020		

For the year ended March 31, 2019:

Equity = Capital ₹1,00,000

Liabilities = Bank Loan + Trade Payables

₹ 1,00,000+ 75,000 = 1,75,000

Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank

₹ 1,25,000+ ₹ 75,000+ ₹ 70,000+ ₹ 5,000 = 2,75,000

Equity + Liabilities = Assets

₹ 1,00,000+ ₹ 1,75,000 = 2,75,000

For the year ended March 31, 2020:

Assets = ₹ 1,10,000+ ₹ 80,000+ ₹ 80,000+6,000 = 2,76,000

Liabilities = ₹ 1,00,000+ ₹ 70,000 = 1,70,000

Equity = Assets – Liabilities = ₹ 2,76,000 - ₹ 1,70,000 = 1,06,000

Profits New Equity - Old Equity = ₹ 1,06,000- ₹ 1,00,000 = ₹ 6,000

2.5 ACCOUNTING CONVENTIONS

Accounting conventions are the practices adopted by various organizations over a period of time. They have emerged out of accounting principles, concepts and accounting practices followed by various entities over the span of time. Based on the usage and practices, these conventions have developed and evolved. Even though these conventions are largely followed by the entities following general accepted accounting principles, they do not have universal application and implications. The accountancy bodies of the world may change the conventions to improve the quality of accounting information.

Following are three important accounting conventions:

- Conservatism
- Consistency
- Materiality

1) Conservatism –

This convention is also known as prudence. In normal language, prudence means to think wisely and anticipate what can go wrong. This is treated as playing safe game in the business. According to the conservative concept, the entity should provide allowance for all the loss and if it is in doubt, then the same should be written off. However, gains need to be recorded only when it is materialized. That means, as per this convention, anticipate no gain but record all the probable losses. This accounting convention is recognized in AS–1, which strongly supports the observation of prudence in the framing of accounting policies. Uncertainties, inevitably, surround many transactions. This should be recognized by exercising prudence in financial statements.

Following are few examples of conservatism concept:

a) Making provision of doubtful debt

b) Providing bad debt

c) Valuing current assets at lower of cost or net realizable value

d) Not providing discount on creditors

e) Not writing off creditors when in doubt but providing for allowancefor debtors.

As per this concept, financial statements shall have following three basic characteristics:

a) Prudence: Providing for all probable futuristic losses and not anticipating gains,
b) Neutrality: Unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,
c) Faithful representation of alternative values

   Parallel, many accounting authors and scholars are of the view that, following the concept of conservatism leads to understatement of income and wealth and it should not be the basis for the preparation of financial statement.

2) Consistency –

Financial statements are comparable for one year with another when the same accounting policies are followed consistently. As per AS–1, consistency is a fundamental assumption and it is assumed that accounting policies are consistent from one period to another. Where this assumption is not followed, such fact should be disclosed with specific reason for not complying with this.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For e.g. SLM or WDV for depreciation, FIFO or Weighted average cost for inventory, etc. In some instances, it may look like apparently there is inconsistency in accounting policy but factually the policies would be constant. In case of inventory, if the company is following principle 'cost or net realizable value; whichever is lower' and when following this principle results in the valuation of inventories in one year at cost price and the market price in the other year, there is no inconsistency even if it appears so.

Consistency does not imply non-flexibility and not to allow the introduction of improved method of accounting.

Eric. L Kohler describes three types of consistencies:

Vertical Consistency: This consistency is maintained within the interrelated financial statement of thesame date. "Interrelation" refers to the binding relationship among the constituents of the financial state-ments namely, Profit and Loss Account (Income Statement) and Balance Sheet. For example, vertical inconsistency will happen where an asset has been depreciated in one basis, say, Straight Line Method for Income Statement and on another basis, say, Written-Down-Value Method for the Balance Sheet.

Horizontal Consistency: This type of consistency is maintained between financial statements from one

year to another year and subsequent years. This enables the comparison of performance of a business enter-prise in one year with its performance in the next year.

Third Dimensional Consistency: This type of consistency enables the comparison of the performance of a business enterprise with the performance of another business enterprise in the same type of industry. and preferably on the same date.

As per accounting standard, an entity should change its accountingpolicy in following circumstances:

a) To bring the books of accounts in accordance with the issued Accounting Standards
b) To comply with the provision of law
c) When under changed circumstances it is felt that new method willreflect more true and fair picture in the financial statement.

And, whenever there is change in accounting policy, the same should be

a) Disclosed in the financial statement
b) Quantify the effect of such change to the extent possible.

3) Materiality –

Materiality concept primarily says that understand the nature and amount of the transaction and then record it accordingly. The item can be material based on its nature or amount.

As per The American Accounting Association (AAA) materiality means, *"An item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investor."*

Eric. L. Kohler has defined materiality as *"The characteristic attachment to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person."*

Thus, materiality is a subjective concept. It varies from business to business and transaction to transaction. Professional judgment needs to be applied while deciding the materiality.

As per AS–1, convention of materiality should govern the selection and application of accounting policies. Financial statements should disclose all items, which are material enough to affect evaluations or decisions. AS–5, in conformity with AS–1, stipulates as "all material information should be disclosed that is necessary to make the financial statements clear and understandable."

As a normal practice, following transactions are considered as material:

a) Having value equal to or more than 1% of total revenue
b) Having value equal to or more than 10% of net profit
c) Having value equal to or more than 1% of total assets

However, this is illustrative and guiding list. Each transaction needs to be assessed separately since materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision, etc. The information which is material for one entity/person, can be immaterial for another entity/person.

2.6 ACCOUNTING ASSUMPTIONS

Following are three underlying accounting assumptions that are followed by entities

1) Accrual Basis

   In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

2) Going Concern

   The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

3) Consistency

The accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

2.7 ACCOUNTING STANDARDS

Section 133 of the Companies Act, 2013 states about the power of the Central Government to prescribe the accounting standards. It tells that Central Government holds the power of making and notifying accounting standards.

It further provides that Central Government shall prescribe the Standards of Accounting as recommended by ICAI.

Meaning of Accounting Standards –

Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financialstatements.

Need of Accounting Standards –

Accounting standards deal with the issues of –

a) Recognition of events and transactions in the financial statements
b) Measurement of these transactions and events
c) Presentation of these transactions events in the financial statements in a manner that is meaningful and understandable to the reader
d) The disclosure requirements should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating then to take prudent and informed business decisions.

Need of Accounting Standards –

Just like all other standards, accounting standards also focus at bringing standardization, harmonization and comparable form for accounting policies and practices for recording transactions, preparing financial statements along with relevant disclosures.

Accounting standards mainly focus at

a) Eliminating the non-comparability of financial statements andthereby improving the reliability of financial statements
b) Providing a set of standard accounting policies, valuation norms and disclosure requirements

Benefits of Accounting Standards –

a) They standardize the alternative accounting treatments by giving brief idea of circumstantial usage of treatments along with its pros and cons
b) They provide requirements for additional disclosure in the notes to accounts to make it more understandable, comparable and relevant. For example, Change in accounting policies, material transactions, not following/significant uncertain of going concern, etc.

Limitation of Accounting Standards –

a) At times, it becomes difficult to choose the correct accounting treatment since each alternate treatment may have its own arguments and valid points.
b) Accounting standards cannot override the statute. Hence, they are having restricted scope to the extent statute and they have to be framed within the ambit of applicable statutory governance

Accounting Standards

The Institute of Chartered Accountant of India issues Guidance Notes' and 'Statements' from time to time. With the formation of the Accounting Standards Board and the Auditing Practices Committee, ‘Accounting Standards’ and ‘Statements on Standard Auditing Practices’ are also being issued.

‘Guidance Notes’ are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature.

List of prevailing accounting standards as on July 1,2019

AS 1	Disclosure of Accounting Policies
AS2	Valuation of Inventories (revised 2016)
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occurring After the Balance Sheet Date (revised 2016)
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Property, Plant and Equipment (revised 2016)
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2018)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments (revised 2016)
AS 14	Accounting for Amalgamations (revised 2016)
AS 15	Employee Benefits (revised 2005)
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share

AS 21	Consolidated Financial Statements (revised 2016)
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent Assets (revised 2016)

Let's have bird eye view of each accounting standard:

Accounting Standards

<u>Accounting Standard (AS) 1 - Disclosure of Accounting Policies</u>

This Standard deals with the disclosure of significant accounting policies that needs to be followed while preparing and presenting financial statements.

Disclosure of significant accounting policies followed is necessary since accounting policies followed vary from enterprise to enterprise.

The ultimate aim of this Standard is to encourage better understanding of financial statements by enacting an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements.

<u>Accounting Standard (AS) 2 - Valuation of Inventories</u>

This Standard should be applied in accounting for inventories other than:

(a) work in progress

(b) shares, debentures and other financial instruments held as stock-in-trade; and

(c) producers' inventories of livestock, agricultural and forest products,and mineral oils

The financial statements should disclose:

(a) the accounting policies adopted and

(b) the total carrying amount of inventories along with its classificationsuch as raw material, work in progress, finished goods, etc.

Accounting Standard (AS) 3 - Cash Flow Statements

Cash flow statement reflects the liquidity of the entity since it includes gross cash inflows and outflows of the entity during the year.

The Standard states the provision 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.

An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

Accounting Standard (AS) 4 - Contingencies and Events Occurring After the Balance Sheet Date

This Standard deals with the treatment in financial statements of contingencies and events occurring after the balance sheet date.

A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. Following the concept of conservatism, the contingencies which might result in probable gain, should not be disclosed.

Events occurring after the balance sheet date are those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved.

Accounting Standard (AS) 5 - Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

This Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities.

This standard aims at making enterprises prepare and present such a statement on a uniform basis with respect to classification anddisclosure of certain items in the statement of profit and loss.

Accounting Standard (AS) 7 - Construction Contracts

This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

This standard helps to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss by addressing the primary issue in accounting for construction contracts i.e. allocation of contract revenue and contract costs to the accounting periods.

Accounting Standard (AS) 9 - Revenue Recognition

This Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from —

a) the sale of goods,

b) the rendering of services, and

c) the use by others of enterprise resources yielding interest, royalties and dividends.

Revenue from sales or service transactions should be recognised when the right to receive has been established.

2) Accounting Standard (AS) 10 - Property, Plant and Equipment

The objective of this Standard is to elaborate the accounting treatment for property, plant and equipment so that users of the financial statements can depict information about investment made by an enterprise in its property, plant and equipment and the changes in such investment.

This Standard does not apply to,

a) biological assets related to agricultural activity other than bearer plants

b) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources

3) Accounting Standard (AS) 11 - The Effects of Changes in Foreign Exchange Rates

This standard addresses primary issues in accounting for foreign currency transactions and foreign operations and they are helpful to decide which exchange rate to use and how to recognize in the financial statements the financial effect of changes in exchange rates.

This Standard should be applied:

(a) in accounting for transactions in foreign currencies; and

(b) in translating the financial statements of foreign operations.

Accounting Standard (AS) 12 - Accounting for Government Grants

This Standard primarily deals with accounting for government grants. Government grants are also called by other names such as subsidies, cash incentives, duty drawbacks, etc.

Government grants should not be recognised until there is reasonable assurance that

(i) the enterprise will comply with the conditions attached to them, and

(ii) the grants will be received.

Accounting Standard (AS) 13 - Accounting for Investments

This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.

This Standard does not deal with

a) the bases for recognition of interest, dividends and rentals earned on investments since they are explained by Accounting Standard 9 on Revenue Recognition;
b) operating or finance leases;
c) investments of retirement benefit plans and life insurance enterprises; and
d) mutual funds and venture capital funds

Accounting Standard (AS) 14 - Accounting for Amalgamations

This standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves.

An amalgamation may be either –

(c) an amalgamation in the nature of merger, or
(d) an amalgamation in the nature of purchase.

There are two main methods of accounting for amalgamations:

(a) the pooling of interests method; and
(b) the purchase method

Accounting Standard (AS) 15 - Employee Benefits

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits except share based payments.

This Standard does not deal with accounting and reporting by employee benefit plans.

Accounting Standard (AS) 16 - Borrowing Costs

The objective of this Standard is to prescribe the accounting treatment for borrowing costs.

This Standard should be applied in accounting for borrowing costs. Substantial period of time primarily depends on the facts and circumstances of each case.

Accounting Standard (AS) 17 – Segment Reporting

The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates.

Information disclosed by segment reporting helps users of financial statements:

a) better understand the performance of the enterprise;
b) better assess the risks and returns of the enterprise; and
c) make more informed judgments about the enterprise as a whole.

Accounting Standard (AS) 18 - Related Party Disclosures

The objective of this Standard is to establish requirements for disclosure of:

(e) related party relationships; and

(f) Transactions between a reporting enterprise and its related parties.

Certain related parties (directors, officers and companies which they control or over which they exert significant influence) are disclosed.

Key management personnel are those persons having authority and responsibility for the planning, directing and controlling the activities or the company directly or indirectly including director, executive or otherwise of the company.

Accounting Standard (AS) 19 – Leases

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Accounting Standard (AS) 20 - Earnings Per Share

The focus of this Standard is on the denominator of the earnings per share calculation.

The standard prescribes principles for the determination andpresentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Accounting Standard (AS) 21 - Consolidated Financial Statements

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group.

Accounting Standard (AS) 22 - Accounting for Taxes on Income The objective of this Standard is to prescribe accounting treatment fortaxes on income.

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income.

Taxes on income shall include all domestic and foreign taxes which are based on taxable income.

Accounting Standard (AS) 23- Accounting for Investments in Associates in Consolidated Financial Statements

The objective of this Standard is to set out principles and procedures for recognizing, in the consolidated financial statements, the effects of the investments in associates on the financial position and operating results of a group.

As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence.

Accounting Standard (AS) 24 - Discontinuing Operations

The objective of this Standard is to establish principles for reporting information about discontinuing operations.

Hence, it enhances the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

Accounting Standard (AS) 25 - Interim Financial Reporting

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period.

The standard believes that timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity and make corporates follow the same practice.

Accounting Standard (AS) 26 - Intangible Assets

This Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met.

The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

This Standard applies to expenditure on advertising, training, start-up, research and development activities since Research and development activities are directed to the development of knowledge.

Accounting Standard (AS) 27 - Financial Reporting of Interests in Joint Ventures

The Standard sets out principles and procedures for accounting for interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors.

Accounting Standard (AS) 28 - Impairment of Assets

The objective of this Standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount.

An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognize an impairment loss.

Accounting Standard (AS) 29 - Provisions, Contingent Liabilities and Contingent Assets

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Indian Accounting Standards

In accordance to be par with International Financial Reporting Standards (IFRSs), India has its converged Indian Accounting Standards which are known as Ind-AS.

As per the notification released by the Ministry of Corporate Affairs (MCA) on 16 February 2015, the roadmap for IndAS implementation was decided as follows:

Financial year	Mandatorily applicable to
2015-16 or later	Entities, not under the mandatoryroadmap, may later voluntarily adopt Ind AS
2016-17	Companies (listed and unlisted) whose net worth is equal to orgreater than 500 crore INR
2017-18	Unlisted companies whose networth is equal to or greater than 250 crore INR and all listed companies
2018-19 onwards	When a company's net worth becomes greater than 250 crore INR

Whenever a company gets covered under the roadmap, Ind-AS becomes mandatory, its holding, subsidiary, associate and joint venture companies will also have to adopt Ind -AS.

Ind AS 101	First-time Adoption of Indian Accounting Standards
Ind AS 102	Share-based Payment
Ind AS 103	Business Combinations
Ind AS 104	Insurance Contracts
Ind AS 105	Non-current Assets Held for Sale and Discontinued Operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources

Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in Other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers
Ind AS 1	Presentation of Financial Statements
Ind AS 2	Inventories
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events after the Reporting Period
Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 17	Leases
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures
Ind AS 27	Separate Financial Statements

Ind AS 28	Investments in Associates and Joint Ventures
Ind AS 29	Financial Reporting in Hyperinflationary Economies
Ind AS 32	Financial Instruments: Presentation
Ind AS 33	Earnings per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture

❖ Check Your Progress

Multiple Choice Questions:

1. The government of India in consultation with ICAI decided to__________
a. Adapt with IFRS
b. Converge with IFRS
c. Apply IFRS in India
d. Notify IFRS in India
2. Capital brought by the owner in the business is___________for business
a. Liability
b. Drawing
c. Asset
d. A&B
3. All the following items are classified as fundamental accounting assumptions except ___________
a. Consistency
b. Going concern
c. Cost concept
d. Revaluation concept
4. The determination of expenses for an accounting period is basedon the principle of
a. Prudence
b. Materiality
c. Matching

d. Going concern

5. Accounting standards for Non-Corporate entities in India areissued by___________

a. Central Government

b. State Government

c. The Institute of Chartered Accountants of India

d. A and C both

1.	2.	3.	4.	5.
b	**a**	**d**	**c**	**c**

Short Questions

1. Define Accounting concepts.
2. Define Accounting Standards.
3. Explain Dual aspect concept.
4. What is materiality?
5. In which circumstances accounting policies can be changed? Which disclosures need to be given in such case?

Long Questions

1. What are Accounting standards? Why is it important to have accountingstandards? Explain its merits and demerits.
2. Enlist accounting concept and explain any 5 in detail.
3. What are Ind-ASs? To which entities such standards are applicable?
4. Brief about following Accounting standards.

a. AS 1

b. AS 5

c. AS 24

d. AS 16

e. AS 9

5. Explain the correlation between accrual concept and matching conceptwith imaginary illustrations.

UNIT: 3 ACCOUNTING INFORMATION AND ITS APPLICATIONS

3.1 INTRODUCTION

We have learned in school that various vitamins are necessary in our body for our survival like vitamin A, B, C, D, E, etc.

As and when we grow, we realize that along with those natural inbuilt vitaminsin the body, we need one more vitamin M - money! From getting our pocket money from our parents to give them the life they deserve, we all realize the value and worth of money.

We all as an individual or entities; whatever economic activity we perform, our primary motive is to earn money. Businessman does business, employee earns salary, entrepreneur makes profit, clubs gets membership fees, schools and colleges get fees, Government gets taxes, etc.

However, it is not necessary that all the economic activities are run for any individual benefit; such economic activities may create social benefit I.e. benefit for public at large.

Whatever economic activities that are being performed, they are either through transactions or events.

Transaction is used to mean 'a business, performance of an act, an agreement' whereas the event means 'a happening, as a consequence of a transaction(s), a result'.

Accounting owes its origin to the origin of mankind. It is as old as money itself. During its evolution, accounting – may it be as an art, policy, principle, method or as a system, has progressed a lot adopting changes in the financial framework, concepts, conventions, other policies and procedure.

3.2 DEFINITION AND MEANING OF ACCOUNTING

Accounting and business both are irreplaceable and inseparable. To have the review over performance of business, it is very much important to keep the track of all the transactions and events. That's when the accounting comes into picture for 'keeping the track record'. Many times we read that Accounting is a language of business. This is not an exaggeration. Accounting decodes the business and communicates the business results to its various stakeholders.

3.2.1 In 1961, American Institute of Certified Public Accountants (AICPA) defined Accounting as, "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."

As per this definition, the essential function of accounting is to record the financial transactions and to summarize them. However, looking to the business environment, only these functions are not sufficient.

3.2.2 In 1966, American Accounting Association (AAA) defined accounting as, "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of information."

Over the years, so many definitions have been formulated by the professionals keeping in view with the changing socio-economic scenario.

3.2.3 In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) briefed the evolved definition as, "The function of accounting is to provide quantitative information, Primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions."

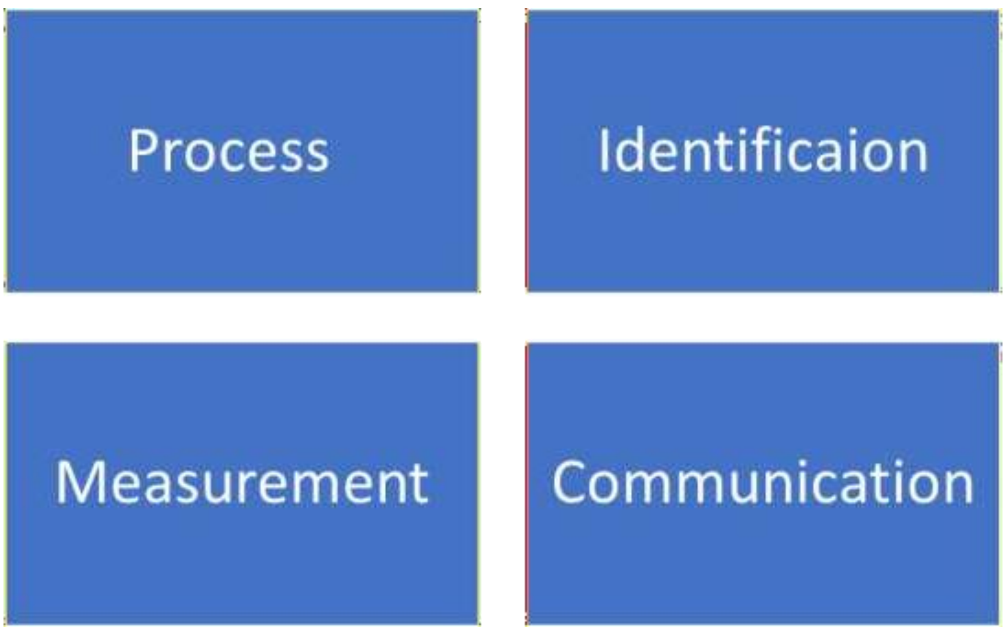
Hence, if we summarize all different definitions mentioned above, the accounting can be summarized as process of

3.2.4 Recording
3.2.5 Classifying
3.2.6 Summarizing
3.2.7 Analyzing and
3.2.8 Interpreting

The financial transactions and communicating the results there of to the persons interested in such information.

3.3 CHARACTERISTICS OF ACCOUNTING

Below mentioned are the characteristics of Accounting:



3.3.1 Process:

Any transaction or event is the starting point of accounting. Once the transaction is completed, then it will be recorded, classified based on the nature of transaction, all transactions will be summarized. Based on that, analysis will be carried on and the financial information will be interpreted. Thus, the process of recording, classification, summarizing, analyzing and interpreting defines accounting.

3.3.2 Identification:

The starting point of accounting is any transaction or economic activity. The transaction or event in which monetary concern is involved; that will have impact on the books of accounts of the business. However, each monetary transaction or event won't be the business related transactions. For example, the proprietor of the shop is spending amount for buying household things, the transaction will not be recorded in the business (except drawings) books since it is not related with business. Hence, accounting involves identifying economic activities or accounting (business) transactions.

3.3.3 Measurement:

Once the relevant transactions are identified, they are measured into the money or equivalent monetary value. The equivalent monetary value is the approximately value paid for the similar kind of services or goods. Measurement of the transactions after quantifying into monetary terms is one of the most important characteristics of the accounting since the transaction will be recorded at the determined/derived value.

3.3.4 Communication:

Various reports, financial statements are the ways to communicate accounting information with all the users of information. That's one of the important characteristics and motive of accounting. Since, accounting is a language of business; it is effective when it is communicated properly with the relevant users.

3.4 OBJECTIVES OF ACCOUNTING

Till now, we have understood various definitions and characteristics of accounting. Accounting is to the business what blood is to the body. Following are the various objectives of accounting:

1) Systematic recording of transactions:

Once the transaction or event occurs in business, the first and foremost important step is to record the transaction with accurate measurement. Each transaction shall be recorded systematically which would cover the financial aspects of business transactions. It is also called as book-keeping. To record the transaction systematically, following points can be kept in mind:

a) It should be recorded date-wise
b) Each transaction should be serially numbered
c) The type of transactions can be bifurcated for simple classification. For e.g., if it is sales transactions then the serial can be recorded as SV1, SV2, etc. If it is purchase transactions, then the serial can be recorded as PV2, PV2, etc.

d) The documents supported with the transactions should be arranged properly. For e.g., while recording the expense transaction, the expense bills should also be sequentially filed.

Once all the transactions are recorded systematically, they will be classified and summarized in a logical manner using professional judgement so as to enable preparation of financial statements.

2) Identifying results of systematically recorded transactions:

Once the transactions are recorded systematically, they are classified on the basis of their nature. Based on that classification, accountant will prepare statement of profit and loss. Profit and loss account stats the performance of the business by recording the revenue and costs. If the revenue is more than total expenses, we can say that business is performing well with profit and vice-e-versa if the total cost is more than revenue, we can say that business is not performing up to the mark since it is incurring losses. Based on the profit and loss account, the management can take various decisions since it reflects the correct result. For example,., if the entity is incurring losses then the management may think of taking corrective actions so as to attain the profit or to minimize loss.

3) Identifying financial position of the entity:

After preparing profit and loss account, the management knows the result of the business for the reporting period. However, knowing the result of the business is not sufficient. The businessman needs to know the financial position of the business as on the date. Financial position includes business's financial liabilities and financial assets i.e. how much the business owes (liabilities) and how much is owed(assets) by the business. Hence, along with profit and loss account, the accountant also prepares the statement of financial position as on the date. It is known as Balance Sheet.

Balance sheet is a statement of assets and liabilities of the business at a particular point of time and it helps in ascertaining the financial health of the business.

4) Sharing of information to the relevant users

Accounting is a language of business, it is effective when it is communicated properly with the relevant users. Financial information, financial results and financial position needs to be communicated effectively to various users. Financial statements are the essential mode to communicate with users. Financial statements includes:

a) Profit and loss account
b) Balance Sheet
c) Cash flow statement

d) Statement of changes in equity
e) Notes to accounts.

When the relevant information is provided to stakeholders, they would be in a better position to take informed, analysed and rational decision. Such stakeholders primarily include management, investors, suppliers, vendors, various authorities, government, public at large, students, etc.

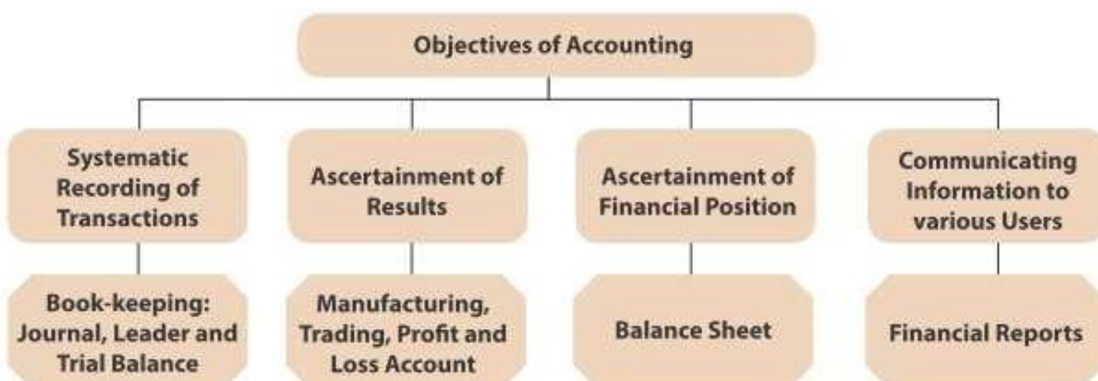
5) Knowing the solvency position:

By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise but it also gives the information regarding entity's ability to meet its liabilities in the short run (liquidity position) and also in the long run (solvency position).

The Institute of Chartered Accountants of India (ICAI), has issued a document under the title, "Framework for the Preparation and Presentation of Financial Statements" which describes the following as the objectives of financial statements:

i) to provide information about the financial position, performance andchanges in financial position of an enterprise,
ii) to provide financial accounting information to a wide range of users inmaking decisions,
iii) to assess the stewardship of management or the accountability of management for the resources entrusted to it.

An overview of objectives of accounting is depicted in the chart given below:



3.5 FUNCTIONS OF ACCOUNTING

1. Decision making –

Accounting provides accurate information about the financial results, position and solvency of the business. Based on such logically arrived information, the stakeholder can take informed and rational decision.

2. Forecasting –

Future is what we create today. Reliable accounting information as on the date will enable the management to forecast its business over a short as well as long term. Using the historic data and trend analysis, an analytical forecast of future performance and financial position of the enterprise can be done.

3. Measurement –

The transaction or economic event is recorded with measured amount. Apart from that, accounting measures past performance of the business entity and depicts its current financial position.

4. Comparison and Evaluation –

Accounting assesses performance achieved against benchmarks set. It compares each line item with that of previous period. The reports and statements also make required disclosure as are required by Generally Accepted Accounting Principles and relevant accounting framework.

5. Analysis –

Based on the computed financial performance and financial position as at the relevant date, accounting enables the stakeholders to do various types of analysis such as trend analysis, ratio analysis, profitability analysis, etc. Such analysis will help them taking informed decisions.

6. Control –

Accounting identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

7. Compliance –

Under any financial reporting framework, there are various authorities including Government that require financial information from the business entities to ensure that the entities are compliant with all laws and regulations of the applicable framework. Accounting provides information to the government to exercise control on the entity as well in collection of tax revenues.

3.6 PROCESS OF ACCOUNTING

Procedure of accounting is bifurcated into two parts:

(A) Generating financial information and

(B) Using the financial information Generating financial information consists of

a) Recording
b) Classifying
c) Summarizing
d) Analyzing
e) Interpreting
f) Communicating

Let's understand each stage step by step.

- **Recording**

Recording is the first and basic step of accounting. All the transactions which are having economic substance and are related with business are recorded in the books of account of business. Each recorded transaction shall be substantiated with the relevant documents as in, purchase transactions evidenced by purchase invoice, sales transactions with sales invoice, loan with loan agreement, dividend income with DEMAT account, dividend paid with resolution, etc. Recording is done in a book called 'Journal'.

- **Classifying**

In business, various transactions take place in one day. After recording them systematically, next task is to classify them in proper heading so as to simplify the analysis. The classification is done on the basis of the nature of transaction. The classification done is called 'Ledger' and the relevant recorded transactions are 'posted' in the ledger. For example, purchase ledger, party ledger, electricity ledger, rent ledger, salary ledger, fixed asset ledger, depreciation ledger. The transactions recorded on different pages, individual account heads under which, all financial transactions ofsimilar nature are collected.

Such classification helps in finding out the total expenditure incurred in each head. Ledgers summarize the transactions and reflect the total balances at the end of the period.

- **Summarizing**

The summary of all ledgers is reflected in the trial balance. Then such summarized data enables the preparation and presentation of the classified data in a useful manner. It will be helpful for internal as well as external users of financial statements.

- **Analysing**

Analysis is detailed examination of the elements and given information so as to enable to conscious decision making. Figures given in the financial statements are mere data unless it is simplified for the users of financial statements. Data becomes information when it is structured and put in a summarized form. The analysis creates and displays relationship between all the items and provides basis for interpretation. Trend analysis, ratio analysis, balance sheet analysis etc. are the various Forms of analysis. Such analysis helps its users in obtaining overall idea about the financial performance and position of the business and decision making.

- **Interpreting**

Once the transaction is recorded, summarized and analysed; it is very important to interpret in a simple language since all the users may not be financial literate to understand the complicate terms of financial accounting. This is the last function of accounting. Interpreting relates with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The financial statements should be self-explanatory to the extent that they explain not only what happened but also why it happened and what is likely to happen under specified conditions.

Let's understand the whole process with a special scenario presented here:

Fly high Ltd. is engaged in the business of tourism. All the transactions for the year 1st April, 2020 to 31st March,2021 of the business are recorded. The transactions are summarized and trial balance is prepared. Based on the trial balance, the accountant prepared financial statements i.e. profit & loss account and balance sheet. After preparing the balance sheet, the accountant analysed that, there has been approx. 78% decrease in the revenue, 82% decrease in net profit and the liquidity has been severely affected. Since the revenues were not enough to meet the daily business requirements, the company had to borrow funds as well. On the analysis, it came to the notice that the financial performance was worsened because of Covid-19. The company has made following disclosures and interpretations:

"The business outlook for 2020 was impacted by significant risks and uncertainties caused by a diverse range of factors mainly the outbreak of Coronavirus (Covid-19) pandemic, some of which are beyond the Company's control. The Company is assessing the forecast conditions considering the impact of Coronavirus (Covid-19) for its future operations and the significant Government support measures being undertaken for the various sectors in the United Arab Emirates (UAE). The extent and duration of the impact remain uncertain and dependent on future developments that cannot be accurately predicted at this time, such as the transmission rate of the coronavirus and the extent and effectiveness of containment actions taken. Since the observed impact of the pandemic has not yet crossed the thresholds set in the existing stress testing scenarios, no change has been made to the Company's products assumptions yet. As at statement of financial position date, the management of the Company is confident to continue with the operations of the Company and accordingly these financial statements have been prepared on a going concern basis.

Economic stress in the markets brought on by the COVID - 19 crisis being felt globally through lack of liquidity in the markets. In this environment, the Company has introduced proactive comprehensive measures to address and mitigate key financial issues arising from the current situation. The Company has already taken measures to manage its liquidity carefully by implementing various controls in the 'treasury process' in order to satisfy its working capital needs, capital expenditure and other liquidity requirements associated with its existing operations. The Company has been closely monitoring the cash flows and forecasts. As of the date of approval of these financial statements, the Company does not have any risk of going concern.

The impact of COVID - 19 continues to evolve, hence the effects of COVID - 19 may not be fully reflected in the Company's financial results until future periods. The Company is taking proactive measures to monitor and manage thesituation to the best of its abilities to support the long business.

3.7 BOOK-KEEPING V/S ACCOUNTING

At times, most of the people generalize book-keeping, accounting and accountancy. Being an accounting professional, it is important to understand the thin line of difference between book-keeping and accounting. In the process of accounting, first two procedural steps describe book-keeping i.e. recording andclassifying. Whereas accounting goes beyond book-keeping.

Book-keeping is an activity concerned with the recording of financial datarelating to business operations in a significant manner. The recording shall be done in a logical order with proper classification. Because accounting mainly depends on careful and efficient book-keeping system. The main motive of having sound book-keeping system is to show the correct position of each head of income, expense, assets and liabilities of the business which would ultimately lead the accountant to measure correct financial performance and derive at true financial position.

There are mainly two objectives of book-keeping:

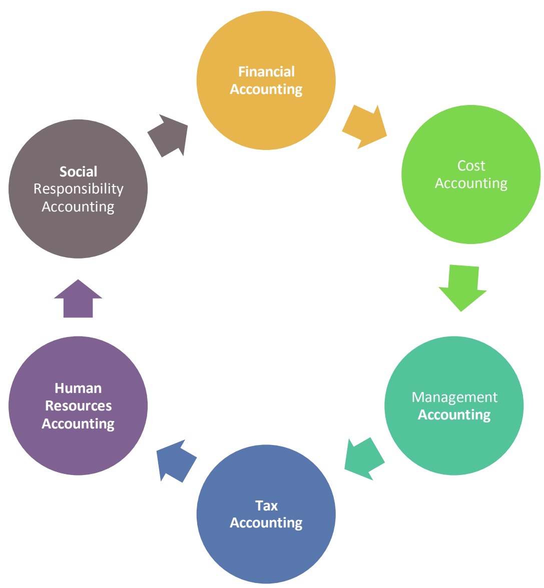
a) Complete recording of transactions which is concerned with complete and permanent record of all transactions in a systematic and logical manner to show its financial effect on the business.

b) Ascertainment of Financial effect on the business which is mainly concerned with the combined effect of all the transactions made during the accounting period upon the financial position of the business as a whole.

Following are the points of difference between book-keeping and accounting:

No.	Book-keeping	Accounting
1.	It is a recording phase i.e., it is aproce transactions.	It is a summarizing phase i.e., it is a process related with summarizing of recorded transactions.
2.	Function of Book-keeping ends a f t e r providing data.	Accounting starts when book- keeping ends.
3.	Financial statements do Form part of book-keeping.	Financial statements are prepared Based on book-keeping.
4.	Communication of financial datais not involved since book- keeping creates a base foraccounting.	Accounting involves communication of financial information and statements with its stakeholdersthat is why it is known as language of business.
5.	Decisions cannot be made basedon book-keeping.	Since accounting involves analysis, interpretation and communication, managerial decision can be taken. Accounting is one of the most important and crucial tool for decision making.
6.	There are no branches of book-keeping.	Accounting has various branches like financial accounting, cost accounting, management accounting, etc.
7,	From book-keeping records, one Cannot ascertain financial position of the business.	Financial position of the business is Ascertained on the basis of accounting reports.

3.8 BRANCHES OF ACCOUNTING



I. Financial Accounting –

- This branch of accounting primarily deals with preparation of financialstatement which includes preparation of
  - Profit and Loss Account,
  - Balance Sheet,
  - statement of change in equity,
  - Cashflow statement,
  - Schedules and notes to the financial statement.
- Thus, this branch deals with preparation and interpretation of financial accounting.
- It helps in determining and measuring the entity's financial performance

for the financial period and financial position as on the reporting date.

II. Cost Accounting –

- As per the Institute of Cost and Management Accountants of England, cost accounting means, *"the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs."*
- As per the Chartered Institute of Management Accountants (CIMA) cost accounting means, *"the establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variance, profitability or the social use of funds."*
- Cost accounting keeps management informed with cost of products or services being produced or sold, with the estimated cost of goods or services to be produced and sold in future, with the costs of goods or services produced and consumed within the company and with the cost of operations and processes carried on.

III. Management Accounting –

- The Institute of Cost and Management Accountants of U.K. Defines management accounting as *"the application of professional knowledge and skill in the preparation of accounting information in such a way as to assist the management in the formulation of policies and in the planning and controlling of the operations of the undertaking."*
- Management accounting provides summarized and analytical information about the finance, cost, tax and all the ancillary matters which are required to the owners and managers that would be helpful tothem in process of planning, control and decision making.

IV. Tax Accounting –

- Tax is the main revenue for any Government. Along with financial reporting framework, there is always a tax legislation with which every entity should be compliant.
- This branch of accounting is primarily related to the statutory tax provisions such as Income tax, Goods and Service Tax, Excise duties, Customs duties, etc.

V. Human Resource Accounting –

- Even after the businesses are becoming technology driven, humans still hold the utmost importance when it comes to the valuable assets of the organization.
- Loyal employees are the assets for the organization and they are brand of organization for the world.

- Human resource accounting involves activities such as to identify, quantity and report the investments made in human resource of an organization that are not presently accounted for under conventional
- This is an emerging concept of accounting.

VI. Social Responsibility Accounting –

- The business runs because of people i.e., society. Society has power to build up, grow and degrade the business.
- Social Responsibility Accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.
- This branch reflects the entity's moral responsibility towards the societyfrom whom they have gained so much.

Let's discuss points of difference between financial accounting and management accounting:

No.	Financial Accounting	Management Accounting
1.	Financial accounting provides general purpose information that can be used widely and variedly. Its users vary from public at large to Government.	Management accounting provides information for specific purpose to the specific people. Its users are management and owners who are involved in specific decision-making process.
2.	Outcome and final stage of financial accounting is preparation of profit and lossaccount as well balance sheet.	Outcome of management accounting may be various reports, statements as well as analytical publications as per requirement that will fulfill the purpose of the decisive people(management and Owners).
3.	Since financial accounting represents financialinformation and for general period, normally the financial statements are prepared for a specific period. Normally it would be a financial year.	Since the management accounting is specific purpose driven, a reporting period cannot be determined and generalized.
4.	Financial accounting reports are prepared once in a year, in most of the cases. If the interim accounts are prepared, then they will be prepared half-yearly or quarterly.	Management accounting reports are prepared frequently so as to meet the purpose.

5.	Financial accounting is governed by the corporate reporting framework and government. For e.g., Financial statements are prepared as per Section 129 and Schedule III of The Companies Act, 2013.	Management accounting will vary from management to management and purpose to purpose. Hence, no such regulation exists for presenting management account reports. Management has flexibility to prepare the reports.
6.	Financial accounting reports can be measured or quantified in terms of money. It is entirely financial in nature.	Generally, it is not financialin nature.
7.	Financial accounting reports donot include management accounting reports.	Management accounting report can obtain, use and rely on financial accounting report as a basis to the Extent financial information are concerned.
8.	Financial accounting uses information, which are objective and which can be Verifiable.	Management accounting uses information, which is subjective and are not verifiable.

3.9 STAKEHOLDERS OF ACCOUNTING

The range of users of financial accounting information varies from the employees of the business to those of the public at large. These users may be broadly classified into two categories –

a) external users and
b) Internal users.

- External users are the users who are not directly associated with the activities of the enterprises but who are directly having economic interest in such business enterprises.
- External users rely on financial accounting information to achieve economic benefit in the case of shareholders, creditors (suppliers of goods/services), customers, donors, employees and to perform statutory obligation in the case of government and other regulatory bodies.
- Internal users are the users who are directly associated with the day-to- day activities of the business (managing, operating and accounting).

- Internal users generally represent the management of the business. They are usually the board of directors, in the case of companies, and owners/proprietors in the case of other enterprises.

Emplyees

Investors

Suppliers

Customers

Lenders

Management

Government

Public at large

A. Employees –

- Employee are interested in financial statements because of their personal interests like salary, overtime facilities, bonus, better service conditions and the retirement benefits.
- If the company is giving Employees Stock Option Scheme (ESOP) whereby the employees are also made shareholders of the company by allotting the shares then the employees are also interested to know the financial position of the enterprises by using the vital information provided in the financial statements.

B. Investors –

- Investors are the people who bring capital to the enterprise. Equity shareholders are termed as the real owners of the Company.
- All the investors need accurate financial information to take decisions whether to buy shares, hold or to sell the shares.
- In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.

C. Suppliers –

- The suppliers of goods and other services, usually known as creditors, are interested in information so as to ascertain whether the amount owing to them will be paid by the company promptly.

- Creditors, both short term and long term, are interested in knowing the solvency of the entities.
- The ability of the firm to meet its short-term liabilities or current liabilities on the stipulated date of maturity is referred to as liquidity.
- The financial statements should contain the relevant information onthis aspect.

D. Customers –

- The earning capacity of the firm in relation to revenue or assets or capital employed is referred to as profitability.
- Customers require information regarding quality of the product, priceand its diversity when they want to develop the long term relationship with the enterprises.
- Customers are more concerned with the stability and profitability of the enterprise because their functioning is dependent on the supply of goods.
- To know the sustainability of the business and its financial aspects, customers utilize the relevant information from financial statements.

E. Lenders –

- Bankers, financial institutions and individuals who extend loans are lenders.
- Lenders are mainly interested in knowing whether the interest will be paid at regular intervals and the principal amount will be repaidon the date of maturity.
- Lenders lend money to business entities with the main motive to earn interest for the loan amount advanced by them.

F. Management –

- Management accounting is primarily concerned with the information needs relating to planning, decision making and controlling.
- While evaluating the performance of an enterprise, in estimating future cash flows, the management of any enterprise rely on the financial statements and other related reports.
- The management of an enterprise (generally companies) is entrusted with the board of directors by the investors (shareholders).
- Management uses the financial information and reports to be informed about business affairs and to take logical, rational and the most relevant decisions.

G. Government –

The government and all the regulating agencies require the accounting information for the following:

- to determine taxes, to collect taxes and to frame taxation policies,
- to provide statistical data in assessing the national income,
- to frame policies on the national level governing all the categories of the business enterprises,
- To bring them under strict regulatory control, thereby eliminating unethical practices in the business entities.

H. Public at large –

- Public at large is interested in the financial results of the entity because the operations substantially contribute to the local economy in various ways.
- The business also provides employment to regional people and gives business to local suppliers.

3.10 ACCOUNTING – SUPPLEMENT AND COMPLEMENTARY WITH OTHER FIELDS

a) Accounting and management –

- A large portion of accounting information is prepared for management decision making.
- Accountant plays an important role in the financial requirement and financial aspects of the business, he understands the data requirements, the reports required to make decisions and the better person to manage the sources and applications of the funds in the most effective manner.
- Hence, accountants are well placed in the management and play a key role in the management team.

b) Accounting and economics

- Accounting is a system and process. It provides the basic data to various users so as to make informed decisions and arrive at analytical judgments.
- Apart from accounting information, non-accounting data are also useful for decision-making because ultimately, business and economy is a larger picture beyond numbers of finance.
- Accounting overlaps economics in various aspects because it contributes majorly in improving the management decision-making process.
- Even though, various economic theories are influenced by the development of the decision-making tools which are used in accounting.
- For example. If the company wants to draft economic policy for the demand and supply, it requires cost data of production and finance data of revenue. Segment wise management reports also help to build

sound economic policies.

c) Accounting and law

- The entity is created and controlled by legal framework. For example Company is incorporated, governed and liquidated as per The Companies Act, 2013 in India. Partnership firm is governed by The Partnership Act.
- Various transactions taking place in the business are also some or the other way governed by various laws such as the Contract Act, Sales ofGoods Act, Negotiable Instrument Act, etc.
- Banking Companies are regulated by The Banking Act, 1949. Insurance and electric companies also have respective legislations controlling the entities.
- Legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline.
- Hence, we can say that accounting influences laws and accounting is influenced by laws.

d) Accounting and statistics and/or mathematics –

- Knowledge of arithmetic and algebra is very important for accounting computations and measurements.
- Mathematics is useful for various computations such as

- Calculations of interest
- Calculation of annuity and present value
- Calculation of depreciation
- Finding out installments in hire-purchase
- Installment payments transactions, etc.

- Accounting is a language of business. Communicating creatively helpsto present it more effectively. In the current era of presentations and PPTs, graphs and charts are being extensively used for communicating accounting information.
- In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting communications system.

3.11 ADVANTAGES OF ACCOUNTING

i. Comparison –

- Accounting enables comparison between
  - Company's current year's financial performance with that ofits previous year's financial performance
  - Company's performance with that of other company
  - Company's performance with that of industry benchmarks

ii. Decision making

- The accounting information is an important tool to determine
  - the price of the unit,
  - total cost of the unit,
  - profitability,
  - Segment wise results, etc.
- Based on the calculations, analysis and interpretations; accounting is a very helpful and core tool for decision making of the enterprise.

iii. Aided advantage for management

- The accounting information is useful to the management in the following ways:
  - in the preparation of budget,
  - in planning the future course of action,
  - in co-coordinating different departments,
  - In controlling the managerial activities.

iv. Legal evidence

- All the transactions that are recorded in the books of accounts shall ideally be supported with the copy of documents that would substantiate the existence of the transactions. I.e. if it is purchase transaction, it should be supported by purchase invoice, etc.
- Such record can be presented in court of law in case of any dispute and such documents would be construed as legal evidence.

v. Helpful to authorities

- Accounting records provide a strong basis for tax computation and hence, it is helpful to the revenue authorities.
- Further, financial statements and other records that are presented to various authorities such as
  - SEBI,
  - RBI,
  - Stock exchanges,
  - Banks,
  - Insurance authorities, etc.

  are helpful to them so as to ensure that the entity is compliant with the relevant framework.

3.12 LIMITATIONS OF ACCOUNTING

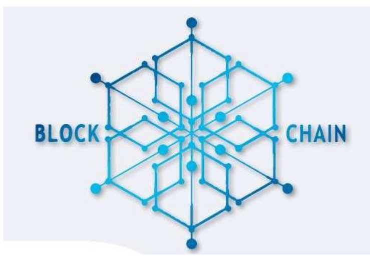
Without accounting, we can’t imagine the organized financial structure of the entity. Accounting is the heart of the business because each financial aspect would be linked with it. However, despite being this usefulness, accounting has its few limitations:

- Most of the times, items are recorded at historic costs hence current and correct valuations are not being taken into consideration.
- Performance of the company are measured solely based on the profitability as far as financial accounting is concerned. Relying highly onprofits may lead to wrong decisions.
- Many times, accounting is done on the estimation basis. In such cases, it may not reflect the absolute correct values to the management.
- Non-monetary items are not given emphasized into accounting and financial statements.

3.13 EMERGING AREAS OF ACCOUNTING

Accounting is a constantly evolving subject. It has evolved a lot from book- keeping to analysis and interpretations. Continuous updates on financial statements and corporate reporting framework reflects its substance to match with growing atmosphere of business. Apart from financial accounting, management accounting, cost accounting and various fields we discussed in 3.9, following are few emerging areas of accounting:

- **Block-chain accounting**



*"You (a "**node**") have a file of transactions on your computer (a "**ledger**"). Two government accountants (let's call them "**miners**") have the **same file** on theirs (so it's "**distributed**"). As you make a transaction, your computer sends an e- mail to each accountant to inform them.*
*Each accountant rushes to be the first to check whether you can afford it (and be paid their salary "**Bit coins**"). The first to check and validate hits "REPLY ALL",attaching their logic for verifying the transaction ("**proof of work**"). If the other accountant agrees, everyone updates their file…*
*This concept is enabled by "**Block chain**" technology." (Delloite)*

Further, William Magyar, Venture advisor, 4x entrepreneur, marketer, strategist, and block chain specialist explains block chain as:

"The traditional way of sharing documents with collaboration is to send a Microsoft Word document to another recipient and ask themto make

revisions to it. The problem with that scenario is that you need to wait until receiving a return copy before you can see or make other changes because you are locked out of editing it until the other person is done with it. That's how databases work today. Two owners can't be messing with the same record at once. That's how banks maintain money balances and transfers; they briefly lock access (or decrease the balance) while they make a transfer, then update the other side, then re-open access (or update again). With Google Docs (or Google Sheets), both parties have access to the same document at the same time, and the single version of that document is always visible to both of them. It is like a shared ledger, but it is a shared document. The distributed part comes into play when sharing involves a number of people.

Imagine the number of legal documents that should be used that way. Instead of passing them to each other, losing track of versions, and not being in sync with the other version, why can't *all* business documents become shared instead of transferred back and forth? So many types of legal contracts would be ideal for that kind of workflow. You don't need a block chain to share documents, but the shared documents analogy is a powerful one."

- **Carbon credit accounting**

- Climate change, or as Dr. John Holdren, Co-Chair of the President's Council of Advisors on Science and Technology, prefers to call it "global climate disruption," is occurring today on our Earth – our home.
- While the exact nature of the causes of these dramatic changes can be discussed, what we have observed over the past 150 year is an increase in our Earth's mean temperature causing global climatic disruption. To mitigate global climate disruption, the forestry carbon market allows landowners to sequester atmospheric carbon dioxide in return for a payment for ecosystem service.

Example

A broker purchases 1,000 credits from a developer whose project is based in the Central American rainforest. Purchase price is $5 per credit, unit cost for the developer is $2.

The total amount the broker pays in the sale is $5,000. The broker records the $5,000 sale on itsbalance sheet as inventory. The journal entry for the broker's purchase is as follows:

Inventory	5,000
Accounts payable	5,000

The gross amount the developer realizes from the sale is also $5000 (less any selling costs, but for this example we will assume the developer incurs no costs to sell the credits). The developer also realizes costs of goods sold related to the credits of $2,000. The developer reduces Inventory on its balance sheet and records the following journal entry for the sale:

Accounts receivable Sales	5,000
Sales	5,000
Cost of goods sold	2,000
Inventory	2,000

When the broker pays the developer for the credits, it makes the following entry:

Accounts payable	5,000
Cash	5,000

The developer makes the following entry when it receives payment from the broker

Cash	5,000
Accounts receivable Sales	5,000

❖ Check your Progress

Multiple Choice Questions:

(1) Financial statements are part of
A. Book-keeping
B. Management Accounting
C. Accounting
D. Cost Accounting

(2) Following is not a branch of Accounting.
A. Book-keeping
B. Management Accounting
C. Human Resource Accounting
D. Cost Accounting

(3) The major internal user of the accounting information is___________.
A. Investors
B. Employee
C. Management
D. B & C both

(4) Accounting is a part of Book-keeping.
A. True
B. False

C. Both are similar
D. Can’t say

(5) Which of the following is not the function of Accounting?
A. Interpreting
B. Decision-making
C. Forecasting
D. Measurement

[(1 - C) (2 - A) (3 - D) (4 - B) (5 - A)]

Short Questions

1. What does Cost Accounting mean?
2. Explain: ‘Accounting is the language of businesses.
3. State the limitations of Accounting.
4. Explain the correlation between Accounting and Statistics.
5. ‘Accounting is a static concept’- Vouch the correctness of the statementwith explanation.

Long Questions

1. What does Accounting mean? Explain Accounting with various evolveddefinitions.
2. State the Qualitative characteristics Financial Statements should possess.
3. Which are the branches of Accounting? Differentiate between Financial Accounting and Management Accounting.
4. ‘Accounting is a process which includes book-keeping’ – Verify the correctness of the statement explaining its process and relation betweenbook-keeping and accounting.
5. Who are the users of Accounting? Discuss them in detail.

UNIT: 4 CONSTRUCTIONS & ANALYSIS OF PROFIT & LOSS ACCOUNTING

4.1 MEANING OF PROFIT AND LOSS ACCOUNT

Introduction

What is profit and loss account?: The term profit and loss (P&L) statement refers to a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a quarter or one fiscal year. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. These statements are often presented on a cash or accrual basis. The P&L statement is one of the three financial statements every public company issues on a quarterly and annual basis, along with the balance sheet and the cash flow statement. It is often the most popular and common financial statement in a business plan as it shows how much profit or loss was generated by a business. P&L statements are also referred to as: statement of profit and loss, statement of operations statement of financial results or income, earnings statement, expense statement and income statement

4.2 FEATURES OF PROFIT AND LOSS ACCOUNT

(1) Profit and loss account is prepared every year and after preparing it is a company would have an idea whether it has made profit or loss during the year. The figure is arrived deducting all expenses from revenue is transferred to the balance sheet. If there is a profit, then it is added to capital and if its loss then it is deducted from capital.

(2) Cash inflow like sales activity made by the company, interest received from deposits, dividend received the year etc. are shown as revenue of the

company whereas cash outflows like salary paid, rent paid are show as expenses of the company.

(3) Capital expenditure like purchase of building, purchase of plant and machinery is not shown in profit and loss statement. Though profit and loss made by selling of capital asset is shown in profit and loss account.

(4) There are some adjustments needed to be cleared like outstanding expenses are to be added to and prepaid expenses to be deducted from respective expenses whereas accrued income is added and income which is not earned is to be deducted from respective income.

(5) In Profit and loss account expenditures like depreciation, amortization, and depletion of natural resources are considered as non-cash expenditures and are shown as expenses of the company.

(6) It does not depict the clear picture of the business that the company is actually doing.

4.3 BENEFITS OF PROFIT AND LOSS ACCOUNT

(1) The actual necessity of the profit and loss account in the financial reporting by increase the interest in the company performance.

(2) The profit and loss account is useful for formulating efficiency of the company to acquired new resources.

(3) This statement is commonly useful for the measurement of assessing activity of the company's financial performance.

(4) The profit and loss account helps as essential information in the forecasting of the company's capability to generate future cash flows.

(5) It also helps in determining the risk or the uncertainty level regarding the future cash flows.

(6) The result which is reflected by the profit and loss account explains how they are obtained for each activity types and how decision is made at the management level in order to coordinate the entire company's activities.

(7) It helps to determine the net profit or loss of the company out of the early found gross profit or loss.

4.3 LIMITATION OF PROFIT AND LOSS ACCOUNT

(1) A company's manager runs the risk of looking at the profit and loss statement as the only picture of the health of the business.

(2) The statement lies with company's businesses that reports the data too often with the wide spread use of computerized accounting systems. Even though profit and loss statement can often be called up and printed on demand of the various user.

(3) A most important disadvantage of the profit and loss statement is that it uses the accrual method of accounting.
(4) The profit and loss account can easily be manipulated by artificially inflating revenue and gains or by deflating current accounting period expenses.

Specimen of profit and loss account

ABC company profit and loss account for the year ended 31st. December

Particular	amount	particular	amount
Gross loss (transfer from trading a/c)	-	Gross profit transfer from trading account	-
Office and administration expenses		Commission received	-
Salary	-	Interest received	-
Rent, rate, and taxes	-	Discount received	-
Postage and telegram	-	Discount from creditor	-
Printing and stationary	-	Discount on purchase	-
Office electricity	-	Dividend received	-
Insurance	-	Interest on drawing	-
Legal expenses	-	Reserve for discount on creditor	-
Marketing and selling expenses		Interest on renewal of bills	-
Carriage outwards	-	Bad debts recovered	-
Freight outward	-	Provision for bad debts	-
Sales salaries	-	Royalty received	-
Advertisement	-	Apprentice premium	-
Godown rent	-	Miscellaneous income	-
Commissions	-	Sundry expenses	
Discount allowed	-		
Bad debt	-		
Financial and other expenses	-		
Bank charges	-		
Interest	-		
Depreciation	-		
Repair and maintenance	-		
Audit fees	-		
Loss by theft,accident and fire	-		
Miscellaneous and sundary expenses	-		
Net profit transfer to capital	-	Net loss (transfer to capital)	-

4.5 MEANING OF BALANCE SHEET

Balance sheet is very important statement which tells us about the financial position of the company. A balance sheet reports a company's assets, liabilities and shareholder equity at a specific point in time. It provides a basis for computing rates of return and evaluating the company's capital structure. This financial statement provides a snapshot of what a company owns and owes, as well as the amount invested by shareholders. The balance sheet shows a company's resources or assets, and it also shows how those assets are financed—whether through debt under liabilities or by issuing equity as shown in shareholder equity. The balance sheet provides both investors and creditors with a snapshot of how effectively a company's management uses its resources. Just like the other financial statements, the balance sheet is used to conduct financial analysis and to calculate financial ratios. Below are a few examples of the items on a typical balance sheet.

4.6 FEATURE OF BALANCE SHEET

(1) Balance sheet is one of the important financial statements.
(2) A balance sheet is a statement of assets and liabilities of a company at a given date.
(3) Balance sheet shows the financial position of a business by detailing the sources of funds and the application of these funds.
(4) Balance sheet shows the assets and liabilities properly classified and arranged in a proper manner.
(5) It is called balance sheets because it is a sheet of balance of different ledger account which have not been closed till the preparation of the trading and profit and loss account
(6) A balance sheet is a list of assets and claims of a business at a specific period of time and is prepared from an adjusted trial balance.

Benefits of balance sheet are as given below:

1. **its provides information to the interested parties:**

The balance sheet provides information relating to financial position of a firm. This information is necessary for various interested users such as shareholder, creditors, debtors, customers, suppliers, employees, government, and investors and the society at large.

2. **Helpful to the shareholder and investors:**

The shareholders are the owners of the business of a company. Basically they invest their money in the share capital. They are not interested in the liquid position of business, but they are interested in the sound financial position of business. However, they want to know from past records and the present balance sheet of the company, whether the company will continue to make progress in future and whether the company will be capable to maintain its financial position. The investors who intend to buy shares of a company are interested in knowing whether the business operation of the company is profitable, how the liquidity position of the company is and how the overall financial conditions of the company is. The balance sheet along with profit and loss account provides such information to them.

3. **Helpful to creditors:**

Balance sheet is equally helpful to the trade creditors of the companies that is the suppliers as well as other creditors of the business. Though the attitude of the trade creditors differ from that of other creditors because interested in making more and more sales to the company.

4. **Helpful to the bankers:**

Balance sheet is helpful for giving essential information about the financial position of the businesses to the banks for getting loan and advance from them. The balance sheet and profit and loss account of the last few years are to be produced to the bank for the purpose of evaluating financial position of the business. Generally, banks are interested in knowing whether the business would be able to make regular payment of interest and principle amount. In such cases, the balance sheet provides necessary information to the bankers.

5. **Provides necessary information to the management**

The balance sheet provides important information to the management on the basis of which they can take important policy decisions. Normally the position is such that the management cannot take arbitrary decisions, therefore they have to base their decision on the financial information provided by financial statements of the companies.

6. **Government regulations:**

The recognized stock exchanges and SEBI exercise control over the companies whose shares are listed on them. They compel the companies to publish essential accounting data for the benefits of shareholders as well as investors.

7. **Helpful to income tax:**

For the purpose of assessing income tax, it is essential for a business to prepare profit and loss statement and a balance sheet. The income tax authorities will easily accept the account if they are properly prepared.

4.7 LIMITATION OF BALANCE SHEET

1. Some of the current assets are values base on the estimated, therefore balance sheet does not in position to show the true financial position of the company.
2. In balance sheet, the fixed assets are shown at original cost less depreciation. Thus balance sheet does not show true value of the assets.
3. Balance sheet cannot reflect those assets which cannot be expressed in monetary terms such as skill, honesty, and loyalty of the employees who are working in the company.
4. There are intangible assets like goodwill, patents, and trademark. They are shown in the balance sheet at imaginary figures which might bear no relationship with the actual market value.
5. Balance sheet does not basically reflect the current value of the business.

Practical case study

Profit and loss account analysis and interpretation

Comparative income statement of Dinesh Mills Ltd.

Particulars	Mar-2001	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Mar-2006	Mar-2007	Mar-2008	Mar-2009
No of Months	12	12	12	12	12	12	12	12	12
INCOME :									
Gross Sales	10.43	-14.57	-8.83	-0.58	1.16	17.04	28.68	34.62	39.49
Less: Excise Duty	9.56	-11.95	-35.33	-30.54	-69.72	-69.19	-58.96	-56.84	-60.42
Net Sales	10.64	-15.17	-5.09	3.69	11.46	29.65	41.46	47.96	54.01
EXPENDITURE :									
Increase/Decrease in Stock	165.65	-173.56	-148.63	-139.21	-111.25	4.56	-141.64	-27.36	-48.63
Raw Material Consumed	26.03	-23.06	2.82	21.08	23.97	50.76	30.82	52.36	56.62
Power & Fuel Cost	19.83	-28.21	-26.67	-18.97	-15.90	-49.57	-56.07	-34.02	-34.36
Employee Cost	5.34	-4.72	-9.43	-1.78	0.18	11.65	38.61	46.71	42.44
Other Manufacturing Expenses	31.14	-36.86	-30.08	-4.66	8.05	29.45	15.04	83.90	60.17
General and Administration Expenses	-8.66	6.49	9.96	10.82	16.45	34.20	-22.08	-0.43	75.76
Selling and Distribution Expenses	7.53	-21.64	-18.22	-17.67	8.49	15.07	30.27	66.71	40.82
Miscellaneous Expenses	51.39	-40.97	-35.07	-34.72	-3.47	-43.06	-36.81	-36.81	-29.17
Less: Expenses Capitalized	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Expenditure	6.86	-8.72	-2.02	8.56	16.26	15.81	25.21	42.58	41.97
Operating Profit (Excl OI)	34.18	-55.37	-24.29	-26.69	-18.50	115.96	142.94	81.50	129.24
Other Income	4.10	41.54	8.72	60.00	35.38	32.82	47.69	91.79	70.77
Operating Profit	27.69	-34.44	-17.17	-7.97	-6.76	98.01	122.26	83.83	116.61
Interest	20.67	-24.58	-30.17	-46.93	-50.84	-13.97	6.70	4.47	22.35
PBDT	29.42	-36.88	-13.81	1.66	4.14	125.69	150.83	103.45	139.92
Depreciation	14.25	-19.86	-21.73	-24.07	-54.91	-20.56	-13.79	4.91	21.03
Profit Before Taxation & Exceptional Items	51.35	-61.49	-2.36	38.85	89.53	337.50	388.85	245.61	311.82
Exceptional Income / Expenses	100.00	-500.00	-100.00	-100.00	-100.00	-100.00	-100.00	-100.00	-926.67
Profit Before Tax	48.75	-38.08	2.85	46.26	99.64	360.85	414.95	264.06	377.94
Provision for Tax	50.38	-88.72	-21.05	-6.02	55.64	226.32	266.92	148.87	252.63
Profit After Tax	47.30	7.43	24.32	93.24	139.19	481.76	547.97	367.57	490.54
Appropriations	27.04	18.24	86.97	167.10	87.95	216.61	275.24	201.30	250.49
Equity Dividend %	33.33	-50.00	-33.33	-16.67	0.00	66.67	66.67	66.67	66.67
Earnings Per Share	47.30	7.37	24.27	93.02	138.51	480.28	546.33	366.69	-41.07
Book Value	-1.00	-5.79	-1.07	4.58	12.90	30.94	62.24	75.46	-80.64

Analysis & Discussion

From Table No.1 it is inferred that comparatively the growth in sales turnover is high of 39.49 percent during the year 2008-09. The company had declined in sales of -0.58, -8.83 and -14.57 during the year of 2003-04, 2002-03 and 2001-02.

The company had an abnormal increase in material cost, employee cost and general administration respectively during the year 2008-09 (56.62 percent, 42.44 percent and 75.76) compared to previous year. Increase in power & fuel cost is high during the year 2000-01(19.83 percent).

Growth in operating profit is significantly high during the year 2006-07(122.2 percent). As a result growth in reported profit is 547.97 percent during the year 2006-07 followed 2008-09 and 2005-06. This resulted in high earning per share and dividend declaration during the year 2006-07, 2008-09 and 2005-06. The general and administration decreased to 8.66 percent but it rose to 6.49 percent. Its increase was very high during the year 2008-09 (75.76 percent). The selling and distribution expense was showing highly fluctuation. It was very high during the year 2007-08 (66.71 percent) and very decreased during the year 2001-02 (-21.64 percent).A selling and distribution expense has significant effect on Reported Net profit. Interest expenses highly increased during the year 2004-05 (50.84 percent). The Reported Net profit was very high during the year 2008-09 (490.54 percent).The reported net profit was significantly affected by material cost, employment cost and power and fuel cost.

The table No.2 shows that the share of net sales is high of 96.60 percent of sales during 2005-06 and the net sales are very low of 86.59 percent during the year 2001-02. The excise duty is 3.64 percent of sales in the year of 2008-09 and increased Table No.2 shows that share of excise duty component is high of 13.21 percent of sales during 2001-02 and 12.94 percent during 2002-01. It is low of 3.37 percent of sales during the year 2005-06. The total net sales is 96.60 percent of gross sales during the year 2005-06 , which is more than the sales turnover due to high net sales 3.40 percent. Power and fuel cost is low during 2006-07 (3.40 percent) and 2005-06 (4.29 percent). Other manufacturing expenses is high of 10.97 percent of sales during the year 2007-08 and low of 5.94 percent of sales during the year 2001-02. Total expenditure is high of 86.37 percent of sales during the year 2004-05 followed by 82.06 percent of sales in the year 2003-04. Reported net profit is high of 12.69 percent of sales during the year 2006-07 and low of 1.48 during year 2000-01.

Common size income statement of Dinesh Mills Ltd

Particulars	Mar-2000	Mar-2001	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Mar-2006	Mar-2007	Mar-2008	Mar-2009
No of Months	12	12	12	12	12	12	12	12	12	12
INCOME :										
Gross Sales	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Less: Excise Duty	12.82	12.94	13.21	9.09	8.95	3.84	3.37	4.09	4.11	3.64
Net Sales	87.20	87.00	86.59	90.78	90.94	96.08	96.60	95.86	95.84	96.28
EXPENDITURE :										
Increase/Decrease in Stock	-5.60	4.10	4.82	2.99	2.21	0.62	-5.00	1.81	-3.02	-2.06
Raw Material Consumed	22.37	18.47	20.14	25.22	27.24	27.41	28.81	22.74	25.31	25.11
Power & Fuel Cost	9.96	8.91	8.37	8.01	8.12	8.28	4.29	3.40	4.88	4.69
Employee Cost	19.13	20.22	21.34	19.01	18.90	18.95	18.25	20.61	20.85	19.54
Other Manufacturing Expenses	8.03	6.18	5.94	6.16	7.70	8.58	8.89	7.18	10.97	9.23
General and Administration Expenses	3.93	4.77	4.90	4.74	4.38	4.53	4.51	2.38	2.91	4.95
Selling and Distribution Expenses	12.43	12.83	11.40	11.15	10.29	13.33	12.22	12.58	15.39	12.54
Miscellaneous Expenses	4.90	2.66	3.39	3.49	3.22	4.68	2.39	2.41	2.30	2.49
Less: Expenses Capitalized	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Expenditure	75.15	78.15	80.29	80.77	82.06	86.37	74.36	73.12	79.59	76.49
Operating Profit (Excl OI)	12.05	8.86	6.30	10.01	8.89	9.71	22.24	22.75	16.25	19.80
Other Income	3.32	3.55	5.50	3.96	5.34	4.44	3.77	3.81	4.73	4.06
Operating Profit	15.37	12.41	11.80	13.97	14.23	14.17	26.00	26.55	20.99	23.87
Interest	3.05	2.70	2.69	2.33	1.63	1.48	2.24	2.53	2.36	2.67
PBDT	12.32	9.71	9.11	11.65	12.60	12.69	23.76	24.02	18.62	21.20
Depreciation	7.29	6.97	6.83	6.25	5.56	3.25	4.94	4.88	5.68	6.32
Profit Before Taxation & Exceptional Items	5.04	2.74	2.27	5.40	7.04	9.44	18.83	19.14	12.93	14.87
Exceptional Income / Expenses	-0.26	0.00	1.20	0.00	0.00	0.00	0.00	0.00	0.00	1.51
Profit Before Tax	4.78	2.74	3.47	5.40	7.04	9.44	18.83	19.14	12.93	16.39
Provision for Tax	2.26	1.25	0.30	1.96	2.14	3.48	6.31	6.46	4.19	5.72
Reported Net profit	2.52	1.48	3.17	3.44	4.90	5.96	12.52	12.69	8.75	10.67
Appropriations	5.23	4.26	7.23	10.72	14.04	9.71	14.14	15.24	11.70	13.13

It can be inferred from table No.3 that share capital is constant during the period under study. The above table shows that the reserves contribute to major part of capital. Reserves constitute more than 65 % of total liabilities. The secured debts were 22.83 percent of total liabilities during the year 2004-05 and 21.14 percent during the year 2008-09. During the year 1999-2000 the unsecured debts was 18.86 percent and it was 4.56 percent of total liabilities during the year 2008-09.The company had 28.76 percent of total debt during the year 2004-05 due to huge secured loan of 22.83 percent.

Gross block is high of 188.71 percent during the year 2001-02 whereas net block is high during 1999-2000 (51.83 percent).investments are high of 28.36 percent. The company had high inventories and sundry debtors of 48.11 percent and 12.16 percent during 1999-2000 and 2001-02 respectively. The company had huge cash balance of 25.95 percent during the year 2005-06. Total current assets are high of 110.64 percent during the year 1999-2000.

Comparative balance sheet of Dinesh Mills Ltd

Particulars	Mar-2001	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Mar-2006	Mar-2007	Mar-2008	Mar-2009
Share Capital	0	0	0	0	0	0	0	0	0
Total Reserves	1.13	-6.64	-1.22	5.23	14.78	35.46	71.33	86.47	107.28
Shareholder's Funds	0.99	-5.80	-1.09	4.56	12.90	30.93	62.23	75.44	93.58
Secured Loans	-100.00	-100.00	2514.29	2000.00	21300.00	21071.43	26800.00	26100.00	32514.29
Unsecured Loans	-24.90	-25.21	-44.09	-59.96	-59.65	-50.31	-47.10	-51.87	-47.93
Total Debts	-25.36	-25.67	-25.57	-45.05	94.54	102.16	146.70	136.91	187.11
Total Liabilities	-4.01	-9.57	-5.73	-4.85	28.39	44.45	78.24	87.11	111.33
APPLICATION OF FUNDS :									
Gross Block	0.00	-1.07	1.88	2.53	23.38	25.74	42.05	44.67	57.86
Less: Accumulated Depreciation	5.68	9.78	14.71	19.09	21.06	26.41	32.25	38.97	46.93
Less: Impairment of Assets	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Net Block	-13.21	-26.31	-27.97	-36.01	28.77	24.16	64.85	57.95	83.28
Lease Adjustment A/c	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capital Work in Progress	0.00	0.00	0.00	0.00	1.34	0.00	0.00	0.00	0.00
Pre-operative Expenses pending	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Assets in transit	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investments	-1.01	101.01	82.76	144.62	148.68	214.40	331.03	375.46	521.30
Current Assets, Loans & Advances									
Inventories	-10.45	-9.92	-14.92	-6.79	-20.09	2.44	-5.94	9.84	21.51
Sundry Debtors	-4.61	-4.10	-9.90	-10.24	10.58	9.39	25.60	15.53	42.49
Cash and Bank	10.62	-15.90	-27.82	-33.82	-29.28	55.39	72.67	72.10	-3.00
Other Current Assets	0.00	210.00	210.00	40.00	200.00	230.00	-100.00	-100.00	1290.00
Loans and Advances	-11.49	-28.82	-32.63	-27.80	-26.19	-26.26	-65.18	-55.01	-67.01
Less: Current Liabilities and Provisions									
Current Liabilities	-8.10	-3.81	-34.56	-31.47	-35.28	-22.47	-24.54	-20.96	-19.86
Provisions	-23.52	-79.86	-64.47	-46.37	-46.56	-24.39	-74.64	-71.35	-66.99
Total Current Liabilities	-12.43	-25.12	-42.92	-35.65	-38.42	-23.03	-38.61	-35.08	-33.07
Net Current Assets	7.57	4.52	19.76	14.93	14.53	66.58	72.22	88.98	59.62
Miscellaneous Expenses not written off	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Tax Assets / Liabilities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Assets	-4.01	-9.57	-5.73	-4.85	28.39	44.45	78.24	87.11	111.33
Contingent Liabilities	5.55	1.01	2.62	2.49	4.18	4.22	2.52	7.38	0.65

The comparative results are of nine years because 1999-2000 is the base year. In the year wise comparison it is found that year 2008-09 had high increase in sales. In the year 20001-02 and 2002-03 there was a negative sales performance. There was a significant increase in raw material consumption, other manufacturing expenses, selling and administrative expenses and miscellaneous expenses during the year 2008-09. The recognition of significant increase in almost all the expenditures happened during 2008-09, resulted in a gradual decrease in the subsequent years and in the year 2007-08 there is a significant reduction in the total expenditure.

Common size balance sheet of Dinesh Mills Ltd

Particulars	Mar-2000	Mar-2001	Mar-2002	Mar-2003	Mar-2004	Mar-2005	Mar-2006	Mar-2007	Mar-2008	Mar-2009
SOURCES OF FUNDS:										
Share Capital	10.33	10.76	11.42	10.96	10.86	8.05	7.15	5.80	5.52	4.89
Total Reserves	70.69	74.48	72.98	74.08	78.18	63.20	66.29	67.95	70.45	69.34
Shareholder's Funds	81.02	85.24	84.40	85.01	89.04	71.24	73.44	73.74	75.97	74.22
Secured Loans	0.14	0.00	0.00	3.80	3.02	22.83	20.07	20.67	19.18	21.14
Unsecured Loans	18.86	14.76	15.60	11.19	7.94	5.93	6.49	5.60	4.85	4.65
Total Debts	18.98	14.76	15.60	14.99	10.96	28.76	26.56	26.27	24.03	25.78
Total Liabilities	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
APPLICATION OF FUNDS :										
Gross Block	172.49	179.70	188.71	186.43	185.87	165.76	150.14	137.46	133.37	128.85
Less: Accumulated Depreciation	120.66	132.84	146.47	146.82	151.02	113.78	105.59	89.53	89.62	83.89
Net Block	51.83	46.86	42.23	39.60	34.86	51.98	44.55	47.94	43.75	44.95
Lease Adjustment A/c	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capital Work in Progress	0.00	0.00	0.00	0.00	0.00	2.04	0.00	0.00	0.00	4.30
Pre-operative Expenses pending	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Assets in transit	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Investments	9.65	9.95	21.44	18.70	24.80	18.68	20.99	23.33	24.51	28.36
Current Assets, Loans & Advances										
Inventories	48.11	44.88	47.92	43.42	47.13	29.95	34.12	25.39	28.24	27.66
Sundry Debtors	11.47	11.39	12.16	10.96	10.82	9.88	8.68	8.08	7.08	7.73
Cash and Bank	24.12	27.80	22.44	18.47	16.78	13.29	25.95	23.37	22.19	11.07
Other Current Assets	0.20	0.20	0.67	0.64	0.29	0.46	0.45	0.00	0.00	1.29
Loans and Advances	26.75	24.66	21.05	19.12	20.30	15.38	13.65	5.23	6.43	4.18
Total Current Assets	110.64	108.97	104.24	92.61	95.31	68.96	82.85	62.06	63.93	51.94
Less: Current Liabilities and Provisions										
Current Liabilities	51.91	49.69	55.21	36.03	37.38	26.17	27.86	21.98	21.93	19.68
Provisions	20.21	16.10	4.50	7.62	11.39	8.41	10.58	2.88	3.10	3.16
Total Current Liabilities	72.12	65.80	59.71	43.67	48.78	34.59	38.43	24.84	25.02	22.84
Net Current Assets	38.52	43.17	44.53	48.94	46.54	34.36	44.43	37.22	38.91	29.10
Miscellaneous Expenses not written off	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Deferred Tax Assets / Liabilities	0.00	0.00	-8.22	-7.22	-6.21	-7.07	-9.97	-8.47	-7.17	-6.70
Total Assets	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Common size Balance sheet also reflects the same. During the study period overall expenditure is high during the year 2007-08. The significant increase on reported Net profit has occurred during the year 2006-07. That is because of the significant reduction in power and fuel cost. The overall total expenditure is low during this period compared to previous year. Though year 2006-07 stands first in the reported net profit, it occupies the first position in terms of earning per share and second position in terms of book value per share it is because of more appropriations.

With regard to share capital there were no changes during the period under study. The funds from reserves, secured loans, sale of fixed assets and inventory have been used for funding the investments. During the period of study the company is able to maintain a constant level of total reserves except in the year 2004-05, 2005-06 and 2006-07. Where the company had more loans and in the year 2003-04 shareholders' funds of 89.04 percent and 10.96 percent of total debt when compared to other financial years in the study.

❖ Check your Progress

Multiple choice Questions:

(1) What is the formula for calculating net income on a profit and loss account?

a) Net income = Revenues – Expenses

b) Net income = Expenses - Revenues

c) Net income = Revenues + Expenses

d) Net income = Revenues / Expenses

(2) Which of the following is NOT a component of a profit and loss account?

a) Revenues

b) Expenses

c) Balance Sheet

d) Cash Flow Statement

(3) A company's net loss on a profit and loss account means:

a) The company has more expenses than revenues

b) The company has more revenues than expenses

c) The company has an equal amount of expenses and revenues

d) The company has negative cash flow

(4) A company's gross profit can be calculated by:

a) Subtracting cost of goods sold from revenues

b) Adding cost of goods sold to revenues

c) Subtracting revenues from cost of goods sold

d) Adding cost of goods sold and operating expenses

(5) A company's operating income is:

a) Gross profit minus operating expenses

b) Operating expenses minus gross profit

c) Net income minus taxes

d) Revenues minus cost of goods sold

Answers:

1. a) Net income = Revenues - Expenses
2. c) Balance Sheet
3. a) The company has more expenses than revenues
4. a) Subtracting cost of goods sold from revenues
5. a) Gross profit minus operating expenses

Short Questions

1. What is the purpose of a profit and loss account?
2. What is net income and how is it calculated?
3. How can a P&L account help a business to identify areas of inefficiency?
4. What is the difference between gross profit and net income?
5. How can a P&L account be used to compare a company's performance to industry benchmarks?
6. How a P&L account is used to make strategic decisions?
7. How does a P&L account differ from a balance sheet?
8. How does a P&L account differ from a cash flow statement?
9. What are the components of a P&L account?
10. How P&L account is important for the investors?

Long Question

1. Explain how a profit and loss account can be used to make strategic business decisions.
2. Analyze the impact of changes in cost of goods sold and operating expenses on a company's net income as shown in its P&L account.
3. Discuss the importance of regularly analyzing a profit and loss account in the context of a business's overall financial performance.
4. Describe how a P&L account can be used to evaluate a company's liquidity and solvency.
5. Explain how a P&L account can be used to identify trends in a company's financial performance over time.
6. Analyze the relationship between a company's gross profit margin and net profit margin as shown in its P&L account.
7. Evaluate the role of a P&L account in the financial planning and budgeting process of a business.

8. Discuss the importance of comparing a company's P&L account to industry benchmarks in the context of business decision making.
9. Describe how a P&L account can be used to evaluate the effectiveness of a company's pricing strategy.
10. Explain how the fluctuations in expenses and revenues of a company affect its net income over the time and how it can be used to predict future performance.
11. Discuss the benefits and limitations of profit and loss account.
12. Describe the salient features and benefits of profit and loss account.
13. Explain the meaning of Balance sheet. Also describe the salient features of Balance sheet.
14. Describe the limitations of balance sheet.

UNIT: 5 CONSTRUCTION & ANALYSIS OF BALANCESHEET ACCOUNTING

5.1 INTRODUCTION TO FINANCIAL STATEMENTS

A statement means a summary of all the transactions. For example, bank statement or credit card statement. Just like that, Financial Statements reflect the financial position and financial performance of the business in a summarized manner. If we take into consideration the statutory meaning and inclusions in financial statements, then as per Section 2(40) of the Companies Act, 2013; financial statements include

- Balance sheet
- Profit and Loss account or Income and Expenditure account
- Cash flow Statement
- Statement of change in equity, if applicable
- any explanatory notes annexed to or forming part of financial statements

Financial statements should be prepared for one financial year. Financial year means for any company or body corporate, a period ending on the 31st day of March every year i.e. 1st April to 31st March.

Financial statements should be prepared in accordance with Schedule III.

5.2 CONSTRUCTION OF BALANCE SHEET

Balance Sheet is a statement of financial position of an enterprise as on a given date, which exhibits its assets, liabilities, capital, reserves and other account balances at their respective book values.

Balance Sheet is constructed i.e. prepared in accordance with Schedule III. Before going through the format, let's understand few general guidelines which will enable us to understand the components of balance sheet with easeand more clarity.

1) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts.
2) Notes to accounts shall contain additional information apart from information presented in the Financial Statements. They should also provide
a. narrative descriptions and
b. information about items that do not qualify for recognition in those statements
3) The disclosure specified in Schedule III is in addition to the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. That means, Schedule III neither substitutes nor replaces Accounting standards. These requirements are over and above standards' requirement.
4) The Financial Statements including notes shall be presented with comparatives with that of immediately preceding reporting period for all Items. However, when Financial Statements are presented for the first time after its incorporation, this requirement is not required to be followed.
5) The amounts in the financial statements can be rounded off based on the below mentioned criteria of Accounting Standards.

Turnover	**Rounding off**
(i) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(ii) one hundred crore rupees or more	To the nearest, lakhs, millions or crores, or decimals thereof.

6) Once a unit of measurement is determined, then it should be uniformly used in the Financial Statements. For example, amount in Rs, amount in Rs.('000), etc.
7) The schedule III sets out minimum requirements for disclosure on the face of the Balance Sheet
a. Line items
b. sub-line items and
c. sub-totals

shall be presented as an addition or substitution on the face of the Financial Statements since such presentation is relevant to an understanding of the company's financial position or performance.

Guidance Note on Division I – Non Ind AS Schedule III to the Companies Act, 2013

PART I – Form of BALANCE SHEET

Name of the Company……………………

Balance Sheet as at ……………………… (Rupees in ....)

	Particulars	NoteNo	Figures as at the end of (Current reporting period) (in Rs.) ________ (DD/MM/YYYY)	Figures as at the end of (Previous reporting period) (in Rs.) ________ (DD/MM/YYYY)
	1	2	3	4
I	**EQUITY AND LIABILITIES**			
1	**Shareholders' funds**			
	(a) Share capital			
	(b) Reserves and surplus			
	(c)Money received against share warrants			
2	**Share application money pending allotment**			
3	**Non-current liabilities**			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
4	**Current liabilities**			
	(a) Short-term borrowings			
	Trade payables:- (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises			
	(c) Other current liabilities			

	(d) Short-term provisions			
	TOTAL			
II.	**ASSETS**			
1	**Non-Current Assets**			
	(a) Property, Plant and Equipment			
	(i) Tangible assets			
	(ii) Intangible assets			
	(iii) Capital work-in progress			
	(iv) Intangible assets under development			
	(b) Non-current investments			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
2	**Current assets**			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and cash equivalents			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

5.3 ANALYSIS OF BALANCE SHEET ACCOUNTING

Above mentioned is the format of Balance sheet. Each line item has its specific disclosures and points of discussion. What kind of disclosures will be relevant, when a situation arises is analyzed in this section.

However, it is pertinent to go through few general instructions for preparing the balance sheet before detailed analysis.

- An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents.
- For seasonal business the operating cycle may vary from 3 months to 6 months. However, where no specific criteria to determine operating cycle is specified, the normal operating cycle is considered as 12 months i.e. financial year.
- To analyze the liquidity, along with operating cycle, cash operating cycle is also important. It is also known as the working capital cycle or the cash conversion cycle. Cash operating cycle is the number of days between paying suppliers and receiving cash from sales.

We can equate it as:

Cash operating cycle = Inventory days + Receivables days – Payables days

- An asset shall be classified as current when it satisfies any of the following criteria:
  - it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle,
  - it is held primarily with primary objective of trading,
  - it is expected to be realized within twelve months after thereporting date or
  - it is cash or cash equivalent.

  Other than above mentioned assets, all assets shall be classified as non-current assets.
- A liability shall be classified as current when it satisfies any of the following criteria:
  - it is expected to be settled in the company's normal operating cycle;
  - it is held primarily for the purpose of being traded;
  - it is due to be settled within twelve months after the reporting date; or
  - The company does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

  Other than above mentioned liabilities, all liabilities shall be classified as non-current liabilities.
- A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. In other words, trade receivables are the receivables which can be directly linked with sales or services provided as a part of the business. All other receivables shall be classified as 'other receivable'.
- Since trade receivable is the receivables and payables in the normal course of business, in most of the cases, they are classified under current assets only because they are related with operating cycle of the business.
- A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business. In other words, trade payable is the payables which can be directly linked with purchase or services received as a part of the business. All other payables shall be classified as 'other payable'.

- The above mentioned difference is the core difference to bifurcate receivables and payable among trade receivables and/or payables aswell as other receivables and/or payables.
- For each line item of balance sheet, Debts due by/due to directors or other officers of the company or any of them either severally or jointly with any other person or debts due by/due to firms or private companies respectively in which any director is a partner or a director ora member should be separately stated.

  After obtaining the general understanding for preparing balance sheet, let's understand its each item in a brief.

A. Share Capital

- Capital generally refers to the amount invested in an enterprise by its owners e.g. paid-up share capital in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.
- Share capital means "Aggregate amount of money paid or credit as paid on the shares and/or stocks of corporate enterprise."
- Preference share capital is the part of the share capital of a corporate enterprise which enjoys preferential rights in respect of
  - Payments of fixed dividend and
  - Repayment of capital.

  Preference shares may also have full or partial participating rights in surplus profits or surplus capital.
- Authorized share capital is the number and par value of each class of shares that an enterprise may issue in accordance with its instrument of incorporation (Articles of Association/Memorandum of Association). Authorized share capital is also known as nominal share capital.
- Issued share capital is the portion of the authorized share capital which has actually been offered for subscription. This also includes bonus shares issued by the company, if any.
- Unissued share capital is the portion of the authorized share capital for which shares have not been offered for subscription.
- Subscribed share capital is the portion of the issued share capital which is actually subscribed and allotted. This also includes bonus shares allotted by the company.
- Called up share capital is the part of the subscribed share capital which shareholders are required to pay to the corporate enterprise.
- Paid up share capital is that part of the subscribed share capital for which consideration in cash or otherwise has been received. This also includes bonus shares allotted by the company.

  For share capital note, following disclosures are required to be made in thenotes to accounts:

- the number and amount of shares authorized
- the number of
- shares issued,
- subscribed and fully paid, and
- subscribed but not fully paid
- par value per share
- a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period
- shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held
- Calls unpaid
- Forfeited shares (amount originally paid up)

➢ Further, there is other detailed disclosure also required for right shares, each class of preference shares, shares issued under contract, commitments, etc.

B. Reserves and Surplus

➢ Reserve means "the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose." (However, in this, provision for depreciation or diminution in the value of assets or for a known liability.)

➢ The reserves are primarily of two types:

- Capital reserves and
- Revenue reserves

➢ Capital reserve is reserve of a corporate enterprise which is not availablefor distribution as dividend.

➢ Revenue reserve means any reserve other than capital reserve.

➢ General Reserve is a revenue reserve which is not earmarked for a specific purpose.

➢ Surplus means "Credit balance in the profit and loss statement afterproviding for proposed appropriations." E.g., dividend or reserves.

➢ Free reserve is a reserve which can be utilized without any restrictions inany manner.

➢ Securities premium is the excess of the issue price of shares over theirface value.

For the purpose of disclosures, reserves and surplus are classified as:

- Capital Reserves

- Capital Redemption Reserve
- Securities Premium
- Debenture Redemption Reserve
- Revaluation Reserve
- Share Options Outstanding Account
- Other Reserves – (specify the nature and purpose of each reserveand the amount in respect thereof)
- Surplus

Let's understand the capital and reserve note through a tabular format:

	Attributable to equity holder of the company				
	Share capital		**Retained earnings**		**Total equity**
As at 1 April, 2019	0		0		0
Profit for the year	0		0		0
Total comprehensive income for the year	0		0		0
As at 31 March, 2020	0		0		0
Profit for the year	0		0		0
Total comprehensive income for the year	0		0		0
As at 31 March, 2021	0		0		0

C. Long term borrowings

- Long-term borrowings are classified as:
- Bonds/debentures
- Term loans
  - From banks
  - From other parties

- Deferred payment liabilities
- Deposits
- Loans and advances from related parties
- Long term maturities of finance lease obligations
- Other loans and advances (specify nature).

➢ Bond/Debenture is a formal document constituting acknowledgement ofa debt by an enterprise usually given under its common seal. They normally contain provisions regarding payment of interest, repayment ofprincipal and security, if any.

➢ Deposits include amounts given for a purpose including fixed deposit for a specified period and at a specified rate of interest.

➢ Deferral is postponement of recognition of a revenue or expense after its related receipt or payment or incurring liability to subsequent period to which it applies.

➢ Deferred payment liabilities are the liabilities whose settlements are postponed to the subsequent period. For Example, deferred tax liability.

➢ All the loan and borrowings can be further divided into

- Secured and
- Unsecured

➢ Secured borrowings are the borrowings which are wholly or partly secured against an asset. Any other borrowing is unsecured borrowing.

➢ When the borrowing is secured, the details of security provided shall be disclosed in notes to accounts.

➢ For the loans, the rate of interest, repayment terms and other details are to be mentioned as a footnote. For example, "Loan bearing interest rate of 4% for Rs. 22, 00,000/- provided as per agreement dated September 18, 2017. Loan to be repaid in one or more equal installment before September 18, 2023."

➢ In case, there is any default in repayment as per original agreement, then the same should be disclosed. Apart from that, if there is any change in any term of the loan, the same shall also be disclosed by footnote. For example, "Loan bearing interest rate of 1% per annum for Rs. 25, 00,000/- provided as per the agreement dated March 14, 2018 and an additional loan bearing interest rate of 1% per annum for Rs. 15, 50,000/- provided as per the amendment to the original agreement dated January 5, 2019. Loan to be repaid in one or more equal installment before April 15, 2025."

D. <u>Other long-term liabilities</u>

➢ Liability is the financial obligation of an enterprise other than owner's funds.

- ➢ Other Long term Liabilities are classified as
- Trade payables
- Others

E. Long-term provisions

- ➢ Provision is an amount written off or retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.
- ➢ Thus, provision is created for the items for which the liability is certain but amount cannot be accurately measured. Hence, the provision is recorded with reasonable accuracy using professional judgement and standards. For example, provision for gratuity, leave salary provision, etc.
- ➢ Long term provisions are classified as
- Provision for employee benefits and
- Others (specify nature). Please check

F. Short-term borrowings

- ➢ Short-term borrowings are classified as
- Loans repayable on demand
  - From banks
  - From other parties
- Loans and advances from related parties
- Deposits
- Other loans and advances (specify nature).
- ➢ All other disclosure requirements mentioned in long term borrowing shall also be applicable for short term borrowings as well.

G. Other current liabilities

- ➢ The amounts of other current liabilities are classified as
- Current maturities of long-term debt
- Current maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings
- Income received in advance
- Unpaid dividends
- Application money received for allotment of securities and due for refund and interest accrued thereon.
- Unpaid matured deposits and interest accrued thereon

- Unpaid matured debentures and interest accrued thereon
- Other payables (specify nature).

H. Short-term provisions

➢ The amounts are classified as

- Provision for employee benefits
- Others (specify nature).

I. Tangible assets

➢ Asset is any tangible object or intangible rights owned by an enterpriseand carrying probable future benefits.

➢ Tangible assets are the assets having physical identity and are to be usedfor operational purpose and rendering the services

➢ They are classified as

- Land
- Buildings
- Plant and Equipment
- Furniture and Fixtures
- Vehicles
- Office equipment
- Others (specify nature).

➢ Assets under lease shall be separately specified under each class of asset.

➢ A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period need to be shown including additions, disposals and other adjustment.

➢ Let’s understand the same with tabular format:

	Building	**Furniture, fixtures and office equipment**	**Vehicles**	**Total (Amount in Rs.)**
Rate of depreciation	**XX%**	**XX%**	**XX%**	
Method of valuation	**Cost**	**Cost**	**Cost**	
Cost or valuation				
As at 1st April, 2020	0	0	0	0
Additions	0	0	0	0
Disposals	0	0	0	0
As at 31st March, 2021	0	0	0	0
Accumulated				

depreciation				
As at 1st April, 2020	0	0	0	0
Charge for the year	0	0	0	0
Eliminated on disposals	0	0	0	0
As at 31st March, 2021	0	0	0	0
Carrying amount				
As at 31st March, 2021	0	0	0	0

J. Intangible assets

- ➢ Intangible assets are the assets which do not have a physical identity.
- ➢ They are classified as
- Goodwill
- Brands /trademarks
- Computer software
- Mastheads and publishing titles
- Mining rights
- Copyrights, and patents and other intellectual property rights, services and operating rights
- Recipes, formulae, models, designs and prototypes
- Licenses and franchise. (i) Others (specify nature)

- ➢ Goodwill is an intangible asset that arises from business connections or trade name or reputation of an enterprise.
- ➢ Brand/trademark is the reputation and earned fame of the enterprise. The use of the brand value for accounting purposes describes an interesting area of capital market information.
- ➢ A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period need to be shown including additions, disposals and other adjustment.

K. Non-current investments

- ➢ Investments are the assets held not for operational purposes or for the rendering services i.e. assets other than fixed assets or current assets such as securities, shares, debentures, immovable properties, etc.)
- ➢ Investment is expenditure on assets held to earn interest, income, profit or other benefits.
- ➢ Non-current investments are primarily classified as

- trade investments and
- other investments

➢ Non-current investments are further classified as:

- Investment property
- Investments in Equity Instruments
- Investments in preference shares
- Investments in Government or trust securities
- Investments in debentures or bonds
- Investments in Mutual Funds
- Investments in partnership firms
- Other non-current investments (specify nature)

➢ Under each classification, details shall be given of names of the bodies corporate such as

- Subsidiaries
- Associates
- joint ventures or
- controlled entities

➢ Investments are mostly carried at its historical cost or the amortised cost. However, Investments which are carried at other than at cost should be separately stated specifying the basis for valuation thereof.

➢ Furthermore, following disclosures shall also be made:

- Aggregate amount of quoted investments and market value
- Aggregate amount of unquoted investments
- Aggregate provision for diminution in value of investments

➢ Let's understand in tabular format:

- Investment in entities

				2020	2019
	Name of company	Country	Effective equity interest	Value (at cost)	Value (at cost)
i	XXX	Xxx	X%	XXX	XXX
				XXX	XXX

- Investment in bond/debenture, etc

	2020	2019
Balance, at the beginning of the year	0	0
Purchases during the year	0	0
Disposals during the year	0	0
Increase in fair value	0	0
Balance, at the end of the year	0	0

L. Long-term loans and advances

- ➢ Advances are the payments made on account of and before the completion of a contract, or before acquisition of goods or receipt of services.
- ➢ Long-term loans and advances shall be classified as
- Capital Advances
- Security Deposits
- Loans and advances to related parties
- Other loans and advances (specify nature).
- ➢ The above mentioned each classification will be separately sub-classifiedas:
- Considered good
- Unsecured, considered good
- Doubtful.
- ➢ Allowance for bad and doubtful loans and advances shall be disclosedunder the relevant heads separately.

M. Other non-current assets

- ➢ Other non-current assets shall be classified as
- Long Term Trade Receivables (including trade receivables on deferred credit terms)
- Others (specify nature)
- Long term Trade Receivables, shall be sub-classified as
- ▪ Secured, considered good
- ▪ Unsecured considered good
- ▪ Doubtful
- Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

N. Current Investments

- ➢ Non-current investments are the investments which are held for lessthan 12 months.

- Current investments shall be classified as
  - Investments in Equity Instruments
  - Investment in Preference Shares
  - Investments in government or trust securities
  - Investments in debentures or bonds
  - Investments in Mutual Funds
  - Investments in partnership firms
  - Other investments (specify nature).
- Under each classification, details shall be given of names of the bodiescorporate such as
  - Subsidiaries
  - Associates
  - joint ventures or
  - controlled entities
- Furthermore, following additional disclosures are required:
  - The basis of valuation of individual investments
  - Aggregate amount of quoted investments and market valuethereof
  - Aggregate amount of unquoted investments
  - Aggregate provision made for diminution in value of investments.

O. Inventories

- Inventories are assets:
  - Held for sale in the ordinary course of business,
  - In the process of production for such sale or
  - In the form of materials or suppliers to be consumed in theproduction process or in the rendering of services.
- Inventories shall be classified as
  - Raw materials
  - Work-in-progress
  - Finished goods
  - Stock-in-trade (in respect of goods acquired for trading)
  - Stores and spares
  - Loose tools
  - Others (specify nature).
- Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- Mode of valuation shall be disclosed separately in notes to accounts i.e.

inventories are measured at cost or net realizable values or lower of both.

- In the case where inventories are lying in the warehouse for exceptionally long period, then the allowance for slow moving inventory shall be provided and the same shall be disclosed along with inventory. Further, the footnote shall be disclosed. e.g., the management is valuing inventories at net realizable and providing for allowance, then the illustrative note can be: “Management estimates the net realisable values of inventories, taking into account the most reliable evidence available at each reporting date. The future realisation of these inventories may be affected by future technology or other market-drivenchanges that may reduce future selling prices.”

P. Trade receivables

- Trade receivables are the persons from whom amounts are due for goods sold or services rendered or in respect of contractual obligations.
- They are also termed as debtors, trade debtors, account receivables or trade receivables.
- Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.
- Trade receivables shall be sub-classified as
- Secured, considered good
- Unsecured considered good and
- Doubtful.
- Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- When the trade debtors are outstanding for long period, professional judgment should be applied to check the requirement of allowance and its impairment.

Q. Cash and cash equivalents

- Cash comprises cash on hand and demand deposits with banks.
- Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject toan insignificant risk of change in value.
- Cash and cash equivalents shall be classified as:
- Balances with banks;
- Cheques, drafts on hand;
- Cash on hand;

- Others (specify nature).

➢ Earmarked balances with banks for specific purpose (for example, for unpaid dividend, guarantee for labor) shall be separately mentioned in the note.

➢ Balances with banks to the extent held as

- margin money or
- Security against the borrowings, guarantees, other commitmentsshall be disclosed separately.

➢ Let's understand with tabular format:

	2020	**2019**
Cash in hand	0	0
Balances with bank in:	0	0
- Current accounts	0	0
- Margin deposits	0	0
- Fixed deposits	0	0
- Guarantee with bank	0	0
Total	**0**	**0**

R. Short-term loans and advances

➢ Short-term loans and advances shall be classified as:

- Loans and advances to related parties (giving details thereof)
- Others (specify nature).

➢ The above shall also be sub-classified as:

- Secured, considered good;
- Unsecured, considered good;
- Doubtful.

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

S. Other current assets (specify nature)

➢ This is an all-inclusive heading, which incorporates current assets that donot fit into any other asset categories.

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

➢ "A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events."

➢ Contingent asset is an asset the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

- Contingent liability is an obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.
- Contingent liabilities shall be classified as:

- Claims against the company not acknowledged as debt;
- Guarantees;
- Other money for which the company is contingently liable

- Commitments shall be classified as:

- Estimated amount of contracts remaining to be executed oncapital account and not provided for;
- Uncalled liability on shares and other investments partly paid
- Other commitments (specify nature).

5.4 ILLUSTRATIONS

Following is the trial balance of Shah & Brothers. Kindly prepare the balance sheet based on thebelow mentioned details.

	Debit	**Credit**
Banks:SBI	2,867.00	0.00
Banks:BOB	23,303.00	0.00
Banks:HDFC	37,219	0.00
Banks:ADIB – USD	0.00	0.00
Deposits	5,190.00	0.00
Prepaid rent	6,007.00	0.00
Accumulated Depreciation	0.00	824,190.00
Furniture (No change in the asset)	5,151,187.00	0.00
Trade Payable:Sheth and brothers	0.00	549,465.00
Other long term Payable:Ramesh and company	0.00	49,883.00
Other long term Payable:Shah & Co.	0.00	6,630,194.
Outstanding electricity bill	0.00	2,854.00
Retained Earnings	1,501,066.00	0.00
Share Capital	0.00	50,272.00
Current year's loss	1,380,019.00	0.00
TOTAL	**8,106,858**	**8,106,858**

Answer:

Balance Sheet of Shah & Brothers as at 31 March, 2021

(Amount in Rs.)

	Particulars	Note No	Figures as at the end of 31 March, 2021 (in Rs.)
I	**EQUITY AND LIABILITIES**		
1	**Shareholders' funds**		
	(a) Share capital	1	50,272
	(b) Reserves and surplus	2	(28,81,085)
2	**Non-current liabilities**		
	(a) Other Long term liabilities	3	66,80,077
3	**Current liabilities**		
	(a) Trade payables		5,49,465
	(b) Short term provisions		2,854
	TOTAL		**44,01,583**
II.	**ASSETS**		
1	**Non Current Assets**		
	(a) Property, Plant and Equipment		
	(i) Tangible assets	4	43,26,997
2	**Current assets**		
	(a) Cash and cash equivalents	5	63,389
	(b) Other current assets	6	11,197
	TOTAL		**44,01,583**

Notes to accounts

1. **Share capital**

Particular	Amount
Authorized share capital (1000 shares of Rs. 50.272 each)	50,272
Share capital (1000 shares of Rs. 50.272 each)	50,272
Total	**50,272**

2. **Reserves and surplus**

Particular	Amount
Opening retained earnings Current year loss	(15,01,066) (13,80,019)
Total	**(28,81,085)**

3. **Other long term liabilities**

Particular	Amount
Payable to Ramesh and company Payable to Shah & Co.	49,883 66,30,194
Total	**66,80,077**

4. **Tangible assets**

Particular	Amount
Furniture	51,51,187
Less : Accumulated depreciation	(8,24,190)
Total	**43,26,997**

Note: There has been no additions/disposal/adjustment during the year.

5. **Cash and cash equivalents**

Particular	Amount
<u>Balance with banks:</u>	
Banks:SBI	2,867
Banks:BOB	23,303
Banks:HDFC	37,219
Total	**63,389**

6. Other current assets

Particular	Amount
Deposits	5,190
Prepaid rent	6,007
Total	**11,197**

Illustration:2

From the following Ledger balances of Varun LTD., prepare the Balance Sheet of the company as on 31 March 2014 as per Schedule III of the Companies Act.

Particulars	Rs.	Particulars	Rs.
Plant & machinery	6,00,000	Immovable property	10,00,000
8% Debenture	8,00,000	Public deposit	5,00,000
Employee's provident Fund	1,30,000	Provision for taxation	1,80,000
Securities premium	80,000	Drafts on hand	5,00,000
Cash at bank	34,000	Bills Receivable	2,40,000
24000 fully paid Equity shares ofRs.100 each Rs. 50 called up	12,00,000	Brokerage on issue of shares	1,10,000
Sundry Creditors	1,16,000	Bank overdraft	1.50,000
Loan to Manager	70,000	Security Deposit	1,24,000
Deposits with ICICI Bank(5 years)	1,98,000	Trade marks	1,80,000
Prepaid insurance	1,00,000		

Answer

Particulars	**Note No.**	**Amount (Rs.).**
I. EQUITY AND LIABILITIES		
1. Shareholders' funds:		
(a) Share capital	1	12,00,000
(b) Reserves and surplus		80,000
2. Share application money pending allotment:		Nil
3. Non-current liabilities:		
(a) Long-term borrowings	2	13,00,000

(d) Long-term provisions		1,30,000
4. Current liabilities:		
(a) Short-term borrowings		1,50,000
(b) Trade payables		1,16,000
(d) Short-term provisions		1,80,000
TOTAL		31,56,000
II. ASSETS		
1.Non-current assets:		
(a) Fixed assets		
(i) Tangible assets	3	16,00,000
(ii) Intangible assets		1,80,000
(b) Non-current investment		1,98,000
(c) Long-term loans & advances		1.24,000
(e) Other non-current assets		
2.Current assets:		1.10,000
(a) Trade receivables		2,40,000
(b) Cash and cash equivalents	4	5,34,000
(c) Short-term loans and advances		70,000
(d) Other current assets		1,00,000
TOTAL		31.56,000

Notes to the financial statements:

1. Share Profile

Authorised Capital (24000 Equity shares of Rs.100 each)	**24,00,000** ---------------- ----------------
Issued & Subscribed capital (24,000 Equity shares of Rs. 100 each)	**24,00,000** ---------------- ----------------
Called up & Paid up capital (24000 Equity shares of 80 each)	**12.00.000**
TOTAL	**12.00.000**

2.Long Term borrowings

8% Debentures	8,00,000
Public deposits	5,00,000
TOTAL	13,00,000

3.Tangible Assets

Plant & Machinery	6,00,000
Immovable property	10,00,000
TOTAL	16,00,000

4. Cash & Cash equivalent

Cash in hand	34,000
Drafts on hand	5,00,000
TOTAL	5,34,000

Illustration:3 From the following ledger balances of Sunshine Co. Ltd., prepare the Balance Sheet of the company as on 31 March 2014 as per Schedule VI of the Companies Act.

Particulars	Rs.	Particulars	Rs.
Equity Share Capital	26,00,000	Advances to employees	1,50,000
General Reserves	30,000	Discount on issue of debentures(unwritten off)	12,500
12% Debenture	4,00,000	Tools and equipment	3,75,000
Land & Buildings	15,54,970	Gratuity Fund	3,00,000
Goodwill	10,00,000	Debtors	1,38,520
Bank Overdraft	2,45,100	Cash at Bank	1,57,160
Proposed Dividend	82,000	Stores & Spares	1,77,800
Prepaid insurance	25,000	Profit & Loss A/c (credit)	21,490
Mutual Fund	1,68,000	Bills Receivable	44,600
Interest payable	32,400	Sundry Creditors	92.560

Balance Sheet of Sunshine Company Limited as on 31 March 2014

Particulars	**Note No.**	**Amount (Rs.)**
i. EQUITY AND LIABILITIES		
1. Shareholders' funds:		
(a) Share capital		26,00,000
(b) Reserves and surplus	1	51.490
2. Share application money pending allotment:		Nil
3. Non-current liabilities:		
(a) Long-term borrowings		4,00,000
(b) Long-term provisions		3,00,000
4. Current liabilities:		
(a) Short-term borrowings		2,45,100
(b) Trade payables		92,560
(c) Other current liabilities		32,400
(d) Short-term provisions		82,000
TOTAL		**38,03,550**
II.ASSETS		
1.Non-current assets:		
(a)Fixed assets		
(i) Tangible assets	2	19,29.970
(ii) Intangible assets		10,00,000
(b) Other non-current assets		12.500
2. Current assets:		
(a) Current investments		1,68,000
(b) Inventories		1.77,800
(c) Trade receivables	3	1.83.120
(d) Cash and cash equivalents		1,57,160
(e) Short-term loans and advances		1.50,000
(g) Other current assets		25,000
TOTAL		**38.03.550**

Notes To the Financial Statement:

1. Reserve and Surplus

General Reserve	30,000
Profit & Loss A/c (Cr.Bal.)	21,490
Total	51,490

2. Tangible Fixed Assets

Land & Buildings	15,54,970
Tools & Equipment	3,75,000
Total	19,29,970

3. Trade Receivables

Sundry Debtors	1,38,520
Bills Receivable	44,600
Total	1,83,120

❖ Check your Progress

Multiple choice Questions

1) Provision is created when_______________

a. Liability is uncertain but amount is accurately measurable
b. Liability is certain but amount is not accurately measurable
c. Liability and amount both are accurately measurable
d. Liability and amount both are inaccurately measurable

2) Operating cycle is of _______________

a. 3 months
b. 6 months
c. 12 months
d. Subjective but normally 12 months

3) Balance sheet is prepared as per Section _______, Part_______of Schedule_ofThe Companies Act, 2013.

a. 128, B, III
b. 129, C, III
c. 129, A, III
d. 128, B, III

4) Cash and cash equivalents are __________________

a. Current assets
b. Noncurrent assets
c. Normally current assets but can be noncurrent assets
d. Can’t say

5) Investment is ___________________

   a. asset held not for operational purposes or for the renderingservices
   b. expenditure on assets held to earn interest, income, profit or other benefits
   c. a & b
   d. None of the above

   [(1 - B) (2 - D) (3 - C) (4 - A) (5 - B)]

Short Questions

1) What is the point of difference between trade receivables and other receivables?
2) What is classification of inventory?
3) Which criteria need to be fulfilled to classify liability as current liability?
4) Enlist the classification of tangible assets.
5) Define reserves and surplus.

Long Questions

1) Define financial statements and its inclusions stating relevant statutory provisions.
2) "Balance sheet reflects financial position as on a specific date" – Examinethe validity of the statement with explanation.
3) Construct the balance sheet format with each line item.
4) What are the types of share capital? Enlist the required disclosures.
5) Explain long term borrowings along with its classification and disclosures required. Kindly elaborate with hypothetical numerical example.

Practical question:

Kindly prepare the balance sheet based on this example:

P a r t i c u l a r s	**Debit**	**Credit**
	Balance	**Balance**
Capital Account		
INTERWORLD & CO		478,866
VIDHYAA & CO		321,476
RAMESH & CO		281,205
Loans (Liability)		
ALPHA MALL PROJECT, 5%		165,889
Current Liabilities		
Sundry Creditors - ABC & CO		28,750
OUTSTANDING EXPENSE		23,000
Current Assets		
Loans & Advances (Asset) (Non-current)	1,237,778	
Bank Accounts		
KOTAK MAHINDRA BANK LTD.	61,408	
Indirect Incomes		
INTEREST ON I.TAX REFUND		27,870
Indirect Expenses		
AUDIT FEES	*28,750*	
LEGAL EXPENSE	*23,000*	
Profit & Loss A/c		23,880
G r a n d T o t a l	**13,50,936**	**13,50,936**

MBA

SEMESTER-1

ACCOUNTING FOR MANAGERS

BLOCK: 2

Authors' Name: Prof. (Dr.) Manoj Shah
Dr. Butalal Ajmera
Dr. Manish Chudasma

Review (Subject): Prof. (Dr.) Manoj Shah
Dr. Shankarsinh Sodha
Dr .Sanjay Bhayani

Review (Language): Dr. Ketan Gediya

Editor's Name: Prof. (Dr.) Manoj Shah,
Professor and Director,
School of Commerce and Management,
Dr. Babasaheb Ambedkar Open University, Ahmedabad.

Co-Editor's Name: Dr. Dhaval Pandya
Assistant Professor,
School of Commerce and Management,
Dr. Babasaheb Ambedkar Open University, Ahmedabad.

Publisher's Name: Registrar,
Dr. Babasaheb Ambedkar Open University,
'JyotirrmayParisar', opp. Shri Balaji Temple,Chharodi,
Ahmedabad, 382481,
Gujarat, India.

Edition: 2022 (First Edition)

ISBN: 978-93-5598-316-9

UNIT : 6 CONSTRUCTION & ANALYSIS OF FUNDS FLOW & CASH FLOW STATEMENT

6.1 INTRODUCTION

Both the Balance sheet and the profit and loss statement do not explain the changes in assets, liabilities and owner's equity. The statement of changes in financial position is prepared to show these changes. Two common forms of such statement are (a) the funds flow statement and (b) the cash flow statement. The term "fund" can be defined at least in three ways. It may mean (1) Cash (2) Working capital (the difference between current asset and current liabilities) or (3) Financial resources (arising from current and non- current items.)

The funds flow statement provides an analysis of changes in the firm's working capital position. The cash flow statement is prepared to analyses changes in the firm's cash position. Both these statements can be recast to incorporate additional financial information which does not affect cash or

Working Capital but influences the financing and asset mix of the firm. The main source of funds Working Capital or cash is the firm's operations. Funds from operations are calculated by adjusting the figure of net profits for non-fund or non-cash items such as depreciation. Depreciation is added to net profits to arrive at funds from operation. To determine cash from operations, changes in current assets and current liabilities are also adjusted in net profits.

Funds flow and cash flow statement are important managerial tools for financial analysis. They help the firm to know the liquidity position. Capital expenditure incurred, dividend paid and extent of external financing. A projected funds or cash flow statement guides the firm to plan the matching of inflow and outflow of funds or cash.

6.2 MEANING OF FUNDS FLOW STATEMENT

This statement is also known as 'Statement of sources and Application of Funds' and 'Statement of sources and uses of working capital'.

The flow statement consists of two terms 'Fund' and 'Flow'. Fund may be interpreted as cash or working capital or all financial resources. Flow means change. This statement contains the source of funds, uses of funds and the changes in net working capital indicating the difference between the total sources and uses. The major sources of working capital are summarized as under:

(1) Issue of shares
(2) Raising Long-term Debt
(3) Sale of Non-Current Assets
(4) Non-operating incomes
(5) Funds from operations

Any transaction which decreases the amount of working capital is an application of working capital. The major uses of working capital are summarized as under:

(1) Redemption of Redeemable Preference Share for cash
(2) Repayment of Long Term Debt
(3) Purchase of Non-Current Assets
(4) Payment of Cash Dividend
(5) Fund (Loss) from Operations
(6) Non-Operating expense

To provide a comparative view of the movements of funds, this statement should be prepared and published for the period covered by the profit and loss account and for the corresponding previous period.

Through there is no fixed form of presentation, yet each enterprise should adopt the form of presentation which is most informative in the given circumstances.

6.3 OBJECTIVES OF FUND FLOW STATEMENT

The objectives of fund flow statement are to indicate the sources from which the funds (i.e. Working Capital) were obtained and the specific uses in which such funds (i.e. Working capital) were applied between the dates of two Balance Sheets.

- It is prepared to indicate how the financial position has changed during a specific period.
- It is a statement of changes in assets and liabilities of an enterprise.
- It is prepared with the help of two consecutive Balance Sheet and additionalinformation.
- All earnings (Whether obtained or distributed) are treated as sources of funds.
- Fund flow statement is not required to be prepared in a prescribed form.
- The heading used in fund flow statement are 'Sources of funds' and 'Application offunds'
- It shows the funds from various sources (including funds from operations)

6.4 USES OF FUND FLOW STATEMENT

The various uses of Fund Flow Statements are as under:

1) As a tool of planning the projected fund flow statement enables the management to plan its future investments. Operating and financial activities such as the repayment of long-term loans and interest thereon, modernization or expansion of plant, payment of cash dividend etc.
2) As a tool of historical analysis, it provides an answer to some of the important financial position such as.

(a) Why did the firm issue new equity or preference shares?

(b) Why did the firm resort to long-term borrowings in spite of large profit?

(c) What happened to the proceeds of the sale of plant and equipment?

(E.g. The firm might have purchased some fixed assets or it might have redeemed the redeemable debentures or preference shares.)

(d) Why has the net working capital increased even though there has been a net loss forthe period?

(I.e. the firm might have raised the funds more than the application of funds)

(e) How was it possible to distribute dividend in excess of current earnings or in thepresence of a net loss for the period?

(I.e. The firm might have raised funds from other sources also in addition to funds from operations.)

(f) Why has the net working capital decreased although the net income for the periodhas gone up?

(I.e. The firm might have applied the funds more than the sources of funds.)

Along with the schedule of changes in components of working capital, the funds flow statement helps in managing and utilizing the working capital. Besides this, the management can identify the magnitude and direction of changes in various components of working capital and if there is any undesired situation such as heavy inventory accumulations, heavy funds locked up in receivable than normally required, the necessary corrective action may be taken so as to achieve the desired level thereof.

6.5 LIMITATIONS OF FUNDS FLOW STATEMENT

The major limitations of fund flow statement are as under: -

(1) It ignores the non-fund transactions it does not take into consideration those transactions which do not affect the working capital e.g. issue of shares against the purchase of fixed assets, conversion of debentures into equity shares.

(2) It is basically historical in nature unless projected fund flow statement are prepared to plan for the future.

(3) It is a secondary data base statement. It merely rearranges the primary data already appearing in other statements. Viz. Income statements and Balance sheet.

The purpose of preparing this statement is to arrive at a single figure of net increase or decrease in working capital at the end of the period as compared with that of the beginning.

6.6 PREPARATION OF FUND FLOW STATEMENT

The steps involved in the preparation of funds flow statement are given below: Step 1:- Prepare schedule of changes in components of working capital.

Step 2:- Analyses the changes in non-current assets and noncurrent liabilities to find out whether there is inflow or outflow of funds on account of these non- current items.

Step 3: - Compute the funds from operations. Step 4: - Prepare funds flow statement.

6.7 MEANING OF FUNDS FROM OPERATIONS

Funds from operations refer to those funds which are generated in the business as a result of carrying out the operations during the normal course of the business and are computed by taking out the difference between the operating revenues that provided funds during the accounting period and operating expenses that involved an outflow of funds during the accounting period.

It indicates the working capital flow as a result of operating activities. It is calculated excluding the effect of non-cash operating items since these items represent merely the book entries. The major source of working capital is the firm's net profit from operations. The ultimate success of a company depends upon its ability to earn profits.

6.8 FORM OF THE FUNDS FLOW STATEMENT

The statement of changes in working capital or funds flow is the summary of the sources and uses of working capital. This statement may be presented in two parts. The first part explains the causes of the change in the amount of working capital from the end of one period to another. It gives a list of sources which provided working capital and uses to which working capital was applied.

The second part of the statement contains an analysis of the changes in the working capital items. This part of the statement shows items of current assets and current liabilities at the beginning and at the end of the accounting period and the effect of their changes between two periods on the working capital.

XYZ Company

Statement of changes in working capital for the year ended 31st December 2019

(a) Sources and Uses of Working Capital

Sources	**Rs.**
Funds from Operations	
Sale of machine	
Issuance of Debentures	
Issuance of Equity shares	
Funds provided	
Uses	**Rs.**
Purchase of long-term investments	
Payment of long term loans	
Payment of cash dividend	
Increase in working capital	
Funds Applied	

(b) Schedule of changes in working capital

Particular		31st Dec 2019	Increase Rs.	Decrease Rs.
Current assets				
Cash				
Debtors				
Inventory				
Total				
Current liabilities				
Bills payable				
Creditors				
Total				
Working capital				
Increase in working capital				
Total				

XYZ Company

Fund Flow Statement

Sources and Uses of Working Capital

Sources	Rs.
Funds from Operations Sale of Machine Issuance of Debentures Issuance of Shares Funds provided	
Uses	**Rs.**
Purchase of Long term Investments Payment of Long term Loans Payment of Cash Dividend Funds applied Increase in Working Capital	

6.9 CASH FLOW STATEMENT

The cash flow statement means the statement of changes in cash and cash equivalents. Cash flows are inflows and outflows of cash and cash equivalents. It shows the following for the period covered by it.

- Net change in Cash and Cash Equivalents.

- Net cash from Investing Activities.
- Net cash flows from Financing Activities.

- Net cash from Operating Activities.

Cash flow excludes movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents. Some of the transactions which represent movements between items of cash or cash equivalent, are given below:

1. Cash deposited in to Bank
2. Cash withdrawn from Bank
3. Purchase/Sale of short-term marketable securities (neither held as Current Assets nor held as Investment)

These transactions do not form part of cash flows. The cash flow arises when the net effect of transaction is either to increase or to decrease the amount of cash or cash Equivalents. Cash comprises cash on hand and demand deposits with banks.

What is meant by the term ' Cash Equivalents '?

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purpose.

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.

For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of say three months or less from the date of acquisition.

Investment in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date.

6.10 SOURCES AND USES OF CASH

An analysis of cash flows is useful for short term planning. A firm needs sufficient cash to pay debts maturing in the near future, to pay interest and other expenses and to pay dividends to shareholders. The firm can make projections of cash inflows and outflows for the near future to determine the availability of cash. A historical analysis of cash flows provides insight to prepare reliable cash flow projections for the immediate future. The cash flow statement is similar to the funds flow statement except that it focuses attention on cash instead of working capital (funds). Thus this statement analysis changes in non-current accounts as well as current accounts (other than cash) to determine the flow of cash.

The following are the Sources of Cash.

1 . Increase in liabilities.
2 . Decrease in assets (except cash)
3 . The profitable Operations of the firm.
4 . Sale proceeds from ordinary shares or preference shares issue.

The following are the Uses of Cash.

1 Decrease in liabilities
2 Increase in assets (except cash)
3 Cash dividend.
4 Resumption of redeemable preference shares
5 The loss from operations

The easiest and direct method of preparing a statement of changes in cash position is to only record inflows and outflows of cash and find out the net change during a given period. These adjustments are made in the same way as in preparing funds flow statement.

6.11 OBJECTIVES OF CASH FLOW STATEMENT

The purpose of cash flow statement is to ascertain the reasons for the net flow (i.e. the difference between the opening and closing balance of cash and cash equivalents) and not simply the net flow which is already known.

1. To ascertain the net change in cash and cash equivalents indicating the difference betweentotal sources and total uses between the dates of two Balance Sheets.
2. To ascertain the specific sources (i.e. Operating / Investing / Financing Activities) for whichcash & cash equivalents were generated by an enterprise.
3. To ascertain the specific uses (i.e. Operating / Investing / Financing Activities) for which cashand cash equivalents were used by an enterprise.

6.12 USES OF CASH FLOW STATEMENT

The various uses of cash flow statement are as follows:

1. It is useful in checking the accuracy of past assessment of future cash flows.
2. It enables the users to assess the needs of the enterprise to utilize cash flows generated.
3. It enables the users to evaluate the enterprise's ability to affect the amounts and timings of cash flows in order to adopt to changing

circumstances and opportunities.

4. It helps the users to ascertain in a more accurate manner the liquidity of the enterprise.
5. It helps to ascertain about the ability of the enterprises to pay dividends and meet its obligations.
6. The information provided by statement of cash flows (SCF) helps investors, creditors and other users to assess different aspects of financial position of the firm.
7. It enables the users to evaluate the changes in net assets of an enterprise.
8. It also explains the difference between the net income and cash provided by operating activities of an enterprise
9. It provides information about cash flows from investing and financing transactions.
10. It helps in efficient Cash Management.

The Management can know the adequacy or otherwise of cash and cash plan for the effective use of surplus Cash or can make the necessary arrangement in case of an inadequacy of cash.

As a tool of planning the projected Cash Flow Statement enables the management to plan its future investments, operating and financial activities such as the repayment of long term loans and interest thereon, modernization or expansion of plant, payment of cash dividend etc.

As a tool of historical analysis, it provides an answer to some of the important financial questions such as

- Why did the firm issue new equity or preference shares ?
- How was the retirement of long term debts or redemption of redeemable preferenceshares accomplished ?
- Why did the firm resort to long term borrowings in spite of large profits ?
- Why has the cash increased even though there has been a net loss for the period ?
- What happened to the proceeds of the sale of land and equipment ?
- Why has the cash decreased although the net income for the period has gone up ?
- How was it possible to distribute dividend in excess of current earnings or in thepresence of a net loss for the period ?

6.13 LIMITATION OF CASH FLOW STATEMENT

The major limitations of Cash Flow Statement are as follows:

- It is a secondary data based statement. It merely re arranges the primary data already appearing in other statements Viz. Income statement and Balance Sheet.

- It is basically historical in nature unless projected Cash Flow Statements are prepared to plan for the future.
- It ignores the non-cash transactions. In other words it does not take in to consideration those transactions which do not affect the cash e.g. issue of shares against the purchase of fixed assets or stock in trade, conversion of debentures into equity shares.

Steps involved in the preparation of Cash Flow Statement

Step-1 Analyses the changes in non-current assets (e.g. Goodwill, Patents, Trade Marks, Copyright, Land & Building, Plant and Machinery, Investments) and non-operating incomes (e.g. Dividend, Interest, Rent received) to find out Cash Flow from Investing Activities.

Step-2 Analyses the Changes in non-current liabilities (e.g. Share Capital, Debentures ,Long Term Loans) and non-operating payments (e.g. Interim, Final Dividend paid on Shares, Interest paid on long term borrowings (including Debentures) to find out Cash Flow from Financing Activities.

Step-3 Compute cash flow after taxation and extra-ordinary item (e.g. Insurance proceeds from earth quake disaster settlement) from Operating Activities.

Step-4 Prepare Cash Flow Statement

6.14 DISTINCTION BETWEEN FUNDS FLOW STATEMENT & CASH FLOW STATEMENT

Sr. No	Basis of Distinction	Cash Flow Statement	Funds Flow Statement
1	Disclosure	It discloses the magnitude, direction and the causes of changes in cash & cash equivalents.	It discloses the magnitude and the causes of changes in Working Capital.
2	Basis of Accounting	Cash from operations rests on Cash	Funds from Operations rests on mercantile or
		Accounting.	accrual accounting.
3	Component s of Working Capital	It is confined to cash and cash-equivalents only. Which is just one of the components of working capital.	It is confined to all the components of working capital.
4	Scope of Manipulation	The management cannot manipulate the cash flows so easily.	The management may manipulate the net change in working capital and the figure

			of funds from operations by applying the method of inventory valuation which is most suitable to it.
5	Usefulness	It is useful for short-range financial planning since it enables the management to assess its ability to meet short-term commitments capital e.g. to pay maturing debts, interest dividend and other expenses.	It is useful for the long range financial planning since in the long run the firm is interested in working capital because all the items of working will ultimately change in to cash.

6.15 SPECIMEN OF CASH FLOW STATEMENT

For the year ended on 31-3-2021

Particulars		Rs.	Rs.
(A) Cash Flow from Operating Activity			
Net Profit		------	
Non Cash and Non-Operating items			
Depreciation		------	
Preliminary Exps, Advertisement Suspense		------	
Account Written offDebenture discount,		------	
Underwriting Commission written off		------	
Goodwill, Patents, Trade Marks etc.		------	
written off		------	
Provision for Taxation		------	
Transferred to General reserve, Capital		------	
reserve etc.Proposed Dividend, Interim		------	
Dividend etc.			
Loss on Sale of Assets	------		
Less:			
Profit on Sale of Assets		------	
Interest and Dividend received on			
Investment	------		
Changes in Working Capital	------		
Add: Increase in Current Liabilities	------		
(Creditors, Bills Payable, Unpaid Exp. etc.)	------		

Decrease in Current Assets (Debtors, Bills Receivables, Stock, Prepaid Exp. etc.)		------	
Less: Decrease in Current Liabilities (Creditors, Bills Payable, Unpaid Exp. etc.)		------	
Increase in Current Assets (Debtors, Bills Receivables, Stock, Prepaid Exp. etc.)			
Payment of tax			
Net Cash Flow from Operating Activities (A)			
Cash Flow From Investing Activity			------
Sale of Fixed Assets		------	
Sale of Investments		------	
Purchase of Fixed Assets		------	
Purchase of Investments		------	
Net Cash Flow from Investing Activities (B)			------
Cash Flow From Financing Activities:			
Issue of Shares or Debentures		------	
Lone taken		------	
Less: Repayment of Loan		------	
Red. Pref. Share Capital / Debenture		------	
Interim Dividend paid		------	
Proposed Dividend		------	
Net Cash Flow from Financing Activities			----
Net Increase Or decrease in Cash and Cash equivalents (A+B+C)			------
+ Opening cash balance and cash equivalents			------
Closing cash balance and cash equivalents			------

6.16 ILLUSTRATION

Que. 1. Calculate Cash Flow from Operating activities from the following details.

Particulars	**1-4-2019**	**31-3-2020**
Debtor	70,000	60,000
Bills Receivables	50,000	70,000
Creditors	25,000	15,000
Bills Payable	35,500	45,500
Profit & Loss A/c	50,000	75,000
General reserve	40,000	50,000
Goodwill	30,000	20,000
Provision for depreciation on Furniture	1,00,000	1,20,000

One item of furniture costing Rs. 30,000 having book value Rs. 20,000 was sold for Rs.25,000 during the year.

Solution:

Particulars	**Rs.**	**Rs.**
Cashflow From Operating Activity		
Profit & Loss A/c	25,000	
+ General reserve	10,000	
+ Goodwill Written off	10,000	
+ Depreciation on Furniture	30,000	
- Profit on sale of Furniture	(5,000)	70,000
Changes in Working Capital		
+ Decrease in Debtors	10,000	
Increase in Bills Receivables	(20,000)	
Decrease in Creditors	(10,000)	
+ Increase in Bills Payable	10,000	(10,000)
Net Cash Flow from Operating Activities		60,000

Dr. **Depreciation Fund Account (Furniture)** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Furniture A/c	10,000	By Balance b/d	1,00,000
" Balance c/d	1,20,000	" Profit & loss A/c	30,000
	1,30,000		1,30,000

Que. 2. Following are the Balance Sheets of Shyam Ltd.

Particulars	1-4-2019	31-3-2020
Assets: Machinery Furniture		
Current Assets	1,80,000	1,00,000
	60,000	80,000
Liabilities: Share Capital	30,000	60,000
General Reserve Debenture	2,70,000	2,40,000
	1,00,000	1,20,000
	40,000	70,000
	1,30,000	50,000
	2,70,000	2,40,000

A Machine worth Rs. 50,000 was sold for Rs. 30,000 had an accumulated depreciation Rs. 10,000. The depreciation provision was Rs. 60,000 and Rs. 90,000 as on 1-4-2019 and 31-3-2020respectively.
Prepare the account of Depreciation Provision and Machinery.

Solution:

Dr. **Depreciation Provision Account** **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Depreciation A/c	10,000	By Balance b/d	60,000
“ **Balance c/d**	90,000	“ Profit & loss A/c	40,000
	1,00,000		1,00,000

Dr. **Dr. Machinery Account** **Cr.**

Particulars	Rs.	Particulars	Rs.
Balance b/d (1,80,000 + 60,000)	2,40,000	By Bank A/c - Sale“ Depreciation	30,000
		Profit & loss A/c - Loss Balance c/d	10,000
		(1,00,000 + 90,000)	10,000
			1,90,000
	2,40,000		2,40,000

Que. 3. Ronak Ltd. has provided the following Balance Sheets and request you to prepare cashflow statement as on 31st March 2019 & 2020

Particulars	Note	31-3-2019 Rs	31-3-2020 Rs
I **. EQUITY AND LIABILITIES:**			
Share holders' Funds:			
Share Capital:		2,00,000	3,00,000
Reserves and Surplus: General		1,50,000	1,70,000
Reserve Profit & Loss A/c		32,000	89,000
Non –Current Liabilities:			
Long Term Borrowings 10% Debentures		1,80,000	50,0000
Current Liabilities:			
Trade Payables: Creditors		50,000	57,500
Bills Payable		68,000	40,000
Short Term Provisions: Provision for Taxation		25,000	42,500
Proposed Dividend		50,000	36,000
Total		7,55,000	7,85,000
II ASSETS:			
Non – Current Assets:			
Fixed Assets			
Tangible Assets: Land and Building		4,00,000	4,25,000
Plant and Machinery		2,00,000	2,80,000
Intangible Assets: Goodwill		15,000	10,000
(2) **Current Assets:**			
Inventories: Stock		40,000	50,000
(b) Trade Receivables: Debtors		80,000	10,000
(c) Cash and Cash Equipment : Cash balance		20,000	5,000
Bank balance		-	5,000
Total		7,55,000	7,85,000

Additional Information:

1) On 1-4-2019 Bonus share at one share for every two shares were issued by capitalizing General Reserve
2) Proposed dividend of last year was paid and income tax of Rs 50,000 of last year was also paid.
3) Depreciation provided on Land-Building was Rs 30,000 and on Machinery was Rs 40,000
4) Redeemed debentures at 5% premium.
5) Sold one machine for Rs. 35,000 , the cost of which was Rs. 50,000 and the depreciation provided on it was Rs. 10,000

Note: All calculations are to be shown as a part of your answer.

Solution:

Firstly, we shall prepare necessary accounts for finding missing items.

Dr. Land and Building Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	4,00,000	By Depreciation	30,000
To Bank A/c Purchase	55,000	By Balance c/d	4,25,000
	4,55,000		4,55,000

Dr. Plant and Machinery Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2,00,000	By Depreciation	40,000
To Bank A/c -Purchase	1,60,000	By Bank A/c- Sale	35,000
		By Profit and Loss A/c	5,000
		By Balance c/d	2,80,000
	3,60,000		3,60,000

Dr. Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance c/d	3,00,000	By Balance b/d	2,00,000
		By General Reserve	1,00,000
	3,00,000		3,00,000

Dr. General Reserve Account Cr.

Particulars	Rs.	Particulars	Rs.
To Share capital A/c	1,00,000	By Balance b/d	1,50,000
To Balance c/d	1,70,000	By Profit & loss A/c	1,20,000
	2,70,000		2,70,000

Dr. Provision For Taxation Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c paid	50,000	By Balance b/d	25,000
To Balance c/d	42,500	By Profit & loss A/c	67,500
	92,500		92,500

Dr. 10% Debenture Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c	1,30,000	By Balance b/d	1,80,000
To Balance c/d	50,000		
	1,80,000		1,80,000

CASH FLOW STATEMENT

Particulars	Rs.	Rs.	Rs.
(A) Cashflow From Operating Activity			
Profit & Loss A/c (89,000 - 32,000)		57,000	
+ Proposed Dividend		36,000	
+ Goodwill written off		5,000	
+ Depreciation on land & Building		30,000	
+ Depreciation on Plant & Machinery		40,000	
+ Debenture Redemption Premium		6,500	
+ Loss on Sale of Machinery		5,000	
+ General reserve		1,20,000	
+ Provision for Taxation		67,500	
		3,67,000	
Changes in Working Capital			
+ Increase in Creditors	7,500		
- Decrease in Bills Payable	(28,000)		
- Increase in Stock	(10,000)		
+ Decrease in Debtors	70,000	**39,500**	
		4,06,500	
- Payment of Tax		(50,000)	
:- **Net Cash Flow from Operating Activities (A)**			**3,56,500**
(B) Cash flow From Investing Activity			
+ Sale of Machinery		35,000	
- Purchase of land and Building		(55,000)	
- Purchase of Plant & Machinery		(1,60,000)	

:- **Net CashFlow from Investing Activities (B)**			**(1,80,000)**
(C) Cash flow From Financing Activity			
- Payment of Proposed Dividend		(50,000)	
- Redemption of Debentures		(1,30,000)	
- Redemption Debenture Premium		(6,500)	
:- **Net Cash Flow from Financing Activities (C)**			**(1,86,500)**
Increase in Cash and cash equivalents (A + B + C)			(10,000)
+ Opening cash balance and cash equivalents			
Opening cash balance			20,000
Closing cash balance and cash equivalents			
Cash balance			5,000
Bank balance			5,000

Que. 4. The following is the Balance Sheet of Sheetal Ltd. on 31st March.

Particulars	**Note**	**31-3-2019 Rs**	**31-3-2020 Rs**
***I*. EQUITY AND LIABILITIES:**			
Share holders' Funds:			
Share Capital:			
Equity shares of Rs. 10 each fully paid up 11% Red. Pref.		2,00,000	5,00,000
Shares of Rs.10 each,		1,40,000	1,00,000
Rs. 7 paid up			
Reserves and Surplus: General Reserve Profit & Loss A/c			
Non –Current Liabilities:		1,00,000	2,50,000
Long Term Borrowings 10% Debentures		70,000	1,00,000
Current Liabilities:			
Trade Payables: Creditors			
Bills Payable			1,50,000
Short Term Provisions: Provision for Taxation Proposed Dividend			
		80,000	60,000
Total			
		30,000	25,000
II ASSETS:			
Non – Current Assets:		40,000	65,000
Fixed Assets		50,000	80,000
Tangible Assets:		7,10,000	13,30,000
Plant and Machinery			
Intangible Assets:			
Goodwill			
Non-Current Investment:			
Investment		4,00,000	8,00,000
Other Non-Current Assets:		70,000	60,000
Debenture Discount			
Current Assets:		90,000	1,30,000
Inventories: Stock			
Trade Receivables: Debtors		5,000	10,000
Bills Receivable			
(c) Cash and Cash Equipment: Cash balance		55,000	87,500
		12,500	68,500
		5,000	10,000
		72,500	1,64,000
		7,10,000	13,30,000

Additional Information :

1) Investments of Rs. 40,000 were sold at 20% profit.
2) Income tax of Rs. 30,000 was paid during the year and last year's dividend was also paidduring the year.
3) On 1-4-2019 Bonus shares at two share for every one share were issued from Generalreserve.
4) A machine costing Rs. 2,50,000 (Depreciation written off to the date Rs. 1,30,000) wassold for Rs. 1,00,000.
5) After fulfillment of company law provisions, preference share were redeemed at 10%premium.
6) During the year debentures were issued at 10% discount. From the above information, Prepare cash flow Statement as per AS-3

Solution:

Firstly, we shall prepare necessary accounts for finding missing items.

Dr. Plant and Machinery Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	4,00,000	By Depreciation	1,30,000
To Bank A/c -Purchase	6,50,000	By Bank A/c -Sale	1,00,000
		By Profit and Loss A/c - Loss	20,000
		B y Balance c/d	8,00,000
	10,50,000		10,50,000

Dr. Investment Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	90,000	By Bank A/c- Sale	48,000
To Profit & loss A/c - Profit	8,000	By Balance c/d	1,30,000
To Bank A/c- Purchase	80,000		
	1,78,000		1,78,000

Dr. Debenture Discount Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	5,000	By Profit & loss A/c	10,000
12% debenture A/c	15,000	B y Balance c/d	10,000
	20,000		20,000

Dr. Equity Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	2,00,000
		By General Reserve	1,00,000
To Balance c/d	5,00,000	B y Bank A/c - Issue	2,00,000
	5,00,000		5,00,000

Dr. Red. Pref. Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c - Payment	1,00,000	By Balance b/d	1,40,000
T o Balance c/d	1,00,000	By Bank A/c – Final Installment	60,000
	2,00,000		2,00,000

Dr. General Reserve Account Cr.

Particulars	Rs.	Particulars	Rs.
To Equity Share capital A/c	1,00,000	By Balance b/d	1,00,000
ToBalance c/d	2,50,000	By Profit & loss A/c	2,50,000
	3,50,000		3,50,000

Dr. 10% Debenture Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	-----
		By Bank A/c	1,35,000
To Balance c/d	1,50,000	By Debenture Discount A/c	15,000
	1,50,000		1,50,000

Dr. Provision For Taxation Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c paid	30,000	By Balance b/d	40,000
To Balance c/d	65,000	By Profit & loss A/c	55,000
	95,000		95,000

CASH FLOW STATEMENT

Particulars	Rs.	Rs.	Rs.
(A) Cash flow From Operating Activity			
Profit & Loss A/c (1,00,000 - 70,000)		30,000	
+ Proposed Dividend		80,000	
+ Goodwill written off		10,000	
+ Depreciation on Plant & Machinery		1,30,000	
+ Debenture Discount written off		10,000	
+ Loss on Sale of Plant & Machinery		20,000	
+ General reserve		2,50,000	
+ Provision for Taxation		55,000	
+ Pref. Share Red. Premium		10,000	
		5,95,000	
- Profit on sale of Investment		(8,000)	
		5,87,000	
Changes in Working Capital			
Decrease in Creditors	(20,000)		
Decrease in Bills Payable	(5,000)		
Increase in Stock	(32,500)		
Increase in Debtors	(56,000)		
Increase in Bills Receivable	(5,000)	**(1,18,500)**	
		4,68,500	
- Payment of Tax		(30,000)	
Net Cash Flow from Operating Activities (A)			**4,38,500**
Cash flow From Investing Activity			
+ Sale of Investment		48,000	
+ Sale of Plant & Machinery		1,00,000	
Purchase of Plant & Machinery		(6,50,000)	
Purchase of Investment		(80,000)	
Net Cash Flow from Investing Activities (B)			**(5,82,000)**
Cash flow From Financing Activity			
Payment of Proposed Dividend		(50,000)	
+ Issue of Debentures		1,35,000	
Redemption Pref. Share Premium		(10,000)	
Redemption Pref. Share Capital		(1,00,000)	
+ Pref. Share Final Installment		60,000	
+ Issue of Equity share		2,00,000	
Net Cash Flow from Financing Activities (C)			**2,35,000**
Increase in Cash and cash equivalents (A + B + C)			91,500
+ Opening cash balance and cash equivalents Opening cash balance			72,500
Closing cash balance and cash equivalents			1,64,000

Que. 5. The following is the Balance Sheet of Manoj Ltd. on 31st March 2019 & 2020

Particulars	Note	31-3-2019 Rs	31-3-2020 Rs
I . **EQUITY AND LIABILITIES:**			
(1) Share holders' Funds:			
(a) Share Capital:			
Equity shares of Rs. 10 each fully paid		3,00,000	4,60,000
up 10% Pref. Share of Rs.10 each fully		1,00,000	50,000
paid up			
(b) Reserves and Surplus: Capital Reserve		40,000	-----
Profit & Loss A/c Security Premium		60,000	70,000
2) Non –Current Liabilities:		-------	10,000
(a) Long Term Borrowings 11%		70,000	
Debentures		50,000	
3) Current Liabilities:		45,000	1,50,000
(a) Trade Payables: Creditors			
Bills Payable			
Total			30,000
II ASSETS:			30,000
(1) Non – Current Assets:		6,65,000	8,00,000
(a) Fixed Assets			
(i) Tangible Assets: land & Building			
Plant (Less Depreciation)			
(ii) Intangible Assets:			
Goodwill		2,00,000	1,60,000
(b) Other Non-Current Assets:		3,00,000	4,60,000
Debenture Discount			
(2) Current Assets:		24,000	15,000
(a) Inventories: Stock			
(b) Trade Receivables: Debtors		6,000	10,000
Bills Receivable			
(c) Cash and Cash Equipment: Cash balance		25,000	35,000
Total			
		40,000	50,000
		20,000	30,000
		50,000	40,000
		6,65,000	8,00,000

Other Information

1) During the year 10% Redeemable preference shares were redeemed at a premium of10%
2) During the year, a piece of land, whose book value was Rs. 40,000 was sold at Rs. 50,000and its profit was credited to Capital Reserve.
3) During the year, 11% Debenture were issued at 5% discount.
4) During the year, the company utilized Capital Reserve to issue Bonus shares to Equityshare holders.
5) Accumulated depreciation on plant:On 31-3-2019 Rs. 60,000
   On 31-3-2020 Rs. 80,000
   During the year, a plant costing Rs. 25,000 (Accumulated depreciation there on Rs.7,000) has been sold Rs. 20,000
   From the above information, Prepare Cash Flow Statement.

Solution:

Dr. Land and Building Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2,00,000	By Bank A/c -Sale	50,000
To Capital Reserve - Profit	10,000	By Balance c/d	1,60,000
	2,10,000		2,10,000

Dr. Plant and Machinery Account Cr.

Particulars	Rs.	Particulars	Rs.
Balance b/d (3,00,000 + 60,000)	3,60,000	By Depreciation	7,000
To Bank A/c -Purchase		By Bank A/c -Sale	20,000
	2,07,000	By Balance c/d (4,60,000 + 80,000)	5,40,000
	5,67,000		5,67,000

Dr. Debenture Discount Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	6,000		
To 11% Debenture A/c	4,000	By Balance c/d	10,000
	10,000		10,000

Dr. Equity Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	3,00,000
		By Capital Reserve - Bonus	50,000
To Balance c/d	4,60,000	B y Bank A/c - Issue	1,10,000
	4,60,000		4,60,000

Dr. 10% Pref. Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c - Payment	50,000	By Balance b/d	1,00,000
To Balance c/d	50,000		
	1,00,000		1,00,000

Dr. Security Premium Account Cr.

Particulars	Rs.	Particulars	Rs.
To Pref. Share	5,000	By Balance b/d	------
To Balance c/d	10,000	By Profit & loss A/c	15,000
	15,000		15,000

Dr. Capital Reserve Account Cr.

Particulars	Rs.	Particulars	Rs.
To Equity Share capital	50,000	By Balance b/d	40,000
To Balance c/d	----	By Land & Building	10,000
	50,000		50,000

Dr. 11% Debenture Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	70,000
		B y Bank A/c	76,000
To Balance c/d	1,50,000	By Debenture Discount A/c	4,000
	1,50,000		1,50,000

Dr. Depreciation Fund Account (Plant) Cr.

Particulars	Rs.	Particulars	Rs.
To Plant and Machinery A/c	7,000	By Balance b/d	60,000
To Balance c/d	80,000	By Profit & loss A/c	27,000
	87,000		87,000

CASH FLOW STATEMENT

Particulars	Rs.	Rs.	Rs.
(A) Cash flow From Operating Activity			
Profit & Loss A/c		10,000	
+ Goodwill written off		9,000	
+ Depreciation Fund (Plant & Machinery)		27,000	
+ Security Premium Account		15,000	
		61,000	
Changes in Working Capital			
Decrease in Creditors	(20,000)		
Decrease in Bills Payable	(15,000)		
Increase in Stock	(10,000)		
Increase in Debtors	(10,000)		
Increase in Bills Receivable	(10,000)	**(65,000)**	
:- **Net Cash Flow from Operating Activities (A)**			**(4,000)**
Cash flow From Investing Activity		50,000	
+ Sale of Land & Building		20,000	
+ Sale of Plant & Machinery		(2,07,000)	
- Purchase of Plant & Machinery			
:- **Net Cash Flow from Investing Activities (B)**			**(1,37,000)**
Cash flow From Financing Activity			
+ Issue of Equity Share Capital		1,10,000	
Redemption Pref. Share Premium		(5,000)	
Redemption Pref. Share Capital		(50,000)	
+ Issue of Debenture		76,000	
:- **Net Cash Flow from Financing Activities (C)**			**1,31,000**
Increase in Cash and cash equivalents (A + B + C)			(10,000)
+ Opening cash balance and cash equivalents			
Opening cash balance			50,000
Closing cash balance and cash equivalents			40,000

Que. 6. The following are the Balance Sheet of Bharat Ltd. for the two years

Particulars	Note	31-3-2019 Rs	31-3-2020 Rs
I . EQUITY AND LIABILITIES:			
Share holders' Funds:			
Share Capital: Equity shares of Rs. 100 each		4,00,000	7,50,000
Reserves and Surplus:General Reserve Profit & Loss A/c Debenture Redemption Reserve		3,50,000	3,70,000
Non –Current Liabilities:		50,000	30,000
Long Term Borrowings:12% Debentures		-------	5,000
Current Liabilities:			
Trade Payables:Creditors Bills Payable		2,00,000	1,00,000
Other Current Liabilities: Unpaid Expenses			
Short Term Provisions: Provision for Taxation Proposed		64,500	88,700
Dividend		15,000	10,000
		2,000	3,500
		40,000	50,000
		25,000	60,000
Total		11,46,500	14,67,200
II ASSETS:			
(1) Non – Current Assets:			
(a) Fixed Assets			
(i) Tangible Assets:			
land & Building		2,00,000	2,50,000
Plant & Machinery		6,00,000	8,00,000
(ii) Intangible Assets:			
Goodwill		15,000	10,000
Patents		25,000	15,000
(b) Non-Current Investment:			
Investment		75,000	1,25,000
(2) Current Assets:			
(a) Inventories: Stock		50,000	40,000
(b) Trade Receivables: Debtors		1,50,000	1,70,000
(c) Cash and Cash Equipment:			
Cash balance		30,000	55,000
(d) Other Current Assets:			
Prepaid Expenses		1,500	2,200
Total		11,46,500	14,67,200

Additional Information :

1) Investment worth Rs. 50,000 have been sold for Rs. 40,000
2) The company issued Bonus share to the existing Equity shareholders by Capitalizing required sum from General Reserve, in the proportion of 2:1
3) Issued new equity shares at the face value, as right shares, on the capital enhanced by issue of Bonus shares, in the ratio of 4:1
4) A machine costing Rs 80,000 (Depreciation written off to the date Rs. 30,000) was sold Rs 40,000
5) Redeemed one half of the debentures at Rs. 95 per debentures and profit on redemption of debentures was transferred to Debenture Redemption Capital Reserve.
6) Paid Rs. 30,000 as tax for the last year and also paid the proposed dividend of last year. From the above information, Prepare Cash Flow Statement.

Solution:

Dr. Land & Building Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	6,00,000	By Depreciation	30,000
To Bank A/c -Purchase	2,80,000	By Bank A/c - Sale	40,000
		By Profit & loss A/c - Loss	10,000
		By Balance c/d	8,00,000
	8,80,000		8,80,000

Dr. Investment Account Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	75,000	By Bank A/c- Sale	40,000
To Bank A/c- Purchase	1,00,000	By Profit & loss A/c - Loss	10,000
		By Balance c/d	1,25,000
	1,75,000		1,75,000

Dr. Equity Share Capital Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	4,00,000
		By General Reserve - Bonus	2,00,000
To Balance c/d	7,50,000	By Bank A/c – Issue Right share	1,50,000
	7,50,000		7,50,000

Dr. General Reserve Account Cr.

Particulars	Rs.	Particulars	Rs.
To Eq. Share Capital- Bonus	2,00,000	By Balance b/d	3,50,000
T o Balance c/d	3,70,000	By Profit & loss A/c	2,20,000
	5,70,000		5,70,000

Dr. Debenture Redemption Reserve Account Cr.

Particulars	Rs.	Particulars	Rs.
		By Balance b/d	------
To Balance c/d	5,000	By Debenture A/c	5,000
	5,000		5,000

Dr. 12% Debenture Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c	95,000	By Balance b/d	2,00,000
To Deb. Red. Reserve A/c	5,000		
To Balance c/d	1,00,000		
	2,00,000		200 ,000

Dr. Provision For Taxation Account Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c paid	30,000	By Balance b/d	40,000
To Balance c/d	50, 000	By Profit & loss A/c	40,000
	80,000		80,000

CASH FLOW STATEMENT

Particulars	Rs.	Rs.	Rs.
(A) Cash flow From Operating Activity			
Profit & Loss A/c		(20,000)	
+ Proposed Dividend		60,000	
+ Goodwill written off		5,000	
+ Patent written off		10,000	
+ Loss on Sale of Investment		10,000	
+ Depreciation on Plant & Machinery		30,000	
+ Loss on Sale of Plant & Machinery		10,000	
+ Provision for Taxation		40,000	
+ General reserve		2,20,000	
		3,65,000	
Changes in Working Capital			
+ Increase in Creditors	24,200		
- Decrease in Bills Payable	(5,000)		
+ Increase in Unpaid Expenses	1,500		
+ Decrease in Stock	10,000		
- Increase in Debtors	(20,000)		
- Increase in Prepaid Expense	(700)	**10,000**	
		3,75,000	
- Payment of Tax		(30,000)	
:- Net Cash Flow from Operating Activities (A)			**3,45,000**
(B) Cash flow From Investing Activity			
- Purchase of land and Building		(50,000)	
- Purchase of Plant & Machinery		(2,80,000)	
- Purchase of Investment		(1,00,000)	
+ Sale of Plant & Machinery		40,000	
+ Sale of Investment		40,000	
			(3,50,000)
:- Net Cash Flow from Investing Activities (B)			
(C) Cash flow From Financing Activity			
- Payment of Proposed Dividend		(25,000)	
- Redemption of Debentures		(95,000)	
+ Issue of Equity share – Right Share		1,50,000	
:- Net Cash Flow from Financing Activities (C)			**30,000**
Increase in Cash and cash equivalents (A + B + C)			25,000
+ Opening cash balance and cash equivalents			
Opening cash balance			30,000
Closing cash balance and cash equivalents			55,000

❖ Check Your Progress

A. THEORY

1. Write notes on

a) Cash Flow Statement

b) Cash flow from Operating Activity

c) Limitation of Cash Flow Statement

2. Explain the importance and limitation of Cash Flow Statement.
3. Explain the difference between Cash Flow Statement and Fund Flow Statement.
4. Discuss the utility of Cash Flow Statement. What are its limitation? Give a specimen of CashFlow Statement.

B. Objective Question

From the following information Calculate cash flow from Operating Activities of a business:

Particulars	1-4-2019	31-3-2020
Debtor	50,000	70,000
Bills Receivables	35,000	15,000
Creditors	1,00,000	1,20,000
Bills Payable	20,000	30,000
General reserve	40,000	60,000
Profit & Loss A/c	1,00,000	1,20,000
Depreciation Fund Account	30,000	60,000

During the year, Plant costing Rs. 1,00,000 on which depreciation of Rs. 20,000 was Written off,was sold for Rs. 75,000.

[**Ans:** Cash Flow from Operating Activities Rs. 85,000 (P & L A/c Rs. -20,000 Add: General Reserve. Rs. 20,000, Depreciation on Plant Rs.50,000, loss on sale of Plant Rs.5,000 Less: Inc. Debtors Rs.20,000 Add: Dec. Bills receivables Rs.20,000, Inc. Creditors Rs.20,000, Inc. Bills Payables Rs.10,000]

C. Multiple Choice Question

Choose the correct answer from the options given below each of the following questions:

1. Which of the following statements is correct?

A. Cash flow decreases due to increase in current assets.

B. Cash flow decreases due to increase in current liabilities.

C. Cash flow increase due to increase in current assets.

D. Cash flow increase due to decreases in current liabilities.

[Ans:- (A) Cash flow decreases due to increase in current assets.]

2. Which of the following statements is not correct?

A. If current asset increases it reduces cash flow.
B. If current asset decreases it increases cash flow.
C. If current liability increases it increases cash flow.
D. If current liability decreases, it increases cash flow.

[Ans:- (D) If current liability decreases, it increases cash flow.]

3. The balance of Depreciation on machine account on 31-3-2019 was Rs. 70,000 and on 31-3- 2020 was Rs. 90,000. During the year, a machine coasting Rs. 50,000, accumulated depreciation thereon being Rs. 20,000 was sold for Rs. 25,000.

Show the amount of depreciation changed to Profit & Loss Account.

(A) Rs. 30,000 (B) Rs. 10,000
(C) Rs. 40,000 (D) Rs. 20,000

[Ans:- (C) Rs. 40,000]

4. If the balance of Machinery Account at cost on 31-3-2019 was Rs. 4,00,000 and on 31-3-2020 was Rs. 6,00,000. What is the amount of purchase of Machinery during the year?

(A) Rs. 1,40,000 (B) Rs. 2,00,000
(C) Rs. 1,80,000 (D) Rs. 60,000

[Ans:- (B) Rs. 2,00,000]

5. Which of the following items is not a cash inflow?

A. Borrowing or incurring any liability.
B. Repayment of loans and debentures.
C. Sale of fixed assets or investment.
D. Earning operating profit.

[Ans:- (B) Repayment of loans and debentures.]

6. In a company, opening balance of the investment was Rs. 50,500 and its closing balance was Rs. 70,000. During the year, some investments were sold for Rs. 5,500 and new investments were purchased worth Rs. 26,000. Find out Loss earned on investment sold.

(A) Rs. 600 (B) Rs. 300
(C) Rs. 1,000 (D) Rs. 850

[Ans:- (C) Rs. 1,000]

7. Fund flow statement and cash flow statement are presented to-
   (A) Managing of Directors
   (B) Board of Directors
   (C) Purchase Manager
   (D) Marketing Manager
   [Ans:- (B) Board of Directors]

8. Which of the following is Cash Flow from Investing Activities?
   (A) Sales Proceeds of Investment
   (B) Payment of Income - tax
   (C) Payment of Interim Dividend
   (D) Redemption of Debentures
   [Ans:- (A) Sales Proceeds of Investment]

9. Provision for taxation was Rs. 35,000 on 31-3-2019 and Rs. 65,000 on 31-3-2020. Income tax of Rs. 25,000 was paid during the year. What amount of Provision for taxation should be made during the year?
   (A) Rs. 55,000 (B) Rs. 54,000
   (C) Rs. 56,000 (D) Rs. 57,000
   [Ans:- (A) Rs. 55,000]

10. Provision for depreciation on Machinery was Rs. 50,000 as on 31-3-2019 and Rs. 80,000 as on 31-3-2020. During the year machinery costing Rs. 50,000 and having book value after depreciation Rs. 32,000 was sold for Rs. 20,000. What amount of Depreciation must have been charged to Profit and Loss Account?

    (A) Rs. 48,000 (B) Rs. 50,000
    (C) Rs. 49,000 (D) Rs. 51,000
    [Ans:- (A) Rs. 48,000]

Practical Questions:

Question – 1

Prepare Cash Flow Statement from the Balance Sheet and other details given below of theBrinda Ltd.

Particulars	31-3-2019 Rs	31-3-2020 Rs
I . **EQUITY AND LIABILITIES:**		
Share holders' Funds:		
Share Capital:		
Equity shares of Rs. 10 each fully paid up10% Red. Pref. Shares of	2,00,000	4,00,000
Rs. 10 each	70,000	-------
Rs. 7 paid up		
Reserves and Surplus:Security premium General Reserve		
Profit & Loss A/c	15,000	10,000
Non –Current Liabilities:	1,00,000	50,000
	55,000	70,000
) Long Term Borrowings12% Debentures		
Current Liabilities:		
Trade Payables: Creditors		
	-------90,000	70,000
Other Current Liabilities:	1,20,000	
Bank Overdraft		30,000
Short Term Provisions:Provision for TaxationProposed Dividend	35,000	-------50,000
Total	15,000	20,000
II ASSETS:		
Non – Current Assets:		
Fixed Assets		
Tangible Assets: land & Building Plant & Machinery		
Intangible Assets:		
Goodwill	7,00,000	7,00,000
Non-Current Investment:		
Investment		
Current Assets:		
Inventories: Stock		
Trade Receivables:Debtors	3,00,000	4,00,000
Bills Receivables	1,50,000	1,84,000
Cash and Cash Equipment:Cash balance		
Total	50,000	40,000
	1,00,000	-------30,000
		16,000
	40,000	10,000
	20,000	
	10,000	20,000
	30,000	
	7,00,000	7,00,000

Additional Information :

During the year ending on 31st March 2021.

1) Depreciation written off: On Land and Building Rs. 20,000, on Plant and machinery Rs. 40,000.
2) Investments are sold at profit of 10% on its sales proceeds.
3) The company has redeemed Red. Pref. Share with 5% Premium after observing necessary requirements of Act for the purpose of redemption of Pref. Shares, the amount of Rs. 1,00,000 has been transferred from General Reserve to Capital Red. Reserve
4) The company issued Bonus shares to the existing equity share holders from Capital Red. Reserve in the proportion of 2:1.
5) Debentures were issued at 5% discount.
6) Rs. 20,000 have been paid as tax for the last year and the amount of proposed dividend of the last year, has also been paid

From the above information, prepare Cash Flow Statement.

[**Ans**: Profit before change in W.C. Rs. 1,68,500. (Difference in Profit Rs. +15,000) Add: Goodwill Written Off Rs. 10,000, Proposed dividend Rs. 20,000, Depreciation on Land & Building Rs. 20,000, Depreciation on Plant & machinery Rs. 40,000, Deb. Discount Rs. 3,500, Gen. Res. Rs. 50,000, Provision For tax Rs. 35,000. Less: Profit on sale of Investment Rs. 25,000 (2) Cash Flow from Operating Activity Rs. 1,02,500 (Profit Rs. 1,68,500 Add: Dec. in Stock Rs. 10,000, Dec. in Debtors Rs. 4,000 Less: Decrease in Creditors Rs. 60,000, Payment of Tax Rs. 20,000) (3) Cash Flow from Investing Activity Rs. -69,000 (Sale of Investment Rs. 1,25,000 Less: Purchase of Land & Building Rs. 1,20,000, Purchase of Plant & machinery Rs. 74,000) (4) Cash Flow from Financing Activity Rs. 76,500 (Pref. Share capital Rs. 30,000, Debenture Rs. 66,500, Equity Share Capital Rs. 1,00,000 Less: Proposed Dividend Rs. 15,000, Red. Pref. Share (With Premium) Rs. 1,05,000 (5) Increase in Cash and Cash Equivalents Rs. 1,10,000 (1,02,500 - 69,000 + 76,500)]

Question – 2

Following is the Balance Sheet of Manoj Ltd. As on 31st March 2019 and 2020

Particulars	31-3-2019 Rs	31-3-2020 Rs
I . **EQUITY AND LIABILITIES:**		
(1) Share holders' Funds:		
(a) Share Capital:		
Equity share capital	1,50,000	2,00,000
(b) Reserve and Surplus: General Reserve Profit &		
Loss A/c	60,000	93,700
(2) Non – Current Liabilities:	53,000	73,500
(a) Long Term Borrowing: 10% Debentures		
(3) Current Liabilities:		
(a) Trade Payables: Creditor	40,500	31,500
Bills Payables		
(b) Short Term Provisions: Provision for Tax		
Proposed Dividend	50,000	11,300
Total	15,000	5,800
II ASSETS:		
(1) Non – Current Assets:	39,300	12,000
(a) Fixed Assets:	42,200	22,200
(i) Tangible Assets: Plant and Machinery Furniture	4,50,000	4,50,000
(ii) Intangible Assets:		
Goodwill		
(b) Non- Current Investment:		
Investment		
(2) Current Assets:	2,10,000	2,10,000
(a) Inventories: Stock	78,600	95,200
(b) Trade Receivables: Debtors		
(c) Cash and Cash Equivalents: Cash balance	7,000	5,000
Total	50,000	31,000
	38,000	28,800
	60,000	70,000
	6,400	10,000
	4,50,000	4,50,000

Additional Informations:

1) Redeemed Debentures at 5% premium.
2) Depreciation provided on Plant and Machinery Rs. 21,000 and Furniture Rs. 8,000.
3) Sold one Machine for Rs. 30,000, the cost of which was Rs. 50,000 and its writtendown value Rs 35,000.
4) Proposed dividend of last year was paid and tax of Rs. 32,000 of last year was alsopaid.
5) Decided to value stock at cost, whereas previously the practice was to value stock atcost less 5%. The Stock on 31-3-2020 was correctly valued at cost.

[**Ans**: Profit before change in W.C. Rs.1,15,550. (Difference in Profit Rs. 20,500) Add: Goodwill Written Off Rs. 2,000, Proposed dividend Rs. 22,200, Depreciation on Furniture Rs. 8,000, Depreciation on Plant & machinery Rs. 21,000, Debenture Red. Premium Rs. 450, Gen. Res. Rs. 33,700, Provision For tax Rs. 4,700, Loss on sale of Plant & Machinery Rs. 5,000. Less: Profit on Stock Rs. 2,000 (2) Cash Flow from Operating Activity Rs. 36,850 (Profit Rs. 1,15,550 Add: Dec. in Stock Rs. 9,200, Stock Difference Rs. 2,000 Less: Decrease in Creditors Rs. 38,700, Decrease in Bills Payable Rs. 9,200, Decrease in Debtors Rs. 10,000, Payment of Tax Rs. 32,000) (3) Cash Flow from Investing Activity Rs. -31,600 (Sale of Investment Rs. 19,000, Sale of Plant & machinery Rs. 30,000 Less: Purchase of Furniture Rs. 24,600, Purchase of Plant & machinery Rs. 56,000) (4) Cash Flow from Financing Activity Rs.

-1,650 (Equity Share Capital Rs. 50,000 Less: Proposed Dividend Rs. 42,200, Debenture Rs. 9,000, Red. Pref. Share (With Premium) Rs. 9,450 (5) Increase in Cash and Cash Equivalents Rs. 3,600(36,850 -31,600 -1,650)

Question- 3

The balance sheet of Umiya Ltd. As on 31-3-2020 and 31-3-2021 is as following:

Particulars	31-3-2020 Rs	31-3-2021 Rs
I **. EQUITY AND LIABILITIES:**		
(1) Share holders' Funds:		
(a) Share Capital:		
Equity Share Capital (Shares of Rs. 10 each)10%	3,00,000	3,30,000
Pref. Share Capital	2,00,000	1,50,000
(Shares of Rs. 10 each)		
(b) Reserve and Surplus: Profit & Loss A/c General		
Reserve	50,000	1,50,000
Capital Redemption Reserve Security Premium	30,000	40,000
(2) Non – Current Liabilities:	-------	20,000
(a) Long Term Borrowing: 10% Debentures	-------	500
Depreciation fund on Fixed Assets		
(3) Current Liabilities:		
(a) Trade Payables: Creditor	50,000	40,500
(b) Short Term Provisions:	22,000	50,000
(c) Provision for Tax	35,000	45,000
Bed depts reserve		
Proposed Dividend	15,000	25,000
Total	8,000	10,000
	12,000	18,000
	7,22,000	8,79,000
II ASSETS:		
(1) Non – Current Assets:		
(a) Fixed Assets:	4,00,000	4,80,000
(b) Non- Current Investment:	1,50,000	1,40,000
Investment		
(2) Current Assets:	54,000	1,50,000
(a) Inventories: Stock	93,000	99,000
(b) Trade Receivables: Debtors	25,000	10,000
(c) Cash and Cash Equivalents: Cash and bank balance		
Total	7,22,000	8,79,000

Additional Information :

1) During the year 2020-21 Preference Shares of Rs. 50,000 were redeemed at 5% premium. This was done partly, by creating Capital Redemption Reserve from Profit, and partly by issuing new Equity share of Rs. 30,000. These new Equity Shares were issued at 10% premium. The premium on redemption of Preference share, was met out of the premium received on issue of new Equity share.
2) Decided to value the stock at cost from the year 2020-21, whereas earlier the practice was to value stock at cost less 10%. The Opening stock was valued as per the practice existing at the time, while closing stock was correctly value at cost.
3) One of the Fixed Assets costing Rs. 70,000 on which accumulated depreciation is Rs. 15,000 has been sold for Rs. 60,000.
4) Proposed dividend of last year was paid and taxes of Rs. 40,000 of last year also. From the above particulars, prepare Cash Flow Statement.

[Ans: Profit before change in W.C. Rs. 2,30,000. (Difference in Profit Rs. 1,00,000) Add: Proposed dividend Rs. 18,000, Depreciation on Fixed assets Rs. 43,000, Gen. Res. Rs. 10,000, Provision For tax Rs. 50,000, Capital Redemption Reserve Rs. 20,000. Less: Profit on StockRs. 6,000, Profit on sale of Fixed assets Rs. 5,000 (2) Cash Flow from Operating Activity Rs. 1,06,000 (Profit Rs. 2,30,000 Add: Increase in Creditors Rs. 10,000, Increase in B.D.Res. Rs 2,000, Dec. in Stock Rs. 6,000, Stock Difference Rs. 6,000 Less: Decrease in Debtors Rs. 6,000, Decrease in Stock Rs. 96,000, Payment of Tax Rs. 40,000) (3) Cash Flow from Investing Activity Rs. -80,000 (Sale of Investment Rs. 10,000, Sale of Fixed assets Rs. 60,000 Less: Purchase of Fixed assets Rs. 1,50,000,) (4) Cash Flow from Financing Activity Rs. - 41,000 (Equity Share Capital Rs. 30,000, Equity Share Premium Rs. 3,000 Less: Proposed Dividend Rs. 12,000, Debenture Rs. 9,500, Red. Pref. Share (With Premium) Rs. 52,500 (5) Increase in Cash and Cash Equivalents Rs. -15,000 (1,06,000 -80,000 . -41,000)]

Question – 4

From the following Balance sheet of Devang Co. Ltd. Prepare Cash Flow statement as perAccounting Standard- 3

Particulars	**31-3-2020 Rs**	**31-3-2021 Rs**
***I*. EQUITY AND LIABILITIES:**		
(1) Share holders' Funds:		
(a) Share Capital:		
Equity Share Capital (Shares of Rs. 10 each)	4,00,000	3,00,000
(b) Reserve and Surplus:General Reserve Profit & Loss A/c Capital Reserve	1,60,500	1,40,500
(2) Non – Current Liabilities:	3,25,000	2,60,000
(a) Long Term Borrowing:10% Debentures	30,000	15,000
(b) Long Term ProvisionsDepreciation Fund		
(3) Current Liabilities:		
(a) Trade Payables:Creditors	90,000	-------
Bills Payable	25,000	30,000
Total		
II ASSETS:		
	15,000	15,000
	58,000	30,000
	11,03,500	7,90,500
(1) Non – Current Assets:		
(a) Fixed Assets:		
(i) Tangible Assets:		
Land and Building		
Furniture (at Cost)	4,00,000	4,20,000
(ii) Intangible Assets:	2,00,000	1,00,000
Goodwill		
(b) Other Non- Current Assets:	1,00,000	1,10,000
Preliminary Expense		
Debenture Discount	52,000	62,000
(2) Current Assets:	12,500	8,000
(a) Inventories: Stock		
(b) Trade Receivables:	1,35,000	25,000
Debtors		
Bills Receivables	72,500	25,500
(c) Cash and Cash Equivalents:	81,000	25,000
Cash		
	50,500	15,000
Total		
	11,03,500	7,90,500

Additional Informations:

1) Debentures were issued at 10% discount during the year.
2) Bonus shares were issued during the year from General Reserve in Proportion of 3:1.
3) A Furniture of which cost price was Rs. 60,000 and on which the accumulated depreciation was Rs. 10,000 was sold for Rs. 45,000.
4) A piece of land was sold and the profit was transferred of Capital Reserve.
5) Dividend was declared and paid at 15% on Equity share in the year 2019-20 for the year 2018-19

[Ans: Profit before change in W.C. Rs. 2,64,500. (Difference in Profit Rs. +65,000) Add: Goodwill Written Off Rs. 10,000, Preliminary Expense Rs. 10,000, Depreciation on Furniture Rs. 5,000, Loss on sale of Furniture Rs. 5,000, Deb. Discount Rs. 4,500, Gen. Res. Rs. 1,20,000, Equity Dividend Rs. 45,000. (2) Cash Flow from Operating Activity Rs. 79,500 (Profit Rs. 2,64,500 Add: Inc. in Bills payable Rs. 28,000 Less: Inc. in Stock Rs. 1,10,000, Inc. in Debtors Rs. 47,000, Inc. in Bills Receivable Rs. 56,000) (3) Cash Flow from Investing Activity Rs. -80,000 (Sale of Furniture Rs. 45,000 , Sale of Land & Building Rs. 35,000 Less: Purchase of Furniture Rs. 1,60,000) (4) Cash Flow from Financing Activity Rs. 36,000 (Debenture Rs. 81,000 Less: Equity Share dividend Rs. 45,000 (5) Increase in Cash and Cash Equivalents Rs. 35,500 (79,500 - 80,000 + 36,000)]

UNIT : 7	FINANCIAL MANAGEMENT

7.1 INTRODUCTION

Finance is very important for any business organization and it is also considered a life blood for any business firm. All the business activities are done by money or finance. Without finance no economic activities can be performed. Thus, finance helps in manufacturing and merchandise activities. It is said that money earns money. Thus to earn money from money, proper management of money is needed. It is also called efficient management of fund or finance.

7.2 MEANING OF BUSINESS FINANCE

Finance means supply of money as and when required for business. Finance is needed for all sorts of business activities. Function of finance is different from finance. Function of finance means procurement of fund at lowest cost and effective utilization of fund. There are different sources of funds but fund required for business should be acquired from those sources where it is available at cheaper rate. Other definitions are as follows:

"Business finance is that business activity which is concerned with the acquisition and conservation of capital funds in meeting financial needs and overall objectives of a business enterprise,"

"Business finance can broadly be defined as the activity concerned with planning, raising, controlling and administering of the funds used in the business.

7.3 MEANING OF FINANCIAL MANAGEMENT

Management of fund is very important to increase wealth and to fulfill the objectives of business. Business finance is mainly concerned with two things – raising fund from various sources and utilization of funds to achieve the business goals. Management of the business uses various techniques to manage finance effectively and efficiently. If Finance is not managed effectively and efficiently, business goals are not achieved. Thus financial management mainly deals with the source of finance and uses of finance.

According to Solo man "Financial management is concerned with the efficient use of an important economic resource, namely, capital funds." Phillippatus has given a more valuable definition for financial management "Financial Management is concerned with the managerial decisions that result in the acquisition and financing of long-term and short term credits for the firm."

7.4 OBJECTIVES OF FINANCIAL MANAGEMENT

Earlier, main objectives of financial management were to maintain liquid assets and maximizing profit of the firm. Maintenance of liquidity is very important because with good liquidity, firm can meet its short term obligation easily. Thus firm can meet its short term liabilities as and when it gets matured. Business firm is doing all economic activities to increase the profit. Thus firm cannot run its business without profit. However there are organizations which are earning excessive profit or unreasonable profit which is also called profiteering. Profiteering is not at all good but at the same time goal of maximization profit has also received many criticisms which are as follows:

7.4.1 It is unclear: the objective of profit maximization is not clear. It is value to understand because there are various types of profit like short term profit, long term profit, profit before tax and profit after tax etc. Thus, it is not clear that about which type of profit maximization they are talking.

7.4.2 It does not consider time value of money: Here there is no difference between profits earned during different time. It means that time period of the earning received is not considered. Money has time value, as time passes the value of money gets decreased. So time value is linked with the life of the project. It is said that rupees received today has more value than rupee received tomorrow. So earning of different year has different value as per the concept of time value of money. So the limitation is that objective of profit maximization does not consider time value of money.

7.4.3 Unreasonable and inappropriate concept: in early 19^{th} century it was appropriate to earn profit because the capital required for business was supplied by the owner. But in today's context owner and supplier of the capital are different. Moreover firm has some responsibility towards society. So in this connection, the objective of profit maximization is not considered appropriate. Now business environment has t o t a l l y changed and technology plays important role in business activities.

7.4.4 It is narrow concept: A firm has many obligations to be fulfilled. So firm can survive in the competitive market by merely increasing profit. But at the same time it has to consider the welfare of all stakeholders.

7.4.5 It does not increase the market value of share: It is believed that increase in earnings per share, increases the stock price. But it cannot be true in all cases. Thus objective maximization is not matched with owners' objective of economic welfare.

7.4.6 It does not concern with social responsibility: in order to fulfill social responsibility firms has to carry out many activities which increase social welfare. Firm with very high profitability does not do not anything for society loses the value in the society. So apart from earning profit, firm has to do some social activities like building school, colleges or any other educational intuitions, health centre, organizing blood donation camps, camps for cataract operation, health checkup camps, Tree plantation programme, donating big amount to needy NGO etc.

Thus considering the above limitation, profit maximization objectives is not considered good or ideal. So profit maximization goal should not be considered while financial decision is taken.

Professor Ezra Solomon has given the concept of wealth maximization for making financial decision. He said that the wealth or earning is received should be discounted at an appropriate discount rate and such discounted earnings should be compared with original investment, if the discounted earning is more than original investment then it is called wealth maximization.

“The gross worthy of a course of action is equal to the capitalized value of the flow of future expected benefits, discounted at the rate which reflects their certainty or uncertainty” as he said that net present value is the difference between total earning discounted and original investment made by the firm in project. So while taking financial decision, the criteria of net present value must be kept in mind. If the net present value is positive, decision should be taken. If the net present value negative, decision should not be taken. Suppose there are two projects which have positive net present value than the net present value of both should be compared and the project is selected which has higher net present value. This type of the decision is called mutual exclusive decision. So this objective is the appropriate objective which is also consistent with maximization of wealth of stakeholders. It is also known fact that share prices , earning per share and dividend can be increased by increasing wealth of the firm thus the objective of wealth maximization is highly relevant in present time Beside these two objectives, there are other objectives also which are given below.

1. To offer fair return to stockholders
2. Increasing reserve and surplus for future growth and development.
3. To increase operational efficiency, so that procured fund can be utilized effectively andefficiently.
4. To ensure the fund suppliers that their fund is utilized for the purpose for which they have given to firm.

7.5 SCOPE OF FINANCIAL MANAGEMENT

The scope of financial management has been changed over the years. At the same time the scope of financial management has increased and has covered more areas of finance. Earlier role of finance manager was different and now the role of financial manager has totally changed. It is also called drastic changes in the role of financial manager. In order to understand the role properly, let us try to understand the traditional approach and modern approach of financial management.

Traditional approach:

The traditional approach was very famous in the beginning of the 19th Century. The role of finance manager was limited under this approach. Under this approach, finance manager has to procure the fund from the market as per need of the firm and administer the fund properly. So here he has to perform two tasks – procurement of fund as per requirement of firm administration of fund. Now let us classify it in broader way.

7.5.1 Making arrangement of fund from financial institutions

7.5.2 Deciding about the financial instruments like equity share, debenture, bond etc.

7.5.3 Balancing between the goal of films and goals of fund suppliers.

The role of finance manager was very limited to just keeping records about fund acquired from various sources. He was more concerned for payment of the original amount as well as interest or dividend on fund procured. The real term was "Corporate finance" not "financial management" In early 19^{th} century some authors wrote books on corporate finance and tried to theorize it. Thomas Greene wrote a book titled "Corporate Finance" in 1897. Then after Edward Meade Wrote another book titled "Corporate Finance" in 1910. There was another book written by Arthur Dewing in 1919. The title of the book was "The financial Policy of Corporations". These books were very much useful in early nineteenth century. I It is said that there was dominance of the books almost three decades in early nineteenth century. However the traditional approach was criticized after 1950. Following criticisms were made.

7.5.3.1 It was outward looking approach. This approach is more concerned about the fund suppliers. It focuses on outward parties like banks, financial institutions and investors. It is least concerned with inside matter of the firm. it means that this approach does not consider the internal matter of the firm because for taking financial decision.

7.5.3.2 Day to day financial problems is not considered. This approach considers some financial issues like merger, acquisition, consolidation, corporate restructuring and liquidation etc. There issues do not take place frequently but happen sometimes in life of firm. There are very important routine issues which should be addressed but this approach does not consider routine issue pertaining to financial management.

7.5.3.3 Limited scope: This approach covers only company or corporate houses which are registered but this approach cannot be applied to those firms which are considered non corporate organization. Thus this approach is limited only to corporate houses and excludes non corporate organizations.

7.5.3.4 Working capital issues: Working capital management is very important because it has an impact on profitability. But this approach considers only long term financing and ignores short term financing which is not good for the health of organization.

7.5.3.5 Allocation of fund is ignored: This approach takes into consideration only procurement of fund and ignores efficient allocation of fund on different department. Solomon has raised some of the issues which cannot be addressed by this approach. The issues are as follows:

7.5.3.5.1 Should a firm raise fund for specific objectives?

7.5.3.5.2 Does financial performance of firm meet the expected return criteria on investors?

7.5.3.5.3 What is the cost of capital and what should be the cost of capital?

7.5.3.5.4 What the cost of capital of the mix is of fund raised from market? Reframe

The traditional approach does not consider the important aspect of financial management like cost of capital, cheaper source of fund, efficient allocation of fund etc.

Modern approach: The traditional approach lasted up to 1950 then there were some changes in business environment like advent of new technology, changing in corporate structure, increasing competition in market etc. Now to address this issues the subject financial management has undergone drastically changes because it started understanding the importance of efficient use of asset. It is said that after the invention of computer, decision making process has been completely changed. Decision makers need information and computer provides this information easily. Thus, computer started helping to the decision makers. Another important aspect of modern management was the use of operation research technique with the help of computer. After operation research, capital budgeting technique was added into financial management. Capital budgeting techniques analyses the profitability of investment proposals. After 1960 different important theories like pricing models, valuation models and portfolio theories like capital asset pricing model, Harry Markowitz model have been developed. Financial manager started showing interest in efficient allocation of fund on asset. Even academicians have also started conducting research on efficient allocation of fund. There was inflation in the year of 1980 which increased the interest rate. The loan rate has also been increased. Because of inflation rate the cost of fund has gone which forced finance manager to utilize scare resource efficiently. The business environment has become more turbulent and business became more risk in turbulent environment. At the same time financing decision has become more challenging. However this environment has changed scope of financial management. Now organization is considered as system which comprises different interrelated and interconnected parts together. A business is now not done is isolation but there are external and internal factors which affect the business. So finance manager has to consider both the factors external as well as internal. Now procurement of the fund is done on the specific purpose and effective and efficient utilization is also considered. Now financial management is total study of fund raising and fund utilizing. Thus new approach of financial management has become wider.

Ezra Solomon defined financial management as "the central issue of financial policy is the wiseuse of funds and the central process involved is a rational matching of advantages of potential uses against the cost of alternative potential uses so as to achieve the broad financial goals which an enterprise sets for itself.

The modern approach has analytical view for financial management. Following are the important things related to the new approach:

I. How much fund does a firm require for project?
II. What type of assets does a firm require to buy?
III. From where the required fund should be raised?

The above points tell about four important areas like funds requirement decision, financing decision, investment decision and dividend decision. These four major areas confine the scope of financial management. It is discussed in detail as under:

It considers need of fund: This is first step for taking financing decision. Finance manager has to know the need of the fund required by the firm. Generally estimation is made to know the requirement of fund. The estimation is based on the requirement fixed capital and working capital. For long term requirement long term capital should be raised and for working capital requirement short capital should be raised.

Financing decision: Availability of fund is the most important aspect of financial management. Fund should be available as and when required. Cost of capital is very important aspect. Fund should be raised at lower cost of capital. Higher cost of capital decreases the value of firm and also decreases the profitability. There are fixed rate bearing securities which help firm to minimize the tax liabilities and maximize the earning per share. There are also non fixed rate bearing securities which increases the risk in firm but generate higher return for investors. However a proper balance is required between fixed rate bearing securities and no fixed rate bearing securities.

Investment decision: investment decision is also known as capital budgeting decision. Investment decision is very important because it is long term decision and fund investment for long term would be irreversible immediately. Hence proper care should be taken while taking investment decision. There are important aspects like how much to be invested? In what type of assets investment to be made? What is rate of interest or discount rate? What is expected earnings from project in which investment to be made? Whether project is independent or mutually exclusive? What is the life of the project? All such type of issues needs to be considered while taking investment decision.

Investment in current assets is important aspect. By considering credit policy of the firm, investment in inventory is decided. There are two type of credit policy- lenient credit policy which helps to increase the sales, whereas strict credit policy reduce the sales but at the same time it also reduces the bad debt and collection expenses. Firm requires more fund if firm has lenient credit policy. First require less fund if the firm adopt strict credit policy. Thus entire working capital management is important because in order to maintain proper liquidity, working capital management should be done properly.

Dividend policy decision: Dividend is the part of profit given to shareholders. Dividend policy means decision regarding to distribute dividend or not to distribute the dividend among the shareholders. Dividend policy decision impacts on stock price of the firm. Dividend policy decision depends on liquidity and profitability of the firm. It is known fact that higher the profitability, higher will be the amount of dividend. So dividend policy decision is the most important area of decision making.

Thus above four types of decision also affect the production department, marketing department and human resource department. Even firms size, growth, risk and profitability of the firm is also affected by these four types of decisions.

Ezra Solomon has rightly said that “The function of financial manager is to review and control decisions to commit or recommit funds to new or outgoing uses. Thus financial management encompasses the area of production, marketing and other department while taking decision. Thus financial management performs traditional task besides, it performs other tasks like determining size and technology, direction of the firm, profitability and risk etc. Financial manager has to selected best assets or project which generates maximum return. Mae Janpes said that financial management includes profit planning, determining volume of output, pricing, selecting product lines etc. Other functions of it are as given below:

1. **Surety about supply of fund:** It is basic function of finance manager

to make the fund available to all departments as and when they need. Organization can smoothly function If the fund is available on demand.

2. **Performance evaluation:** Financial performance evaluation should be done regularly of the different division of the organization. Thus financial performance helps to detect errors in policy. Financial performance increases if policy is right. Financial performance deceases if there is defect in policy.
3. **Bargaining with fund suppliers:** Firm raises fund from banks, financial institutions and other suppliers. To reduce the cost of capital, there should be bargaining with fund suppliers. Thus a financial manager negotiates with banks, financial institutions and fund suppliers to procure fund at cheaper rate.
4. **To watch the behavior of stock exchange:** capital market is very important for the economy of any country. The trend of stock reflects economic condition of the country. Financial manager makes planning for business if the stock price is showing progressive trend. Moreover upward trend stock market fills the positive vibrations into the investors. Thus fund is easily available if the capital market is flourishing.

From the above analysis it can be observed that financial management has emerged as a new subject which has encompassed many areas of business. Now financial manager has become analyst for business organization.

7.6 LIQUIDITY AND PROFITABILITY

Liquidity and profitability have direct relationship. Liquidity means availability of fund as and when a current liability gets matured. It is also said that liquidity means the firms has adequate cash on hand to meet unexpected expenses. The firm has very good liquidity if firm has cash reserve to meet emergency expenses. On the other hand profitability means ability of the firm to earn profit. Profitability shows financial soundness of the firm. Liquidity and profitability has inverse relationship. Higher is the liquidity, lower is the profitability. To maintain liquidity more amount is invested in current assets like inventory, debtors and cash. Investment in current assets does not generate higher return which reduces the profitability. Suppose investment is made in inventories to take the benefit of price fluctuation in future which increases the profitability but at the same liquidity is reduced because fund is blocked in inventories. Same is true for credit period. By extending credit period sales is increased but fund is blocked in debtors which reduces the liquidity. When credit period is reduced, a sale is decreased but liquidity can be increased. Profitability, liquidity and risk are also correlated. When profitability is increased, risk is also increased. But liquidity gets decreased. To have higher return higher degree of risk is assumed. Risk means use of higher degree of debt in capital structure. Interest on debt fund is exempted from tax. Therefore debt is the cheaper source of finance. By increasing debt – equity ratio, earning per share can be increased but at the same time increased debt-equity ratio increases the technical or financial risk in firm. Fixed financial charges must be paid irrespective of profit or loss in the firm. Thus firm needs to fix amount of interest as per predetermined scheduled which leads to financial burden on firm.

Financial manager has to balance between risk, return and liquidity. He should forecast cash flows and analyses various sources of funds. Forecasting of cash flows and managing the flow of internal funds are the functions which lead to liquidity. Cost control and forecasting future profits are the functions of finance manager which lead to profitability. An efficient finance fixes that level of operation where both return and risk are optimize. Such a level is termed as risk and return trade off and every financial decision involves this trade –off. At this level the market value of the company’s shares would be the maximum.

7.7 ROLE OF FINANCE MANAGER IN THE CHANGING SCENARIO

Many changes have taken place in Indian financial system in 21st century. Advent of technology has brought many unprecedented changes in financial system. From 1950 to 1975, our economy was growing as per five year plan and the five year plan was formulated by central government. Economy was planned from 1950 to 1975 which focused on public sector growth. Our economy was flourishing at that time. Controlled economy means no businessman can start business without licenses. This period was also known as “permit raj”. In 1980 we had opened our economy considerably. Indian government started making efforts to accelerate export and made efforts to reduce imports. Government concentrated on food production, enhancement in industrial growth and big growth in middle class population. Government had also allowed NIRs inventors to invest in capital market. Even control over capital market was also reduced which allowed new companies in the market. In 1991 Indian government made major changes in policies. In 1992 Indian government adopted Liberalization, Privatization and

Globalization policy (LPG) Liberalization means government has become liberal in granting licenses to firms. Privatization means government has opened some of the sectors for private players. Initially telecommunication sector, transportation sector, health sector, banking sector and education sector were opened for private business. Globalization means doing business at global level. Globalization integrated national economy with international economy. Indian business house can do business with international firm. Indian company can hire expert from foreign and also import technology for business. Maruti Udhyog Limited, Hero and Honda Limited have collaborated with foreign companies because of globalization. Indian company can take the benefits of foreign market. After globalization entire business structure has become very complex and such business structure has been very difficult for management. It has posed lots of challenges to financial manager. Many firms raise fund from international market. So the financial manager has to understand the foreign capital market rules and regulation, tax structure and pattern of risk. Risk is totally different at domestic level business and international level business. So the financial manager has to assess different types of risk. Even financial instruments are different at national level and international stock market. Global depository receipt, American depository receipt and euro issues are very famous financial instruments.

Globalization has brought following opportunities and challenges for financial manager.

7.7.1 Financial Decision: Financial decision in global context means acquiring fund from foreign capital market. Because of globalization fund can be raised at competitive rates from foreign market. Even foreign institutions investors and Non-resident Indians can put money in Indian business. Now fund from FIIs have increased during the last many years.

7.7.2 Investment decision: After globalization, investment opportunities have been increased in foreign market. While doing business in foreign market, some of the important factors must be observed like political risk, interest rate risk, regulatory risk and economic risk. Finance manager has to evaluate all types of risk properly. Then only he can start business over there. Moreover he needs to collect more information about the market and its related risk factors.

7.7.3 Dividend Policy: Finance manager has to take dividend policy decision looking the current scenario at global level. Moreover he has to evaluate the portfolio of foreign investors. If foreign investors are interested in dividend income then dividend should be declared. If they are interested in capital appreciation, then dividend should not be declared but the amount of dividend should be reinvested in business. If there is global financial crisis, then dividend policy decision is taken carefully because small mistake can sabotage the very objective of wealth maximization.

Globalization, liberalization and privatization has changed entire situation of business world . There was a time when business was done in a protected environment and the level of competition was very low. There was competition among local business firms. But after globalization the completion has increased because local firm has to compete the firm being operated at global level. So now business is done in global environment which is more complex than before. It has been the experienced that many local firms who could not stand in global competition shut down their business. There are some benefits of globalization also which are explained below

1. There is increase in trade and commerce
2. Many Indian companies have started business in collaboration with foreign companieswhich help them to bring latest technology in India.
3. The efficiency and effectiveness of Indian business firms have gone up
4. Exports has also increased which has led to increase foreign reserve
5. The existing infrastructure has been strengthened because of globalization.

7.8 METHODS OF FINANCIAL MANAGEMENT

The goal of financial management is to acquire fund and use fund efficiently to maximize the wealth. There are two important words "financial tool and Financial method" both words have their own importance. But one thing is very clear that use offinancial method or financial tool benefit the business in a following way.

7.8.1 It helps to increase effectiveness of the firm: Effectiveness and efficiency are very important concept for the growth and progress of the firm. Suppose a firm invested Rs. 2,00,000 in project A and Rs. 2,00,000 in Project B. Now project A generated profit ofRs. 20,000 and Project B generated profit of Rs. 15,000. It means that Project A has 10% returns on investment and Project B has 7.5% return on investment. Here Project is effective and efficient both. Finance manager has to always select those projects which maximize the wealth. This is only possible when finance manager uses fund efficiency and effectively.

7.8.2 Make easy for finance manager to take decision: Financial tool helps finance manager to take decision. When there are two projects which one is to be selected is a big problem and finance manager gets confused. At this time financial tool helps to select the project which maximize the wealth. Financial tool helps to take decision under uncertain condition.

Following tools or methods are widely used by finance manager to take finance decision. **Cost of capital:** Cost of capital means amount of charges paid on fund raised from fundsuppliers. It is the fact that lower cost of capital helps to construct optimal capital structure. Finance manager raise fund by considering its cost of capital. If the fund is available at cheaper cost then it is good for finance manager to rise from this source.

Trade on equity: trade on equity is called financial leverage. Higher financial leverage increases the earning available to the shareholders. Financial leverage is called double edge sword because it has to be used judiciously.

Various methods of Capital budgeting: Financial manager can use capital budgeting methods such as payback period, average rate of return, net present value method, internal rate of return method and profitability index method. Net present value method and internal rate of return method are very good method because both the methods use the concept of time value.

Ratio analysis: The ratio analysis is very important tool to analysis financial position of the firm. Liquidity ratio, profitability ratio, leverage ratio, efficiency ratio are used as tool.

Fund flow and cash flow analysis: fund flow statement shows the fluctuation in fund during the study period. Cash flow statement shows movement in cash during the study financial year. Fund flow and cash flow statement help finance manager to know about from where fund comes and where the fund is being utilized.

Other tools: there are other useful tools like Cash management models, ABC analysis, inventory turnover ratio, debtor turnover etc. With help of these tools a financial manager can manage working capital properly.

7.9 RELATIONSHIP BETWEEN FINANCIAL MANAGEMENT AND OTHER INTER-DISCIPLINE

Financial management is multidisciplinary subject which has drawn concept from many subjects like cost accounting, marketing, financial accounting, assets management, Statistics and strategic management etc.

Financial management and cost accounting: Cost accounting is very useful to control the cost. In the present competitive market, it is very difficult to increase market price but with help of cost accounting techniques cost can be reduced and profit can be increased. Thus cost accounting is also helpful to control the cost. Cost accounting data are also useful to finance manager in knowing whether fund is used efficiently or not.

Financial Management and marketing: Marketing is very important thing in the competitive market. With the help of marketing efforts, brand image can be built. Even marketing manager helps to determine the price of the product. Marketing manager knows the effect of different pricing policy on demand of the product. So marketing helps to determine the reasonable market price of the product. Finance manager can also help in deterring price of the product by calculating per unit cost of the product.

Financial Management and Asset management: Assets management is concerned with acquisition of assets and utilization of assets. There are two types of assets long termassets which include land, building and plant and machinery and current assets which includes debtors, inventories, cash and bank. Finance manager raise fund for long term for financing fixed assets like land, building and plant machinery etc. Finance manager while taking decision has to keep in mind the efficient utilization of assets to achieve the goal of wealth maximization.

Financial Management and financial accounting: Financial management and financial accounting both are different. Financial accounting records the economic transactions of the business in a systematic way. It prepares profit and loss account and balance sheets at the end of the year. The financial manager collects data prepared by financial accounting and takes the decisions. Profit and loss account shows profit or loss occurred during the year. Balance sheet indicates the financial position of the film at the end of the year. Financial manager is always interested in earning per share which comes from profit and loss account. Even divined policy decision is also based on profit that comes from profit and loss account. Thus it is said that financial accounting is very much useful to financial manager. Both are complementary to each other.

7.10 FINANCIAL MANAGEMENT & STRATEGIC MANAGEMENT

The main function of financial management is to raise fund and utilize the fund. But finance manager has to keep in mind the main goal of wealth maximization. Besides, while taking financial decision and investment decision, he has to keep in mind following assumptions

7.10.1 Capital market is perfect. Investors are well informed about capital market; investors behave rationally while taking decision. There is not transaction cost like floatation cost and commission of broker.

7.10.2 Investors can take loan against the security on the same rate as the firm can take.

7.10.3 The main goal of the firm is to maximize the wealth of the shareholders because they are the real owners of the firm. The role of financial manager is like agent who has to balance between interest of firm and shareholders.

Financial manager has to understand the theory of finance which has following important parameters.

1. Financial manager should always be concerned with owner's interest. He should make an attempt to increase the wealth of shareholders. Avoiding shareholders creates a problem which is known as agency problem. Besides, managing firm very well, he should also take care of the interest of the shareholders.
2. Shareholders are always interested in market value of the share. So finance manager should make such an attempt which lead to increase the market price of stock.
3. It is also a fact that positive net present value of the project enhances the market price. While negative net present value of project decreases the market price of share. So finance manager has to select that project which has positive net present value. And he should not select the project which has negative present value.
4. The decision regarding dividend policy or capital structure is not relevant to the value of firm because capital market is perfect.

Another important thing is corporate strategy which helps to do business in practical way. Strategy means flexible approach to manage the condition. Without right corporate strategy, a firm cannot grow and develop. Financial policy should be linked with the corporate strategy to achieve corporate goal. Market is ever changing and business environment is also changing. Moreover strategic management considers labour, capital and product for taking decision.

1. Financial policy is more concerned with resources like materials, labour and capital whereas strategy management is more concerned with effective use of resources for the betterment of business. Financial manager has to know that the market is imperfect and doing business in imperfect market is a challenge for the growth and

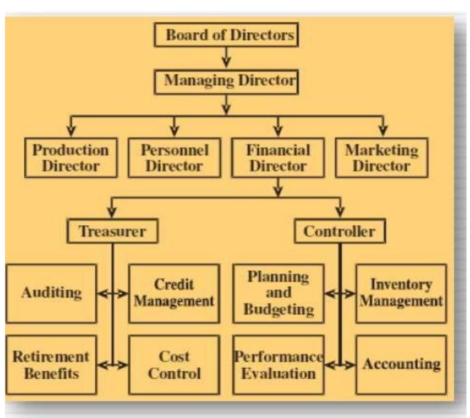
development of business.

2. Strategic management is also concerned with the use of tools and techniques so that business can excel and compete with other firm within same industry. The main aim of the shareholders is to earn maximum return from the firm in which they have invested. There are stockholders like bankers, debenture holders, creditors, suppliers and employees whose interest must be looked upon.
3. Strategic management is multifold takes which focuses on profitability, utilization of fund to maximize the wealth of the stakeholders. When wealth is maximized it is reflected positively on stock price. The main goal of financial policy is to have sustainable growth which would create permanent place in the market.

   Thus strategic management and financial policy are interconnected and intern linked with each other. With help of corporate strategy strength, weakness, opportunities and threat analysis can be done easily. The financial policy is developed in consonance with corporate strategy. Financial policy like capital structure, dividend policy and investment policy can be developed within range of corporate policy. For example if the company has high profit then company increase debt in capital structure which would generate earning to shareholders.

7.11 ORGANIZATION OF THE FINANCIAL FUNCTION

There are various departments like production department, human resource department, marketing department and finance department. But finance department is very important among all departments because all other department depend on the finance department. The role of financial manager must be clearly defined so that he can work properly. However the structure of finance function varies from firm to firm because it depended on financial requirement and utilization of fund. There are some companies where financial department is not important but in some companies it is highly important. Moreover financial philosophy of the company is utmost important design the structure for finance function. There are some known designation like vice-president, chief executive, general manager, controller and treasurer.



Organization for finance function

The above chart shows that financial director exercises his function through his two deputies known as

7.11.1 Controller of comptroller

7.11.2 Treasurer

The main function of the controller is to control the assets of the firm not being utilized inefficiently. He has to perform duties like tax compliance, preparing annual reports, preparing budgets, internal audit and inventory control etc. Where the function of treasurer includes management of fund of firm, preparing cash budget, management of bill payables and bills receivables, initial public offer related process and constantly remains in touch with financial institutions etc. Now let us discuss the functions of controller briefly as follows:

Functions of controller

Planning and control: Planning includes profit planning, capita budgeting and various budgets. Controlling means to have control on the unnecessary expense. The fund should be utilized as per budgeted. If the expenses are more than the budgeted then it would create an issue.

Reporting: The Controller has to report to the top management. Reporting includes the detailed analysis of variance between standard expenses and actual expenses. The analysis and interpretation is also done with due care so that there could be no errors in taking decision.

Taxation: taxation is a complex matter. The controller has to do advance planning about tax to be paid to the tax department. Minimizing tax liabilities in a legitimate way is most import aspect. Illegitimate ways of minimizing tax liabilities are called tax evasion which is not good.

Reporting to various government bodies like SEBI is very important aspect to be performed by the controller.

Safeguarding assets against the risk: There are two type current assets and fixed assets. Fixed assets are used for longer period of time. So the fixed assets must be protected against any danger like risk of fire, flooding, tsunami and other calamities. To protect the assets against the risk of fire or other type of risk insurance is also purchased.

Appraisal: Company is a part of the society hence it has some obligation toward society. The controller has to make appraisal about the firm frequently so that what firm is doing can be known. Through appraisal firm's financial performance, performance toward society, performance toward stakeholders likes banks, suppliers of the raw materials, employees and investors can be known.

Function of Treasurer:

Provision of finance: Provision of finance means firm should have enough finance to start project. In order to procure fund from financial institution at a lower cost negotiation should be done. With the help of adequate fund requirement of fund by department can be met easily.

Relationship with Investor: Increasing stock pleases the investors. So frequently market should be observed so that inconvenience caused to investors can be known. There are many instances where investors need some information which a treasurer can give so that confidence of the investor can be increased.

Short- term financing: working capital is important to meet with day to day expenses. So in order to maintain liquidity, firm should reserve some surplus amount as working capital.

Banking and Custody: Banking related transaction comes under function of treasurer. Maintaining enough balance in current account with bank is also utmost important which fall under the purview of function of treasurer.

Credit and collection: Collection from debtors and discounting bill receivable are important taskdone by the treasurer.

Investment: Investment of firm's fund is done very carefully otherwise firm has to pay huge cost. If firm has surplus profit firm can retain it or invest for welfare of employees.

Insurance: Risk assets and item should be provided insurance coverage. With the help of insurance firm can protect itself against risk.

7.12 FINANCIAL MANAGEMENT: SCIENCE OR ART

Financial management is both arts and science, financial management is done based on certain principles and at the same time taking financial decision needs some skills and experience. Science is based on certain principle like physics, chemistry and mathematics. For example the law of gravitational forces is based on certain principles propounded by Isaac Newton, Archimedes' principle, law of buoyancy etc. are based on certain principles. However financial management is not the pure science like physics but financial management is applied science. Theory of financial management like capital structure theory, dividend policy theory and cost of capital theories are based on certain principles. Financial management has also taken help of the subject like statistics, operation research, computer and technology etc.

Financial management is also an art because for taking important decision it required to have skills and experience. Financial manager has to use his brain while taking decision. It means that other decision power of the financial manager come from within. He must have expertise and training for taking decision. Thus financial Management is both arts and science.

Test questions Review question

7.12.1 Explain the concept of wealth in the context of wealth maximization objective.

7.12.2 Explain the role and scope of the finance function in business distinguishing it from theaccounting function.

7.12.3 Give specimen organization chart for the finance function in a large corporate enterprise.

7.12.4 What are the major types of financial management decision that business firms take?Describe each of them.

7.12.5 Explain the concepts of „'profit maximization"‟ and 'profitability maximization'". Which of these, do you think, is a better operational guide for a finance manager?

7.12.6 "The financial manager's primary task is to plan for the acquisition and use of funds so asto maximize the value of the firm. "Do you agree?

❖ **Check Your Progress**

Multiple Types of Question

1) The expected rate of return that an investor could earn by investing his money inFinancial assets of equivalent risk is called,

(a) Retention ratio
(b) Dividend –payout ratio
(c) Optimum capital structure
(d) Opportunity cost of capital

2) The change in profit due to the change in sales is referred to as ,

(a) Financial leverage
(b) Operating leverage
(c) Profit planning
(d) Dividend-payout ratio

3) Financial decisions of the firm are guided by

(a) Firm‟s wealth
(b) Risk–return trade –off
(c) Retention ratio
(d) Financial leverage

4) Which of these is not a financial asset?

(a) Bonds
(b) Lease obligations
(c) Shares

(d) Patents

5) Select the incorrect statement –

(a) Dividends rate for ordinary shareholders is not fixed

(b) The payment of dividends to shareholders is a legal obligation

(c) Ordinary shareholders are generally called owners of residue

(d) Preference shareholders receive dividend at fixed rate

6) Select the correct statement about Profit Maximization-

(a) It ignores the timing of returns

(b) It is quite accurate

(c) It takes in to account risk

(d) It does not assume perfect competition

7) Determining optimum capital structure is-

(a) An investment decision

(b) A financing decision

(c) A dividend decision

(d) A liquidity decision

UNIT: 8 RATIO ANALYSIS

8.1 INTRODUCTION

In earlier chapters, we have learned that the goal of every financial manager of the company is to maximize the shareholders' wealth and which can earn when the firm's share price is maximized.

The basic financial statements of any firm are Balance sheet and Profit and Loss accountwhich provide useful financial data regarding the firm's operation. The data contained in financial statements are used by various stakeholders and other parties to asses performance and position of the firm.

The Balance sheet contains information about the firm's assets and liabilities and Profit and Loss Account represents the information of items which is related to the revenue and the expenses of the firm of a particular period of time.

Both the Financial statements provide brief picture of the operation of a firm but more precisely can be learnt about the firm from careful evaluation of its financial statements.

Various methods are used for analysis of financial statements like common size, comparative statements and ratio analysis. The most widely used method is Ratio Analysis.

In this unit, we are going to study different types of ratio which are used for different purposes and which are calculated by using accounting data contained in financial statements.

8.2 MEANING, OBJECTIVES, IMPORTANCE, SCOPES AND ITS LIMITATIONS

Meaning of Ratio

A Ratio is a mathematical number which indicates relation between two numbers and refers to a quantitative relationship between two values. It can be expressed as a percentage, fraction, and proportion and even by number of times.

For example, Raju have 600 mangoes and 300 pineapples. The Ratio of mangoes to Pineapples is 600/300 and which can be expressed as 2:1 or 2.

When the Ratio is calculated by using two accounting numbers which is derived from the financial statements, it is termed as accounting Ratio

Ratio is a Relative Measure of financial data and is used to analysis the efficiency of the firm. As stated earlier, the accounting ratios are an important tool of financial statements analysis.

The financial health of firm can be known by its key financial Ratio.

Objectives of Ratio Analysis

1. To summarize and simplify the accounting information of the Firm
2. To determine the short term and long-term solvency of the firm
3. To assess the efficiency of the firm in terms of operation
4. To analyze the profitability of the Firm
5. To estimate the overall financial strength
6. To help in comparison analysis of Inter firm and Intra firm Companies
7. To diagnosis the financial health of an enterprises
8. To analysis the financial statement of the firm
9. To formulate Proper collection and Payment Policy
10. To estimate Return on Investments

Importance of Ratio Analysis

The analysis of financial statement in terms of Ratio Analysis is of interest to number of parties like shareholders, creditors, etc. shareholders are interested in Ratio Analysis to know the earning capacity of the firm and creditors are interested in knowing the ability of the firm to meet its financial obligation. The Importance of Ratio Analysis is as described under

1. **Analysis of Financial Statement**: The Balance sheet is a reflection of the financial position of the firm and Profit & Loss Account shows the result of Business. Thus, the financial statement provides a summarized view of the operation of firm. The Analysis of Financial statement is an important part of financial analysis. To understand the financial statement is important for stakeholders of the company. Ratio

Analysis helps in understanding the financial statement by calculating different types of ratios. With the help of Ratio analysis, we can interpret numbers from balance sheet and Income statement.

2. **Measures Company Efficiency**: With the help of Ratio analysis, the large amount of accounting data is summarized and simplified. The Ratio analysis is important in understanding the firm ability to generate Profit, to assess the return on Assets and Return on Equity. Through Ratio analysis, the company overall efficiency of the firm is measured.
3. **Facilitate Decision Making**: Ratio analysis helps to measure the degree of efficiency of the management and the utilization of Resources by Company. Ratio Analysis helps the management in taking proper decision by calculating different types of ratios.
4. **Measures Financial Solvency**: The Ratios are useful tools of management to evaluate the firm's performance over a period of time. Ratio Analysis identify the company's ability to pay short term obligations. By calculating current ratio, the firm is in position to determine the short-term solvency of the firm.
5. **Assist in corrective action**: The companies operate under various types of risk like market risk, operating risk and various other risks. With the help of Ratio analysis, the company can understand these risks and can take corrective action. Interfirm comparison is possible with the help of Ratio Analysis.
6. **Aid in Intra Firm Companies**: The Intrafirm comparisons are facilitated through ratio Analysis which act as instrument to diagnose the financial health of an enterprises. It helps management to know whether the firm's financial position is improving or not by calculating different types of Ratios and having comparisons with another firm.
7. **Helps in Forecasting & Planning**: With the help of Ratio analysis, the management of the firm can perform the function such as forecasting, planning and control etc. It helps management to prepare budgets, to formulate policies and prepare future course of action by scrutinizing the past result.
8. **Effective Tool**: Ratio analysis is an effective tool which helps in making effective control of the business, measures the performance and even controls the cost etc.
9. **Act as a Barometer**: Ratios serve as barometer for future of the company. With the help of Ratio analysis one can predict the value and which will be helpful in planning the business activities of the future.

10.

11. Better source of Communication: Ratios act as an effective means of communication and play an important role in informing the position and progress of the firm to all those parties who are interested in the firm.

Scope of ratio Analysis

Ratio Analysis is an effective tool of financial Analysis. The firm is answerable to many parties such as owners, creditors, shareholders, employees and even to government. The analysis of financial statement is not restricted to one concept but takes into account all concept such as Earning Capacity of the firm, solvency and Liquidity Position, financial obligation and Profit concepts.

Limitations of the Firm

1. The Information of Ratio Analysis is Historical and it is not including the current information.
2. The comparisons are made difficult due to difference in definition of various financial terms.
3. The Analysis of Ratio does not take into account External Factors such as a world-wide Recession.
4. It does not measure the Human Element of the firm.
5. The Ratio Analysis cannot be used for Comparisons with other firm of the different size and type.
6. The changes in Accounting Methods i.e., Methods of Valuation of stock and Methods of Depreciation on Fixed Assets make comparison difficult in reality.
7. It is very difficult to ascertain the standard ratio in order to make proper comparison. Because it differs from Firm to Firm and Industry to Industry.
8. Ratio Analysis is based on information provided by financial statement which sometimessubject to limitations due to inaccuracy of data.

8.3 STEPS OF RATIO ANALYSIS

The first step of the financial Analyst is to identify the information and select the information which is relevant to the decision under consideration from the financial statements and based on that calculate appropriate Ratios.

The second step is to have comparison of the calculated ratios with the Ratio of the same typeof the firm which help to determine the success and failure of the firm.

The third step involves interpretation of calculated ratio and prepare report writing and lastly draw the conclusion of the financial position of the firm.

8.4 PRESENTATION OF RATIO ANALYSIS

The Mode of Expression of Ratios can be done in different ways.

The different ways of presenting the Ratios are as follows:

a) In terms of Proportion
b) In terms of Percentage
c) In terms of Times
d) In terms of Fraction
e) In terms of days/ weeks/ months

a) In Terms of Proportion:

Ratio can be expressed in the form of proportion by dividing one number by another. The oneamount is used as numerator and the other number is used as denominator and based on that proportion is determined. To measure the liquidity position of the firm, current ratio is used to find out the relation between current assets and current liabilities.

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

For Example the current assets of the firm is 2,00,000 and current liabilities is 1,00,000.

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Ratio = $\frac{200000}{100000}$

Current Ratio = 2: 1 which is expressed in the form of Proportion

b) In terms of Percentage:

The form of expression where one amount is substitute in numerator and another amount in denominator and then after the percentage is determined. The relationship between two variables in hundreds i.e. in percentage.

Net Profit = $\frac{Net\ Profit}{sales} * 100$

If sale of the firm 3,00,000 and Profit is of 60,000

Net Profit = $\frac{3,00,000}{60,000} * 100$

Net Profit = 20% which is expressed in the form of percentage

c) **In terms of Times:**

Similar like Proportion, one amount is disclosed in numerator and another amount indenominator but the interpretation of Ratio is in terms of times. For e.g., stock Turnover ratio

Stock Turnover Ratio = $\frac{Cost\ of\ goods\ sold}{Average\ stock}$

If the cost of goods sold is 5,00,000 and average stock is 1,00,000

Stock Turnover Ratio = $\frac{5,00,000}{1,00,000}$

Stock Turnover Ratio = 5 Times

d) **In terms of Fraction:**

When the firm needs to evaluate the proportion of one component against anothercomponent, this form is used. For e.g. the share capital of business unit is Rs. 500000. Non current assets of business are of share capital.

In this case,

Non current Assets = share Capital * share of non current assets in share capital

Non current Assets = 5,00,000 * $\frac{2}{3}$

Non current Assets = 2,00,000

e) **In terms of days/ weeks/ months:**

In certain cases of ratios time period is determined. This time period is calculated in terms of days , weeks and months. Time period provide information regarding collection period and payment period.

For Example if debtors are of Rs. 9000 and Bills Receivables Rs. 2000 and credit sales are 73000.

Debtors Collection Period = $\frac{Average\ Debtors+Bills\ Receivables}{credit\ sales} * 365$

$= \frac{Average\ Debtors+Bills\ Receivables}{credit\ sales} * 365$

$= \frac{9000+2000}{73000} * 365$

= 55 days

8.5 CLASSIFICATION OF RATIO ANALYSIS

The financial Ratios are classified in various ways. Different authors have classified the ratios in varying groups by taking different bases.

The classifications of Ratio are as follows:Profitability Ratio

- Gross Profit Ratio.
- Operating Profit Ratio
- Net Profit ratio
- Return on Assets
- Return of Capital Employed
- Return on Share Holder FundsEfficiency Ratios
- Stock Turnover Ratio
- Debtors Ratio
- Creditor Ratio
- Working Capital Turnover Ratios
- Operating Ratio Liquidity and Solvency Ratios
- Current Ratio
- Liquid Ratio
- Acid test Ratio
- Proprietary Ratio
- Debt-Equity Ratio
- Capital Gearing Ratio
- Fixed Assets to Proprietary Ratio.
- Long Term Fund to Fixed Assets.
- Interest Coverage Ratio
- Total Assets to Debt RatioProfit cover Ratio
- Interest Coverage
- Dividend coverage
- Equity Shareholders coverage

Profitability Ratio

- Gross Profit Ratio.
- Operating Profit Ratio
- Net Profit Ratio
- Return of Capital Employed
- Return on Share Holder Funds

The understanding of Ratio Analysis begins with the profitability Ratios, as they are most important from the Business point of view.

Each and every type of business is concerned with the aim of earning Profit. A Company should earn Profits to survive and to grow over a Longer Period of Time.

Profitability Ratio measures the overall efficiency of the firm and even identify how effectively the firm uses resources to generate incomes. It should be clear that profitability should be differentiate from Profits. Profits refers to absolute numbers whereas Profitability refers to the ability to Earn Profits.

Profitability Ratio is a measure of firm efficiency and effectiveness. The difference between total revenue and total expenses over a period of time is Profit and it is considered to be an ultimate output of Firm.

Profitability ratio consists the study of sales, operating expenses, cost of goods sold, operating profit and rate of return Ratios. Profitability Ratio can be determined on the basis ofeither sales or investments.

The ratio under profitability analysis are as follows:

- **Gross Profit Ratio**:

Gross Profit Ratio is a measure by dividing its gross profit by Net sales. In the other words, the difference between Net sales and cost of goods sold is also known as Gross Profit. The Ratio is expressed as a Per cent form. Gross Profit measures the Earning capacity and management efficiency of a firm.

It is generally contented that the margin of Gross Profit should be sufficient enough to recover all operating expenses and other expenses and even leave adequate amount as Net Profit in relation to sales and owners' equity.

It is also known as Gross Profit Margin and Trading Margin Ratio etc.

Gross Profit = $\frac{Gross\ Profit}{Net\ Sales} * 100$

Gross Profit = $\frac{Sales - cost\ of\ goods\ sold}{Net\ Sales} * 100$

Cost of goods sold = opening stock + purchases + purchases Expenses – closing stockNet Sales = Total sales – sales Return

Gross Profit = Net Sales – Cost of goods soldCost of goods sold = Net Sales – Gross Profit

In case of Trading Business,

Gross Profit is the difference between Net Sales minus trading cost of sales

Gross Profit = $\frac{Sales - cost\ of\ goods\ sold}{Net\ Sales} * 100$

Cost of goods sold = Trading expenses

- **Operating Ratio:**

  Operating Ratio show the relationship between total operating Expenses and Net sales. Total operating Expenses includes the cost of goods, administration expenses, financial expenses and selling Expenses. It is generally expressed in Percentage.

  Operating Ratio is calculated as follows:

  Operating Ratio = $\frac{cost\ of\ goods\ sold + operating\ expenses}{Net\ Sales} * 100$

  Cost of goods sold = opening stock + purchases – closing stock

  Operating Expenses = Administrative Expenses +Office Expenses + selling Expenses

  Operating ratio is used to measure the efficiency of the firm. The firm is said to be efficient ifit is able to keep up the cost of goods sold and other operating expenses as low a possible in relation to the Net sales.

  If the operating Ratio is low, then it shows higher operating profit of the firm.

- **Net Profit Ratio:**

  Net Profit Ratio is the ratio of Net Income to sales. In other word a Ratio of Net Profit to sales. The Ratio will help us to measures managerial ability to operate the business successfully or not. This ratio is used to measure the overall profitability and hence it is very useful to owners.

  Net Profit Ratio = $\frac{Net\ Profit}{Net\ Sales} * 100$

llustration:1

For the following Information drawn from Profit & Loss Account of Aarti ManufacturingCompany as on year ended 31st March 2014

Particulars	Amount	Particulars	Amount
To opening stock	25,000	By sales	1,60,000
To Purchases	70,000	By Closing Stock	38,000
To wages	22,000		
To Manufacturing Expenses	12,000		
To Gross Profit	69,000		
	1,98,000		**1,98,000**
To selling & Distribution	3000	By Gross Profit	69,000
To Administrative Expenses	22,000	By Profit on sale of Building	4,500
To General expenses	1,400		
To loss on sale of Furniture	700		
To Net Profit	46,400		
	73,500		**73,500**

Calculate

1. Gross profit
2. Net Profit
3. Operating Profit

Gross Profit

Gross Profit = $\frac{Gross\ Profit}{Net\ Sales} * 100$

Gross Profit = $\frac{69{,}000}{1{,}60{,}000} * 100$

Gross Profit = 43.125%

Gross Profit = 43.1%

Net profit

Net Profit = $\frac{Net\ Profit}{Net\ Sales} * 100$

Net Profit = $\frac{46{,}400}{16{,}0000}$

Net Profit = 29%

Operating Profit

Operating Ratio = $\frac{cost\ of\ goods\ sold\ +operating\ expenses}{Net\ Sales} * 100$

Cost of goods sold = opening stock + purchases+ Purchases Expenses – closing stock

= 25,000 + 70,000 + 22,000 + 12,000 – 38,000

= 91,000

Operating Expenses = Administrative Expenses + selling Expenses + General Expenses

= 3000 + 22,000 + 1400

= 26,400

Operating Ratio = $\frac{cost\ of\ goods\ sold\ +operating\ expenses}{Net\ Sales} * 100$

Operating Ratio = $\frac{91{,}000+26{,}400}{16{,}0000} * 100$

Operating Ratio = 73.4 %

Illustration: 2 The following Profit and Loss Account information related to Alpha Manufacturing Co. forthe year ended 2000

Particulars	Amount	Particulars	Amount
Opening stock	90,000	Sales	8,00,000
Purchases	3,00,000	Closing stock of materials	70,000
Wages	1,90,000	Closing stock of finished goods	40,000
Manufacturing Expenses	13,000	Profit on sales of shares	4,000
Selling & distribution expenses	25,000	Non-operating income	1,000
Administrative expenses	1,30,000		
Loss on sale of Assets	2,000		
Net Profit	1,65,000		
Total	9,15,000		9,15000

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

Solution:

Particulars	Amount	Particulars	Amount
To opening stock	90,000	By sales	8,00,000
To Purchases	3,00,000	By closing stock materials	70,000
To Wages	1,90,000	By closing stock of finished goods	40,000
To Manufacturing expenses	13,000		
To Gross Profit	3,17,000		
	9,10,000		**9,10,000**
		By gross profit	3,17,000
To selling and distribution expenses	25,000	By Profit on sales of shares	4,000
To administrative expenses	1,30,000	By non operating incomes	1,000
Loss on sale of assets	2,000		
To net profit	1,65,000		
	3,22,000		3,22,000

Gross Profit ratio = $\frac{Gross\ Profit}{Net\ Sales} * 100$

Gross Profit ratio = $\frac{3,17,000}{8,00,000} * 100$

Gross Profit ratio = 39.63%

Net profit

Net Profit = $\frac{Net\ Profit}{Net\ Sales} * 100$

Net Profit = $\frac{1,65,000}{8,00,000} * 100$

Net Profit = 20.63%

Operating Profit

Operating Ratio = $\frac{cost\ of\ goods\ sold\ + operation\ expenses}{Net\ Sales} * 100$

Cost of goods sold = opening stock + purchases+ Purchases Expenses – closing stock

= 90,000 + 3,00,000 + 2,03,000 – 1,10,000

= 4,83,000

Operating Expenses = Administrative Expenses + selling Expenses

= 1,30,000 + 25,000

= 1,55,000

Operating Ratio = $\frac{cost\ of\ goods\ sold + operating\ expenses}{Net\ Sales} * 100$

Operating Ratio = $\frac{4,83,000+1,55,000}{8,00,000} * 100$

Operating Ratio = 79.75%

Illustration: 3

The following figures related to Hind Traders Ltd. For the year ending 30th June 2018

Particulars	Amount
Sales	5,20,000
Purchases	3,22,250
Opening stock	76,250
Closing stock	98,500
Sales Return	20,000
Selling & distribution Expenses :	
Salary	15,300
Advertisement	4,500
Travelling Expenses	2,500
Administrative Expenses:	
Salary	27,000
Rent	2,700
Stationery	2,500
Depreciation	9,300

Provision for taxation	16,500
Non operating Incomes :	
Dividend on shares	9,000
Profit on sales of shares	3,000
Non operating expenses :	
Loss on sales of assets	4,200

Find out:

1. Gross Profit
2. Net Profit
3. Operating RatioProfit & Loss Account

Particulars	Amount	Particulars	Amount
To opening stock	76,500	By sales 5,20,000 Less: Sales return 20,000	5,00,000
To purchases	3,22,000	By closing stock	98,000
To gross Profit	1,99,500		
	5,98,000		**5,98,000**
To selling and distribution expenses:		By gross Profit	1,99,500
Salary	15,300	By non-operating Incomes:	
Advertisement	4,500	Dividend on shares	9,000
Travelling	2,000	Profit on sales of shares	3,000
To administrative Expenses:			
Salary	27,000		
Rent	2,700		
Stationery	2,500		
Depreciation	9,300		
Provision for taxation	16,500		
To Non-operating Expenses:			
Loss on sale of assets	42,000		
To Net Profit	89,700		

Gross Profit

Gross Profit = $\frac{Gross\ Profit}{Net\ Sales} * 100$

Gross Profit = $\frac{1,99,500}{5,00,000} * 100$

Gross Profit = 39.9%

Net profit

Net Profit = $\frac{Net\ Profit}{Net\ sales} * 100$

Net Profit = $\frac{89,700}{5,00,000} * 100$

Net Profit = 17.9%

Operating Profit

Operating Ratio = $\frac{cost\ of\ goods\ sold + operating\ expenses}{Net\ Sales} * 100$

Cost of goods sold = opening stock + purchases+ Purchases Expenses – closing stock

= 76,500 + 3,22,000 + 0 – 98,000

= 3,00,500

Operating Expenses = Administrative Expenses + selling Expenses + General Expenses

= 15,300 +4,500 + 2,000 + 27,000 + 2,700 + 2,500 + 9,300 +16,500

= 79,800

Operating Ratio = $\frac{cost\ of\ goods\ sold + operating\ expenses}{Net\ Sales} * 100$

Operating Ratio = $\frac{3,00,500 + 79,800}{5,00,000} * 100$

Operating Ratio = 76.06%

- **Profitability Ratios Related to Investment**

The above Ratios which draws conclusions on the basis of Profit to sales ratios which sometimes be misleading as it might be possible that profit in terms of sales is enough but sales with the regard to capital may be inadequate. So, efficiency of firm cannot be measured by the volume of profits only but even consider the investment of the firm.

The firm Profitability is also measured in relation to investments. The investments of the firmare total assets, owners' equity. The ratios are as follows:

- **Return on Assets:**

The profitability of the firm can be measured in relation between net Profit and sales which measures the profitability of Investments.

Return on Assets = $\frac{Net\ Profif\ After\ Tax}{Total\ Assets} * 100$

- **Return on Capital Employed**

It is called Return on Investment or Rate of Return. The main objectives of making investments in any business is to obtain maximum return. This Ratio indicate the percentage of return on the capital Employed in the business and can measure the efficiency of Business as whole

Return on Capital Employed = $\frac{Profit\ Before\ Tax\ \&\ Interest}{Capital\ Employed} * 100$

The capital employed included the business long term fund and owners funds.

- **Return on shareholders' Equity:**

The Ratio measures profitability from shareholders' point of view. The Ratio finds the Rate of Return on shareholders' equity. Shareholders' funds include both equity and preference shares and all funds raise which belong to shareholders

Return on shareholders' = $\frac{Net\ Profit\ After\ tax}{Shareholders\ funds} * 100$

Illustration: 4

The following Table contains the Balance sheet information of Xyz Company. With the help of additional information, you are required to calculate:

1. Return on Assets
2. Return on Capital Employed
3. Return on Shareholder's Fund

Net Profit before tax = Rs. 2,00,000
Assume Tax Rate at 50%
Dividend Amount = 1,00,000

Balance Sheet

Liabilities	Amount	Assets	Amount
Share Capital (Rs. 10)	8,00,000	Fixed Assets	9,00,000
Reserves	2,00,000	Current Assets	3,80,000
8% Debentures	1,50,000		
Creditors	1,30,000		
	12,80,000		12,80,000

Return on Total Assets

Net Profit after Tax = 2,00,000 – (50% tax)
= 1,00,000

Return on Assets = $\frac{Net\ Profit\ after\ tax}{Total\ Assets} * 100$

Return on Assets = $\frac{1,00,000}{12,80,000} * 100$

Return on Assets = 7. 81%

Return on capital Employed

Profit before Tax & Interest = 2,00,000 + 8% interest on debentures
= 2,00,000 + 12,000
= 2,12,000

Return on Capital Employed = $\frac{Profit\ Before\ Tax\ \&\ Interest}{Capital\ Employed} * 100$

Return on Capital Employed = $\frac{2,12,000}{11,50,000} * 100$

Return on Capital Employed = 18. 4%

Return on shareholder's fund

Return on shareholders = $\frac{Net\ Profit\ after\ tax}{shareholders\ funds} * 100$

Return on shareholders = $\frac{10,000}{10,00,000} * 100$

Return on shareholders = 14%

Efficiency Ratios

- Stock Turnover Ratio
- Debtors Ratio
- Creditor Ratio

Working Capital Turnover Ratios

Operating Ratio

This classification of Ratios includes those ratios which emphasis upon the activity and operational efficiency of the Business concerned. These Ratios indicate the speed with which assets are converted or turned into sales.

To measure and examine the efficiency and profitability in making use of these resources, certain ratios are used and they are collectively called as Activity Ratios.

- **Stock Turnover Ratio:**

Stock turnover Ratio determines how much frequently the inventory is converted into sales revenue from operations during the accounting period of time. Stock Turnover Ratio is a ratio of cost of goods sold to Inventory. The Ratio is used to measure the Profitability and Liquidity of the firm

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Cost of goods sold = opening + Purchases + Direct Expenses – closing stock

Average Inventory = $\frac{opening\ stock+closing\ stock}{2}$

Average Inventory invoke the average of opening and closing Inventory

If Stock Turnover Ratio is low, then it may indicate the reason like bad buying, obsolete inventory, and excessive inventory and have bad impact on the firm. If Stock Turnover Ratio is high, then it must be interpreted properly and it showbusiness running it efficiently.

Illustration: 5

Opening stock	30,000
Purchases	60,000
Wages	4,000
Carriage Inward	3,000
Freight Outward	6,000
Closing stock	15,000

Find out the stock Turnover Ratio

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Cost of goods sold = opening + Purchases + Direct Expenses – closing stock

Average Inventory = $\frac{opening\ stock+closing\ stock}{2}$

Average Inventory = $\frac{opening\ stock+closing\ stock}{2}$

Average Inventory = $\frac{30{,}000+15{,}000}{2}$

Average Inventory = 22,500

Cost of goods sold = opening + Purchases +wages + carriage Inward – closing stock

Cost of goods sold = 30,000 + 60,000 + 4,000 + 3,000 – 15,000 = 82,000

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Stock Turnover Ratio = $\frac{82{,}000}{22{,}500}$

= 3.6 Times

Illustration: 6

ABC Ltd contains the following information from which calculate stock TurnoverRatio

Particulars	Amount
Opening stock	20,000
Purchases	35,000
Wages	2,000
Manufacturing expenses	3,000
Closing stock	25,000
Sales	2,30,000
Sales Return	30,000

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Cost of goods sold = opening + Purchases + Direct Expenses – closing stock

Average Inventory = $\frac{Opening\ Stock + Closing\ Stock}{2}$

Average Inventory = $\frac{20{,}000+25{,}000}{2}$

Average Inventory = 22,500

Cost of goods sold = opening + Purchases +wages + manufacturing expenses–closing stock

Cost of goods sold = 20,000 + 35,000 + 2,000 + 3,000 – 25,000

= 35,000

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Stock Turnover Ratio = $\frac{35{,}000}{22{,}500}$

= 1.56 Times

Illustration: 7

From the following information of Ragu & company regarding year ended 31st march.Calculate stock Turnover Ratio

Particulars	Amount
Cash sales	70,000
Credit sales	1,90,000
Return Inward	9,000
Opening stock	24,000
Closing stock	29,000
Gross Profit Ratio	20%

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ Inventory}$

Net sales = Total Sales – sales Return

= 2,60,000 – 9,000

= 2,51,000

Cost of goods sold = sales – gross profit

= 2,51,000 – (20 % of 2,51,000)

= 2,51,000 – 50,200

= 2,00,800

Average Inventory = $\frac{opening\ stock+closing\ stock}{2}$

Average Inventory = $\frac{24{,}000+29{,}000}{2}$

Average Inventory = 26,500

Stock Turnover Ratio = $\frac{2{,}00{,}800}{26{,}500}$

= 7.57 Times

- **Debtors Turnover Ratio:**

Every business sells the goods on cash and credit basis. Whenever the goods are sold on credit to customer, receivables or debtors are created in the account period of time.

Debtors are included in current Assets and are expected to convert into cash in short Time period. Debtors include the amount of Bills Receivables and Book Debts. If the amount from debtors or Receivables are not collected on time, the amount is unnecessarily blocked.

So, Debtors Turnover Ratio is an accounting Ratio which is used to measure thecompany effective in collecting its Receivables.

The Ratio is used to measure how company manages credit sales which is extended to customer and how quickly that amount is collected.

Debtors Turnover Ratio is a Ratio of Credit sales to Average Debtors.

Average Debtors is an average between opening and closing balance of Debtors

Debtors Turnover Ratio = $\frac{Average\ Debtors+bills\ Receivables}{Credit\ Sales}$

Average Debtors = $\frac{opening\ debtors\ Balance+closing\ debtors\ Balance}{2}$

The alternative method is used when there is difficulty in solving the above formula if adequate information is not available. Thus, Debtors Turnover is terms of the relationship between total sales and closing balance of Debtors.

Debtors Turnover Ratio = $\frac{Total\ Sales}{Closing\ Balance\ of\ Debtors}$

Debtors' collection period is calculated by any of the following Ratios:

a) $\frac{Months\ in\ a\ year}{debtors\ Turnover}$

b) $Average\ Debtors* \frac{Moths\ (or\ Days) in\ a\ year}{Net\ Credit\ Sales\ for\ the\ Fear}$

$\frac{Accounts\ Receivables}{Average\ Monthly\ or\ Daily\ Credit\ Sales}$

d) $\frac{Average\ Debtors + Bills\ Receivables}{Credit\ Sales}$

If Debtors Turnover Ratio is high then it shows that the company has inadequate collection process, bad credit Policies. If Debtors Turnover Ratio is low then it shows that firm's customers have high credit worthiness.

Illustration: 8

From the following information find out the debtors Collection Period

Particulars	Amount
Total sales	1,00,000
Cash sales	20,000
Sales return	7,000
Debtors as on 31st Dec '04	9,000
Bills Receivables as on 31st '04	2,000
Provision for doubt debt	1,000
Total Creditors	1,00,000

Debtors Collection Period = $\frac{Average\ Debtors + Bills\ Receivables}{Credit\ sales} * 365$

$$\frac{Averag + Bills\ Receivable}{Credit\ sales} * 365$$

$= \frac{9,000+2,000}{73,000} * 365$

$= \quad 55$ days

Net Sales = Total Sales – sales Return

= 10,00,00 – 7,000

= 93,000

Credit sales = Net Sales – cash sales

= 93,000 – 20,000

= 73,000

Debtors turnover Ratio

Debtors Turnover Ratio = $\frac{\text{credit Sales}}{\text{Average Debtors+bills Receivables}}$

Debtors Turnover Ratio = $\frac{73,000}{9,000+2,000}$

Debtors Turnover Ratio = 6.64 Times

Or

Debtors Ratio

a) $\frac{\text{Days in a year}}{debtors\ Turnover}$

$= \frac{365}{6.64}$

= 55 Days

- **Creditors Turnover Ratio:**

A Business firm purchases goods on credit. The amount of payment depends upon thepurchase policy.

Creditor's turnover Ratio is used to measure the relationship between net credit purchases andAverage Payables.

Creditors Turnover Ratio = $\frac{Net\ Credit\ Purchases}{Average\ Accounts\ Payable}$

Average Payment Period = $\frac{months\ in\ a\ year}{Creditors\ Turnover\ Ratio}$

Or

$= \frac{Average\ Accounts\ Payable}{Credit\ Purchase\ in\ the\ year} * Months\ in\ a\ year$

Or

$$= \frac{Average\ Accounts\ Payable}{Average\ Monthly\ Credit\ Purchases}$$

Creditors Ratio = $\frac{Average\ Creditors+Bills\ Receivables}{Credit\ Purchases} * 365$

Illustration: 9

From the following information calculate creditors Turnover Ratio

Particulars	Amount
Total Purchases	5,00,000
Cash purchases	25,000
Purchases Return	45,000
Creditors at the end	90,000
Bills Payable at the end	50,000

Net Purchases = Total Purchases – Purchases Return
= 5,00,000 – 45,000
= 4,55,000
Credit Purchases = Net Purchases – cash Purchases
= 4,55,000 – 25,000
= 4,30,000
Average Account Payable = 90,000 + 50,000
= 1,40,000

Average Payment Period = $\frac{Average\ Accounts\ Payable}{Credit\ Purchases\ in\ the\ year} * Months\ in\ a\ year$

Average Payment Period = $\frac{1,40,000}{4,30,000} * 65$

Average Payment Period = 119 days

Illustration: 10

Find out Creditors Turnover Ratio

Particulars	Amount
Total purchases	5,31,000
Cash purchases	30,000
Purchase Return	51,000
Bills Payable	60,000
Creditors at the end	1,05,000
Discount on creditors	10,000

Creditors Ratio = $\frac{Average\ Creditors+Bills\ Receivables}{Credit\ Purchases} * 365$

Net Purchases = Total Purchases – Purchases Return
= 5,31,000 – 51,000
= 5,30,000

Credit Purchases = Net Purchases – Cash Purchases
= 5,30,000 – 30,000
= 5,00,000

Creditors Ratio = $\frac{1,05,000+60,000}{5,00,000} * 365$
= 120 days

Illustration: 11

From the following information find out Creditors Ratio

Particulars	Amount
Credit Purchases	1,00,000
Creditors as on 1st Jan ’05	2,00,000
Creditors as on 31st Jan ’05	1,00,000
Bills Receivables as on 1st Jan ’05	40,000
Bills Receivables as on 31st Jan ’05	60,000

Creditors Ratio = $\frac{Average\ Creditors+Bills\ Receivables}{Credit\ Purchases} * 365$

Creditors Ratio = $\frac{1,50,000+5,000}{1,00,000} * 365$

Creditors Ratio = 730 days

Average Creditors = $\frac{20,000+10,000}{2}$
Average Creditors = 1,50,000

Average Bills Receivables = $\frac{40,000+60,000}{2}$

Average Bills Receivables = 50,000

- **Working capital Turnover Ratio:**

Working capital Turnover Ratio measures how effectively a company is using its Working Capital to support sales. The working capital is the difference between Current Assets and Current Liabilities.

It shows the relationship between Net sales and working capital and also determines the liquidity of a firm.

If the working capital Turnover Ratio is higher, then it indicates that firm is able to generate large amount of money and can run the business smoothly and requires less additional fund and if the working capital Turnover Ratio is lower, then it indicates that the firm is investing too much of amount in Receivables and Inventory which may create excessive bad debts.

Working Capital Turnover Ratio $= \frac{Net\ sales}{Net\ Working\ Capital}$

Illustration: 12

Find out working capital Turnover Ratio from the below information

Particulars	Amount
Credit sales	11,00,000
Cash sales	2,50,000
Sales Return	19,000
Current Assets	5,90,000
Current Liabilities	1,10,000

Net sales = credit sales + cash sales – sales return

= 11,00,000 + 2,50,000 – 19,000

Net sales = 13,31,000

Working capital = current Assets – Current LiabilitiesWorking capital

= 5,90,000 – 1,10,000

Working capital = 4,80,000

Working capital Turnover Ratio = $\frac{Net\ sales}{Net\ Working\ Capital}$

Working capital Turnover Ratio = $\frac{13{,}31{,}000}{4{,}80{,}000}$

Working capital Turnover Ratio = 2.77 times

Illustration: 13

From the following information calculate working capital Turnover Ratio

Particulars	Amount
Capital Employed	5,00,000
Net Fixed Assets	3,00,000
Cost of goods sold	19,00,000
Gross Profit	3,00,000

Working capital = capital employed – Net Fixed Assets
= 5,00,000 – 3,00,000
= 2,00,000
Net sales = cost of goods sold + Gross Profit
= 19,00,000 + 3,00,000
= 22,00,000

Working capital Turnover Ratio = $\frac{Ner\ sales}{Net\ Working\ Capital}$

Working capital Turnover Ratio = $\frac{22,00,000}{20,00,00}$

Working capital Turnover Ratio = 11 times

- **Operating Ratio**

The operating Ratio indicates the firm efficiency by comparing the total expenses of firm to sales. Operating Ratio is a Ratio of Operating Expenses to Net sales. Operating cost is equal to cost of goods sold plus operating expenses. Non-Operating Expenses are excluded like interest charges, taxes.

Operating Ratio = $\frac{operating\ Expenses}{Net\ Sales}$

8.6 LIQUIDITY AND SOLVENCY RATIOS

- Current Ratio
- Quick Ratio
- Proprietary Ratio
- Debt-Equity Ratio
- Capital Gearing Ratio
- Fixed Assets to Proprietary Ratio.
- Long Term Fund to Fixed Assets.

Current Ratio:

Current Ratio is the ratio of current assets to current liabilities. It measures the liquidity of the firm i.e., the ability to meet short term obligations. It expresses the relationship between current assets and current liabilities. The Ratio is calculated by dividing current Assets by current Liabilities.

Current Ratio = $\frac{Current\ Assets}{Current\ Liabilities}$

Current Assets are those assets which can be easily converted into cash. These assets are most liquid assets. The current assets are cash in hand, cash at Bank, debtors, Bills Receivables, prepaid Expenses, stock.

Current liabilities are those liabilities which are payable within a period of one year. The current liabilities are creditors, Bills Payable, Bank Overdraft, expenses outstanding and many other which needs to be paid within short period.

Current Ratio measures that amount of current assets which are available to meet current liabilities.

The higher the current ratio, it means the large amount is available to meet the short-term obligations. The standard current Ratio is 2:1 which is considered to be an ideal one. If current assets are equal to current liabilities, it means that firm has no working capital. Current Ratio shows the firm short term financial strength and even solvency of the firm.

- **Quick Ratio:**

Quick ratio is the Ratio between liquid Assets and Liquid liabilities. Due to limitation of current ratio which studies the solvency of the firm may be sometimes misleading due to high ratio of stock to current assets.

Liquid assets are those assets whose amount is almost certain on hand. Liquid assets include all current assets minus stock and prepaid expenses. Stock is excluded from liquid assets because stock is not converted into immediate future and prepaid expenses are not available to pay off current debts.

Liquid liabilities include all current liabilities minus bank overdraft. Bank overdraft is excluded from liquid liabilities as it is not required to pay off in the immediate future. It is also liquid ratio or Acid Test Ratio.

Quick Ratio = $\frac{liquid\ assets}{liquid\ liabilities}$

Liquid assets = current Assets – stock – prepaid expensesLiquid
Liabilities = current liabilities – Bank overdraft

Illustration: 14

From the following Balance Sheet calculate current Ratio and Liquid Ratio

Liabilities	Amount	Assets	Amount
Equity share Capital	29,000	Fixed Assets	15,500
Creditors	7,000	Cash	900
Bills Payable	1,400	Bad Debts	5,000
Provision for Tax	2,800	Bills Receivable	1,900
		Stock	16,500
		Prepaid Expenses	400
	40,200		40,200

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Assets = Cash + Book Debts + Bills Receivables + Stock + Prepaid Expenses

= 900 + 5,000 + 1,900 + 16,500 + 400

= 24,700

Current Liabilities = Creditors + Bills Payable + Provision for Tax

= 7,000 + 1,400 + 2,800

= 11,200

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Ratio = $\frac{24{,}700}{11{,}200}$

Current Ratio = 2.21

Quick Ratio = $\frac{liquid\ assets}{liquid\ liabilities}$

Liquid assets = current Assets – stock – prepaid expensesLiquid Assets

= 24,700 – 16,500 - 400

= 7,800

Liquid Liabilities = current liabilities – Bank overdraft

= 11,200 – 0

= 11,200

Quick Ratio = $\frac{liquid\ assets}{liquid\ liabilities}$

Quick Ratio = $\frac{7{,}800}{11{,}200}$

Quick Ratio = 0.69: 1

Illustration: 15

From the following balance sheet of the firm as on year 2003 -04 you are required tocalculate current Ratio and Liquid Ratio

Particulars	2003	2004
Stock	25,000	49,000
Debtors	10,000	16,000
Bills payable	2,000	3,000
Creditors	8,000	15,000
Provision for Taxation	5,000	7,000
Cash	5,000	4,000
Bank Overdraft	5,000	15,000

For the year 2003

Current Ratio = $\frac{current\ Assets}{Current\ Liabilities}$

Current Assets = Cash + debtors + Stock

= 25,000 + 10,000 + 5,000

= 40,000

Current Liabilities = Creditors + Bills Payable + Provision for Tax + Bank Overdraft

= 8,000 + 2,000 + 5,000 + 5,000

= 2,0000

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Ratio = $\frac{40,000}{20,000}$

= 2 : 1

Liquid assets = current Assets – stock

Liquid Assets = 40,000– 25,000

= 15,000

Liquid Liabilities = current liabilities – Bank overdraft

= 20,000 – 5,000

= 15,000

Quick Ratio = $\frac{liquid\ assets}{liquid\ liabilities}$

Quick Ratio = $\frac{15,000}{15,000}$

Quick Ratio = 1: 1

For the year 2004

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Assets = Cash + debtors + Stock

= 49,000 + 16,000 + 4,000

= 69,000

Current Liabilities = Creditors + Bills Payable + Provision for Tax + Bank Overdraft

= 15,000 + 3,000 + 7,000 + 15,000

= 40,000

Current Ratio = $\frac{Current\ Assets}{Current\ Liabilities}$

Current Ratio = $\frac{69,000}{4,000}$

=1.73: 1

Liquid assets = current Assets – stock

Liquid Assets = 69,000– 49,000

= 20,000

Liquid Liabilities = current liabilities – Bank overdraft

= 40,000 – 15,000

= 25,000

Quick Ratio = $\frac{liquid\ assets}{liquid\ liabilities}$

Quick Ratio = $\frac{20,000}{15,000}$

Quick Ratio =0.8: 1

- **Proprietary Ratio:**

It is ratio of shareholders' funds to total assets. It measures long term solvency of the firm. The ratio is calculated by dividing shareholders' funds by the total assets. Shareholders' funds include all Equity and Preference share capital plus all reserves. Total assets include allassets of the firm. The ratio is very important for creditors as higher the ratio which indicate secured and safety position for creditors and lower the ratio, the greater will be risk for creditors.

Proprietary Ratio = $\frac{Shareholders\ Funds}{Total\ Assets}$

The further analysed in term of Proprietary Ratio are as follows:

a) Fixed Assets to proprietors Funds Ratio
b) Current Assets to Proprietors Funds Ratio

a) **Fixed Assets to proprietors Funds Ratio**:

It shows the relationship between fixed assets to shareholders funds. It is been calculated tosee how much amount is being invested by owners

Fixed Assets to shareholders Funds = $\frac{Fixed\ Assets}{Proprietors\ Funds}$

b) **Current Assets to Proprietors Funds Ratio:**

The ratio shows the relationship between current asset and shareholders' funds.

CurrentAssets to Proprietors Funds Ratio = $\frac{current\ Assets}{Proprietors\ Funds}$

- **Debt – Equity Ratio:**

The debt Equity Ratio shows the ratio of total debts against its Equity. With the help of this ratio the company can know how much fund is provided by the owners and how much fund isprovided by the outsiders. The Debt – Equity Ratio Measures the long term solvency of the firm. Ratio shows the relationship between borrowed fund and owners' capital. Debt Equity Ratio is also known as External – Internal Equity Ratio. Total debts refers to the total liabilities and Equity refers to all equity and preference shareholders and all reserves and surplus. Higher the debt equity ratio, it shows that the claims are more from outsiders than insiders which show unfavorable from the firm's point of view. Lower the Debt Equity Ratio which stated that a greater amount of owners than debts which represents satisfactory capital structure.

a) Debt – equity Ratio = $\frac{Long\ term\ Debts}{Equity\ /shareholder's\ fund}$

Illustration: 16

Find out Debt – Equity Ratio

Particulars	Amount
Total Debts	1,70,000
Total Assets	2,50,000
Current Liabilities	19,000

Long term Debt = Total Debts – Current Liabilities

Long Term Debt = 1,70,000 – 19,000

= 1,51,000

Shareholders' funds = Total Assets – Total Debts
= 2,50,000 – 1,70,000
= 80,000

Debt – Equity Ratio = $\frac{outsiders\ Fund}{Shareholders\ Fund}$

Debt – Equity Ratio = $\frac{1,51,000}{80,000}$

= 1.9: 1

Illustration: 17

Find out Debt – Equity Ratio from the following information

Particulars	Amount
Capital Employed	23,00,000
Long term Debt	15,00,000

Shareholders Fund = capital Employed – long term debt
= 23,00,000 – 15,00,000
= 8,00,000

Debt – Equity Ratio = $\frac{Long\ Term\ Debts}{Shareholders\ Fund}$

Debt – Equity Ratio = $\frac{15,00,000}{80,00,00}$

= 1.88: 1

Illustration: 18

Find out Debt – Equity Ratio from the below information

Particulars	Amount
Equity Share Capital	10,00,000
Preference Share Capital	2,00,000
Reserve	4,00,000
Profit & Loss Account	1,00,000
6% Debentures	4,00,000
Creditors	2,00,000
Bills payable	1,00,000
Provision for Taxation	1,50,000
Outstanding Creditors	1,40,000

Shareholders Fund = Equity share capital + preference share capital + reserve + Profit & loss

Shareholders fund = 10,00,000 + 2,00,000 + 4,00,000 + 1,00,000

Shareholders fund = 17,00,000

Total Debts = 6% debentures + creditors + Bills Payable + Provision for Taxation + outstanding Creditors

Total Debts = 4,00,000 + 2,00,000 + 1,00,000 + 1,50,000 + 1,40,000
= 9,90,000

Debt – Equity Ratio = $\frac{Long\ Term\ Debts}{Shareholders\ Fund}$

Debt – Equity Ratio = $\frac{17,00,000}{9,90,000}$

= 1.71 : 1

- **Capital Gearing Ratio:**

Capital Gearing Ratio shows the ratio of the Fixed Interest-Bearing Funds to Equity Shareholders funds. The capital gearing ratio expresses the relation between the fixed interest-bearing funds to non-fixed interest-bearing funds. The ratio is related to the solvency of the firm and is used to analyses the capital structure of the firm. It indicates the relation between owner's fund and non-owner's funds. If the ratio is high, the capital gearing is said to be high and which indicated the under capitalization which means that the amount of capital is disproportionate to the needs measured by the volume of activity and if the ratio is low, the capital gearing is said to be low and which indicates over capitalization.

Capital Gearing Ratio = $\frac{Fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ Holders\ Funds}$

Illustration: 19

From the following information calculate capital gearing ratio

Particulars	Amount
Equity share capital	10,00,000
10% preference share capital	5,00,000
18% debentures	8,00,000
Loan at 15% (long period)	1,40,000
Current liabilities	3,00,000
General reserve	8,00,000

Capital Gearing Ratio = $\frac{Fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ Holders\ Funds}$

Fixed Interest-Bearing Funds = 10% preference share + 18% debentures + loan at 15%

Fixed Interest-Bearing Funds = 5,00,000 + 8,00,000 + 1,40,000

Fixed Interest-Bearing funds = 14,40,000

Equity shares holders fund = Equity share capital + General Reserve

Equity Shares holders fund = 10,00,000 + 8,00,000

Equity shareholders fund = 18,00,000

Capital Gearing Ratio = $\frac{Fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ Holders\ Funds}$

Capital Gearing Ratio = $\frac{14,40,000}{18,00,000}$

= 0.8

- **Long Term Fund to Fixed Assets**: The ratio shows the relation between the longterm funds and Fixed Assets.

Long Term Fund to Fixed Assets = $\frac{Long\ term\ Fund}{Fixed\ Assets}$

Profit Cover Ratio

The coverage ratio indicates the firm's ability to meet the financial obligation from the operations of the firm. The important coverage ratio are as follows:

a) Interest Coverage
b) Dividend coverage
c) Equity Shareholders coverage

- **Interest coverage:**

Interest coverage ratio measures the company's ability to pay its interest on debt with its operating income. It shows the relation between earning before interest and tax and fixed interest charges. Higher Interest Coverage Ratio shows the firm have ability to meet interest expenses i.e financial obligations and lower the ratio will indicate the less ability to meet its obligations. Interest coverage Ratio = $\frac{EBIT}{Fixed\ Interest}$

- **Dividend Ratio:**

The dividend ratio indicates the firm's ability to pay dividend to its shareholders. The ratio shows the relation between Net Income and dividend entitled to preference shareholders.

Dividend Ratio = $\frac{Net\ Profit\ After\ Tax\ and\ Interest}{Preference\ Dividend}$

- **Equity Shareholders coverage:**

The Ratio indicates the company's ability to pay the equity dividend by the Net Profit i.e net profit after tax, interest, preference dividend. The higher ratio shows the strong financial strength of the firm.

Equity Shareholders coverage = $\frac{Net\ Profit\ after\ Tax,and\ Prefernce\ Divident}{equity\ divident}$

Illustration: 20

The A Ltd has the following capital structure

Particulars	Amount
Equity shares of Rs. 10 Each	7,00,000
8% Preference share capital	4,00,000
Profit After Tax (tax 60%)	2,50,000
Equity dividend paid	20%

I.Find out dividend coverage and equity shareholders coverage ratio

Dividend Ratio = $\frac{Net\ Profit\ After\ Tax\ and\ Interest}{Prefernce\ Divident}$

Dividend Ratio = $\frac{25,0000}{32,000}$

Dividend Ratio = 7.81 times Preference Dividend = (8% of 400000)

Preference Dividend = 32,000

Equity Shareholders coverage = $\frac{Net\ Profit\ after\ Tax,and\ Prefence\ Divident}{Equity\ Divident}$

Equity Shareholders coverage = $\frac{2,18,000}{14,000}$

Equity Dividend = 1.56 Times

Net Profit after Tax – Dividend

2,50,000 – 32,000

2,18,000

- **Projections Through Ratios**

Future projections regarding various items of Income Statement and Balance sheet can be projected with the use of Ratio Analysis. Pro forma statements can be drawn which may help management in assessment of

Actual Performance. For the future Projections, past account data are used to calculate various accounting Ratios and take into consideration the expected changes and try to compare it with standard Ratio which are prepared. With the help of interpolations and extrapolations the various items are found out.

Illustration: 21

Draw up the Balance sheet from the following information

current Ratio	3.5
Quick Ratio	2.5
Net Working Capital	Rs. 40,000
stock Turnover Ratio (cost of sales / closing stock)	7 Times
Gross Profit Ratio	20%
Fixed Assets Turnover Ratio(cost of sales)	3 Times
Debtors Turnover Ratio	3 Times
Fixed assets to shareholders net worth	0.8
Reserves and Surplus to capital	0.5
Long term loans	Rs. 26,000

Solution:

1. Current Ratio = 3.5 : 1
   Working Capital = current Assets – current Liabilities
   Working capital = 3.5 – 1
   40,000 = 2.5

   2.5 40,000
   1 ?
   Current Liabilities = 16,000
   Current Assets = 16,000 * 3.5 = 56,000

2. stock
   Liquid Liabilities = current Liabilities
   Liquid Assets = current assets
   Liquid Assets = Rs. 16,000 * 2.5
   Liquid Assets = 40,000
   Liquid Assets = current Assets – stock
   ∴Stock = current Assets – liquid Assets
   ∴ Stock = 56,000 – 40,000
   ∴ Stock = 16,000

3) fixed Assets:

Stock Turnover Ratio = $\frac{cost\ of\ sales}{Stock} = 7\ Times$

Cost of sales = stock * stock Turnover Ratio

Cost of sales = 16,000 * 7

Cost of sales = 1,12,000

Gross profit Ratio = 20%

Gross Profit Ratio = $\frac{G.P}{Net\ Sales} * 100$

20 = $\frac{Gross\ Profit}{140000} * 10$

Gross Profit = 28,000

Assume SP	100
-20% of G.P	<u>20</u>
Cost Price	80

Cost	SP
80	100
1,12,000	?

Sales = $\frac{1,12,000}{80} * 100$

Sales = 1,40,000

Fixed Assets Turnover Ratio = 3 Times

Fixed Assets = $\frac{cost\ of\ sales}{2}$

Fixed Assets = $\frac{1,12,000}{2}$

Fixed Assets = 56,000

4. Debtors:

Debtors Turnover Ratio = $\frac{receivable*12}{sales}$

3 Times = $\frac{debtors*12}{1,40,000}$

Debtors = Rs. 35,000

5. Bank:

Bank = Liquid Assets – debtors

Bank = 40,000 – 35,000

Bank = 5,000

6. Shareholders Net worth = $\frac{fixed\ Assets}{shareholders\ Net\ worth}$

0.80 * shareholders Net worth = fixed Assets

Shareholders Net Worth = $\frac{56{,}000}{0.80} = 70{,}000$

7. Reserves & surplus:

Reserves & surplus to capital = 0.5 : 1

Shareholders Net Worth = capital and Reserves and surplus

Reserves & Surplus = $\frac{70{,}000 * 0.5}{1.5} = 23{,}333$

Capital = $\frac{70{,}000 * 1}{1.5} = 46{,}667$

Liabilities	Amount	Assets	Amount
Share capital	46,667	Fixed assets	56,000
Reserves	23,333	Stock	16,000
Long term Loans	26,000	Debtors	35,000
Current Liabilities	16,000	Bank	5,000
	1,12,000		1,12,000

Illustration: 22

The owner's Equity of A Ltd is 1,00,000.

The ratios of the firm are as follows:

Current Debt to Total Debt = 0.60

Fixed Assets to owner's equity = 0.80

Total Debts to owner's equity = 0.80

Total Assets Turnover = 2 Times

Inventory Turnover 8 Times

From the above information you are required to complete the Balance sheet.

Equities	Amount	Assets	Amount
Current Debt	…..	Cash	……
Long term debt	…..	Inventory	……
Total debt	…..	Total current Assets	……
Owners Equity	…..	Fixed Assets	……
Total Equity	…..	Total Assets	……

Solution

Fixed assets to owners equity = $\frac{fixed\ Assets}{owners\ Equity}$

0.80 = $\frac{fixed\ Assets}{1{,}00{,}000}$

Fixed Assets = 80,000

Total Debts to Owners Equity $= \frac{Total\ Debts}{Owners\ Equity}$

$0.80 = \frac{Total\ Debts}{100000}$

Total Debts = 1,00,000 * 0.80

Total Debts = 80,000

Current Debt to Total Debt $= \frac{Current\ Debt}{Total\ Debt}$

$0.60 = \frac{current\ Debt}{80{,}000}$

Current Debt = 48000

Total Assets Turnover Ratio $= \frac{cost\ of\ Goods\ Sold}{Total\ Assets}$

$2 = \frac{cost\ of\ Goods\ Sold}{1{,}80{,}000}$

Cost of Goods Sold = 1,80,000 * 2

Cost of Goods Sold = 3,60,000

Inventory Turnover $= \frac{sales}{Inventory}$

$8 = \frac{36{,}000}{Inventory}$

Inventory = 45,000

Equities	Amount	Assets	Amount
Current Debt	48,000	Cash	55,000
Long term debt	32,000	Inventory	45,000
Total debt	80,000	Total current Assets	1,00,000
Owners Equity	1,00,000	Fixed Assets	80,000
Total Equity	1,80,000	Total Assets	1,80,000

Illustration: 23

From the following information prepare balance sheet of the firm:

Estimated sales = 2,00,000

Sales to Net Worth (capital) = 2.5

Current Debt to Net Worth = 25%

Total Debt to Net Worth = 60%

Current Ratio= 3.6: 1

Net sales to Inventory = 4 Times

Average collection Period (360) = 36 days

Fixed Assets to Net worth = 70

Solution

Sales to Net Worth = $\frac{sales}{Net\ worth}$

$$2.5 = \frac{2{,}00{,}000}{Net\ worth}$$

Net Worth = 80,000

Current Debt to Net Worth $= \frac{current\ Debt}{Net\ worth}$

25% $= \frac{current\ Debt}{80000}$

Current debt = 20,000

Total Debt to Net Worth = $\frac{Total\ Debt}{Net\ Worth}$

60% = $\frac{Total\ Debt}{80000}$

Total Debt = 48,000

Net sales to Inventory = $\frac{Net\ Sales}{Inventory}$

4 Times = $\frac{20{,}000}{Inventory}$

Inventory = 50,000

Average collection period = $\frac{Average\ Debtors + bills\ Receivables}{credit\ sales} * 360$

$$36 = \frac{Average\ Debtors + bills\ Receivables}{20{,}000} * 360$$

Average Debtors + bills Receivables = 20,000

Fixed Assets to Net Worth = $\frac{fixed\ Assets}{Net\ Worth}$

70% = $\frac{fixed\ Assets}{80{,}000}$

Fixed Assets = 56,000

Current Ratio = $\frac{current\ Assets}{current\ Debt}$

3.6 = $\frac{current\ Assets}{20{,}000}$

Current Assets = 72,000

Liabilities	Amount	Assets	
Net worth	80,000	Fixed Assets	56,000
Long term Debt	28,000	Current Assets	
Current Debt	20,000	Inventory 50000	
Total Debt	48,000	Debtors 20000	
		Cash 2000	72,000
Total	1,28,000		1,28,000

Illustration: 24

From the following information prepare balance sheet

Receivable Turnover	5 Times
Payable Turnover	7 Times
Inventory turnover	9 Times
Capital Turnover Ratio	3Times
Fixed Assets Turnover Ratio	9 Times
Gross Profit Ratio	25%
Gross Profit during the Year	90,000
Long term debt and overdraft	Nil
Reserves & surplus	30,000
Ending Inventory of the year is 2000 more than opening inventory	
Net Receivables	6,000
Payables	3,000

Solution

Gross profit Ratio = $\frac{Gross\ profit}{Net\ sales} * 100$

25% = $\frac{90000}{Net\ sales} * 100$

Net sales = 3,60,000

Cost of Goods Sold = Net sales – Gross Profit

Cost of goods sold = 3,60,000 – 90,000

Cost of goods sold = 2,70,000

(When sales is not given at that time you can calculated by using below method)

Receivables Turnover = $\frac{Credit\ sales}{Average\ Debtors + Bills\ Receivables}$

6 = $\frac{3,60,000}{Average\ Debtors + Bills\ Receivables}$

7 Average Debtors + Bills Receivables = 72,000Average Debtors = 72,000 – Bills ReceivablesAverage Debtors = 72,000 – 6,000

Average Debtors = 66,000

Receivables Turnover = $\frac{cost\ of\ goods\ sold}{Average\ Debtors+Bills\ Receiavables}$

5 Times = $\frac{2,70,000}{Average\ Debtors+Bills\ Receiavables}$

Average Debtors + Bills Receivables = $\frac{2,70,000}{5}$

Average Debtors + Bills Receivables = 54,000

Average Debtors + 6,000 = 54,000

Average Debtors = 54,000 – 6,000

Average Debtors = 48,000

Inventory Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ stock}$

8 = $\frac{2,70,000}{Average\ stock}$

Average stock = 33,750

Average stock = $\frac{opening+closing\ stock}{2}$

33,750 = $\frac{2\ opening\ stock\ +2000}{2}$

67,500 = 2 opening stock + 2,000

65,500 = 2 opening stock

Opening stock = 32,750

Closing stock = opening stock + 2000

Closing stock = 32,750 + 2,000

Closing stock = 34,750

Cost of goods sold = opening stock + purchases - closing stock

2,70,000 = 32,750 + purchases – 34,750

Purchases = 2,72,000

Payable turnover Ratio = $\frac{credit\ purchase}{Average\ Creditors+Bill'Payables}$

7 Times = $\frac{2,72,000}{Average\ Creditors+Bill'Payables}$

Average Creditors + bills Payable = 38,857

Average Creditors + 3,000 = 38,857

Average Creditors = 38,857 – 3,000

Average creditors = 35,857

Capital Turnover Ratio = $\frac{cost\ of\ goods\ sold}{capital}$

$3 = \frac{27,000}{capital}$

Capital = 90,000

Fixed Assets Turnover Ratio = $\frac{cost\ of\ goods\ sold}{fixed\ Assets}$

$9 = \frac{2,70,000}{fixed\ Assets}$

Fixed Assets = 30,000

Liabilities	Amount	Assets	Amount
Capital 90,000		Fixed Assets	30,000
+ reserves 30,000	1,20,000	Debtors	66,000
Creditors	35,857	Bills receivables	6,000
Bills Payables	3,000	Closing stock	34,750
		Cash balance	22,107
	1,58,857		

MISCELLANOUS SUMS

Illustration: 25

From the following information calculate

I. capital Gearing Ratio
II. current Ratio
III. Liquid Ratio
IV. Current Assets to Fixed Assets
V. Debt Equity Ratio
VI. Proprietary Ratio

Liabilities	Amount	Assets	Amount
Share capital	2,50,000	Plant & Machinery	1,50,000
General Reserve	50,000	Land & Building	4,00,000
Profit & loss Account	40,000	Stock	2,00,000
910% Debentures	4,40,000	Bills receivables	15,000
Creditors	1,50,000	Debtors	1,50,000
Bills Payable	40,000	Bank Balance	55,000
	9,70,000		9,70,000

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Assets = stock + Bills Receivables + debtors + bank balance

Current Assets = 2,00,000 + 15,000 + 1,50,000 + 55,000
Current Assets = 4,20,000
Current Liabilities = creditors + Bills Payable
Current liabilities = 1,50,000 + 40,000
Current Liabilities = 1,90,000
Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Ratio = $\frac{4,20,000}{1,90,000}$
Current Ratio = 2.21: 1

Liquid Assets = current Assets – stock
Liquid Assets = 4,20,000 – 2,00,000
= 2,20,000
Liquid Liabilities = current liabilities – Bank overdraft
= 1,90,000 – 0
= 1,90,000
Quick Ratio = $\frac{Liquid\ Assets}{Liquid\ liabilities}$
Quick Ratio = $\frac{2,20,000}{1,90,000}$
Quick Ratio =1.15 : 1

Current Assets to Fixed Assets = $\frac{current\ Assets}{fixed\ Assets}$

Fixed Assets = Plant & Machinery + land & Building
Fixed Assets = 1,50,000 + 4,00,000
Fixed Assets = 5,50,000
Current Assets to Fixed Assets = $\frac{current\ Assets}{fixed\ Assets}$
Current Assets to Fixed Assets = $\frac{4,20,000}{5,50,000}$

Current Assets to Fixed Assets = 0.76

Capital Gearing Ratio = $\frac{fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ holders\ Funds}$

Fixed Interest-Bearing Funds = 10 % debenturesFixed Interest-Bearing Funds = 4,40,000

Equity = share capital + General Reserve + Profit & Loss Account
Equity = 2,50,000 + 40,000 + 50,000
Equity = 3,40,000

Capital Gearing Ratio = $\frac{fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ holders\ Funds}$

Capital Gearing Ratio = $\frac{4,40,000}{3,40,000} = 1.29$

Debt – Equity Ratio = $\frac{Outsiders\ Fund}{Shareholders\ Fund}$
Debt = 10% debentures
Debt = 4,40,000
Equity = share capital + General Reserve + Profit & Loss Account
Equity = 2,50,000 + 40,000 + 50,000
Equity = 3,40,000

Debt – Equity Ratio = $\frac{outsiders\ Fund}{Shareholders\ Fund}$

Debt – Equity Ratio = $\frac{4,40,000}{3,40,000}$
Debt – Equity = 1.29: 1

Proprietary Ratio = $\frac{Shareholders\ Funds}{Total\ Assets}$

Equity = share capital + General Reserve + Profit & Loss Account
Equity = 2,50,000 + 40,000 + 50,000
Equity = 3,40,000
Total Assets = fixed Assets + current Assets
Total Assets = 5,50,000 + 4,20,000
Total Assets = 9,70,000

Proprietary Ratio = $\frac{Shareholders\ Funds}{Total\ Assets}$

Proprietary Ratio = $\frac{3,40,000}{9,70,000}$
Proprietary Ratio = 0.35

Illustration: 26

From the Following Balance sheet, calculate

8.5.4.1 Current Ratio
8.5.4.2 Liquid Ratio
8.5.4.3 Proprietary Ratio

8.5.4.4 Capital Gearing Ratio

8.5.4.5 Current Assets to working Capital Ratio

Liabilities	**Amount**	**Assets**	**Amount**
Equity share Capital	3,00,000	Plant & machinery	3,00,000
10% preference share capital	2,00,000	Land & building	3,50,000
10% debentures	2,00,000	Stock	2,00,000
Reserves & surplus	1,00,000	Debtors	70,000
Long term debt	60,000	Cash	1,00,000
Creditors	1,00,000		
Bank Overdraft	60,000		
	10,20,000		10,20,000

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Assets = stock + Debtors + cash balance

Current Assets = 2,00,000 + 70,000 + 1,00,000

Current Assets = 3,70,000

Current Liabilities = creditors + Bank overdraft

Current liabilities = 1,00,000 + 60,000

Current Liabilities = 1,60,000

Current Ratio = $\frac{current\ Assets}{current\ Liabilities}$

Current Ratio = $\frac{3,70,000}{1,60,000}$

Current Ratio = 2.31: 1

Liquid Assets = current Assets – stock

Liquid Assets = 3,70,000 – 2,00,000

= 1,70,000

Liquid Liabilities = current liabilities – Bank overdraft

= 1,60,000 – 60,000

= 1,00,000

Quick Ratio = $\frac{liquid\ Assets}{liquid\ liabilities}$

Quick Ratio = $\frac{1,70,000}{1,00,000}$

Quick Ratio =1.7: 1

Proprietary Ratio = $\frac{Shareholders\ Funds}{Total\ Assets}$

Equity = share capital + General Reserve

Equity = 3,00,000 + 1,00,000

Equity = 4,00,000

Total Assets = fixed Assets + current Assets

Total Assets = 6,50,000 + 3,70,000

Total Assets = 10,20,000

Proprietary Ratio = $\frac{Shareholders\ Funds}{Total\ Assets}$

Proprietary Ratio = $\frac{4,00,000}{10,20,000}$

Proprietary Ratio = 0.39

Debt – Equity Ratio = $\frac{Outsiders\ Funds}{Shareholders\ Fund}$

Debt = 10% debentures

Debt = 4,40,000

Equity = share capital + General Reserve + Profit & Loss Account

Equity = 2,50,000 + 40,000 + 50,000

Equity = 3,40,000

Capital Gearing Ratio = $\frac{Fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ holders\ Funds}$

Fixed Interest-Bearing Funds = 20 % debentures + 10% Preference + long term loan

Fixed Interest-Bearing Funds = 2,00,000 + 2,00,000 + 60,000

Fixed Interest Bearing Funds = 4,60,000

Equity = share capital + General Reserve

Equity = 3,00,000 + 1,00,000

Equity = 4,00,000

Capital Gearing Ratio = $\frac{Fixed\ Interest\ Bearing\ Funds}{Equity\ Share\ holders\ Funds}$

Capital Gearing Ratio = $\frac{4,60,000}{4,00,000} = 1.15$

Current Assets to working Capital Ratio = $\frac{Current\ Assets}{working\ capital}$

Current Assets to working Capital Ratio = $\frac{3,70,000}{1,60,000}$

= 2.31

Working capital = current Assets – Current Liabilities

Working Capital = 3,70,000 – 1,60,000

Working Capital = 2,10,000

Illustration: 27

From the following information calculate

i. Current Ratio
ii. Liquid Ratio
iii. Proprietary Ratio
iv. Fixed Assets to Proprietary Ratio
v. Debt – Equity Ratio
vi. Gross Profit Ratio
vii. Net Profit Ratio
viii. Stock Turnover Ratio
ix. Sales Turnover to Fixed Assets RatioBalance sheet

Liabilities	Amount	Assets	Amount
5% Preference Share Capital	1,60,000	Goodwill	20,000
Equity share capital	2,60,000	Land & building	2,60,000
General Reserves	20,000	Machinery	1,85,000
Profit & Loss Alc	15,000	Furniture	10,000
5% Debentures	1,00,000	Stock	90,000
Creditors	29,000	Debtors	22,000
Bills Payable	12,000	Cash & bank balance	5,000
		Preliminary Expenses	4,000
Total	5,96,000		5,96,000

Total sales are Rs. 4,00,000 and gross Profit as well as Net Profit amounted to Rs. 8,0000 and2,0000 respectively

1. Current Ratio = $\frac{Current\ Assets}{Current\ Liabilties}$

Current Ratio = $\frac{1,17,000}{41,000}$

Current Ratio = 2.85

Current Assets = stock + Debtors + cash & Bank balance

Current Assets = 90,000 + 22,000 + 5,000

Current Assets = 1,17,000

Current Liabilities = creditors + bills Payable

Current Liabilities = 29,000 + 12,000

Current Labilities = 41,000

2. Liquid Ratio = $\frac{Liquid\ Assets}{Liquid\ Liabilties}$

Liquid Assets = current Assets – stock
Liquid Assets = 1,17,000 – 90,000
Liquid Assets = 27,000

Liquid Liabilities = current Liabilities – bank overdraft
Liquid Liabilities = 41,000 - 0
Liquid Liabilities = 41,000

3. Proprietary Ratio = $\frac{shareholders\ funds}{Total\ Assets}$

Proprietary Ratio = $\frac{4,36,000}{5,96,000}$

Proprietary Ratio = 0.73

Shareholders funds = Equity Shareholders Funds + 5 % preference share + Reserves –Fictitious Assets
Shareholders Funds = 2,60,000 + 1,60,000 + 20,000 – 4,000
Shareholders' Funds = 4,36,000
Total Assets = 5,96,000

4. Fixed Assets To Proprietary Funds= $\frac{fixed\ Assets}{shareholders\ Funds}$

Fixed Assets To Proprietary Funds = $\frac{4,70,000}{4,36,000}$

Fixed Assets to Proprietary Funds = 1.07

5. Debt Equity Ratio = $\frac{Debt.}{Equity}$

Debt Equity Ratio = $\frac{10,00,00}{4,36,000}$
Debt Equity Ratio = 0.22

6. gross Profit ratio = $\frac{Gross\ Profit}{sales} * 100$

Gross Profit ratio = $\frac{80,000}{4,00,000} * 100$

Gross profit ratio = 20%

7. Net profit Ratio = $\frac{Net\ Profit}{Sales} * 100$

Net Profit ratio = $\frac{20,000}{4,00,000} * 100$

Net Profit Ratio = 5%

8. Stock Turnover Ratio = $\frac{cost\ of\ Goods\ sold}{stock}$

Stock Turnover Ratio = $\frac{3,20,000}{90,000}$

Stock Turnover Ratio = 3.56 times

9. Turnover to Fixed Assets = $\frac{sales}{fixed\ Assets}$

Turnover to Fixed Assets = $\frac{40,000}{4,70,000}$

Turnover to fixed Assets = 0.85

Illustration: 28

Xyz & Company supplies following information from which calculate stock Turnover Ratio

Particulars	Amount
Credit sales	3,00,000
Cash sales	9,00,000
Sales Return	1,00,000
Opening stock	25,000
Closing stock	30,000
Gross Profit Ratio	25%

Stock Turnover Ratio = $\frac{costr\ of\ goods\ sold}{Average\ stock}$

Average Stock = $\frac{opening\ stock+closing\ stock}{2}$

Average Stock = $\frac{25,000+30,000}{2}$

Average stock = 27,500

Total sales = cash sales + credit sales – sales return

Total sales = 90,000 + 3,00,000 – 10,000

Total sales = 3,80,000

Gross Profit Ratio = $\frac{gross\ Profit}{Net\ sales} * 100$

25% = $\frac{gross\ Profit}{38000} * 100$

Gross Profit = 95,000

Cost of goods sold = Net Sales – Gross Profit

Cost of goods sold = 3,80,000 – 95,000

Cost of goods sold = 2,85,000

Stock Turnover Ratio = $\frac{costr\ of\ goods\ sold}{Average\ stock}$

Stock Turnover Ratio = $\frac{2,85,000}{27,500}$

Stock Turnover Ratio = 10.36

Illustration: 29

From the following information calculate Average Collection period

Particulars	Amount
Gross sales	1,60,000
Cash sales	40,000
Sales return	14,000
Total Debtors for sales (31/12/2012)	18,000
Bills Receivables on (31/12/2012)	5,000
Provision for Doubtful debts (31/12/2012)	3,000
Total creditors (31/12/2012)	20,000

Average collection Period = $\frac{Debtors+Bills\ Receivable}{Net\ Credit\ Sales} * 365$

Average collection Period = $\frac{18,000+5,000}{1,46,000} * 365$

Average Collection Period = 55 Days

Illustration: 30

From the following information calculate the following Ratios

I. Stock Turnover Ratio
II. Fixed Assets Turnover Ratio
III. Debtors Turnover Ratio
IV. Creditors Turnover Ratio

Particulars	Amount
Sales	18,000
Sales Return	200
Cost of sales	16,000
Depreciation	100
Administration Expenses	1,900
Purchases	18,000
Interest Expenses	500
Purchase Returns	100
Debtors	10,000
Bills Receivables	3,000
Creditors	6,000
Bills Payables	2,000
Opening stock	5,000
Closing stock	4,000
Fixed Assets	7,000

Stock Turnover Ratio = $\frac{cost\ of\ goods\ sold}{Average\ stock}$

Average Stock = $\frac{opening\ stock+closing\ stock}{2}$

Average Stock = $\frac{5{,}000+4{,}000}{2}$

Average stock = 4,500

Stock Turnover Ratio = $\frac{16{,}000}{45{,}000}$

Stock Turnover Ratio = 3.56 Times

Fixed Assets Turnover Ratio = $\frac{cost\ of\ Sales}{Fixed\ Assets}$

Fixed Assets Turnover Ratio = $\frac{16{,}000}{7{,}000}$

Fixed Assets Turnover ratio = 2.29 Times

Debtors Turnover Ratio = $\frac{credit\ Sales}{Average\ Accounts\ Receivables}$

Debtors Turnover Ratio = $\frac{17,800}{10,000+3,000}$

Debtors Turnover Ratio = 1.37 Times

Credit sales = 18,000 – 200

Credit sales = 17,800

Creditors Turnover Ratio = $\frac{18,000-100}{6,000+2,000}$

Creditors Turnover Ratio = 2.24 Times

Illustration: 31

From the following information calculate :

I. Gross Profit Ratio
II. Net Profit Ratio
III. Return on Total Assets
IV. Inventory Turnover
V. Working Capital Turnover
VI. Net Worth to Debt

Sales	25,20,000
Cost of sales	19,20,000
Net profit	3,60,000
Inventory	8,00,000
Other current Assets	7,60,000
Fixed Assets	14,40,000
Net worth	15,00,000
Debt	9,00,000
Current Liabilities	6,00,000

I. Gross Profit Ratio

Gross profit = sales – cost of sales

Gross Profit = 25,20,000 – 19,20,000

Gross Profit = 6,00,000

Gross Profit Ratio = $\frac{6,00,000}{25,20,000} * 100$

Gross Profit Ratio = 23.81 %

II. Net Profit Ratio = $\frac{Net\ Profit}{Net\ Sales} * 100$

Return on Total Assets = $\frac{3,60,000}{30,00,000} * 100$

Return on Total Assets = 12 %

Total Assets = Inventories + Other Current Assets + Fixed Assets
Total Assets = 8,00,000 + 7,60,000 + 14,40,000
Total Assets = 30,00,000

III. Return on total Assets = $\frac{Net\ Profit}{Net\ Sales} * 100$

Return on Total Assets = $\frac{3,60,000}{30,00,000} * 100$

Return on Total Assets = 12 %

Total Assets = Inventories + Other Current Assets + Fixed Assets
Total Assets = 8,00,000 + 7,60,000 + 14,40,000
Total Assets = 30,00,000

IV. Inventory Turnover = $\frac{cost\ of\ sales}{inventory}$

Inventory Turnover = $\frac{19,20,000}{8,00,000}$

Inventory Turnover 2.4 Times

V. Working Capital Turnover = $\frac{cost\ of\ sales}{working\ capital}$

Working Capital = current Assets – current Liabilities
Working Capital = 8,00,000 + 7,60,000 – 6,00,00
Working capital = 9,60,000

Working Capital Turnover = $\frac{19,20,000}{9,60,000}$
Working Capital Turnover = 2 Times

VI. Net worth to Debt Ratio = $\frac{net\ worth}{debt}$

Net worth to Debt Ratio = $\frac{15,00,000}{9,00,00}$
Net worth to Debt Ratio = 1.6 Times

UNIT: 9 LEVERAGE ANALYSIS

9.1 INTRODUCTION

In all business units, the management aims at maximization of the return on the owners' capital. The essence of financial management also capital structure in such a too devise manner that the equity shareholders who bear the risk of business receive the maximum possible return. For this purpose, the funds available at fixed rate of interest or dividend are used to finance business. In other words, the business is not entirely financed through the issue of debentures carrying a fixed rate of interest and preference shares carrying a fixed burden of dividends.

If the rate of return on investments in business is higher than the rate of interest on debentures issued by the company, the earning per share goes up and therefore the company can distribute dividends at a higher rate. In this way to use fixed Interest- bearing Securities along with equity capital is called "Leverage".

9.2 DEFINITION

(1) According to Solomon, "Leverage is the ratio of the net rate of return on shareholders' equity and the net rate of return on capitalization."

(2) According to Walter, Leverage may be defined as "Percentage return on equity and the net rate of to return on capitalization."

(3) In the words of J.C. Van Horne, "Leverage may be defined as "the employmentof an asset or funds for which the firm pays a fixed cost or fixed return. "

From the above definitions, it becomes clear that the fixed cost or return is thefulcrum of leverage. If the company is not required to pay a fixed cost or return there

will be no leverage. Leverage is the result of use of funds carrying fixed cost or fixed return. In other words, leverage is the use of funds having a fixed cost, in order to raise the return available to owners.

The decision with regard to capital structure is the most important financial decision. The decision concerning the issue of debentures or Preference shares carrying a fixed burden along with the issue of equity shares which impose on the company is uncertain and unstable burden on the company is known as the Capital Structure Decision. This decision can have significant impact on the rate of return available to the equity shareholders as also on the degree of risks they bear. The management must work out a proper capital structure, when the company is set up and also when additional investment is to be made. In view of its significant effects,capital structure must be so framed that balance may be achieved and maintained between the return on equity shares on one hand and degree of risks they impose on the other.

9.3 TYPES OF LEVERAGE

There were two types of leverage (i) Operating Leverage (ii) Financial Leverage when two leverages are combined, it is called mixed leverage.

1) Operating Leverage

In devising a Proper capital Structure, however it is not enough to consider the financial leverage only. It is also necessary to ascertain the extent of operating leverage, in the business. There are certain fixed expenses in the business which do not change with the level of output or sales. They remain constant in the short run. Due to these expenses, Operating Profit increase more rapidly than the volume of sale. This situation is known as Operating Leverage...

The degree of Operating leverage is defined as the percentage change in the earnings before interest and tax relative to a given Percentage change insales.

$$OL = \frac{\%\text{ change in EBIT}}{\%\text{ change in sales}}$$

Wherever Operating leverage exists profit rises by more than sales.

Operatingleverage indicates the ratio of change in Profit to change in sales.

$$OL = \frac{X\,(P-V)}{X\,(P-V)-F}$$

X= Volume of salesP= Per unit Price

V=Variable cost Per unitF=Fixed cost

OL = Operating Leverage

OR

OL = $\frac{Total\ Contribution}{operating\ profit} = \frac{C}{EBIT}$

(2) Financial Leverage:

Financial leverage refers to inclusion of securities carrying fixed financial burden such as debentures and Preference shares along with equity shares in capital Structure of the company. A company can raise the funds from different sources to finance in business. It can obtain funds either through the issue of equityshares or through the issue of Preference shares or debentures along with equity shares.

A company has to pay a fixed rate of interest on its debentures irrespective of whether it makes profit or not. Hence, debentures are described as securities carrying a fixed financial charge on preference share also.

The rate of dividend is to be paid is fixed, though it is to be paid only when the company makes profit. But it is a fixed charge, and must be paid before anything is paid to the ordinary shareholders.

When a company includes in its capital structure debentures and preference shares in addition to equity shares, Financial Leverage is said to be used. The objective of financial leverage is to increase the returns on equity shares by earninga profit greater than the total amount of fixed charges on debentures and Preferenceshares.

Thus, financial leverage is a double-edged sword. If the circumstances are favorable, it will raise the rate of dividend on equity shares; but if the circumstances are unfavorable, (it will reduce return equity shares.) please check

- **Degree of Financial Leverage:**

Following formula is used to find out the ratio of financial leverage in a firm:

DFL = $\frac{Operating\ Profit\ (EBIT)}{EBT} = \frac{EBIT}{EBI}$

DFL = Degree of Financial Leverage

EBIT = Earning Before Interest and Tax

EBT = Earning Before Tax but After Interest

- **Combined effect of operating leverage and financial leverage :**

The policy regarding capital structure should be framed keeping in view the combined effect of operating leverage and financial leverage both. Formula to ascertain both leverage is:

$$\frac{C}{EBIT} X \frac{EBIT}{EBT} X \frac{C}{EBT}$$

Where C = Total contribution.

Considering the combined effect of both leverages, we feel that if the degree of both leverages is very high, business will become more risky because a high degree of these leverages implies a greater amount of fixed cost and also a high proportion of funds, imposing a fixed burden of financial charges in the total amount of funds with the company.

On the other hand, too low a degree of both leverages is also undesirable. Because low degree of these leverages suggests that the amount of fixed costs istoo small and the proportion of debts is to total capital of the company is also extremely low. As the result of such a policy, the management will be deprived of a large number of profitable opportunities of investment.

If operating leverage is high and financial leverage is low, it means that the management has adopted very good approach in connection with debt capital. But the optimum solution is one in which operating leverage is high and financial leverage is low.

Many companies in India are carelessly raising the proportion of debt capital. This is risky as the amount of fixed expenses is large in their business because the degree of both leverages till move up as the result of this policy. The conclusion is that if the financial leverage is to be kept high. (i.t.) if funds are to be obtained mainly through preference shares, debentures and other long term debts, then the base should be strengthened by keeping operating leverage low.

- **Earning Per Share (EPS) :**

While taking financial decisions, management's main concern generally is earning per share**.** Hence the decision on the degree of financial leverage always aims at maximization of earning per share. To obtain the earning per share, profit of the company and interest is divided by the total number of its equity shares.

$$EPS = \frac{(X - R)\,(1 - t)}{N}$$

Where, X = Earning before int. and tax (EBIT)R = Interest
T = rate of tax
N = No. of equity shares

For example: If the profit before interest and tax is Rs. 1,00,000 the number of equity shares of Rs.100 each is 3000 and 10% debentures are worth Rs.2,00,000 and tax rate is 50% the earning Per share can be ascertained as follows:

Earning Per Shares = Rs.1,00,000 – Rs. 20,000 (int.)
= Rs.80,000 – Rs.40,000 (Tax)
= Rs.40,000 ÷3000
= 13.33

$$\text{EPS} = \frac{(X-R)(1-t)}{N} = \frac{(1{,}00{,}000-20{,}000)(1-0.5)}{3{,}000}$$

$$= \frac{(80{,}000)\ x\ 0.5}{3{,}000} = \frac{40{,}000}{3{,}000}$$

= Rs. 13.33

If financial leverage is determined keeping in view EPS only, it would favour the use of Debt capital only when the rate of interest on debentures is lower than the rate of return in business, the EPS will go on increasing with the increased debts, i.e. financial leverage. Thus, if the decision is based only on the consideration of EPS, the emphasis will be on debts without any indication of the risks it involves. The concept of EPS is very deceptive. It is misleading to induce the management to put their business in jeopardy by relying too much on the debentures. In short, EPS is not a sufficient consideration in deciding the degree of financial leverage.

Ex-1 A company intends to start a new manufacturing unit for which it needs Rs. 15,00,000. The new factory is expected to yield an annual EBIT of Rs.2,50,000. In choosing a financial plan, the company has an objective of maximizing earning.per share (EPS). It has three alternatives of issuing debentures RS. 1,50,000 or RS 6,00,000 or RS. 9,00,000. The rate of interest in each case would be (i) up to Rs.2,00,000 at 10% (ii) over Rs. 2,00,000 up to Rs. 8,00,000 at 11% and (iii) over Rs. 8,00,000 at 18%.

The current market price per share is Rs.30 and it is expected to drop to RS. 24, ifthe funds are borrowed of RS. 7,00,000. Assume tax rate to be 50%.

Give your opinion on all these alternatives on the basis of Earnings Per share.

Ans.

(1) Interest :- Rs.

First alternative Rs. 1,50,000 x 10% = 15,000

(on deb of RS 1.50.000)

Second alternative: (on deb of Rs. 6,00,000)	= 2,00,000 × 10%	= 20,000
	=4,00,000 × 11%	<u>= 44,000</u> = 64,000
Third alternative: (on deb of Rs. 9,00,000)	= 2,00,000 × 10%	= 20,000
	= 6,00,000 × 11%	= 66,000

= 1,00,000 × 18%<u>= 18,000</u>

= 1,04,000

(2) If the First Alternative is adopted, then RS. 1,50,000 will be raised by issue of debentures and Rs.13,50,000 will have to be raised RS.13,50,000 /30 = <u>45,000</u> <u>Equity</u> shares are to be issued.

If the Second Alternative is accepted, then out of Rs.15,00,000, debentures of Rs 6,00,000 will be issued and the remaining amount of RS 9,00,000 will be issued through issue of equity shares and number of shares to be issued at market price will be RS. 9,00,000 / 30 <u>=30,000 shares.</u>

In case, the Third Alternative is adopted, RS 9,00,000 will be raised through issue of debentures and Rs.6,00,000 will be raised by issue of equity shares. The no- of equity shares issued at a market of 24 will be 6,00,000/24 <u>= 25,000 equity</u> <u>shares.</u>

Particulars	First Alternative (Rs.1,50,000 Deb.)	SecondAlternative (Rs.6,00,000 Deb.)	Third Alternative (Rs.9,00,000 Deb.)
1) EBIT	2,50,000	2,50,000	2,50,000
2) Interest	15,000	64,000	1,04,000
PAT/EBT	2,65,000	1,86,000	1,46,000
Less : 50% Tax	1,17,500	93,000	73,000
EAT	1,17,500	93,000	73,000
No. of Equity shares earning per share – EDS –PAT No. of shares	45,000 Rs.2.61	30,000 Rs.3.10	25,000 Rs.2.92

Ex-2 A company intends to establish a new factory for which an investment ofRs.20,00,000 is required. The company is considering two alternatives:

a) Proportion of Equity shares and Debenture to be maintained at 70 : 30 and

b) Proportion of Equity shares and Deb. to be kept 50: 50.

If the first alternative is accepted, then equity shares can be sold at Rs.40 per share and debentures can be issued at an interest rate of 10% P.a. If however, second alternative is adopted equity shares are sold for Rs.25 per share and debentures can be issued at 12 % interest P.a. The factory is expected to earn Rs.3,20,000 before interest & taxes. If the tax rate is50% , which alternative should be accepted on the basis of earnings per share. In both cases, computethe financial Leverage.

Ans:

1) First Alternative:

Total capital = Rs.20,00,000

Ratio between Owner & Borrowed cup is 70:30

∴ Equity share capital = Rs.14,00,000

Debenture = Rs.6,00,000

∴ No of Equity shares $= \frac{14,00,000}{40}$ =35,000 shares

Interest on Deb. = 6,00,000 × 10% = Rs.60,000

2) Total Capital = Rs.2,00,000

Ratio between Owners & Borrowed cap = 50:50

Equity share capital = 10,00,000

Debentures = 10,00,000

No. of Equity shares $= \frac{Rs.10,00,000}{25}$ = 40,000 shares

Int: on Deb. = 10,00,000 × 12% = RS.1,20,000

Particulars	First Alternative 70 : 30	Second Alternative 50 : 50
Earnings Before Interest and Tax-EBIT	3,20,000	3,20,000
Less : Interest	60,000	1,20,000
PBT	2,60,000	2,00,000
Less : 50 % Tax	1,30,000	1,00,000
	1,30,000	1,00,000
EPS (PAT/No. of Shares)	3.71	2.50

Financial Leverage	$= \frac{EBIT}{EBT}$
- First Alternative :	$= \frac{3,20,000}{2,60,000} = 1.23$
- Second Alternatives :	$= \frac{3,20,000}{2,00,000} = 1.60$

Ex. 3 A company has a capital structure of 6,000 Equity shares of Rs 100 each. The company now wishes to raise additional Rs.6,00,000 for expansion. The company has four alternative financial Plans.

(A) It can issue 6,000 new Equity Shares of Rs.100 each.

(B) It can raise 50% as Equity Shares and 50% as 8% Debentures.

(C) It can raise the entire amount as 8% Debentures.

(D) It can raise as 3,000 Equity shares amt.100 each and 10% 3,000 preferenceshares at Rs.100 each.

Ans-

If the company's profits before interest and faxes are Rs 90,000 and the rate is 50% then which alternative is acceptable to maximize Calculate Earning per share?

Calculation of No. of shares & Debenture & Interest

A) 6,000 old shares + New shares = 12,000 shares

B) 6,000 old shares + 3000 New shares = 9,000 shares
Debenture Interest 8% of RS. 3,00,00 = Rs.24,000

C) New shares - Nil + 6,000 old shares = 6,000
Deb. Interest = 8% of 6,00,000 = RS. 48,000

D) 6000 old shares & 3000 New shares = 9000 shares
Pref. Dividend 10% of Rs.3,00,000 = Rs. 30,000

Particulars	**A Rs.**	**B Rs.**	**C Rs.**	**D Rs.**
EBIT	90,000	90,000	90,000	90,000
Less: Interest	-	24,000	48,000	-
PBT	90,000	66,000	42,000	90,000
Less : 50%Taxes	45,000	33,000	21,000	45,000
PAT	45,000	33,000	21,000	45,000
Less: Pref.Dividend	-	-	-	30,000
Profit foe Eq.shares	45,000	33,000	21,000	15,000
EPS	3.75	3.67	3.50	1.67

EX-4 The balance sheet of ABC Co. Ltd. as on30-6-01 is as follows:

Balance Sheet

Liabilities	Rs	Assets	Rs
Equity share capital Rs.10per share	1,00,000	Net Fixed Assets	2,50,000
12% Debenture	1,20,000	Current Assets	80,000
Reserve & surplus	40,000		
Current Liabilities	70,000		
	3,30,000		3,30,000

During 2000-01 company's sale is Rs.8,00,000.

Fixed expenses are Rs. 1,60,000 while variable cost is 45% of sale.

Income-tax rate is 50%

A) Calculate for the company all the three types of leverages

B) Determine the level of EBIT if EPS is Rs.2, Rs.3, Rs.4 and Rs. 0.

Ans:

Income statement of the company

Particulars	Rs.
Sales	8,00,000
Less: variable cost (45% of sales)	3,60,000
contribution	4,40,000
Less: Fixed cost	1,60,000
EBIT	2,80,000
Less: Interest	14,400
PBT	2,65,600
Less: 50% Tax	1,32,800
PAT	1,32,800

A) 1) Operating Leverage :

$$= \frac{Contribution}{EBIT} = \frac{4,40,000}{2,80,000} = 1.57$$

2) Financial Leverage :

$$= \frac{EBIT}{EBT} = \frac{2,80,000}{2,65,600} = 1.66$$

B) EPS = $\frac{(X-R)(1-t)}{N}$

Where, X = EBIT

R = Interest

t = Rate of income tax

N = No. of equity shares

(i) Rs. 2 = $\frac{(x-14,400)\ (1-0.5)}{10,000}$

$\therefore$ 20,000 = 0.5 (x-14,400)

$\therefore$ 20,000 = 0.5x – 7,200

$\therefore$ 0.5x = 27,200

X = 54,400

(ii) Rs.0 = $\dfrac{\underline{(x\text{-}14{,}400)\ (0.5)}}{10{,}000}$

$\therefore$ 0 = 0.5x – 7,200

$\therefore$ 0.5 = 7,20

X = 14,400

EX- 5 A,B,C and D are four companies falling in the same industry class with different financial plans. Following data are extracted from their respective financial Statements for the year ended 31-3-2011.

	A	B	C	D
Equity capital (RS 10 each)	5,00,000	4,00,000	2,50,000	1,00,000
12% Debentures	-	1,00,000	2,50,000	4,00,000
EBIT	1,00,000	1,00, 000	1,00,000	1,00,000

All the companies fall under 50% tax bracket calculate-

(1) EPS for each of the company

(2) Explain why the EPS or A is substantially different from that of D, despitethe identical capital employed and EBIT.

Ans.

Earning Per Share (EPS)

	Company			
	A	B	C	D
EBIT	1,00,000	1,00,000	1,00,000	1,00,000
Less : Interest	-	12,000	30,000	48,000
PBT	1,00,000	88,000	70,000	52,000
Less : 50% taxes	50,000	44,000	35,000	26,000
PAT	50,000	44,000	35,000	26,000

	A	B	C	D
No. of equity shares	50,000	40,000	25,000	10,000
EPS = $\frac{PAT}{No.of\ Iquity\ Shares}$	$\frac{50,000}{50,000}$	$\frac{44,000}{40,000}$	$\frac{35,000}{25,000}$	$\frac{26,000}{10,000}$
EPS	Rs.1.00	Rs.1.10	Rs.1.40	Rs.2.60

Ex 6 The Ahmedabad Co. Ltd. has the following Balance Sheet and incomeStatement information.

Balance Sheet as on 31-3-2001

Liability	Rs.	Assets	Rs.
Equity share capital (Rs.10 per share)	10,00,000	Fixed assets	14,00,000
10% Debenture	8,00,000	Current assets	11,00,000
Research & Surplus	5,00,000		
Current Liability	2,00,000		
	25,00,000		25,00,000

Income statement for the year ended 31-03-2001

Rs.

Sales	4,50,000
Operating expenses	
(including Rs. 90,000 depreciation)	1,50,000
EBIT	
Less : Interest	80,000
EBT	2,20,000
Less : 50% Tax	1,10,000
Net Profit	1,10,000

(A) Determine the degree of operating, financial and combined leverages at the current sales level if all operating expenses, other than depreciation are variablecosts.

(B) If total Assets remain at the same level but sales increases or decreases by 25%,what will be the earnings per share?

Ans.

A) Calculate of Leverage :-

1) Operating Leverage

$$= \frac{Contribution}{EBIT}$$

$$= \frac{Sales - Variable\ cost}{EBIT}$$

$$= \frac{4{,}50{,}000 - 60{,}000}{EBIT} \quad == \frac{3{,}90{,}000}{3{,}00{,}000} = 1.30$$

2) Financial Leverage :-

$$= \frac{EBIT}{EBT} \quad = \frac{3{,}00{,}000}{2{,}20{,}000} = 1.36$$

3) Combined Leverage :-

$$= \frac{C}{EBIT} \quad = \frac{3{,}90{,}000}{2{,}20{,}000} \quad = 1.77$$

(B) Increase or Decrease in sales by 25%

	Increase 25%	Decrease 25%
Sales	5,62,500	3,37,500
Less: Variable Costs	75,000	45,000
Contribution	4,87,00	2,92,000
Less: Fixed Exp. (Depreciation)	90,000	90,000
EBIT	3,97,500	2,02,500
Less : Interest	80,000	80,000
EBT	3,17,500	1,22,500
Less: 50% Tax	1,58,750	61,250
Net profit	1,58,750	61,250
Number of Equity shares	1,00,000	1,00,000
Earning per Share (EPS)	1.59	0.61

Ex. 7 The Capital structure of the Progressive Corporation consists of an equity share capital of Rs.10,00,000 (Shares of Rs.100 per value) and Rs10,00,000 of 10% debentures. Sales increased by 20% from 1,00,000 units to 1,20,000 units, the selling price is Rs10 Per share, variable costs amount to Rs.6 per unit and fixed expenses amount to Rs2,00,000 The income tax rate is assumed to be 50%.

(a) You are required to calculate the following:

(i) The percentage increase in earnings per share

(ii) The degree of financial leverage at 1,00,000 units and 1,20,000 units.

(iii) The degree of operating leverage at 1,00,000 units and 1,20,000 units.and 1,20.000 units.

(b) Comment on the behaviour of operating and financial leverages in relation toincrease Production from 1,00,000 units to 1,20,000 units.

Ans.

Statement of Earnings Per share

	1,00,000 units (Rs.)	1,20,000 units (Rs.)
Sales (Rs. 10 Per Unit)	10,00,000	12,00,000
Less : Variable Costs (Rs. 6 per units)	6,00,000	7,20,000
Contribution	4,00,000	4,80,000
Less : Fixed Costs	2,00,000	2,00,000
EBIT	2,00,000	2,80,000
Less : Interest	1,00,000	1,00,000
EBT	1,00,000	1,80,000
Less: 50 % Taxes	50,000	90,000
Net Profit	50,000	90,000
No. of Equity Shares	10,000	10,000
Earnings Per Share	Rs.5	Rs.9

(a) (1) Percentage Increase in EPS :

$= \frac{4}{5}$ x 100 = 80%

(2) DFL $= \frac{EBIT}{EBT}$

1,00,000 units = $\frac{2,00,000}{1,00,000}$ = 2

1,20,000 units = $\frac{2,80,000}{1,80,000}$ = 1.56

(3) DOL = $\frac{C}{EBIT}$

1,00,000 units = $\frac{4,00,000}{2,00,000} = 2$

1,20,000 units = $\frac{4,80,000}{2,80,000} = 1.71$

(b) As production and sales have increased from 1,00,000 units to 1,20,000 units. The value of EPS has gone up by 80% .Besides both type of leverages operating as well as financial, have gone down suggesting a decline in the total risk of the company. Due to a lower degree of risk the market price of its shares is likely to rise. The net income increased by Rs. 40,000 as a result of increase in sales level. It can be attributed to the fact that there has been no increase in either fixed overheads or fixed interest cost.

Ex.8 The Selected financial data for A, B and C companies for the current yearended 31-3-2001 are as follows:

Particulars	A	B	C
Variable expenses as a % of sales	66.2/3	75	50
Interest expenses	Rs.200	Rs.300	Rs.1000
Degree of OP. leverage	5	6	2
Degree of Fin. Leverage	3	4	2
Income tax rate	0.50	0.50	0.50

(a) Prepare income statements for A, B and C companies

(b) Comment on the financial position and structure of these companies.

Ans.

- Company –A : Financial Leverage:

$$= \frac{EBIT}{EBIT-I}$$

$$\therefore 3 = \frac{x}{x-1}$$

$\therefore$ 3(x-I) = x

$\therefore$ 3(x-200) = x

$\therefore$ 3x - 600 =x

$\therefore$ 2x = 600

$\therefore$ x = Rs. 300

→ Operating Leverage :

$$= \frac{C}{EBIT} \qquad = \frac{\text{sales – variable exp.}}{EBIT}$$

$$\therefore 5 = \frac{y- 2/3y}{300}$$

$\therefore$ 1,500 = y-2/3y

$$\therefore 1{,}500 = \frac{3y- 2y}{3}$$

$\therefore$ y = 4,500 Rs.

$\therefore$ Sale = Rs.4,500

Variable Exp. = 4,500 $\therefore$ 2/3 = Rs.3,000

Fixed Expenses

= sales- variable exp.- profit

= 4,500 – 3,000 – 300

= Rs.1,200

- Company B:

Financial Leverage:

$$= \frac{EBIT}{EBIT- I} \qquad = \frac{x}{x-1}$$

$$\therefore 4 = \frac{x}{x-1}$$

$\therefore$ 4 (x-300) = x

$\therefore$ 3x = 1,200

$\therefore$ x = Rs.400

- Operating Leverage :

$= \frac{C}{EBIT} = \frac{sales - variable\ cost}{EBIT\ (x)}$

∴ 6 = $\frac{y - 3/4y}{400}$

∴ 2,400 = y – 3/4 y

∴ 2,400 = $\frac{4y - 3y}{4}$

∴ y = Rs. 9,600

∴ Variable cost = 9,600 × 314 = Rs.7,200

∴ Fixed cost = 9,600 – 7,200 - 400 = RS. 2,000

=> Company - C:

Financial Leverage :

= $\frac{x}{x-I}$

∴ 2 = $\frac{x}{x-1}$

∴ 2 (x-1000) = x

∴ x = 2,000

Operating Leverage :

= $\frac{Sales - Variable\ cost}{x}$

∴ 2 = $\frac{y - 1/2y}{2000}$

∴ 4,000 = $\frac{2y - y}{2}$

∴ y = Rs.8,000

∴ Variable cost = 8,000 ∴ ½ = Rs.4,000

∴ Fixed cost = 8,000 – 4,000 – 2,000 = Rs.2,000

Income Statement

Particulars	**Co. A**	**Co. B**	**Co. C**
Sales	4,500	9,600	8,000
Less : variable cost	3,000	7,200	4,000
Contribution	1,500	2,400	4,000
Less : Fixed Expense	1,200	2,000	2,000
EBIT	300	400	2,000

Less : Interest	200	300	1,000
PBT	100	100	1,000
Less : 50% Tax	50	50	500
PAT	50	50	500

EX-9 M,N,R and T are 4 companies falling in same financial plans. Following data are extracted from the respective financial statement for the year ended 31-03-2006.

	M	N	R	P
Equity capital (Rs.10each)	4,00,000	3,00,000	2,00,000	1,00,000
10% Debentures	-	1,00,000	2,00,000	3,00,000
EBIT	90,000	90,000	90,000	90,000

All the companies fall under 50% tax bracket Answer the following.

(1) Calculate EPS for each of the company

(2) Explain why EPS differs despite the identical capital employed and EBIT.

Ans. => Earnings Per Share (EPS)

particulars	M	N	R	P
EBIT	90,000	90,000	90,000	90,000
Less : Interest	-	10,000	20,000	30,000
EBT	90,000	80,000	70,000	60,000
Less : 50% tax	45,000	40,000	35,000	30,000
EAT	45,000	40,000	35,000	30,000
No. of equity shares EPS = $\frac{\text{EAT}}{\text{No. of eq. shares}}$	40,000 $\frac{45,000}{40,000}$	30,000 $\frac{40,000}{30,000}$	20,000 $\frac{35,000}{20,000}$	10,000 $\frac{30,000}{10,000}$
	= 1.125	=1.333	=1.75	=3

EX-10 The following is the balance sheet of a company :

Liability	Rs.	Assets	Rs.
Share capital Rs. 10 pershares	1,50,000	Fixed Assets	2,00,000
10% Debenture	1,20,000	Current Assets	70,000
Reserves & Surplus	30,000		
creditors	30,000		
	3,30,000		3,30,000

During the year 2005-06, company's sale is Rs.9,00,000. Fixed expenses are Rs.1,60,000 while variable cost is 60% of sales. Income tax rate is 50% Calculate all the 3 types of leverage

Ans.

	Rs.
Sales	9,00,000
Less : Variable cost (90,000 ∴ 60%)	5,40,000
Contribution	3,60,000
Less : Fixed Cost	1,60,000
EBIT	2,00,000
Less : Interest (1,20,000 ∴ 10%)	12,000
EBT	1,88,000
Less : 50% tax	94,000
EAT	94,000

Operating Leverage:

$$= \frac{C}{EBIT} = \frac{3,60,000}{2,00,000} = 1.8$$

Financial Leverage:

$$= \frac{EBIT}{EBT} = \frac{2,00,000}{1,88,000} = 1.063$$

Combined Leverage:

$$= \frac{C}{EBT} = \frac{3{,}60{,}000}{1{,}88{,}000} = 1.914$$

❖ **Check Your Progress:**

Answer the following question

Q.1 Define Leverage. Explain the operating Leverage, operating and CombinedLeverage.

Q.2 Explain with illustrations Earning Per Share.

Solve the Following Questions

Q.1 Calculate Operating and Combined leverage from the following information.

Sales 20,000 Units, Rs 20 per Unit as Selling Price

Variable Cost Rs. 5 Per Unit

Fixed Cost Rs. 20,000

Interest Cost Rs. 10,000

Answer: Operating Leverage = 1.07 and Combined Leverage 1.10

Q.2 A company needs Rs.8,00,000 for purchase of a new machinery. Thefollowing three financial plans are feasible.

1) The company may issue 80,000 Equity shares at RS 10 Per share.
2) The company may issue 40,000 Equity shares at RS10 per share and 10% 4000 debentures at R.S.100.
3) The company may issue 40,000 Equity shares at RS 10 Per share and 10% 4000 Preference shares at Rs.100 per share

If the company's earnings before interest and taxes are Rs.16,000, Rs.32,000, RS. 64,000, Rs.96,000 and RS.1,60,000 respectively, what will be the Earning Per Share under each of three financial plains?Assume that corporate tax 50%.

Answer:

EBIT	16,000	32,000	64,000	96,000	1,60,000
First Alternative EPS	0.10	0.20	0.40	0.60	1.00
Second Alternative EPS	-0.60	-0.20	0.30	0.70	1.50
Third Alternative EPS	-0.80	-0.60	-0.20	0.20	1.00

Q.3 The information of ABC Ltd are as follows

Variable Cost Per Unit = Rs. 10

Selling Price Per Unit = Rs. 20

Actual Sales = Rs. 500 Units

Calculate Operating Leverage in each of the following cases

1. When Fixed Cost Rs. 2,000
2. When Fixed Cost Rs. 1,000

Answer: Operating Leverage is 1.67 in 1st cases and 1.25 in 2nd cases

Q.4 The Financial manager of a company expects that its EBIT in the current year would amount to Rs.25,000. The capital structure of the company includes 1,000 equity shares, 5% Debenture of Rs.1,00,000 and 10% preference shares of Rs.50,000. Calculate EPS. Also, degree of financial leverage.

If the profits are Rs.15,000 and Rs.35,000 how would the EPS be affected?

Answer:

Particulars	Original	Alternative 1	Alternative 2
EBIT	25,000	15,000	35,000
EPS	5.00	0	10.00
Degree of Financial Leverage	1.25	1.50	1.16

Q.5 The Financial manager of the Hypothetical Ltd expects that its EBIT in the Current year would amount to Rs.10,00,000. The firm has 5% bonds aggregating. to Rs.40,00,000, while 10% Preference shares amount would to Rs.20,00,000.

What would be the EPS ? Assuming the EBIT being

i) Rs.6,00,000 the to be and ii) Rs.14,00,000 how would the EPS be affected ? The firm can be assumed to be in 50% bracket. The number of outstanding ordinary shares is 1,00,000.

Answer:

Particulars	Current EBIT 10,00,000	Assumed EBIT 6,00,000	Assumed EBIT 14,00,000
EPS	2	0	4

Q.6 Find out Operating and Financial Leverage :

Sales = 50,00,000

Variable cost = 20,00,000

Fixed Cost = 5,00,000

Interest = 5,00,000

Answer: Operating Leverage = 1.2 and Financial Leverage = 1.25

Q.7 Information regarding Sunrise Co. Limited is as under :

Sales	10,00,000
Variable cost	7,00,000
Fixed cost	2,00,000
10% Debentures	80,000
Equity shares in numbers	1,000
Tax Rate	50%

Find out Degree of Financial Leverage

Answer: DFL = 1.087

Q.8 Following three companies are in the same industry but their capital makesdiffer.

	A	B	C
Equity fund	1,00,000	3,00,000	1,00,000
15% Debenture	3,00,000	1,00,000	3,00,000
	4,00,000	4,00,000	4,00,000
Equity capital: Reserve Ratio	0.25	2	4

All the equity shares are fully paid-up with free value of Rs.10. The company fall under 40% tax bracket. The operating profits of all company are 25% on total capital employed.

Calculate EPS of each Company.

Answer:

Particulars	Company A	Company B	Company C
EPS	16.5	2.55	4.125

UNIT: 10 BUDGETING & BUDGETARY CONTROL

10.1 INTRODUCTION

Budgets are one of the most important aspects of any system. It is important in domestic life,a corporate house or be it a nation. At home we often prepare yearly, monthly, weekly or even daily budgets that would influence our expenses and savings. Budget of any organization will tell you about its growth and expansion plans. Union government Budget not only allocates resources for various programmes that decide our nation's progress, it even affects the income tax and other taxes which will affect everybody directly or indirectly.

Most people rich or poor, make estimates of their income and plan expenditure for food, education, entertainment, savings, housing, clothing and so on. Knowingly or unknowingly most of us go through a budgeting process.

A budget is a formal expression of the management's plans for the future and how these plans are to be accomplished. The act of preparing a budget is called Budgeting. An organization may attain certain degree of success without budget, but it cannot reach that height that it could have been reached without a well co- ordinated budgeting systems.

A budget is a plan expressed in quantitative, usually monetary terms covering a specified period of time, usually one year. Practically all companies, except some of the smallest, prepare budgets. Many companies refer to their annual budget as a profit plan. Since it shows the planned activities that the company expects to undertake in its responsibility centers in order to obtain its profit goal. Almost all nonprofit organizations also prepare budgets.

10.2 DEFINITIONS AND CHARACTERISTICS OF BUDGET

Numerous definition of a budget have been given by different authorities and authors, but common to all is that - a budget is a written plan covering projected activities of an organisation for a definite period of time.

CIMA (U.K) terminology defines a budget as "A financial and / or quantitative statement,prepared and approved prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective. It may include expenditure and the employment of capital."

According to Shubin," A budget is a comprehensive overall plan in which management, on the basis of estimated sales volume and receipts, establishes cost and expense allowances for future operations. In this way effectively integrating and directing activities towards carefully determined goals."

The above definitions make it clear that budgets are prepared to achieve objectives and targets of business.

Characteristics of Budget

The main characteristics of budget as derived from the above definitions are as follows: -

(1) Budgeting is an ongoing (continuous) process: -

The budgetary process helps to ensure that all parts of the organization are in balance with one another. A framing of business budget and its implementations should go hand in hand.

(2) It covers a definite period of time in future: -

The business budgets represent management's plans for the future.

(3) Business budget is a plan of the resources and its operation as

well:-

The overall business plan is crystalized in the form of projected accounts for each year of the budgetary period, including the manufacturing or operating accounts, trading and profit and loss account i.e. cash forecast and a balance sheet. The projected accounts will therefore cover the whole of the future expected transaction of the business and will include budgets for expenditure on capital equipment.

(4) **It is a detailed (comprehensive) plan: -**

When everyone is committed to budgeting as a means of achieving set goals and of going from one objective to another, budgeting will be most valuable. The whole idea is to see what can be achieved and then making a determined effort to see that actual performance matches the target.

(5) **It is expressed in a financial form: -**

Budget can be prepared for research and development costs. Financial budgets are ordinarily prepared for 12 months. The budget period should be in line with the financial year of the organization so that the budget figure can be compared with the actual figures.

(6) **It is an integrated plan:-**

All sections and departments and divisions should try to see what can be achieved given a willing and coordinated effort.

(7) **Budget is an important instrument of control: -**

Budgeting, undertaken as a routine activity, loses much of its value. But as dynamic forward looking exercise, it can be of immense use. The very first requirement in this regard is that all the peoples should be actively involved.

10.3 OBJECTIVES OF BUDGET

The main objectives of budget are as follows: -

(1) Budget is most widely known as a device for control. Control is exercised by comparing the actual cost or expenditure with the budgeted cost.

(2) Budget is a good device for communicating plans to various managers.

(3) Budget can be useful device for motivating managers to perform in line with the objectivesof the organization.

(4) The main objective of budget is co-ordination. Without co-ordination the departmental heads may follow courses which are beneficial for their departments, but may not be beneficial for the organization as a whole.

(5) One important objective of budget is planning. The existence of a budget forces managers to think for future, trying to anticipate possible problems and their solutions.

10.4 USES OF THE BUDGET

1. A means of educating managers.
2. A way of motivating managers to achieve their goals.
3. An aid in making and coordinating short range plans.
4. A benchmark for controlling ongoing activities.
5. A Device for communicating these plans to the various responsibility center managers.
6. A base for evaluating the performance of responsibility centers and their managers.
7. Major planning decisions are usually made in the strategic planning activity and the process of developing the budget is essentially a refinement of these plans.
8. The organization also needs to be aware of policies and constraints to which it is expected to adhere. Management's plans will not be carried out unless the organization understands what the plans are.
9. If the atmosphere is right, the budgeting process also can be a powerful force in motivating managers to work towards the objectives of their responsibilities.
10. A carefully prepared budget is the best possible standard against which to compare actual performance. It incorporates the estimated effect of all variables that were foreseen when the budget was being prepared.
11. Budget preparation is an educational tool. Budget serves to educate managers about the detailed workings of their responsibility centers and the inter relationships of their centers withother centers in the organization.
12. Budget preparation can be complicated process. Managers may introduce bias when preparing their portion of the budget. They do this to protect themselves against uncertainties that may result in unfavorable variance that would look bad in the evaluation phase of the management control cycle.

10.5 ADVANTAGES OF BUDGET

(1) It helps to allocate resources of the organization for the most economical use.
(2) It forces management to make an early study of their problems.
(3) It compels all members of management to participate in the establishment of goals of theorganization.
(4) It forces all managers to think about the future and chalk out plan for the future.
(5) It provides an advance estimate of revenues and expenses.
(6) It provides a way of communicating the plans of the management throughout theorganization.
(7) It pinpoints the extent and lack of efficiency in the organization.
(8) Periodical review of a budget will help to check the progress of the target to be achieved.
(9) It helps to develop at all levels of management the habit of timely, careful and adequate consideration of all factors before reaching important decisions.
(10) It provides a platform for evaluating subsequent performance.

10.6 LIMITATIONS OF BUDGET

(1) A budget is a based on estimates. It is very difficult to make right estimate. Wrong estimatemay create more problems than solutions.
(2) A budget may prevent achieving the full potential of the organisation.
(3) Lack of coordination between different departments may create problems in achieving thedesired results.
(4) In many cases, a budget is formulated by the superior executive without consulting theachievers.
(5) A budget may encourage rivalry among the departments which may hamper the workingenvironment of the organisation.

10.7 ESSENTIAL FACTORS IN PREPARATION OF BUDGET

There are three essential factors in preparation of budget.
(1) Budget key factor
(2) Budget centers
(3) Budget period

(1) Budget key factor: - Budget key factor is also called 'limiting factor'. Budget depends upon the level of activity which depends upon production. Production depends in turn on how much the organisation plans to produce. Thus production is the key factor or limiting factor. Based upon these factors or factor the maximum that can be produced is determined and on this level of activity the budget is based.

Following are the key factors which can affect budgeting.

Sales

1. Shortage of talented and experienced salesmen
2. Weak market demand.
3. Inadequate advertising due to lack of funds.

Materials

1. Availability of supply.
2. Constraints due to licenses and quotas.

Labour

1. Shortage of labour
2. Shortage in labour related facilities

Plant and Equipment

1. Limited capacity due to lack of capital.
2. Inadequate capacity due to shortage of space.

Management

1. Overall inadequacy of capital.
2. Limited availability of technical and managerialexperts.
3. Inadequate research efforts and product designing.

(2) Budget centers: - Budget centre has been defined as a section of the organisation. It is necessary that in every organisation the level of responsibility should be clearly laid down and the sphere of control of each individual should be specifically defined. The nature of budget means the functional aspect of budget. Most of the manufacturing industries use one year as budget period.

(3) Budget period: - A budget period means the period for which a budget is prepared and employed. The period of budget depends upon

1. The nature of budget
2. Nature of demand and supply of product and3.Extent of control needed.

10.8 ESTABLISHMENT OF BUDGETS

Budgets may be prepared in summary format or may be quite detailed for each business function, for example, sales, production, plant utilisation etc. The types of budgets prepared and level of detail found will vary from organization to organization. There are many types of functional budgets; some of these are given below.

(1) Cash Budget
(2) Purchasing Budget
(3) Plant Utilization Budget
(4) Capital Expenditure Budget
(5) Research and Development Budget
(6) Administration Cost Budget
(7) Distribution Cost Budget
(8) Selling Cost Budget
(9) Production Cost Budget
(10) Production Budget
(11) Sales Budget
(12) Selling and Distribution Cost Budget
(13) Stock Budget
(14) Cost of Goods Sold Budget
(15) Selling and Distribution Cost Budget

The budget department at first prepares the budget manual in a rough draft form. This draft manual is circulated to all concerned for comments and suggestions. After considering all the suggestions and comments, a final budget manual is prepared.

10.9 MEANING AND DEFINITION OF BUDGETARY CONTROL

The chartered institute of Management Accountants (CIMA) defines budgetary Control as: "The establishment of budgets relating the responsibilities of executive to the requirements of a policy, and the continuous comparisons of actual with budgeted results either tosecure by individual action the objective of the policy or to provide a firm basis for its revision."

Budgetary control means laying down in monetary and quantitative terms what exactly has to be done and how exactly it has to be done over coming period and then to ensure that actual results do not diverge from the planned course more than necessary. The past record represents thelog and the auditor is responsible for verifying, so far as he can that those records are correct andreveal a true and fair view of the financial position of the concern. Modern management requires, for day to day operating purpose. During the course of the year management requires immediate reports of any material variance from the predetermined course, together with explanation of the reason for them.

The business budgets represent management's plans for the future.

10.10 REQUISITIES OF EFFECTIVE BUDGETARY CONTROL

(1) To achieve success, the exact goal to be reached must be laid down, otherwise budgeting willbe aimless. Objectives for each field of activity should also be determined.

(2) Usually budgets are drawn up for a year basis but this will depend upon the nature of a business. However from the control point of view it is important that budget should not be for periods longer than necessary.

(3) In every business there is one or more limiting factor. Such limiting factors are known as key factors. It is no use planning without taking into account the factors has a vital influence.

(4) Budgetary controller plays a very important role in success of the system of budgetary control.

(5) Budgets are drawn up after full and frank discussion; otherwise co-operation will not be forthcoming.

(6) Actual business conditions may be different from what were anticipated. Budgetary controlleris most concerned with it.

10.11 OBJECTIVE OF BUDGETARY CONTROL

(1) To control each function so that the best possible results are achieved.

(2) To lay down a plan to implement the policy of the firm.

(3) To co-ordinate the activities of various departments of a business.

Thus budgetary control provides for logical forward planning for the organization.

10.12 ADVANTAGES OF BUDGETARY CONTROL

(1) Managers will be well motivated to achieve the forward plan.

(2) The employees themselves know what it is exactly that they will be judged by.

(3) There is no delay since budgets, once adopted, operates as a sanction to proceed.

(4) Budgets serve as targets and therefore, as a measure of efficiency of departments and people.

(5) Wastages and losses of all types are avoided and maximum efficiency is achieved.

(6) Everyone concerned knows what exactly to do.

10.13 LIMITATIONS OF BUDGETARYCONTROL

There are certain limitations of budgetary control.

(1) Cost control through budget has limited effectiveness.

(2) Long term budgets suffer from inflexibility.

(3) The managers may have to operate within budget limits even its circumstances require a change.

(4) In budgets even most minor expense are analysed in detail. Managers are left with a very little freedomin operating the departments. These aspects are called over budgeting and rigidity.

(5) In the business there are inherent uncertainties and the budget assumptions are often falsified by events, unpredictable changes occurrences in markets, technology, prices, labour rates, economic and social conditions. As a result budgets tend to lose their validity with the result managers lose faith in the system.

(6) Budgets are usually devices of hiding inefficiency. The managers may inflate their demands in the hope that the Budget committee would cut down their allocation.

(7) Managers tend to become complacent if the budgeted performance is easy to achieve.

10.14 PREPARATION OF THE BUDGET

The Board of director appoints a budget committee. The board instructs the committee to prepare a budget for the forthcoming financial year on the basis of the financial parameters it laysdown.

The Budget committee, in turn, appoints a budget officer. The budget officer is usually the financial controller or chief accountant or a senior staff member of the accounts department.

The budget officer is responsible for complication of the budgets received from differentdepartments.

Budget committee

Budget committee is usually a high - level steering committee. The functions of the budgetcommittee are as follows.

- Ensuring that employees participate in the budgeting process.
- Developing the time-table for budget preparation.
- Consulting different managers for solving their problems.
- Reviewing and coordinating all budget works.
- Establishing the roles and responsibilities of all the participants in the budgeting process.
- Communicating financial data of the previous period to all parties and to help them in theirforecasting.
- Reviewing and co-ordinating all budget works and budget estimates to ensure theorganisation's long-term objectives are achieved.
- Establishing the roles and responsibilities of all the participants in the budgeting process.

Budget period

The budget period is largely dependent upon the nature of the business. In case of seasonal businesses the budget period may be less than a year. the purpose for which a budget is prepared. May also determine the budget period. a capital expenditure budget will cover a period of several years. As a budget preparation is a costly affair, the budget period should not be too short or too long. Significant number of organisations use continuous budget.

The main advantages of continuous budget are:-

(1) The budget becomes a better forecast of actual results.
(2) It keeps the manager focused on the future at least" one year ahead.
(3) Annual budget preparation job is spread over more evenly throughout the year.
(4) It results in budgets that are up to date and realistic in the light of current events.
(5) It forces managers to reassess budgets on regular basis.

Budget Manual

Budget manual is a document prepared by budget department under the supervision of the Budget committee. It states the specific procedures to be followed in the development of the budget. Generally, a budget manual contains the following:

(1) Forms of different schedules.
(2) A statement of the objectives of the business.
(3) Time schedule of budget preparation.
(4) A statement of duties and responsibilities of different personnel involved in the preparation ofthe budget.
(5) Procedures for obtaining approval.
(6) Procedures for budgetary control.

Advantages of a Budget Manual

(1) Reliance on memory is eliminated when procedure is given in writing.
(2) Less confusion will occur if answers to questions can be obtained from the manual.
(3) It acts as a guide book of all departments involved in the budgeting process.
(4) It will be easier to resolve any difference between two departments.
(5) Clear instructions in budget manual will save time of the superiors.
(6) It will reduce training time of the employees.

10.15 CLASSIFICATION OF BUDGETS

Budgets may be classified on following basis.

(1) Classification according to the time factor

(1) When budgets are prepared for a period of 5 to 10 years these are called long term budget.
(2) These are budgets for a short period of a year or two.
(3) These are very short term budgets covering of period of month or so.

Industries which require huge capital investment like shipping, transport services, electric generation etc. may have long term budgets extending from 5 to 10 years because there is changes in the equipment and operations very slow. Short term budgets are used for mass production industries and concerns producing fashionable products.

(2) Functional classification of Budget

Budget may be classified on the basis of the process of other business.
Functional Budgets are:

(1) Direct Material Purchase Budget
(2) Production Budget
(3) Direct Material Usage Budget
(4) Sales Budget
(5) Master Budget
(6) Cash Budget
(7) Capital Expenditure Budget
(8) Research and Development Cost Budget
(9) Selling and Distribution Cost Budget
(10) Administration Cost Budget
(11) Cost of Goods Sold Budget
(12) Stock Budget
(13) Production Cost Budget
(14) Plant Utilization Budget
(15) Production Overhead Budgets
(16) Direct Labor Cost Budgets

(3) Classification according to capacity

There are two types of budgets according to capacity.

(1) **Fixed Budgets:** - Fixed Budget is a budget for a given level of activity. It does not provide for any change in expenditure arising out of changes in the level of activity of production.

(2) **Flexible Budgets**: - Flexible budgets are designed to change with the level of activity attained. For preparing these budgets, expenses are classified as fixed, semi - variable and variable.

At the time of complication of the budget, the close co-operation and co-ordination between the sales department and production department is necessary. Principal Budget factor is a factor which will limit the activities of an undertaking and which is taken into account in preparing budget. Principal Budget factor are.

(1) Sales quantity
(2) Availability of required labor
(3) Plant capacity
(4) Availability of raw materials.

10.16 ACTIVITY BASED BUDGETING (ABB) AND ZERO BASE BUDGETING (ZBB)

The management literature contains many references to Activity Based Budgeting (ABB) and Zero Base Budgeting (ZBB). Both of these budgeting approaches rely on detailed knowledge of activities for budgeting purposes, and both involve zero base reviews for all programmes as a part of the annual budgeting process. The major difference between the two approaches is –

- ABB requires the setting of a single budget amount for each activity based on therecommended service level at the expected volume.
- ZBB was first used by Jimmy Carter.
- ZBB involves preparation of multiple decision packages with varied service levels.

ZBB is the older approach. It became popular in the 1970s. In this budget all activities arerevaluated each time a budget is prepared. Each budget is started with the assumption for the function does not exist and it is at zero level of cost. Each manager has to justify his entire budget from zero base. In Zero Base Budget, the previous year expenditure is not taken as granted andeach manager has to explain the entire expenditure to be included in the budget.

Features of Zero Base Budgeting

- Zero Base Budgeting framed for every 3 to 5 years.
- ZBB have zero as starting point.
- In ZBB entire expenditures are analysed.
- In ZBB a rational analysis of entire demand is done.

10.17 CHARACTERISTICS OF BUDGETARY CONTROL

- Budgetary control system covers all aspects of the business-manufacturing operations, trading operations, marketing operations etc.
- Budgetary control system can be operated in parts. For example budget can be preparedfor research and development costs.
- Budgetary control system helps in control of cost in broader way.
- Budgetary control is concerned with base of the expenditure at functional level.
- Investment of accounts and finance departments are more important than any otherdepartments of the organisation.
- Budgetary control system is very broad in nature. Here only the deviation is calculated but not the investigated in detail to pin-point the reason.

- All types of organization big, small, profit seeking and not for profit organisations andgovernment prepares annual budget regularly.
- Budgets are not revised frequently during the accounting period. It is an annual exercise. It is to be prepared in advance of the budget period.
- Scope of Budgetary Control System is increasing day by day and it is helping themanagement in future planning.

10.18 DISTINCTION BETWEEN FIXED BUDGET & FLEXIBLE BUDGET

Sr.No	Flexible budget	Fixed Budget
(1)	A flexible budget is prepared for different levels of activity.	A fixed budget is prepared for or one level of activity.
(2)	At the time of preparing a flexible budget costs are classified into fixed element andvariable element.	At the time of preparing a fixed budget, costs are not classified into fixed elementand variable element.
(3)	A flexible budget is prepared mainly for control purpose.	A fixed budget is prepared for different purposes. (e.g. R&D, Advertisement)
(4)	A flexible budget facilitates the assessment of cost, fixation of selling price and tendering of quotation where actual output a Widely from budgeted output.	A fixed budget is not helpful for assessment of cost, fixation of selling price, where actual output vary widely from budgeted output.
(5)	A flexible budget is a very useful tool for controlling costs under dynamic situations.	A fixed budget is not effective as a tool of control when the actual activity differswidely from the budgeted activity.

10.19 MASTER BUDGET

The budget, the complete budget package in an organisation includes several items. We shall therefore refer to the total package as the master budget. The four principal parts of a masterbudget are:-

(1) An Operating budget, showing planned operations for the coming year, including revenues, expenditure and changes in inventory and other working capital items.

(2) A Cash budget showing the anticipated sources and uses of cash in that year.

(3) A Capital expenditure budget, showing planned changes in property, plant and equipment.

(4) The budgeted profit and loss A/c and balance sheet.

(1) The operating Budget:- The operating budget sets forth first-year slice of the long range plan in terms of the responsibility centers obligated for implementing the plan. The long range plan is structured in terms of programmes. The operating budget is in excellent control device because comparing it with actual performance can provide a basis for assessment. Each manager is responsible for preparing those parts of the operating budget that correspond to her or his sphere of responsibility. Responsibility budgets are broken down into cost element for example labour, materials, supplies, maintenance, supervision and utilities.

The foregoing description of budgets emphasized monetary information because such information is incorporated in an accounting system. At best, it measures profitability and althoughprofitability is a useful measure in a profit oriented company. The operating budget are developedand the time when each must be completed. Most components of the companys operating budget are affected by decisions or estimate made in constructing other components. In general, the time table covers the following steps:-

(1) Distribution of the approved budget.

(2) Final approval

(3) Coordination and review of the components

(4) Preparing the sales budget.

(5) Setting planning guidelines.

(6) Negotiation to agree on final plants for each component.

(7) Initial preparation of other budget components.

The budget preparation process is not the mechanism through which most major programme decisions are made. If the organization has a formal long - range plan this plan provides a starting point in preparing the budget.

(2) **Cash Budget:-** The cash budget is the first element of a master budget. It depicts the forecast of expected cash receipts and cash disbursement during a budget period. By preparing the cash budget the management can take steps in advance, to carry out the planned activities. The period of time covered by a cash budget depends upon the nature of the business and the cashposition of the organization. Generally, monthly cash budget is prepared if the cash position is good and consistent. When cash position is not good weekly cash budget or even a daily cash budget may be necessary. The cash budget is composed of four major sections.

(1) The Receipts section: In this section all anticipated cash receipts are shown. These may include,

(1) Cash sales
(2) Sale of investment, assets, etc.
(3) Cash collected from debtors.
(4) Dividends
(5) Interest on investment
(6) Royalties etc.

(2) The Disbursement section: In this section all anticipated cash payments are shown. Thesemay include,

(1) Cash purchases
(2) Cash paid to creditors
(3) Payment of wages, taxes, insurance etc.
(4) Purchase of assets, investments
(5) Repayment of loans
(6) Redemption of debentures etc.
(7) Payment of dividend etc.

(3) The cash Excess or Deficiency section: In this sections the difference between the receipts section and disbursement section is shown. The excess or deficiency is calculatedas follows:-

Opening cash balance	------
Add: Receipts	------
Total cash available before current financing	------
Less: Disbursement	------
Excess (deficiency) of cash available	_____
Over disbursement	------

(4) The Financing section: The investment and borrowings are shown in the financing section.

(3) A Capital Expenditure Budget: - Capital expenditure budget may be short term and long term budgets. In this budget the availability of capital fund is limiting factor. It is closely connected with production budget which will show how much machine capacity is needed and when. This budget shows estimated cost of each project and the timing of related expenditures. Proposals for capital investment projects may originate anywhere in the organization. In the capital expenditurebudget, individual projects are often classified by purpose, such as

1. Cost reduction and replacement
2. New products
3. Expansion and improvement of exciting product lines
4. Health, safety and/or pollution control.
5. Other.

As proposal for capital expenditures come up through the organization, they are screened at variouslevels. The sufficiently attractive ones flow up to the top and appear in the final capital expenditure budget. Approval of the capital budget usually means approval of the projects in principle but does not constitute final authority to proceed with them. Depending on their size and character, these authorization requests are approved at various levels in the organization. This also goes for buildings and other assets of fixed the nature. Of course much of the capital expenditure may be avoided by getting some work done by outsiders. It is desirable that capital expenditure budget must be coordinated with each budget because in the cash budget, provision for cash required forcapital expenditure has to be made. In the factory overhead budget also, there should be provision for repairs, maintenance, insurance, and depreciation on new capital asset.

(4) **The Budgeted Profit and Loss Account:-** The budgeted profit and loss account is a veryimportant document in the budget process. It will project the coming budget period's profit. It stands as a benchmark against which actual performance is compared.

The Budgeted Balance Sheet:

The budgeted balance sheet is the last element of master budget. A budgeted balance sheet is prepared after preparing not only the functional budgets but also cash budget and budgeted profitand loss account.

10.20 OTHER TYPES OF BUDGETS

(1) Sales Budget:- The sales budget shows the total sales proceeds. It must be supplemented by an estimate of selling and distribution costs which in turn will be spilt into two parts. Fixed and variable. Sales budget is often the starting budget since usually the limiting factor is sales. The sales budget is a forecast of the sales for the year.

(2) Production Budget:- Production Budget is drawn up after taking into account the expected opening stock, the estimated sales and desired closing stock of each article. Having determined the quantity to be produced, the requirements of raw materials for or each articles have to be laid down. In addition to budget for raw materials, labour and machine capacity, a budget for other expenses required to be e incurred will be necessary. Such expenses must be spilt into fixed and variable portions. The total of all these budgets will show the total amount to be spent on production.

(3) Direct material usage Budget: Direct Material Budget deals with direct material, indirect material and stores and are included in the works overhead budgets. Direct material budget shows quantities of material required in budgeted production.

(4) Direct Material Purchase Budget: This budget shows the quantity of raw material which should be available at a particular time and estimated cost of the material. The purchase department on the basis of material budget prepares purchase budget. Purchase manager has to formulate purchasing plants in accordance with as established inventory procedure and availableraw material on hand.

(5) Direct labour cost Budget: This budget contains an estimate of all direct labour cost required to produce the budgeted products shown in the production budget. Direct labour budget is also a part of production. Labour of different grades needed for a product or job or process is ascertained in terms of labour hour, machine hours and wage rate.

(6) Factory overhead or production overhead Budgets: Budget for factory overhead is based on level of activity to be attained. Factory overhead budget shows the forecast of all production overheads. Production overheads are divided between fixed factory overhead, variablefactory overhead and semi variable expense. Fixed overhead normally remain fixed but it may increase when there is necessity to increase capacity or size of the factory. Variable and semi variable expenses change with the level of activity.

(7) Plant utilization Budget: Plant utilization Budget is of much use because it shows machine load in every production department. Over loading or under loading is identified and corrective measures may be taken in time. Plant utilization budget represents the plant and machinery requirements to meet the production budget.

(8) Production cost Budget: Production cost budget is combination of three budgets Viz. Material Purchase Budget, Factory Overhead Budget and Labour Budget.

(9) Stock Budgets: Stock Budget is prepared in respect of work in progress, raw materials, finished goods and closing stocks. Closing stocks are shown in this budget in terms of quantity aswell as money. Finished stock is based on per unit cost of production.

(10) Administration Cost Budget: Administration cost budget shows estimated expenditure of administration, offices and Management remunerations during the budget period. There may be several departments or budget centers which are responsible for the preparation of its own budgets. These petty budgets are incorporated in the Administration cost Budget.

(11) Selling and Distribution Cost Budget: This budget is normally prepared by the sales manager and selling office manager, distribution manager and advertising or publicity manager. Advertising is now a days a costly item in the selling and distribution cost budgets. Selling and distribution cost budget is the forecast of all expenses incurred in selling and distribution function during the budget period. This budget is closely connected with sales budget because it is based on the volume of sales projected for the budget period.

(12) Cost of goods sold Budget: Cost of Goods Sold Budget is prepared to show budgeted cost of goods sold meant for sales. This budget is prepared by adjusting cost of production by opening or closing stock of finished goods. This budget may also be prepared product wise.

(13) Research & Development Budget: The R & D budget is normally a long term budget. The research and development project provide information regarding control of research and development cost. The budget is naturally drawn up taking into account the research project in hand and new projects to be taken up.

10.21 BUDGET REPORT

Budget reports are reports submitted by the budgetary controller or budget officer to various departments and functionaries setting out their budget for the period concerned and the actual performance together with reasons for any difference between the actual and budgeted performance. The essential features of a good budget report are as follows:

(1) It should be brief, if long; it should be sub summarized on one page and accompanied bysupporting schedules.
(2) The heading should convey the purpose of the report.
(3) It should be dated.
(4) It mast state who has prepared it and to whom it is being forwarded.
(5) It should be drawn up for each area of responsibility separately So that individual responsibility may be fixed.
(6) It should set out the standards and actuals in a way to afford ready comparison.
(7) Controllable and uncontrollable items should be separately stated.
(8) It should be as accurate as possible but a degree of in accuracy is permissible for promptness.
(9) The report must be prompt, that is it should be prepared and submitted soon after the periodconcerned it over.

Budget reports may be classified as information reports economic performance reports, or managerial performance reports. Reports are designed to highlight significant information, especially information relating to key success factors.

A report by itself does not more than identify the possible existence of a situation requiring management attention; variances are developed that do this. The next step is to investigate and the final step is to act.

❖ **Check Your Progress:**

Multiple Choice Questions:

(A) Select Correct option

1) Master budget is:
a) Expansion of all budgets
(b) Total of all budgets
(c) Summary of all budgets

Ans. c) Summary of all budgets

2) Budget is prepared-
   a) In advance for a specified period
   b) After a specific period
   c) Within a specific period

   Ans. a) In advance for a specified period

3) Budgetary control is a useful cost control.
   a) Short term budgets
   b) Long term budgets
   c) Middle term budgets Ans. a) Short term budgets

4) Production budget is governed by
   a) Sales budget
   b) Flexible budget
   c) Material budget Ans. a) Sales budget

5) When demand forecasting is difficult, budget is prepared:
   a) Production
   b) Sales
   c) Flexible Ans. c) Flexible

6) A principal budget factor is….
   a) The highest value item of cost
   b) A factor which limits the activities of an organization
   c) A factor common to all budget centres.

   Ans . b) A factor which limits the activities of an organization

7) Which of the following is the best description of zero based budgeting ?
   a) A method of budgeting which requires each cost item in the budget to be specifically justified.
   b) A method of budgeting which assumes a zero level of cost inflation from the previous year.
   c) A method of budgeting which requires under performing cost centres to accept a budgetallowance of zero.

   Ans . a) A method of budgeting which requires each cost item in the budget to be specifically justified.

8) A fixed budget is…
   a) A budget comprising variable production cost budget only.
   b) A budget which shows costs and revenues at different levels of activity.
   c) A budget for single level of activity

Ans . c) A budget for single level of activity

9) Of the four costs shown below, which would not be included in the cash budget of amanufacturing company?
a) Depreciation of fixed assets.
b) Repairs and maintenance expenses.
c) Staff salaries
Ans .a) Depreciation of fixed assets.

10) Master budget comprises:-
a) A Cash budget only
b) The capital expenditure budget
c) A Cash budget, a budgeted profit and loss account and budgeted balance sheet.
Ans . c) A Cash budget, a budgeted profit and loss account and budgeted balance sheet.

(B) Fill up the blanks

1) Budgetary control is a system of controlling______________
Ans. Costs
2) Master budget incorporates all__________budgets
Ans. Functional
3) A factor which influences all other budget is called__________factor.
Ans. Key
4) A Budget manual spells out_________of various executives concerned with budgets.
Ans. duties and responsibilities
5) Budget plan is based on_________
Ans. Estimates
6) Budget is a_________planning.
Ans. Financial
7) Production budget is governed by_________budget.
Ans. Sales
8) __________ Budget is useful where it is difficult to foresee the demand.
Ans. Flexible
9) Budget relating to ok factors should be prepared_________
Ans. First
10) Budget is a statement which is expressed in terms of______________

Ans. Money

(C) State whether the following statements are 'True' or 'False'.

1) Budget is based on plan estimates.Ans. True
2) Budget is automatic.Ans. False
3) Zero based budgeting was first used by Jimmy Carter.Ans. True
4) Flexible budgets does not change with the level of activity.Ans. False
5) Budgeting may be said to be an act of determining costing standards. Ans. False
6) Budget is a statement which is expressed in terms of money.Ans. True
7) The budget is an estimate prepared in advance for future specific period.Ans. True
8) Calendar ratio calculate the ratio between actual and standard costs. Ans. False
9) Budget is a financial planning.Ans. True
10) Efficiency ratio determines the capacity used by the factory.Ans. False

(D) Brief Answer Questions:

1. What do you understand by budget ?
2. Discuss the objects of budget.
3. Discuss the advantages of budgetary control.
4. What is production budget ?
5. Distinguish between fixed budget and flexible budget.
6. Explain the concept of zero based budgeting.
7. Define the term „budget" and ' budgetary control' list down any five objectives of budgetarycontrol system.
8. Give description of cash budget?
9. What is budget report?
10. What is capital expenditure budget?

(E) Long Answer Questions:

1) What are the three main parts of master budget?
2) Explain various types of budget.
3) Explain uses, advantages and limitations of budget.
4) Explain essential factor in preparation of budget.
5) Explain the requisites, advantages and limitations of budgetary control.
6) Explain preparation of Budget.
7) Explain classifications of budget.
8) Explain characteristics of budgetary control.

9) Explain cash budget.
10) Explain budget report.

યુનિવર્સિટી ગીત

સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ

શિક્ષણ, સંસ્કૃતિ, સદ્ભાવ, દિવ્યબોધનું ધામ
ડૉ. બાબાસાહેબ આંબેડકર ઓપન યુનિવર્સિટી નામ;
સૌને સૌની પાંખ મળે, ને સૌને સૌનું આભ,
દશે દિશામાં સ્મિત વહે હો દશે દિશે શુભ-લાભ.

અભણ રહી અજ્ઞાનના શાને, અંધકારને પીવો ?
કહે બુદ્ધ આંબેડકર કહે, તું થા તારો દીવો;
શારદીય અજવાળા પહોંચ્યાં ગુર્જર ગામે ગામ
ધ્રુવ તારકની જેમ ઝળહળે એકલવ્યની શાન.

સરસ્વતીના મયૂર તમારે ફળિયે આવી ગહેકે
અંધકારને હડસેલીને ઉજાસના ફૂલ મહેંકે;
બંધન નહીં કો સ્થાન સમયના જવું ન ઘરથી દૂર
ઘર આવી મા હરે શારદા દૈન્ય તિમિરના પૂર.

સંસ્કારોની સુગંધ મહેંકે, મન મંદિરને ધામે
સુખની ટપાલ પહોંચે સૌને પોતાને સરનામે;
સમાજ કેરે દરિયે હાંકી શિક્ષણ કેરું વહાણ,
આવો કરીયે આપણ સૌ
ભવ્ય રાષ્ટ્ર નિર્માણ...
દિવ્ય રાષ્ટ્ર નિર્માણ...
ભવ્ય રાષ્ટ્ર નિર્માણ

DR. BABASAHEB AMBEDKAR OPEN UNIVERSITY
(Established by Government of Gujarat)
'Jyotirmay' Parisar,
Sarkhej-Gandhinagar Highway, Chharodi, Ahmedabad-382 481
Website : www.baou.edu.in