ACCOUNTING FOR MANAGERS

PGDBA-103

BLOCK 1:
BASICS OF ACCOUNTING

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ACCOUNTING FOR MANAGERS

Knowledge Management and
Research Organization
Pune

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ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

ACCOUNTING FOR MANAGERS

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BLOCK 1: BASICS OF ACCOUNTING

Block Introduction

Accounting is defined as "the art of recording, classifying and summarising the financial transactions and interpreting the results to meet the objectives". Besides, it provides necessary business information to the interested parties.

In this block, students will get the detail knowledge about accounting and its principles. The ideas about design of Bookkeeping with related entries are explained along with diagrams and solved examples. The concept of debit and credit along with ledger is explained to the students. The concept of ledger formatting and posting is explained in such a way that a normal student will be able to perform entries in a book. The block will detail about Cash Book, Petty Cash Book and Sales Book.

After studying this block, students will be able to understand correctly about an accounting process and how it is normally done. The idea about various entries in Bookkeeping will help them in order to work for any concern. The basic understanding of entries in cash book, petty cash book and sales book will made the student to aware about real accounting procedure.

Block Objective

After learning this block, you will be able to understand:

- Concept of Accounting and its Features
- Bookkeeping
- Debit (Dr.) & Credit (Cr.)
- Journal and Entries
- Mechanism of Ledger Format and Posting
- Working Principle of Cash Book, Petty Cash Book, Sales Book
- Purchase Return Book

Block Structure

Unit 1: **Accounting: Meaning and Scope**

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UNIT 1: ACCOUNTING: MEANING AND SCOPE

Unit Structure

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1.3 Origin and Growth of Accounting

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1.0 Learning Objectives

After learning this unit, you will be able to understand:

- The importance of need, origin and functions of accounting.
- The information of users of accounting.
- The types of accounts and the golden rules of accounting.

1.1 Introduction

In today's challenging environment, finance and accounting have assumed prime importance. Accounting is not merely a calculating of a debit or credit or a narration of the profit and loss of an organization. It is much more than that. In any business undertaking correct analysis of the financial statements are crucial to successful decision making. This is only possible if the accounts are recorded properly, verified and maintained in up-to-date and accurate manner and the financial information is presented neatly, free from errors.

Fig 1.1 Accounting

The main objective of accounting is to ascertain profit or loss during a specific period and to determine financial position of a business enterprise on a particular date.

Accounting includes following activities:

- Recording of business transactions either in journal or subsidiary books
- Classifying business transactions by posting them to ledger accounts
- Closing the ledger accounts and preparation of summary of all ledger accounts called trail balance
- Preparation of final accounts viz. trading and profit and loss account and balance sheet

During the nineteenth century, the volume of transactions of all the business houses increased to great extent and it became clear that the Journal was

inadequate as the sole book of original entry. In order to save time, efforts and avoid inconvenience of classifying transactions for posting purposes, similar types of transactions are recorded in special journals called subsidiary books. This would facilitate not only the division of journal but it would also make easier the job of posting in the ledger as the posting are done in the form of totals being transactions of similar nature. Various subsidiary books are cash book, sales book, purchase book, sales returns book, purchases returns book, bills receivable book, bills payable book, journal proper, etc.

1.2 Need for Accounting

Accounting is often called the language of business. Language serves as means of communication. Similarly, accounting is one of the means of communicating information regarding the results of business operations to interested parties in the business viz., the proprietor, creditors, Government and other agencies. In order to provide correct information it is necessary for the business organization to record its transactions in clear and systematic manner.

A clear and systematic record will serve the twin purposes like:

- Ascertainment of transactions of business to determine profits or loss made during any accounting period
- Showcase of impact of business transactions on the net worth of the business unit i.e. financial position of the business in terms of assets and liabilities of business as a whole

Since resources are scarce, it is wiser to check regularly what has happened to our resources whether there has been any generation of income or squeezing or shrinking of resources. It is primarily important and is considered as an indispensable tool of measuring operating efficiency of any profit making or non-profit making entity.

Check your progress 1

1. Accounting can be called as:

a. language of business
b. language of communication
c. language of art
d. language of accounts

1.3 Origin and Growth of Accounting

Many people have the opinion that accounting has been developed in recent years. But from the puranas, we see that Chitragupta maintains accounts for qualities and vices. In olden days if we see the kingdoms, in each Kingdom there was financial minister who used to look after the financial matters like cash transactions, taxes payable by people to king, etc.

If we come to know about the chapter "The business of keeping of accounts in the Office of Accounts" from the book named "Arthashastra" written by Kautilya, Minister of king Chandragupta, it becomes clear that Accountancy was practiced in India Twenty-Three centuries back. However, the current structure of accounting based on the principles of double entry system owes its cause to Luco Pacioli, Franciscan Monk who first published the principles of double entry system in 1494 at Venice in Italy. The work was translated and published in English by H. O. Castle in 1543. In the 1553 James Pule published his work on ‘how to keep a perfect account of debtors and creditors.’

After various other publications the most important publication was that of Edward Jones (1795) who innovated the concept of two column journal. This was followed by many other innovations, which were introduced later from time to time.

The present system of accounting occupies a vital position in today's business. With the help of accounting, manager or owner can take countless important decisions and make right decisions at right time, which is key to success. Owners can know whether they have made profitable investment. The cost accountant can know how to control the cost of production. Government can get date for tax and license purpose. Therefore, accounts will provide information to every person regarding the particular concern.

Check your progress 2

1. The work of cost accountant is to:

   a. control the cost of communication.

   b. control the cost of production.

   c. control the cost of development.

   d. control the cost of purchasing.

1.4 Definitions of Accounting

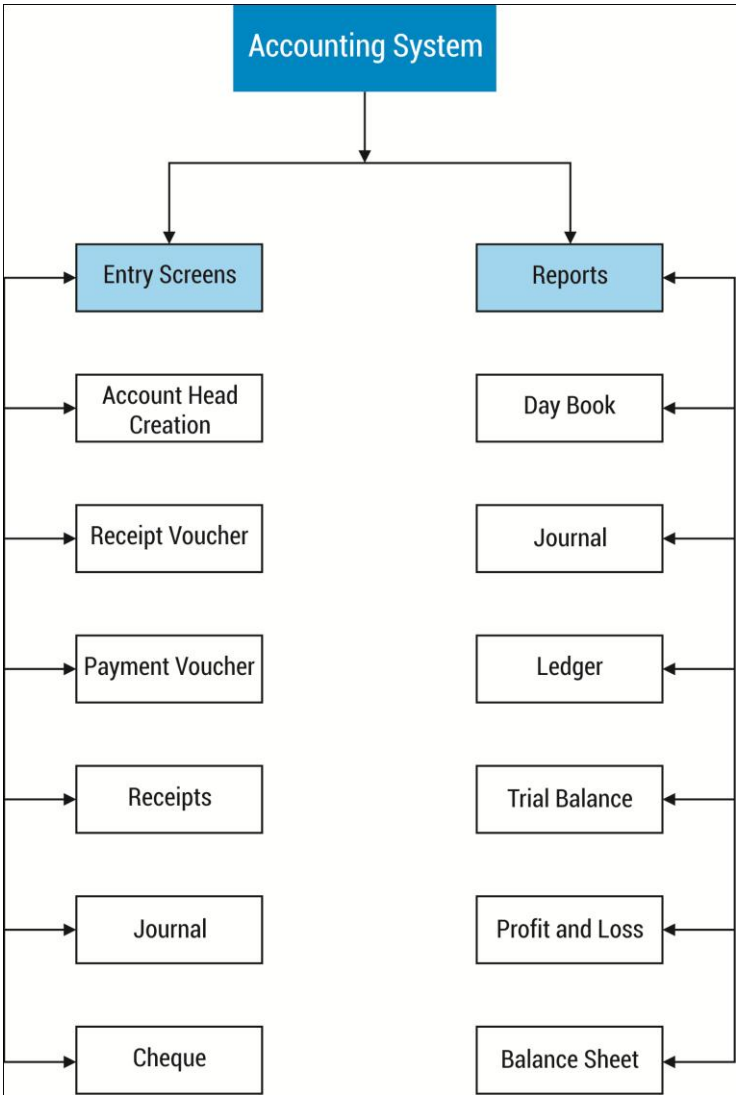

Fig 1.2 Accounting System

Over a period, the concept of accounting and the role of accountant have undergone a revolutionary change. There is no unanimity of opinions regarding precise definition of accounting. Different authorities have given different definitions. However, the central idea of all definitions has been the same almost except the fact that their emphasis has been shifting from one aspect to other.

During the year 1941, American Institute of Certified Public Accountant has explained accounting as an art or recording which will classify and detailed about significant manner which in terms of money, transactions and events that could be part having minimum financial character along with result calculations.

Further it was noted that American Accounting Association written and explains about Accounting as a generalised procedure of finding and calculating

with use of communication that relates to economic information which will allow informed judgments along with decisions as per user details.

Check your progress 3

1. Which is not the part of accounting system?

a. cheque
b. ledger
c. journal
d. pass book

1.5 Functions of Accounting

The Accounting Principles Board (APB) of AICPA during the year 1970 detailed about various applications and functions that appears in accounting which could be:

"Functioning of accounting is as per quantitative information which is mainly financial in nature. It deals with economic entities that are required to be of any use in taking and preparing economic decisions. Further, accounting manipulates as defined procedure in which recording, classifying, summarize, analyse and interpreting financial transactions as per communication which results to certain interested persons.

Functions of Accounting

- **Maintaining systematic records:** It is a primary function of accounting to keep proper record of transactions and events that take place in chronological order. These records provide a base analysis and decision-making. It consists of recording in the original/subsidiary books of entry, posting to ledger, preparation of trial balance and final accounts.
- **Meeting legal requirements:** Under the provision of law, a businessman has to file various statements e.g., income tax returns, returns for sales tax purpose, etc. Accounting system aims at fulfilling the requirements of law. Accounting is a base, with the help of which various returns, documents, statements, etc., are prepared.
- **Protecting and safeguarding business assets:** Records serve as evidence in case of any clash regarding ownership title of any property or assets of the business. Accounting helps to protect the property of business from unjustified and unwanted use. The accountant thus has to design such a

system of accounting, which protects its assets from an unjustified and unwanted use.

- **Facilitates rational decision-making:** Accounting helps in correct decision-making process. Managerial decisions are taken on the basis of facts and figures. An effective price policy, satisfied wage structure, inventory policy, advertisement and sales promotion policy, etc. are result of proper accounting structure. Accounting provides necessary data on which managerial decision-making process is based.
- **Communicating and reporting:** It is known that the best language of business as applied is accounting that are communicated on the basis of transactions. There are many parties such as owners, creditors, government and employees, etc., who are interested in knowing the results of the firm. Accounting communicates the results to interested parties. Accountant prepares report on the basis of accounting information to show financial position of firm to interested parties. Thus, accounting shows a true and fair financial position of firm.

Check your progress 4

1. Accounts helps to prepare:

   a. returns

   b. documents

   c. statements

   d. all

1.6 Users of Accounting Information

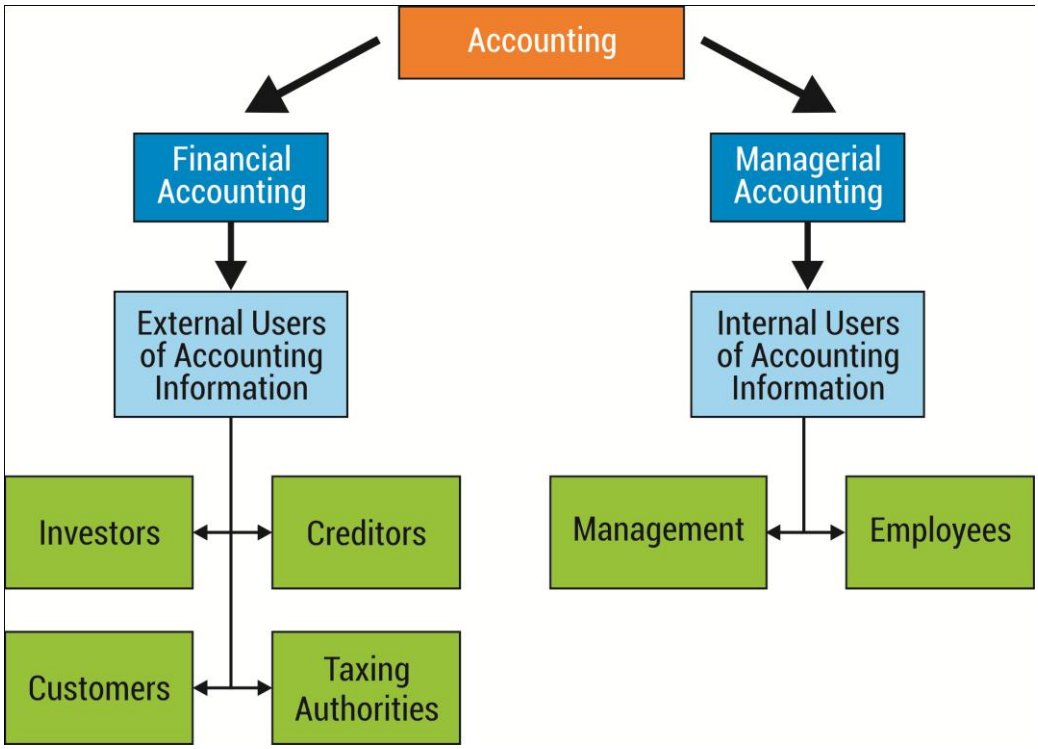

Fig 1.3 Internal and external users of Accounting Information

Accounting information is of prime importance to its interested parties to understand the financial position of firm and its future prospects. The interested parties or users of accounting can be divided into two main categories namely, External and Internal Users.

External Users

- **Creditors:** People who have extended credit to the company are termed as Creditors. These are ardent to know financial position of firm to determine whether the enterprise will be able to meet its obligations in time. The statement of accounts helps to determine a liquidity position on which creditors can rely upon and check their credit policy or supply decisions.

- **Investors:** An individual who puts his money in any business with aim of making more money. Any investor before making investments considers three important factors i.e. safety of his principle amount, Rate of return on his investment in the form of dividend/interest and Regular and consistent rate of return. Detailed study of the financial statements of firm enables investor in taking correct investment decision.

- **Government:** The Government is not interested in making money or investments. They are concerned with the accounting information of company for purpose of taxation, labour and corporate laws. Thus, they are interested in allocation of resources, taxation policies and statistical interests.
- **Bankers:** Banks and financial institutions who lend money to business want to know financial stability and healthiness of the company in terms of their ability to pay interest and principle amount. They want to know whether this company can turn into defaulters, if so banks would not want to lend to such company. Thus before lending money, bank wants to be sure of the financial soundness of the company through its financial statements.
- **Competitors:** Competitors of the company are interested in its financial background to improve its own strategies, policies and systems. Comparison of one company with another can provide valuable clues about the financial health of organization. It helps to benchmark their own financial results.
- **Others:** In addition to above other users of accounting information are Researchers, Consumers, Stock exchange, brokers, underwriters, economists, press and public in general. However, their interests and goals altogether being different in nature, yet require accounting information for serving their own interests.

Internal Users

- **Owners:** Owners include Shareholders, Partners and Proprietors of the firm. They are the backbone of the business in the sense that they provide necessary funds for its smooth running, growth and development. Company's profitability and financial security are, therefore of prime importance to these people who have vested interest in the business. Such information can be obtained through published accounts, annual report and other supplementary statements.
- **Management:** Accounting provides necessary information for managerial decision-making. The managerial tools, such as production budget, sales budget and cash budget, capital budget, etc. are the results of efficient accounting system. Various functions of management such as planning, organising, coordination, motivation and control can be implemented effectively through proper accounting system.
- **Employees:** Healthy industrial relations between employer and employee are key to growth and development of firm. Accounting information helps to

settle industrial disputes, prevent strike or likewise situation arising from demand for wage hike, bonus, higher compensation, etc. It helps employees to determine whether they are paid fair wages or not. Sometimes employees are given shares of the company in which they work. Thus accounting information becomes vital for them too.

Check your progress 5

1. Which is an external user of accounting information?

a. Employee c. Stock broker

b. Government d. Consumer

1.7 Bookkeeping

Fig 1.4 Role of Bookkeeping

The process of recording financial transactions in the books of accounts is called as bookkeeping. These transactions include sales, purchases, income and payments by an individual or organization. Bookkeeping should not be confused with accounting. Accounting is the process of recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

Book-Keeping is just recording of transactions. Bookkeeping is the base of accounting. The accountant analyses the books of accounts and prepares reports from the financial transactions recorded by the bookkeeper. There are two common bookkeeping systems used by Business organisations: single-entry bookkeeping system and the double-entry bookkeeping system. Single-entry bookkeeping uses only income and expense accounts, recorded primarily in a revenue and expense journal. Single-entry bookkeeping is adequate for many small businesses. Double-entry bookkeeping requires posting (recording) each transaction twice, using debits and credits.

Main Objectives of Bookkeeping

- To have a permanent record of each transaction of the business and to show its financial effect to the business.
- To ascertain the combined effect of all the transactions made during an accounting period upon the financial position of the business as a whole.

Check your progress 6

1. Bookkeeping involves:

   a. recording of balance

   b. recording of profits

   c. recording of transactions

   d. recording of loss

1.8 Accounting Mechanics: The Double Entry System

Accountancy continues the science of registering, categorizing as well as generalizing transactions. Commonly, a business enterprise has many activities every day in the course of an accounting duration. Unless the transactions are analysed as well as transcribed independently, it is not feasible to check the impact of each activity in the above two basic statements. The transactions may be recorded in various fashions. However, double entry system has been found to be the most suitable for this purpose.

Under this system, each and every transaction is split up into two aspects and both these aspects are recorded without any exception, whatsoever. Any change in the concern. Whenever there is any action, there must be opposite and

equal reaction. Thus, if furniture is purchased with cash, cash is depleted as against furniture, which increases. If, however, furniture is purchased on credit, furniture increases as against increase in liability. Each transaction is recorded in documents providing all the required information of the transaction.

The common documents that are generally used are as under:

- **Payment Voucher:** It is usually on a printed standard form, is a record of payment. When payment is made for an expense, generally a bill is prepared to record full particulars of the claim by the person or organisation receiving payment. From the bill, the accounting department prepares a voucher for each payment to be made.
- **Money Receipt:** It is a document, which is issued against cash / cheque receipts. It may also be on a printed standard form. This document shows that a certain sum of money was received from a person or organization with the purpose for which the money was received.
- **Journal Voucher:** It is used to record the residuary transactions. An internal transaction or a transaction not involving any cash payment or cash receipt is recorded in the journal voucher.

Check your progress 7

1. Which document is used for recording payments?

   a. journal voucher

   b. payment voucher

   c. money receipt

   d. none of this

1.9 Types of Accounts

According to Kohler, an account is the record of transactions of a person, firm, thing, an item of an expense or an item of an income. There are various types of accounts which are grouped as under:

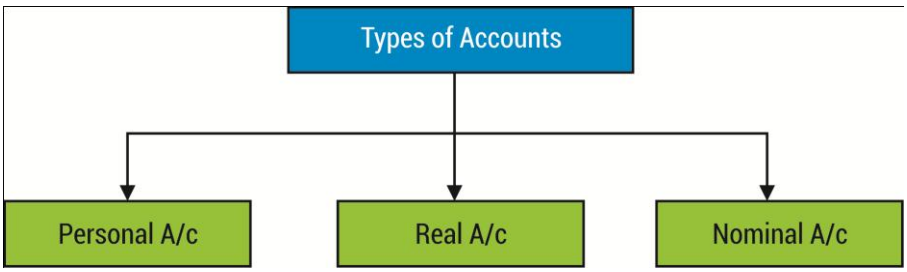

Fig 1.5 Types of Accounts

- **Personal Accounts:** Personal accounts include the accounts of persons with whom the business deals. These accounts show the transactions with the customers, suppliers, money lenders, Bank, etc. the main purpose of preparing personal accounts is to ascertain the balances due to or due from persons or organisation.
- **Real Accounts:** Accounts of each property or assets acquired by the firm named real accounts. Real accounts may be of the following types:
    - **Tangible Real Accounts:** These accounts relate to such things which can be touched, felt, measured, etc. for example, cash, land, building, plant, machinery, furniture, inventory, etc.
    - **Intangible Real Accounts:** These accounts represent such things, which cannot be touched. Of course, they can be measured in terms of money. For example, patents, goodwill, etc.
- **Nominal Accounts:** These are the accounts of incomes, expenses, gains and losses. The business has to incur certain expenses to earn certain income or to meet the requirements or certain business transaction. Example of this accounts are rent, wages or salary paid, telephone expenses, purchase, sale, etc.

When an item of nominal account becomes due or accrued it is treated as personal account i.e. rent is by nature nominal a/c but outstanding rent is personal a/c.

Illustration 1

Classify the following accounts:

Capital A/c, 2, drawings A/c, 3, goodwill A/c, 4. Bank A/c, 5, rent paid A/c, 6. Interest A/c, 7, building A/c, 8, stock A/c, 9, A & Co. A/c, 10, salaries A/c, 11, purchase A/c, 12, sales A/c, 13, outstanding Wages A/c, 14, prepaid Salary A/c.

Solution:

1.	Capital A/c	=	Personal A/c
2.	Drawings A/c	=	Personal A/c
3.	Goodwill A/c	=	Real A/c
4.	Bank A/c	=	Personal A/c
5.	Rent paid A/c	=	Nominal A/c
6.	Interest A/c	=	Nominal A/c
7.	Building A/c	=	Real A/c
8.	Stock A/c	=	Real A/c
9.	A & Co. A/c	=	Personal A/c
10.	Salaries A/c	=	Nominal A/c
11.	Purchase A/c	=	Nominal A/c
12.	Sales A/c	=	Nominal A/c
13.	Outstanding Wages A/c	=	Personal A/c
14.	Prepaid Salary A/c	=	Personal A/c

Check your progress 8

1. Personal accounts show the transactions with:

   a. customers

   b. suppliers

   c. money lenders

   d. all of above

1.10 Rules for Debit (Dr.) and Credit (Cr.)

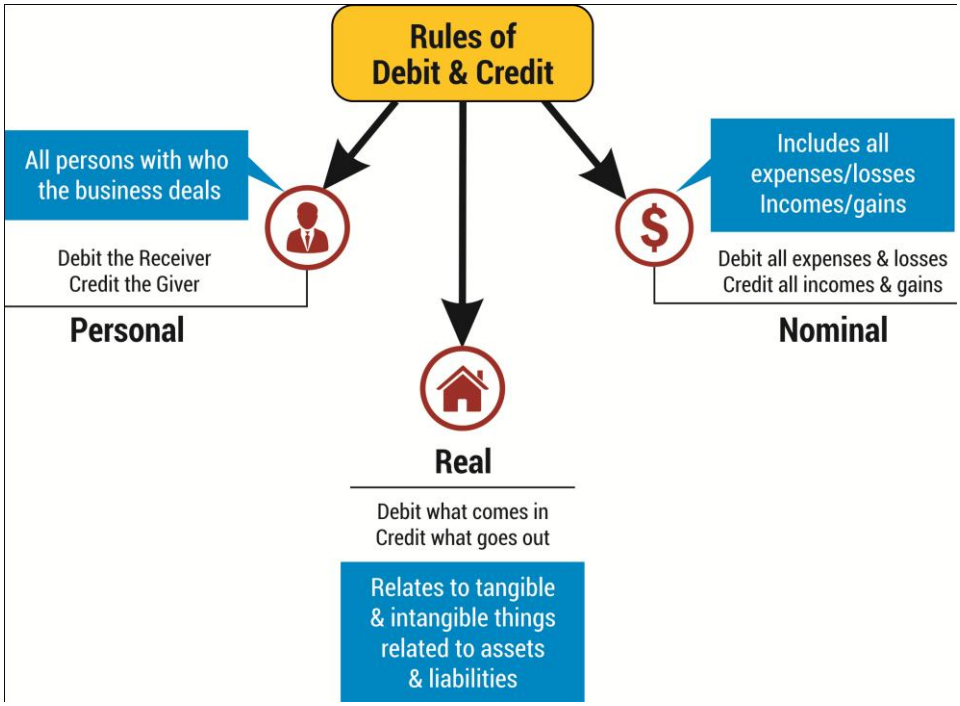

Fig 1.6 Rules of Debit and Credit

From the Double Entry principle, the working rules for debit and credit may be formed. The working rules are different for three types of accounts. It may be pointed out that in any transaction the accounts may fall in one group or in two groups and the rules to each account shall apply accordingly. Following are the rules:

- **Personal Account:** Debit the Receiver and Credit the Giver
- **Real Account:** Debit what comes in and Credit what goes out
- **Nominal Account:** Debit all expenses and losses and credit all incomes and gains

Illustration 2

From the following transaction, determine the Accounts to be debited and credited:

1. Machine purchased for cash.
2. Typewriter purchased for cash from Mahesh.
3. Cash paid to Deshmukh.
4. Cheque received from Dilip.

5. Rent paid by cheque.
6. Dividend received from ABC Ltd. by cheque.
7. Salary paid to Shri Anand Salunke in cash.

Solution:

1	Machine A/c	Dr.
	Cash A/c	Cr.
2	Typewriter A/c	Dr.
	Cash A/c	Cr.
3	Deshmukh A/c	Dr.
	Cash A/c	Cr.
4	Bank A/c	Dr.
	Dilip A/c	Cr.
5	Rent A/c	Dr.
	Bank A/c	Cr.
6	Bank A/c	Dr.
	Dividend A/c	Cr.
7	Salary A/c	Dr.
	Cash A/c	Cr.

Check your progress 9

1. What is correct?

   a. Debit is made to the Receiver in personal account.

   b. Credit is given to the Giver in real account.

   c. Debit goes out in normal account.

   d. Credit income and gain in normal account.

1.11 Basic of Accounting

There are three basic approaches to accounting for recognizing revenues and expenses while preparing Financial Statements. We need an approach, which can measure systematically the result of working operations and to know the financial position at a regular interval. There are three basis of accounting. They are:

- Cash basis
- Mercantile basis or accrual basis
- Hybrid basis or mixed basis

Cash Basis

Under cash basis of accounting, the revenues or expenses are recognised only when these are received or paid for in cash. Credit transactions do not find a place under cash basis of accounting. However, no distinction is made between the items of current year or last year or for next year. It totally ignores the accounting period. Another drawback of this basis is that it totally ignores the expenses incurred but not paid and also the income already generated but not received.

Mercantile Basis or Accrual Basis

This system strictly follows accounting period concept, revenue recognition and matching concept or realization concept. It takes into account the revenue for the whole accounting period (say 12 months) whether received or not. Likewise all expenses associated with the generation of revenue are matched against the revenue earned during the same accounting period. This accounting system takes into account all the financial transactions made during an accounting period, thus discloses correct amount of profits or losses, and exhibits true financial position of the business.

Hybrid Basis or Mixed Basis

Under this system of accounting revenues and assets are recorded on cash basis whereas expenses and liabilities are recorded on accrual basis. This is the most conservative system of ascertaining income because income received in cash only is recognised whereas all possible expenses pertain to the period whether paid or not are taken into account. Thus, it has the basic characteristics of both the methods.

Check your progress 10

1. In which accounting system, revenues and assets are recorded on cash basis and expenses and liabilities are recorded on accrual basis.

   a. Cash basis c. Hybrid basis

   b. Mercantile basis d. All

1.12 Let Us Sum Up

In this unit we have studied that accounting is not merely a calculating of a debit or credit or narration of the profit and loss of an organization. It is seen that accounting is a procedure of recording, classifying, summarize, analyse and interpreting financial transactions as per communication which results to certain interested persons.

The process of recording financial transactions in the books of accounts is called as Bookkeeping. Such transactions will include sales, purchases, income and payments by an individual or organization.

It is studied that in any transaction, accounts may fall in several groups with certain rules like Personal Account where Debit the Receiver and Credit the Giver, Real Account where Debit comes in and Credit goes out and Nominal Account where Debit all expenses and losses and credit all incomes and gains.

1.13 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-b)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-d)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-c)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-a)

Check your progress 10

Answers: (1-c)

1.14 Glossary

1. **Accounting -** The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.
2. **Accounts -** Receivable in account in the nominal ledger which contains the overall balance of the sales ledger.
3. **Assets -** Represent what a business owns or is due; equipment, vehicles, buildings, creditors, money in the bank, cash are all examples of the assets of a business.
4. **Book Value -** It is an accounting term, which usually refers to a business historical cost of assets less liabilities.

5. **Balance Sheet -** A summary of all the accounts of a business, usually prepared at the end of each financial year.

1.15 Assignment

Discuss the difference between Bookkeeping and accountancy.

1.16 Activities

State which item is part of what type of account?

a. Copyrights account

b. Non-profit organisation account

c. Fixed assets account

d. Goodwill account

e. Salaries account

f. Commission account

g. Prepaid rent account

h. Municipal Corporation account

i. My. Mike's account

j. Bank account

1.17 Case Study

Determine the rules of debit and credit for following transaction and given reasons why.

a. Started business with Rs. 2, 00,000 in the Bank and Rs. 50,000 cash

b. XYZ Co. company borrows Rs.50, 000 from the bank

c. J. Smith, a sole proprietor, withdraws Rs.3000 from the business for personal use

d. Trends Ltd. pays Rs.600 for the current month's rent

e. Bought stationery, paid in cash Rs. 1500

f. Cash purchases Rs. 15,000

g. Received from Rao & Co Rs. 25,000 by cheque

h. Paid salary to assistant in cash Rs. 10,000

i. Bought goods for resale on credit from John & co. Rs. 30,000

j. Cash sales Rs. 25,000.

k. Paid insurance by cheque Rs. 500.

1.18 Further Readings

1. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.

2. Accounting for Managers, Jawaharlal.

3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.

4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

UNIT 2: INTRODUCTION TO JOURNAL AND LEDGER

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 The Journal

2.3 Advantages of using Journal

2.4 Types of Entries

2.5 Ruling of a Journal

2.6 The Ledger

2.7 Sub-Division of Ledger

2.8 Ledger Format

2.9 Ledger Posting

2.10 Balancing Ledger Accounts

2.11 Difference between Journal and Ledger

2.12 Let Us Sum Up

2.13 Answers for Check Your Progress

2.14 Glossary

2.15 Assignment

2.16 Activities

2.17 Case Study

2.18 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Study about Ledger.
- Concept of Journal.
- Explain various kinds of ledger.

- Study about format of ledger.

2.1 Introduction

Journal is a book which is not balanced and helps in testing the accuracy of books. In this, the Debit and credit amounts of a transaction are recorded in adjacent columns. With the computerization of accounting journal may not be used for routine transactions like receipts, purchases, sales, etc.

Ledger is also a type of book in which the accuracy is tested by means of list of balances. Here the Debit and credit amounts of a transaction are recorded in two different sides of two different accounts. It is found that every account in the ledger is balanced periodically. Ledger cannot be avoided. However, it may be loose leaf ledger or a computerised ledger. But ledger is a must.

2.2 The Journal

General Journal				page 14
Date	**Description**	**Folio**	**Debit**	**Credit**
Jan. 10	Machinery	GL 12	15,000	
	James	PL 9		15,000
	Bought machinery on credit from James			
Jan. 14	Bad debts	GL 4	500	
	Andrew	SL 6		500
	Andrew cannot pay his debt			
Jan. 15	Electricity	GL 5	400	
	Electricity payable	GL 10		400
	Electricity expense for the month of Jan. charged in the accounts			

Fig 2.1 Format of Journal

The books of accounts in which, the business transactions are recorded first is called as a journal. It is also, double entry called books of prime or original entry. The process of recording transaction in journal is called Journalising.

Check your progress 1

1. Which is not a part of journal?

   a. Date

   b. Debit

   c. Credit

   d. Serial Number

2.3 Advantages of using Journal

Transactions can be recorded directly to the ledger accounts. But still journal is used for the following reasons:

- It shows all necessary information regarding a transaction.
- It provides an explanation of the transaction.
- It provides a date wise record of all the transactions.
- It helps to locate and prevent errors.

Check your progress 2

1. The benefit of a journal is:

   a. show necessary information in a transaction.

   b. provides explanation of transaction.

   c. provides date wise record of transactions.

   d. all of these.

2.4 Types of Entries

There are two types of entries, which are recorded in the Journal:

1. Simple Entry
2. Compound Entry

A simple entry involves two accounts only, one affecting the debit side and other affecting the credit side with an equal amount.

Sometimes a journal entry may have more than one debit or more than one credit entry. This type of journal entry is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.

Illustration 3

Example of Simple Entry	**Example of Compound Entry**
1. Started business and introduced Rs. Rs. 20,000 as capital Cash A/c Dr. 20,000 To Capital A/c 20,000	1. Started business and introduced 10,000 as capital and stock worth Rs. 10,000 Cash A/c Dr. 10,000 Stock A/c Dr. 10,000 To Capital A/c 20,000
2. Purchased Machinery from Kulkarni Kulkarni & Co. for Rs.14, 000 for cash Machinery A/c Dr. 14,000 To Cash A/c 14,000	2. Purchased Machinery from & Co. for Rs.25,000 and paid Rs.10,000 Machinery A/c Dr. 25,000 To Cash A/c 10,000 To Kulkarni & Co. 15,000

Check your progress 3

1. The compound journal entry involves:

   a. one accounts on debit side

   b. one account on credit side

   c. more than one debit entry

   d. all of these

2.5 Ruling of a Journal

A journal is generally kept on a columnar basis. There are five columns in the journal, which are as under:

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

1. **Date:** Recording date and year of transaction.
2. **Particulars:** Recording the titles, description of transaction and passing entries; It is seen that the name of account which is to be debited here is marked with 'Dr' on the first line and name of account to be credited is written along with a prefix 'To' on the second line. Finally, a short explanation of the transaction known as narration begins on the line immediately below the account credited. The narration always appears within parentheses and is begun with the word "Being", which means "what it is".
3. **L.F:** Recording ledger folio number, which helps in identifying where the transaction is recorded in ledger.
4. **Debit Amount:** Recoding amount debited.
5. **Credit Amount:** Recording amount credited.

1st column shows the date of the transaction.

2nd column named particulars is the column for account titles and description. The name of Account marked with 'Dr' is debited on first line and name of the Account to be credited is written along with a prefix 'To' on the second line. Finally a short explanation of the transaction known as narration

begins on the line immediately below the account credited. The narration always appears within parentheses and is begun with the word "Being" – which means what it is.

3rd column 'L.F.' stands for Ledger Folio, which shows the page number on which the various accounts appear in the ledger.

4th column 'Amount (Dr.) It highlights amount that is to be adjusted to debit account that involves transaction.

5th column 'Amount (Cr.)' It represents amount that is to be adjusted to credit account which involves transaction.

Illustration 4

Record journal entries in the books of J. Smith & Co. from the following transaction:

Transactions during January 2006

1 Started business with a capital of Rs.50, 000 and Building valued Rs.5,00,000 and stock of Rs. 50,000

6 Paid into bank Rs. 30,000

8 Cash Sales of Rs. 10,000

10 Purchased goods of Rs.4, 000

17 Goods sold to Ramakant of Rs.2, 800 and cash received of Rs.2,750/-

25 Paid telephone Bill of Rs.300

26 Paid wages to workers Rs.5000

28 Withdrawn from Bank for personal use Rs.5000

31 Purchased computer & paid by cheque Rs.22, 000

Solution

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2006 Jan. 1	Cash A/c Dr.		50,000	
	Building A/c Dr.		5, 00,000	
	Stock A/c Dr.		50,000	
	To Capital A/c			6,00,000
	(Being business started with cash, building and stock)			
2006 Jan. 6	Bank A/c Dr.		30,000	
	To Cash A/c			
	(Being the cash paid to bank)			30,000
8	Cash A/c Dr.		10,000	
	To Sales A/c			10,000
	(Being goods sold for cash)			
10	Purchase A/c Dr.		4,000	
	To Cash A/c			4,000
	(Being goods purchased for cash)			
17	Cash A/c Dr.		2,750	
	Discount Allowed A/c Dr.			50
	To Sales A/c			2,800
	(Being the goods sold and allowed discount)			

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2006 Jan.25	Telephone Expenses A/c Dr.		300	
	To Cash A/c			300
	(Being the telephone bill paid)			
26	Wages A/c Dr.		5,000	
	To Cash A/c			5,000
	(Being the wages paid to the workers)			
28	Drawings A/c Dr.		5,000	
	To Bank A/c			5,000
	(Being the amount withdrawn for personal use)			
31	Computer A/c Dr.		22,000	
	To Bank A/c			22,000
	(Being the computer purchased)			

Check your progress 4

1. Journal contains:

a. four column

b. five column

c. two column

d. eight columns

2.6 The Ledger

Ledger is the book of analytical record, which classifies the business transactions. A ledger is an account of an asset, expense, income, or a person showing a summary of all transactions taken place during a specific period. Ledger may be regarded as Book of secondary entries. Actually, the entries in all primary books affecting the same accounts are classified and grouped up under different accounts heads in the ledger. Each account maintained in the ledger book is closed by balancing which shows the difference between the totals of debit side and credit side.

Check your progress 5

1. Ledger shows the _____account of transactions.

a. asset c. address

b. information d. none of above

2.7 Sub-Division of Ledger

When the size of organization is very large and number of accounts is abundant, it is necessary to maintain a separate ledger for different accounts.

The following three kinds of ledger are maintained by organisations:

- Debtors' Ledger
- Creditors' Ledger
- General Ledger

Debtors' Ledger

Debtors are the customers of the business to whom goods are sold on credit. Debtor's ledger contains all the details of transactions with debtors. Entries in this ledger are made mostly from sales day books, sales returns book and cash book. Therefore, it is also called as Sales ledger.

Creditors' Ledger

Creditors are suppliers of the material to business from whom goods are purchased on credit. Purchase day book, purchase return book are one of the main source of entries for this ledger. Therefore, it is also known as Purchase Ledger.

General Ledger

It may contain all residual accounts – mainly real and nominal accounts. This ledger is also called nominal ledger.

Check your progress 6

1. Creditor Ledger is also called as:

a. nominal ledger c. sales ledger

b. purchase ledger d. none of above

2.8 Ledger Format

Ledger accounts are represented in "T" format. This consists of two sides, the left side represents the debit side and the right side represents credit side. Each side divided into four columns of varying sizes for the following:

- **Date:** Used for date of transaction
- **Particulars:** Recording the name of the accounts debited or credited
- **Journal Folio (J.F):** Used to mark the page number of the journal for which the transaction is being recorded.
- **Amount:** Recording the amount debited or credited

It may be kept in

(i) Bound ledger or

(ii) Loose leaf form

Ledger Format

Dr. **Cr.**

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount

Check your progress 7

1. Which column highlights page number in the journal?

a. Particulars c. Amount

b. J.F. d. None of above

2.9 Ledger Posting

The process of transferring of the debits and credits from the journal to the ledger accounts is called posting. It should be noted that the exact names of accounts used in the Journal should be carried to the Ledger. Posting may be done at any time. However, it should be completed before the financial statements are prepared. It is advisable to keep the more active accounts posted to date.

As we know under double entry system each transaction is transferred in two different ledger accounts, affecting the debit side of one and credit side of the other one. The following procedures are followed for posting:

1. Open separate ledger account for posting transactions relating to different accounts.
2. Consider each transaction separately for posting purposes.
3. Locate the transaction in Journals, to be posted in the Ledger.
4. Locate in the ledger the 1st account named in the Journal
5. Now put date of transaction in date column as per dates of Journal entry.
6. Here, in the Ledger books debit side, mark the name of account credited in journal entry with prefix “To”.
7. In case of Folio column of ledger book, put journal page no. of posting is being done.
8. Find in Ledger 2nd account named in Journal.
9. Repeat the step 5.
10. Enter in the credit side of the ledger in particular column, the name of the account debited with a prefix “By”.
11. Repeat the step 7.

Illustration 5

From the following Journal Entries, post the transactions in ledger.

Journal entries

In the books of P. Bask

Date	Particulars	L.F.	Rs.	Rs.
1991 Jan 1				
1	Bank A/c Dr.		2,00,000	
	Cash A/c Dr.		40,000	
	To Capital A/c			2,40,000
	(Capital invested)			
2	Furniture & Fittings A/c Dr .		40,000	
	Van A/c Dr.			60,000
	To Bank A/c			1,00,000
	(Purchase for fittings and van for business)			
3	Rent A/c Dr.		5,000	
	To Bank A/c			5,000
	(Paid by cheque)			
5	Purchase A/c Dr.		50,000	
	To Zakir & Co. A/c			50,000
	(Purchased on credit)			
8	Cash A/c Dr.		5,000	
	To Sales A/c			5,000
	(Sold for cash)			
10	Wages A/c Dr.		1,000	
	To Sales A/c			1,000

	(Paid to assistant)		
12	Insurance A/c Dr.	500	
	To Bank A/c		500
	(Paid by cheque)		
15	Cash A/c Dr.	8,000	
	To Sales A/c		8,000
	(Being goods sold for cash)		
15	Wages A/c Dr.	1,000	
	To Cash A/c		1,000
	(Being wages paid in cash)		
17	Zakir & Co A/c Dr.	6,000	
	To Returns Outwards A/c		6,000
	(Being goods returned to Zakir & Co)		
19	Zakir & Co A/c Dr.	30,000	
	To Bank A/c		30,000
	(Being paid by cheque)		
19	Purchase A/c Dr.	25,000	
	To Rao & Co A/c		25,000
	(Being goods purchased on credit)		
22	Cash A/c Dr.	7,000	
	To Sales A/c		7,000
	(Being goods sold for cash)		
24	Wages A/c Dr.	1,000	
	To Cash A/c		1,000
	(Being wages paid to assistant)		
25	Stationery A/c Dr.	500	
	To Cash A/c		500
	(Being purchase of stationery)		

27	Cash A/c Dr.	15,000	
	To Sales A/c		15,000
	(Being goods sold for cash)		
29	Rao & Co A/c Dr.	14,000	
	To Bank A/c		14,000
	(Being paid by cheque)		
31	Wages A/c Dr	1,000	
	To Cash A/c		1,000
	(Being wages to assistant paid in cash)		
	Bank A/c Dr.	20,000	
	To Cash A/c		20,000
	(Being Cash paid into Bank)		
	Grand Total	**5,30,000**	**5,30,000**

Solution:

Ledger Entries

Dr. Bank Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
1.1.91	To Capital A/c		2, 00,000	1.1.91	By Furniture & Fittings A/c		40,000
31.1.91	To Cash A/c		20,000		By Van A/c		60,000
				2.1.91	By Insurance A/c		5,000
				10.1.91	By Insurance A/c		500
				17.1.91	By Zakir & Co A/c		30,000
				27.1.91	By Rao & Co A/c		14,000
				31.1.91	By Balance c/d		70,500
			2, 20,000				2,20,000
1.2.91	To Balance b/d		70,500				

Dr. Bank Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
1.1.91	To Capital A/c		40,000	5.1.91	By Wages A/c		1,000
5.1.91	To Sales A/c		5,000	15.1.91	By Wages A/c		1,000
12.1.91	To Sales A/c		8,000	22.1.91	By Cash A/c		1,000
19.1.91	To Sales A/c		7,000	24.1.91	By Stationery A/c		500
25.1.91	To Sales A/c		15,000	29.1.91	By Wages A/c		1,000
				31.1. 91	By Bank A/c		20,000
				31.1.91	By Balance c/d		50,500
			75,000				75,000
1.2.91	To Balance b/d		50,000				

Dr. Capital Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J. F.	Rs.
31.1.91	To Balance c/d		2, 40,000	1.1.91	By Bank A/c		2,00,000
				1.1.91	By Cash A/c		40,000
			2, 40,000				2,40,000
				1.2.91	By Balance b/d		2, 40,000

Dr. Furniture & Fitting Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
1.1.91	To Bank A/c		40,000	31.1.91	By Balance c/d		40,000
1.2.91	To Balance b/d		40,000				

Dr. Van Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
1.1.91	To Bank A/c		60,000	31.1.91	By Balance c/d		60,000
1.2.9	To Balance b/d		60,000				

Dr. Rent Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
2.1.91	To Bank A/c		5,000	31.1.91	By Balance c/d		5,000
1.2.91	To Balance b/d		5,000				

Dr. Zakair & Co. Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
15.1.91	To Returns			31.1.91	By Purchase A/c		50,000
	outwordsA/c		6,000				
17.1.91	To Bank A/c		30,000				
31.1.91	To Balance c/d		14,000				
			50,000				50,000
				1.2.91	By Balance		14,000

Dr. Sales Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
31.1.91	To Balance c/d		35,000	5.1.91	By Cash A/c		5,000
				12.1.91	By Cash A/c		8,000
				19.1.91	By Cash A/c		7,000
				25.1.91	By Cash A/c		15,000
			35,000				35,000
				1.2.91	By Balance b/d		35,000

Dr. Sales Account Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
31.1..91	To Balance c/d		35,000	5.1.91	By Cash A/c		5,000
				12.1.91	By Cash A/c		8,000
				19.1.91	By Cash A/c		7,000
				25.1.91	By Cash A/c		15,000
			35,000				35,000
				1.2.91	By Balance A/c		35,000

Dr. Wages Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
8.1.91	To Cash A/c		1,000	31.1.91	By Balance b/d		4,000
15.1.91	To Cash A/c		1,000				
22.1.91	To Cash A/c		1,000				
29.1.91	To Cash A/c		1,000				
			4,000				4,000
1.2.91	To Balance b/d		4,000				

Dr. Insurance Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
10.1.91	To Bank A/c		500	31.1.91	By Balance b/d		500
1.2.91	To Balance b/d		500				

Dr. Insurance Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
31.1.91	To Balance b/d		6,000	31.1.91	By Zakir & Co A/c		6,000
				1.2.91	By Balance b/d		6,000

Dr. Rao & Co. Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
27.1.91	To Bank A/c		14,000	19.1.91	By Purchase A/c		25,000
31.1.91	To Balance c/d		11,000				
			25,000				25,000
				1.2.91	By Balance b/d		11,000

Dr. Insurance Account Cr.

Date	Particulars	J. F.	Rs.	Date	Particulars	J.F.	Rs.
24.1.91	To Cash A/c		500	19.1.91	By Balance c/d		500
1.2.91	To Balance b/d		500				

Check your progress 8

1. Posting involves:

   a. keeping data in debit part

   b. keeping data in credit part

   c. moving of data from debit to credit

   d. transfer of debit and credit from journal to ledger

2.10 Balancing Ledger Accounts

All the accounts in a ledger are balanced periodically to ascertain the cumulative effect of entries on the accounts. By balance we mean the difference among two sides in an account. If the total of debit side is more than the total of credit side, then we can say that the account is said to have debit balance. Whereas, when the total of the credit side exceeds the total of the debit side, the account is said to have a credit balance.

The following steps should be taken for the purpose of balancing or closing of ledger accounts:

1. On a rough paper, total both the debit amount column and credit amount column separately.
2. Find out the difference between the two sides if there is no difference; close the account by showing the totals of both the sides which are equal.
3. If the debit side total is more, put the difference on the credit side amount column, by writing the words in particulars column "By Balance c/d" to make the totals of both sides equal. Conversely, if there is an excess of credit side total, the same must be put to debit side as "To Balance c/d".
4. Carry forward the balance c/d to the opposite side of the Account as "To Balance b/d" or "To Balance b/d" as applicable, in the beginning of the accounting year.

Check your progress 9

1. Carry forward of balance c/d to "To Balance b/d" or "To Balance b/d" is done at the _____of accounting year.

a. end

b. start

c. middle

d. all

2.11 Difference between Journal and Ledger

Following table shows the difference between Journal and Ledger:

Journal	Ledger
1. Is the book of prime entry	1. Is the book of final entry
2. As soon as transaction originates it is recorded in journal	2. Transactions that have been recorded in the journal are posted in ledger.
3. Transactions are recorded in order of occurrence i.e. strictly in order of dates.	3. Transactions are classified according to the nature and are grouped in the concerned accounts.
4. Narration (brief description) is written for each entry.	4. Narration is not required.
5. Ledger folio is written	5. Folio of the journal or sub-journal is written.
6. Relevant information cannot be ascertained readily e.g., cash in hand can't be found out easily.	6. Since transactions of particular nature are grouped at one place therefore relevant information can be ascertained.
7. Final accounts cannot be prepared directly from journal.	7. Ledger is the basis of preparing final accounts.

Check your progress 10

1. Which is incorrect in case of ledger?

   a. It is a book of prime entry.

   b. In this, the transactions recorded in journal are posted in ledger.

   c. In this the transactions are classified as per nature.

   d. In this, narration is not required.

2.12 Let Us Sum Up

In this unit we have learnt that Journal is a book that is not balanced where debit and credit transaction are recorded in adjacent columns. It is found that with computerization of accounting journal may not be used for routine transactions like receipts, purchases, sales, etc. Ledger is book where accuracy is tested through list of balances where debit and credit transaction are recorded in two different sides of two different accounts.

It is seen that every account in ledger is balanced periodically that cannot be avoided. There exist two types of entries that are recorded in Journal that are Simple Entry and Compound Entry. It is analysed that ledger contains secondary book entries where primary books affects same accounts that are classified and grouped under different accounts heads.

It is found that ledger comprises of three types: Debtors' Ledger, Creditors' Ledger and General Ledger that are maintained by the organisations. The process of transferring of the debits and credits from the journal to the ledger accounts is called posting. It should be noted that the exact names of accounts used in the Journal should be carried to the Ledger.

2.13 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-b)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-b)

Check your progress 10

Answers: (1-a)

2.14 Glossary

1. **Journal -** It is an accounting book where debit and credit transaction are recorded in adjacent columns.
2. **Ledger -** It is an accounting book where debit and credit transaction are recorded in two different sides of two different accounts.
3. **Posting -** It is an accounting principle that is involved in transferring of debits and credits from journal to ledger accounts

2.15 Assignment

Discuss the following:

a. Creditor's ledger

b. Debtor's Ledger

c. General Ledger

2.16 Activities

Discuss the various forms of ledger.

2.17 Case Study

Can a ledger works as journal? Comment.

2.18 Further Readings

1. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
2. Accounting for Managers, Jawaharlal.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

UNIT 3: INTRODUCTION TO SUBSIDIARY BOOKS, CASH BOOK, PETTY CASH BOOK, SALES BOOK

Unit Structure

3.0 Learning Objectives

3.1 Introduction

3.2 Purchase Book

3.3 Sales Return Book

3.4 Purchase Return Book

3.5 Bills Receivable Book

3.6 Bills Payable Book

3.7 Journal Proper

3.8 Let Us Sum Up

3.9 Answers for Check Your Progress

3.10 Glossary

3.11 Assignment

3.12 Activities

3.13 Case Study

3.14 Further Readings

3.0 Learning Objectives

After learning this unit, you will be able to understand:

- Purchase Book
- Sales return book
- Bill payable book
- Journal proper

3.1 Introduction

Cash books are the subsidiary books. All these subsidiary books are called books of original entry, as transactions in their original form are entered therein. It records all the cash receipts and payments. When there is no credit transactions, also in that case such type of transactions are recorded in cash book.

In case of single column cash book, it is seen that the transactions which involves cash receipts and payments are only recorded. In this, only single money column on every side of debit and credit is available in cash book. Here every cash receipts are entered in debit side while the cash payments are received on credit side as shown.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount

In case of double column cash book, there exist two separate columns on debit as well as on credit side which will record cash and discount. In many concerns, it is customary for the trader to allow or to receive small allowance off or against the dues.

Date	Particulars	V.N.	L.F.	Discount	Cash	Date	Particulars	V.N.	L.F.	Discount	Cash

A three column cash book is one in which there are three columns on each side - debit and credit side. One is used to record cash transactions, the second is used to record bank transactions and third is used to record discount received and paid.

Debit Side | Credit Side

Date	Particulars	V. N.	L. F.	Discount	Cash	Bank	Date	Particulars	V.N.	L.F.	Discount	Cash	Bank

3.2 Purchase Book

All transaction related to credit purchases of goods are primarily recorded in this book. It is also known as 'Purchase Day Book', 'Bought Day Book' and 'Purchase Journal'. On receiving the goods and the invoice, the receiving department compare both with the copy of the order placed by purchase department. If everything is found in order, the goods are sent to the stores. On the basis of the invoice received from the supplier, necessary entry is passed in the Purchase Book.

Specimen of Purchase Book

Date	Invoice No.	Particulars	L Folio	Details	Amount (Rs.)	Remarks

Illustration 6

(Only purchase book no ledger entry)

Enter the following transactions in Purchases Book and post them into Ledger Accounts 2001

Jan.1 Purchased on credit from Ambani & Co. 100 shirts @ 125 each less 5 % trade discount.

3 Purchased from Behri Brothers 60 shirts @ Rs. 200 each, trade discount allowed by them 10 %

10 Purchased a type writer from Big Brothers for Rs. 5,000

12 Purchased 300 shirts @ Rs. 175 each from Rehman & Co

15 Purchased 150 Shirts @ Rs. 150 each less 20 % trade discount

20 Purchased a Computer's Printer for Rs. 2,500

22 Purchased 50 shirts @ Rs. 350 each less 10 % trade discount

31 Bought 100 shirts @ Rs.220 each less 15 % trade discount

Solution: M/s Ambani & Co. A/c

Dr. **Cr.**

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2001	M/s Behri Brothers A/c		1,875	Jan. 1	By Purchases A/c		1,875

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2001	M/s Rehman & Co. A/c		1,875	Jan. 3	By Purchases A/c		10,800

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2001	Purchases A/c A/c		1,875	Jan. 12	By Purchases A/c		52,500

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
Jan.15	To Cash A/c		18,000				
22	To Cash A/c		15,750				
31	To Cash A/c		18,700				
31	To Sundries A/c		75,175				
			1,27,625				

Purchases Book

Date	**Invoice**	**Particulars**	**Folio**	**Details**	**Amount**	**Remark**
2001						
Jan.1		M/s Ambani & Co.				
		100 Shirts @ Rs. 125			12,500	
		each less 5 % trade discount		625	11,875	1 week credit
3		M/s Behri Borthers				
		60 shirts @ Rs. 200 each			12,000	
		less 10 % trade discount		1,200	10,800	10 days credit
12		M/s Rehman & Co.				52,500
		300 shirts @ Rs. 175 each				
		Total 75,175		12 days credit		

Check your progress 1

1. Purchase book is also called as:

   a. Purchase Day Book

   b. Bought Day Book

   c. Purchase Journal

   d. all of these

3.3 Sales Return Book

Goods may be returned by the customers for a variety of reasons such as wrong quantity and /or quality. All goods returned by the customers are primarily recorded in this. This book is also known as 'Return Inward Book'. It only records the transaction of those goods returned by the credit customers.

When goods are returned by the customer following procedure is followed:

1. **Preparation of 'Credit Note':** When the credit customers return the goods, the company prepares a credit note in the customer's name. This note mentions that the account of the customers has been credited with the amount stated therein. The original being sent to the customer and the duplicate is preserved in the file, which provides basis for recording entries in the Sales Return Book.
2. **Posting from the Sales Return Book:** The total values of the goods returned by customers are posted to various ledger accounts concerned periodically.

Specimen of Sales Return Book

Date	Particulars	Credit Note No.	L.F.	Amount (Rs.)	Remarks

Illustration 7

April 1 Returned by Sur – O – Bani 4 pieces of Philips radio costing Rs. 1,500 each

April 9 Returned by Capital Electronics 3 pieces of VCP costing Rs. 9,000 each

April 29 Returned by K. B. & Co. 2 pieces of Two – in costing Rs. 2,000 each.

Specimen of Sales Return Book

Date	Particulars	Credit Note No.	L. F.	Amount (Rs.)	Remarks
April 1	**Sur - O- Bani**				
	4 pcs. of Philips radio @ Rs.1,500 each			6,000	

April 9	**Capital Electronics**	27,000
	3 Pcs. of VCP @ Rs. 9,000 each	
April 29	**K.B. & Co.**	
	2 pcs. of Two-in-one@	
	Rs. 2,000 each	4,000
		37,000

General Ledger

Sales Returns Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
April 30	To Sundry Detors A/c	37,000			

Sundry Debtors Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
April 30	To Sales Returns A/c	37,000			

Debtors' Ledger

Sur -O-Bani Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
April 1	By Sales Returns A/c	6,000			

Capital Electronics Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
April 9	By Sales Returns A/c	27,000			

K. B. & Co. Account

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
April 9	By Sales Returns A/c	4,000			

Check your progress 2

1. Sales Return Book will record transaction of goods that are:

   a. bought by the customer

   b. sale by the customer

   c. returned by credit customers

   d. None of the above

3.4 Purchase Return Book

It may be necessary to return some goods that the firm has bought on credit for a variety of reasons such as defective or excess quantity of goods supplied, etc. all returns of goods are recorded primarily in the Purchase Return Book. This book is also known as 'Return Outward Book'. Like sales return book, it also records only the return of goods that has been purchased on credit.

The following procedure is adopted on dispatch of goods returned to credit suppliers:

1. **Preparation of 'Debit Note':** When a firm returns some goods to its credit supplier, it prepares a 'Debit Note' and sends it along with the goods returned. This note contains the date of the return, name of supplier and value of goods returned as well as the reasons for returning goods. Original is sent to the supplier and the duplicate is retained for the recording purpose.
2. **Posting from the Purchase Return Book:** The total values of the goods returned to the supplier are posted to various ledger accounts concerned periodically.

Specimen of Purchase Return Book

Date	**Debit Note No.**	**Name of the supplier**	**LF**	**Details**		**Amount**	
				Rs.	**Ps.**	**Rs.**	**Ps.**

Illustration 8

Enter the following purchases returns in the books of Mohan.

Date	Invoice No.	Particulars
12/5/08	78125	Returned to Gupta Traders, 5sets of Dining tables @ 8000
28/06/08	78256	Returned to Godrej & co 3 Wardrobes, Costing Rs. 15000, 18500, 26000 respectively.
8/09/08	78345	Returned to Croma Furnitures 2 sofa-sets costing Rs.25000 &18900 respectively.

Solution: In the books of Mohan

Purchase Return Book (08-09)

Date	Purchase Invoice No	Name of the supplier	L F	Details		Amount	
				Rs.	Ps.	Rs.	Ps.
12/5	78125	Gupta Traders 5 sets of dining tables @ 8000		40000	00	40000	00
28/06	78256	Godrej & co 3 Wardrobes, costing Rs.15000,18500,26000 respectively		59500	00	59500	00
8/09	78345	Croma Furnitures 2 sofa-sets, costing Rs.25000 &18900 respectively		43900	00	43900	00

Check your progress 3

1. Purchase Return Book will record transaction of goods that are:

   a. bought by the customer

   b. sale by the customer

   c. returned by customers

   d. None of the above

3.5 Bills Receivable Book

When goods are sold on credit, the funds are blocked in the form of debtors and can be materialized in near future. Sometimes the seller wants from the credit customer, a written undertaking, to pay after a specific period. Such document, containing an undertaking to pay with the details of payments is termed as bills of exchange. When the bill is drawn by the seller and accepted by the buyer it is termed as bills receivable from seller's point of view. All such bills receivables are recorded in the books of accounts through a subsidiary book called as bills receivable book.

Check your progress 4

1. Bill of exchange involves undertaking:

   a. to pay for goods in cash

   b. to pay for goods in advance

   c. to pay for goods after sometime

   d. none of these

3.6 Bills Payable Book

When the business unit purchases goods on credit, the creditor may want an undertaking from the unit, for the payment in future on or before a specific date, such written promise to pay the specific amount on specific date, is termed as bills of exchange. For the person or the organization who promises, the bill is bills

payable and for the one whom it is promised, it is bills receivable. Bills payable book is maintained for the bills accepted by the drawee.

Illustration 9

From the following particulars, prepare bills receivable and bills payable books,

2002 Jan.

2 A Bill Rs, 2,100 drawn by Anil at 2 months

6 Drew a bill on Raman at 3 months for Rs. 1,500

10 Accepted a bill of Rs. 2,250 at 3 months drawn by Bhanu

15 Accepted a bill at 3 months for 1,500 drawn by Chaman Lal

20 Bill for Rs. 1,200 at 2 months drawn on Manoj, duly accepted by him.

25 A bill drawn by Ramesh at 3 months for Rs. 3,000, which is duly accepted

30 Acceptance given by Somesh at 4 months bill for Rs. 3,000

Check your progress 5

1. Bills payable book is maintained for bills which are accepted by:

a. drawer

b. drawee

c. payer

d. all

3.7 Journal Proper

Journal Proper is used for making the original record of those transactions, which do not find a place in any of the a foresaid books of original entry.

The journal proper is used to record the following types of entries:

1. **Opening Entries:** It is found that opening entries starts at beginning of financial year to open books by recording of assets, liabilities and capital which appears in previous year Balance Sheet as:

Assets Account Dr.

To Liabilities Account

To Capital Account

2. **Closing Entries:** It is noted that closing entries are passed at end of each financial year whereby Revenue Items (expenses and incomes losses and profits) are transferred to Revenue Account (i.e. Trading and Profit & Loss Account). Balances in Capital Items (as assets, liabilities, proprietary balances, etc.) remain as such and then are transferred to Balance Sheet. The closing entries are often avoided now and, instead, in the ledger itself the destination of the balances is indicated as: transfer to Trading Account, transfer to Profit & Loss Account, etc.

3. **Adjustment Entries:** Adjustment entries are passed at the time of finalisation. These entries are needed to bring into books outstanding expenses, accrued incomes, depreciation, provision for bad and doubtful debt, provision for discounts, etc.

4. **Rectification Entries:** Rectification entries are required to rectify different types of errors located, as errors of omission, commission, principle, etc. (for details refer unit – V)

5. **Transfer Entries:** Transfer entries are needed for transfer of any amount from one account to another account. If it is in the nature of appropriation then Profit & Loss Appropriation A/c is debited are account concerned is credited. Whenever any transfer is made out of profit & loss account, which is in the nature of charge, then Profit & Loss Account is debited and concerned account is credited.

6. **Share Issue Entries:** Share issue entries are needed for issue of share and making calls, etc. in case of companies.

Illustration 10

(1) Opening Balance:

	Rs.		**Rs.**
Plant	80,000	Cash	5,000
Creditors	40,000	Debtors	40,000
Stock	10,000	Reserve	15,000

(2) Closing figures as per Trial Balance include:

	Rs.
Purchases	70,000
Sales	1, 00,000
Expenses	12,000

(3) Closing Stock Rs. 5,000

(4) Transfer Rs. 1,000 from credit of A to credit of B. (5) Rs. 1,000 repairs to furniture debited to furniture account by mistake (6) Provide 10 % depreciation on assets of Rs. 60,000. (7) First call at Rs. 5 per share is made on 10,000 shares.

Journal

Date	**Particulars**	**Ledger Folio**	**Dr.**	**Cr.**
1) Sundries	Dr.		Rs.	Rs.
	Plant		80,000	
	Stock		10,000	
	Debtors		40,000	
	Cash		5,000	
	To Sundries			
	Creditors			40,000
	Reserve			15,000
	Capital			80,000
	(Being opening Balances)			
2)	Trading Account Dr.		80,000	
	To Sundries			
	Opening Stock	10,000		
	Purchases	70,000		
	(Being transfer to Trading Account)			

3)	Sales	1,00,000	
	To Trading A/c		1,00,000
	(Being transfer to Trading Account)		
4)	Closing Stock Dr.	5,000	
	To Trading A/c		5,000
	(Being closing stock brought into Accounts)		
5)	Trading Account Dr.	25,000	
	To, Profit & Loss A/c		25,000
	(Being Gross Profit Transferred)		
6)	Profit & Loss A/c Dr.	12,000	
	To, Expenses		12,000
	(Being transfer to Profit & loss Account)		
7)	Profit & Loss A/c Dr.	13,000	
	To, Capital A/c		13,000
8)	A Dr.	1,000	
	To, B		1,000
	(Being transfer)		
9)	Repairs A/c Dr.	1,000	
	To, Furniture A/c		1,000
	(Being repairs wrongly debited to Furniture Account, now rectified)		
10)	Depreciation A/c Dr.	6,000	
	To, Assets A/c		6,000
	(Being provision of deprecation @ 10 % p.a.)		

11)	Share 1st Call	Dr.	50,000	
	To, Share Capital			50,000
	(Being 1st call on 10,000 shares @ Rs. 5 as per Board's Resolution dated ...)			
	Total		**4, 28,000**	**4,28,000**

Check your progress 6

1. The open entry in journal is not used for:

   a. assets

   b. liabilities

   c. capital

   d. incomes losses

3.8 Let Us Sum Up

Cash books are the subsidiary books. All these subsidiary books are called books of original entry, as transactions in their original form are entered therein. It records all the cash receipts and payments. All transaction related to credit purchases of goods are primarily recorded in this book. It is also known as 'Purchase Day Book', 'Bought Day Book' and 'Purchase Journal'.

It may be necessary to return some goods that the firm has bought on credit for a variety of reasons such as defective or excess quantity of goods supplied, etc. all returns of goods are recorded primarily in the Purchase Return Book.

3.9 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-c)

Check your progress 3

Answers: (1-c)

Check your progress 4

Answers: (1-c)

Check your progress 5

Answers: (1-b)

Check your progress 6

Answers: (1-d)

3.10 Glossary

1. **Return Inward -** Goods returned by customers; known as 'sales returns'.
2. **Return Outward -** Goods returned to suppliers. It is also known as 'purchases returns'.

3.11 Assignment

Discuss the procedure of preparing purchase return book.

3.12 Activities

Fill in the blanks:

a. _____ and _____ entries are passed through ash book.

b. Bill dishonoured and Bill endorsement entries are recorded through _____.

c. _____ is termed as debtors.

d. Bill drawn by seller and accepted by buyer is called as _____.

e. _____ and _____ details are recorded in remark column of bills receivable book.

3.13 Case Study

From the following transactions of a trader, prepare the bills receivable:

Jan 91	Particulars
5	Drew a bill on Abdullah & Co. at 2 m/d for Rs.700
10	Acceptance received from Rahim at 3 m/d for Rs. 1,000
20	A. Riaz gives his acceptance at 3 m/d for Rs.800
30	Bill at 2 m/d for Rs.100 is drawn on Bashir

1. Define and explain bills payable book.
2. Explain the format of bills payable book.

3.14 Further Readings

1. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
2. Accounting for Managers, Jawaharlal.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

Block Summary

In this block, students have given a detailed knowledge about accounting and its principles. The basic about knowledge of Bookkeeping with related entries are explained along with illustrations. The concept of debit and credit along with ledger and Journals are explained which will allow the students to work as trainees. The concept of ledger formatting and posting is explained in such a way that a normal student will be able to perform entries in a book. The block will detail about Cash Book, Petty Cash Book and Sales Book.

After studying this block, students understands correctly about various accounting process and features related to it. The idea about various entries in Bookkeeping will help them in order to work for any concern. The basic understanding of entries in cash book, petty cash book and sales book will made the student to aware about real accounting procedure.

Block Assignment

Short Answer Questions

1. What are the main functions of accounting?
2. What are the various kinds of ledger?
3. What is a purchase book?
4. What is Bills Receivable Book?
5. Discuss the history of accounting.

Long Answer Questions

1. What is "Double-entry Bookkeeping system"?
2. Discuss the procedure of preparing sales return book.
3. Explain the procedure for ledger posting.

Enrolment No. ☐

1. How many hours did you need for studying the units?

Unit No	1	2	3	4
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____ _____
Language and Style	☐	☐	☐	☐	_____ _____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____ _____
Conceptual Clarity	☐	☐	☐	☐	_____ _____
Check your progress Quest	☐	☐	☐	☐	_____ _____
Feed back to CYP Question	☐	☐	☐	☐	_____ _____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
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ACCOUNTING FOR MANAGERS

PGDBA-103

BLOCK 2:
TRAIL BALANCE AND CAPITAL AND REVENUE TRANSACTIONS

Dr. Babasaheb Ambedkar Open University
Ahmedabad

ACCOUNTING FOR MANAGERS

Knowledge Management and
Research Organization
Pune

Acknowledgment
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The content is developed by taking reference of online and print publications that are mentioned in Bibliography. The content developed represents the breadth of research excellence in this multidisciplinary academic field. Some of the information, illustrations and examples are taken "as is" and as available in the references mentioned in Bibliography for academic purpose and better understanding by learner.'

ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

ACCOUNTING FOR MANAGERS

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BLOCK 1: BASICS OF ACCOUNTING

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UNIT 3 INTRODUCTION TO SUBSIDIARY BOOKS, CASH BOOK, PETTY CASH BOOK, SALES BOOK

Purchase Book, Sales Return Book, Purchase Return Book, Bills Receivable Book, Bills Payable Book, Journal Proper

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BLOCK 2: TRAIL BALANCE AND CAPITAL AND REVENUE TRANSACTIONS

UNIT 1 INTRODUCTION TO TRIAL BALANCE

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UNIT 2 **INTRODUCTION TO CAPITAL AND REVENUE TRANSACTION**

Capital Expenditure, Revenue Expenditure, Deferred Revenue Expenditures, Difference between Capital Expenditure, Revenue Expenditure and Deferred Revenue Expenditure, Capital Receipt, Revenue Receipt, Capital and Revenue Profits, Capital and Revenue Losses.

BLOCK 3: **BANK RECONCILIATION STATEMENT AND FINAL ACCOUNT**

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Introduction, Causes of Difference, Need for Bank Reconciliation Statement, Method of preparation (Without Adjustment)

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UNIT 3 **BALANCE SHEET**

Difference between a Trial Balance and a Balance Sheet, Preparation and Presentation of Balance Sheet, Explanation and Clarification of certain Items, Limitations of balance Sheet, Illustrations, Introduction to Company Financial Statements, Meaning and Type of Financial Statements, Nature of Financial Statements, Limitations of Financial Statements, Preparation of Company Financial Statements, Profit and Loss Account, Balance Sheet

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UNIT 2 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENT

Introduction, Relationship between Analysis and Interpretation, Steps Involved in the Financial Statements Analysis, Ratio Analysis, Classification of Ratios, Profitability Ratios, Turnover Ratios, Financial Ratios, Advantages of Ratio Analysis, Limitations of Accounting Ratios, Computation of Ratios

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PGDBA-103

ACCOUNTING FOR MANAGERS

BLOCK 2: TRAIL BALANCE AND CAPITAL AND REVENUE TRANSACTIONS

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BLOCK 2: TRIAL BALANCE AND CAPITAL AND REVENUE TRANSACTIONS

Block Introduction

During the end of a period, the balances of accounts from ledger containing Dr. and Cr. Totals or Net balances gets extracted in a sheet called Trial Balance along with Cash and Bank Balances from Cash Book. Trial Balance ensures that all transactions have been recorded with identical debit and credit amounts and the balance of each account has been computed correctly.

In this block, students will get knowledge about trial balance and its occurrence and will study about the preparation step involved in it. The concept of suspense account with its origination is also well explained. The block will detailed about revenue expenditure which incurred with study of capital and revenue receipts. The knowledge about capital and revenue profit is also well detailed.

After studying this block, students will be able to understand correctly about how trial balance can be prepared with relevant details. The concept of suspense account is also beneficial as it will help the student to gain knowledge as to how such accounts are created. The concepts of capital and revenue profit will allow the students to understand more about capital and revenue incurred in trial balance.

Block Objective

After learning this block, you will be able to understand:

- The errors not disclosed by Trial Balance.
- The steps involved in preparing Trial Balance.
- Concept of Suspense Account.
- Limitations and significance of trial balance.
- Features of Revenue Expenditure.
- Comparative features of Capital and Revenue Receipts.
- Capital and Revenue Profits.

Block Structure

Unit 1: Introduction to Trial Balance

Unit 2: Introduction to Capital and Revenue Transaction

UNIT 1: INTRODUCTION TO TRIAL BALANCE

Unit Structure

1.0 Learning Objectives

1.1 Introduction

1.2 Objectives of Trial Balance

1.3 Limitations of Trial Balance

1.4 Errors Disclosed by a Trial Balance

1.5 Errors that are not Disclosed by Trial Balance

1.6 Methods of Preparing Trial Balance

1.7 Methods of Locating Errors

1.8 Suspense Account

1.9 Let Us Sum Up

1.10 Answers for Check Your Progress

1.11 Glossary

1.12 Assignment

1.13 Activities

1.14 Case Study

1.15 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Features of Trial Balance.
- The type of errors in Trial Balance.
- Preparing of Trial Balance.
- Introduction to Suspense Account.

1.1 Introduction

At the end of a period, the balances of accounts from ledger (Dr. and Cr. Totals or Net balances) are extracted in a sheet called Trial Balance, together with Cash and Bank Balances from Cash Book. Since the entire system of accounting is based on the double entry system, it should have debit and credit totals equal to each other in absence of any error. Trial balance is not a part of any journal entry or ledger account, it is simply a summary of various debit and credit balances pertaining to all the accounts operated and maintained by a business enterprise.

1.2 Objectives of Trial Balance

If all the transactions were correctly recorded in the ledger accounts and if the balances of the accounts have also been struck correctly, the debit and credit columns of the trial balance should agree. Therefore, a trial balance proves the accuracy of the books of accounts.

Trial Balance serves the following objective:

1. It ensures that all transactions have been recorded with identical debit and credit amounts and the balance of each account has been computed correctly.
2. It provide arithmetical accuracy of various ledger accounts.
3. As the Trial Balance contains the ledger balance on a particular date, thus the entire ledger is summarised in the form of a trial balance. Hence, it is a summarised ledger.
4. It provide base for preparing final accounts.

Check your progress 1

1. Which is not an objective of Trial Balance?

   a. It ensures recording of all transactions.

   b. It ensures correctly computation of balance of each account.

   c. It does not show arithmetical accuracy of accounts.

   d. It serves as base for preparing final accounts.

1.3 Limitations of Trial Balance

An agreed trial balance does not prove that:

1. All transactions have been correctly analysed and recorded in the proper accounts. For example, if the wages paid for the installation of plant had been erroneously recorded by debiting the wages account in place of the plant account, the trial balance would still agree.
2. All transactions have been recorded in the books of original entry. If, for example, a sales invoice were to be completely omitted from being recorded in the sales day book, the error would not be disclosed in the trial balance.

To conclude, we can say that a trial balance should not, therefore, regarded as conclusive proof of the correctness of the books of accounts.

Check your progress 2

1. A trial balance correctly:

   a. analysed and record accounts

   b. serves as proper proof

   c. enters data as duplicate entry

   d. all of these

1.4 Errors Disclosed by a Trial Balance

To understand the nature of errors and rectification we may classify them into Errors disclosed by trial balance and Errors not disclosed by trial balance.

Following errors in books of accounts as mentioned by trial balance:

1. **Omission to post an amount into ledger:** It is noted that in double sided trial balance, the idea of transaction which are not recorded correctly in books of accounts will not be agreed.
2. **Debit or Credit entries are not posted at all or posted twice:** In case of single sided, if the transaction is recorded at one goal or twice, then also the trial balance will not agree.

3. **Debits wrongly posted as credits and vice versa:** If a transaction is recorded on wrong side of account, then also the trial balance will be disagreed.
4. **Wrong totaling of subsidiary books:** In case of wrong entry of total subsidiary book, then the trial balance will also not agree.
5. **Difference in amount between the entries:** The trial balance will not agree if varied amounts are posted in different accounts.
6. **Error in computation of an account balance:** In a situation when balance of account is not properly entered and calculated, in such situation the correct position will not exists, under such circumstance, the trial balance will show an error.
7. **Omission of Account Balance:** Also if the account balance is not listed in trial balance, then under such circumstances, the trial balance will not agree.
8. **Balance of an account wrongly recorded in trial balance:** When the account balance is wrongly posted in trial balance, then also it will not agree.
9. **Errors in extraction of the trial balance:** There are situations when trial balance will not tally completely when any or both columns are not correctly added up.

Check your progress 3

1. Trial balance will not agree to:

   a. record every time

   b. wrong side recording of transaction

   c. positing of various accounts

   d. all of these

1.5 Errors that are not disclosed by Trial Balance

1. **Errors of omission:** It exists when certain transactions are not there in books of original entry.
2. **Errors of principal:** In case of incorrect application of principles like obtaining difference among revenue and capital expenses, such type of errors exists.
3. **Compensating errors:** Certain error groups whose full effect does not reflect in trial balance results in errors.
4. **Recording wrong amount in books of original entry:** In case of wrong transaction recorded in books with original entry, which performs through ledger, there will be no disagreement in trial balance.
5. **Recording a transaction more than once:** There will be no error in trial balance, if the transaction is recorded correctly more than once.

Check your progress 4

1. Which among the following is an undisclosed Trial balance error?

   a. Balance of an account wrongly recorded in trial balance.

   b. Recording wrong amount in books of original entry.

   c. Omission of Account Balance.

   d. Wrong totalling of subsidiary books.

1.6 Methods of Preparing Trial Balance

A trial balance may be prepared based on the following methods:

1. Total method
2. Balance method
3. Total-cum-balance or compound method

1. **Total Method:** This method has debit and credit side totals of account that are shifted to trial balance without having difference of each side. It is found that the excess of debit side over credit side will automatically adjust.

Illustration 1

Trial Balance as on 31/03/09

Sr. No.	Account Head	LF	Debit Amount	Credit Amount
1	Capital		0	4,00,000
2	Drawing		50,000	0
3	Plant and Machinery		2,00,000	0
4	Building		4,00,000	
5	Furniture		50,000	14,000
6	Stationary		2,000	
7	Salary		40,000	12,000
8	Wages		12,000	3,000
9	Loan		0	4,00,000
10	Bank OD		50,000	1,50,000
11	Cash		60,000	22,000
12	Purchases		1,20,000	
13	Sales			2,00,000
14	Debtors		60,000	10,000
15	Sales return		10,000	
16	Creditors		5,000	40,000

17	Purchase Return			5,000
18	Investments		1,60,000	14,000
	Total		**12,19,000**	**12,19,000**

2. **Balance Method:** In this method, the difference exists among two sides of debit and credit is considered for trial balance. Here, excess of debit total above credit is kept in debit column and vice versa.

Illustration 2

Trial Balance as on 31/03/09

Sr. No.	**Account Head**	**LF**	**Debit Amount**	**Credit Amount**
1	Capital			8,00,000
2	Drawing		50,000	
3	Plant and Machinery		4,00,000	
4	Building		6,00,000	
5	Furniture		50,000	
6	Stationary		3,000	
7	Salary		28,000	
8	Wages		18,000	
9	Loan			4,00,000
10	Bank OD			1,20,000
11	Cash		18,000	
12	Purchases		2,80,000	

13	Sales			3,20,000
14	Debtors		80,000	
15	Sales return		8,000	
16	Creditors			30,000
17	Purchase Return			6,000
18	Investments		1,41,000	
	Total		**16,76,000**	**16,76,000**

2. **Compound Method:** In compound method, trial balance is opted with balances along with total accounts. This method is mixture of total method and balance method.

Check your progress 5

1. In which method it is seen that excess of debit side over credit side gets adjusted automatically?

   a. Total method

   b. Balance method

   c. Compound method

   d. None of above

1.7 Methods of Locating Errors

If Trial Balance does not agree, need to follow the following procedure carefully:

- First, check extraction and Listing of ledger account balances step by step.
- Now check addition of both Dr. and Cr. columns of trial balance and find the difference.
- Then divide exact difference by 9. If this is divisible by 9, then it can be transposition error or slide error.
- Now, divide differences by 2 and scan columns to analyse whether said figure appears on correct side of Dr. or Cr.
- Check extra subsidiary books.
- Find again balances of ledger accounts.
- Finally, check posting from subsidiary books to ledger.

Illustration 3

The Following is the Trial Balance of R. & Co. showing debit total of Rs. 3, 18,200 and credit total of Rs. 3,76,200.

You are required to ascertain the correct total of trial balance after pointing out the causing the disagreement.

Trial Balance

as on 31 / 12/ 1989

	Debit	**Credit**
	Rs.	**Rs.**
Capital	-	1, 00,000
Cash in hand	1,200	-
Bills Payable	22,000	-
Bills Receivable	-	20,000
Purchases	1, 20,000	-
Opening Stock	35,000	-

Creditors	24,000	-
Sales	-	2, 00,200
Debtors	1000	-
Plant & Machinery	60,000	-
Furniture	15,000	-
Rent & Taxes	5,000	-
Drawings	5,000	-
Wages	10,000	-
Income -tax	-	6,000
Salaries	20,000	-
3, 18,200	3,76,200	

Solution:

The above Trial Balance can be redrafted under any of the following ways:

Method I

Trial Balance

as at 31 December 1989

Heads of Accounts	**L.F.**	**Debit Rs.**	**Credit Rs.**
Capital A/c		-	1, 00,000
Cash A/c		1,200	-
Bills Payable A/c		-	22,000
Bills Receivable A/c		20,000	-
Purchases A/c		1, 20,000	-
Opening Stock		35,000	-
Creditors A/c		-	24,000
Sales A/c		-	2, 00,200
Bad debts Reserve A/c		-	1,000

Debtors A/c	50,000	-
Plant and Machinery A/c	60,000	-
Furniture	15,000	-
Rent & Taxes	5,000	-
Drawings	5,000	-
Wages	10,000	-
Income - Tax	-	6,000
Salaries	20,000	-
	3, 18,200	**3, 18,200**

Solution,

The above Trial Balance can be redrafted under any of the following ways:

Method 1

Trial Balance

As at 31st December 1989

Heads of Accounts	**L.F.**	**Debit**	**Credit**
		Rs.	**Rs.**
Capital A/ c		-	1, 00,000
Cash A/ C		1,200	-
Bills Receivable A/c		-	22,000
Bills Receivable A/c		20,000	-
Purchases A/c		1, 20,000	-
Opening Stock		35,000	-
Creditors A/c		-	24,000
Sales A/c		-	2, 00,200
Bad Debts Reserve A/c		-	1,000
Debtors A/c		50,000	-
Plant and Machinery A/c		60,000	-

Furniture A/c	15,000	-
Rent & Taxes A/c	5,000	-
Drawings A/c	5,000	-
Wages A/c	10,000	-
Income - Tax A/c	6,000	-
Salaries A/c	20,000	-
	3, 47,200	**3,47,200**

Method II

(Note: Under this method, only the wrong postings should be corrected.)

Correction of Trial Balance

	Debit Rs.	**Credit Rs.**
Total as per Trial Balance	3, 18,200	3,76,200
Bills payable being credit Balance but	-22,000	+22,000
Shown as debit balance	2, 96,200	3,98,200
Bills Receivable being debit balance but	+20,000	-20,000
Shown as credit balance	3, 16,200	3,78,200
Creditors being credit balance but shown	-24,000	+24,000
as debit balance	2,92,200	4,02,200
Bad debts Reserve being a credit balance	-1,000	+1,000
but shown as debit balance	2,91,200	4,03,200
Debit being debtors balance but shown	+ 50,000	- 50,000
as credit balance	3,41,200	3,53,200
Income tax being debit balance but	+ 6,000	- 6,000
Shown as credit balance	**3, 47,200**	**3,47,200**

Check your progress 6

1. While checking errors, the step of posting is the:

a. First step c. Second last step

b. Second step d. last step

1.8 Suspense Account

If it is not possible to locate the errors in spite of the above steps, the difference of the trial balance is transferred temporarily to an account known as **"Suspense Account".** After transferring the difference, the trial balance can thus be totalled up and balanced. This account will be automatically closed when the error or errors in trial balance are subsequently discovered or rectified.

Check your progress 7

1. Suspense account gets automatically closed when:

a. error exists c. errors are discovered

b. errors are rectified d. all of these

1.9 Let Us Sum Up

In this unit we have learnt that at the end of a period, the balances of accounts from ledger containing Dr. and Cr. Totals or Net balances gets extracted in a sheet called Trial Balance along with Cash and Bank Balances from Cash Book. It is studied that a trial balance should not, therefore, regarded as conclusive proof of the correctness of the books of accounts.

It is found that a trial balance is prepared on the basis of Total method, Balance method and Total-cum-balance or compound method

1.10 Answers for Check Your Progress

Check your progress 1

Answers: (1-c)

Check your progress 2

Answers: (1-a)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-d)

1.11 Glossary

1. **Balance Sheet -** A summary of all the accounts of a business, usually prepared at the end of each financial year.
2. **Capital -** An amount of money put into the business.
3. **Closing Balance -** The balance of an account at the end, of an accounting period; this figure is then carried forward to the next accounting period.
4. **Fixed Assets -** Consisting of anything which a business owns or buys for use within the business and which retains a value at year end.
5. **Gross loss -** The balance of the trading account, assuming it has a debit balance.
6. **Gross profit -** The balance of the trading account, assuming it has a credit balance.

1.12 Assignment

Discuss the purpose of preparing trial balance.

1.13 Activities

Discuss with examples the types of errors not disclosed by trial balance.

1.14 Case Study

Take an example of any trial balance and locate the errors causing disagreement in it.

1.15 Further Readings

1. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
2. Accounting for Managers, Jawaharlal.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

UNIT 2: INTRODUCTION TO CAPITAL AND REVENUE TRANSACTION

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 Capital Expenditure

2.3 Revenue Expenditure

2.4 Deferred Revenue Expenditures

2.5 Difference between Capital Expenditure and Revenue Expenditure

2.6 Capital Expenditure and Deferred Revenue Expenditure

2.7 Capital Receipt

2.8 Revenue Receipt

2.9 Capital and Revenue Profits

2.10 Capital and Revenue Losses

2.11 Let Us Sum Up

2.12 Answers for Check Your Progress

2.13 Glossary

2.14 Assignment

2.15 Activities

2.16 Case Study

2.17 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Revenue expenditure
- Revenue receipt
- Capital loss

2.1 Introduction

A receipt is the inflow of money into the business, which indicates the money received by a business enterprise. A receipt of money is considered as capital receipt when a contribution is made by the proprietor, partners or shareholders towards the capital of the business or a contribution of capital to the by someone outside the business.

2.2 Capital Expenditure

Expenditure means the amount spent.

Any expenditure incurred for following purposes is capital expenditure:

1. To obtain fixed assets like land, building, plant and machinery, fitting, and motor vehicles
2. To improve and extend fixed asset e.g., additions to buildings
3. To increase earning capacity of business or reduce cost of manufacturing, administration or distribution in business
4. In order to raise capital duty for business like brokerage for loans or discount on shares and debentures

List of Capital Expenditures - (Capital Expenditures):

The list shown below will display items of capital expenditures:

1. Cost of goodwill
2. Cost of freehold land and building and the legal charges incurred in this contention
3. Cost of lease
4. Cost of machineries, plants, tools, fixtures, etc.
5. Cost of trademarks, patents, copyrights, designs, etc.
6. Cost of car, lorry, etc.
7. Cost of installation of lights and fans
8. Cost of any other assets acquired by way of equipment
9. Cost of erection of plant and machinery
10. Cost of addition to existing assets

11. Structural improvements and alteration in existing assets
12. Expenses for developments in case of mines and plantations
13. Expenses for administration occur during construction and equipment of industrial enterprise
14. Expenses occurred in experimenting that result in acquisition of patent or other rights

Check your progress 1

1. Capital Expenditure will cover:

   a. cost of machinery

   b. cost of extra effort

   c. coat of installation

   d. all of these

2.3 Revenue Expenditure

Expenditures treated as revenue expenditures if it occurs for following purposes:

1. Expenditure for buying floating assets for resale at profit or for converted into saleable goods like cost of goods, raw materials and stores.
2. Expenditures occur by maintaining assets in proper working order like repairs to plant and machinery, building furniture and fittings.
3. Expenditures occur for meeting everyday expenses for doing business such as salaries, rent, rates, taxes, stationery, postage, etc.

List of revenue expenditures (revenue expenditures):

Following is the list of usual items of revenue expenditures:

1. Expenses due to ordinary administration and canjing on business.
2. Expenses for repairs, renewals and replacement of pennanent assets
3. Cost of goods for resale.
4. Cost of raw materials and stores acquired for consumption in course of manufacturing.

5. Expenses due to ordinary administration and carrying on business.
6. Expenses for repairs, renewals and replacement of permanent assets.
7. Cost of goods for resale.
8. Cost of raw materials and stores acquired for consumption in course of manufacturing wages paid for manufacture of products for sales.
9. Expenses for the manufacture and distribution of the finished goods.
10. Loss from wear and tear and obsolescence of assets.
11. Depreciation of lease.
12. Interest on loans borrowed for business.
13. Loss from sale of fixed assets.
14. Fees for renewal of patent rights.
15. Up-keep and maintenance of motor car and van.
16. 0 Maintenance of fan and lights.
17. Book value of assets discarded or totally damaged or destroyed by fire or other reasons.

Check your progress 2

1. Which is a part of revenue expenditure?

   a. cost of machinery

   b. cost of extra effort

   c. coat of installation

   d. cost of goods for resale

2.4 Deferred Revenue Expenditures

When a large sum of revenue expenditure is incurred in any particular year, the benefit of such expenditure may carry on to several years; such expenditure is called 'Deferred Revenue' Expenditure. The utilized portion of expenditure is charged to Profit and Loss Account and the balance is carried forward and are written off in future accounting periods and shown in assets side of the Balance Sheet of the current year.

Following are the main characteristics of deferred revenue expenditure:

1. Such expenses are of revenue nature.
2. These expenses are relatively of very large amount.
3. The benefit of such expenses is extended beyond the accounting year or several accounting year.

Deferred Revenue Expenditure comprises of the following:

- **Expenditures wholly paid in advance:** These are the expenses, which are usually paid in advance in full during the accounting year.
- **Expenditures partly paid in advance:** Such expenses include insurance premium, which is, payable partly for the current year and partly for the next year. The expired period expenditure is charged to profit & loss A/c and the unexpired portion is taken into the assets side of balance sheet.

Abnormal Losses: Any loss of exceptional nature arising on account of uninsured risk-say, loss by fire, loss in transit due to accident or confiscation or property in a foreign country. Such losses are spread over two to three years. The amount to be written off is charged to profit and loss account and balance is shown to assets side of the balance sheet.

Check your progress 3

1. Which is not a part of Abnormal Loss?

   a. loss by fire

   b. loss in transit due to accident

   c. loss of property in foreign country

   d. all of these

2.5 Difference between Capital Expenditure, Revenue Expenditure

Point	Capital Expenditure	Revenue Expenditure
1) Incurred on	Acquisition, extension, modification of fixed asset e.g. purchase of a plant, modification of machinery.	Day to day activities of business E.g. Administrative maintenance expenditures
2)Effect on earning capacity	These expenditures increase the earning capacity of the business e.g. purchases of new, modern machine would increase the speed, accuracy of performance.	These expenditures maintain the earning capacity of business, expenses on regular maintenance would help to avoid stoppage in performance.
3) Not recognised on the basis of amount spent	Expenditure is not capital in nature only because the amount involved is quite huge.	Expenditure is not revenue in nature only because the amount involved is small.
4) Add value to existing asset	This type of expenditure adds value to an existing asset, when modification, extension to existing asset is done.	This type of expenditure does not add any value to an existing asset.
5) Benefit derived	Benefits more than one accounting period or several periods	Normally benefits one accounting period
6) Where recorded	Recorded in Balance Sheet subject to depreciation	Recorded in Income Statement subject to prepaid and outstanding expenses

Check your progress 4

1. Which is not a part of revenue expenditure?

   a. administrative expense

   b. expense on modification of fixed asset

   c. maintenance expense

   d. day to day expenditures

2.6 Capital Expenditure and Deferred Revenue Expenditure

Difference between Capital Expenditure, Deferred Revenue Expenditure

Point	**Capital Expenditure**	**Deferred Revenue Expenditure**
1) Incurred on	Acquisition, extension, modification of fixed asset e.g. purchase of a plant, modification of machinery.	An item the benefits of which would be derived for 2 to 5 years in near future, An abnormal expense like the one loss by fire and the amount is huge that cannot be justifiably accounted in a single period. An expense, which provide part benefit in current period and part in next period.
2)Effect on Earning Capacity	These expenditures increase the earning capacity of the business e.g. purchases of new, modern machine would increase the speed, accuracy of performance.	No effect on earning capacity but some of these expenditures may help in maintaining the capacity as like revenue expenditures.
3) Not recognised	Expenditure is not capital in nature only because the	Recognition is also based on the amount spent e.g. loss by

on the basis of amount spent	amount involved is quite huge.	fire if it is small to be treated as revenue and written of during the period but if heavy then deferred over a period of time.
4) Add value to existing asset	This type of expenditure adds value to an existing asset, when modification, extension to existing asset is done.	Does not add value to an existing asset
5) Benefit derived	Benefits more than one accounting period or several periods	Benefits may be derived for more than one accounting period but for near future.
6) Where recorded	Recorded in balance sheet subject to depreciation	The part of the amount to be written off during current period is recorded in Income Statement and the rest of the amount is recorded in balance sheet

Check your progress 5

1. Which is not a feature of capital expenditure?

   a. increases earning capacity of business

   b. involves purchases of new, modern machine

   c. expenditure does not add value to existing asset

   d. expenditure is not capital in nature

2.7 Capital Receipt

As such capital receipt creates a liability for the business. Capital receipts do not have any effect on profit or losses of the business enterprise.

Capital receipts can take one or more of the following forms:

- Additional capital introduced by the proprietor or partners or shareholders by issuing fresh shares.
- When a loan or a mortgage on property is arranged.
- By selling assets, previously not intended for resale.

Check your progress 6

1. Capital receipt:

a. extra capital c. loan arranged

b. issued to selling of asset d. all of above

2.8 Revenue Receipt

A receipt of money is considered as revenue receipt when it is received from customers for goods supplied, or fees received for services rendered in the ordinary course of business, which result of the firm's activity in the current period. Revenue receipts increases the profits, reduce the losses of the firm, and as such credited to trading, profit & loss account or income statement.

Examples of Revenue Receipts:

1. Sale proceeds of goods in which the firm deals
2. Discount received
3. Commission received
4. Interest received
5. Dividend received on investment
6. Subscriptions received
7. Rent received, etc.

Check your progress 7

1. Which is not an example of revenue receipt?

a. issued to selling of asset

b. sale proceeds of goods in which the firm deals

c. against discount received

d. against commission received

2.9 Capital and Revenue Profits

Capital profit

A profit obtained on sale of fixed asset or earned on carrying dues for business. It is seen that a house is bought for Rs. 15,000 and is sold for Rs.20,000 then the profit earned will be Rs.5,000 which is termed as capital profit.

Revenue profit

It is a type of profit, which is obtained through business, which can be sale of goods, income from investments or commission earned.

In case of capital profit is obtained, it is transferred into capital account of proprietor or is transferred into capital reserve account that will act as liability on balance sheet. Also it is seen that the capital profits at any cause not be transferred into profit and loss account as it is a non-trading profit. As seen, revenue profits are transferred into profit and loss account as it is obtained from regular trading operation.

Check your progress 8

1. What will be the capital profit, if a car is bought for Rs. 1,15,000 and is sold for Rs.1,45,000?

a. 12,000

b. 22,000

c. 30,000

d. 34,000

2.10 Capital and Revenue Losses

Capital loss

It is a type of loss which occurred on sale of fixed asset or can be obtained by rising of money for business. It is seen that capital loss be serve as an asset in balance sheet.

Revenue loss

It is another type of loss which occurs while trading like loss on sale of goods. It is debited to profit and loss account of year in which it occurs.

Illustration: 4

State with reason which of the following items are to be considered as capital and which Revenue is:

1. Spent Rs. 20,000 for remodeling the factory and the value of factory enhanced by Rs. 15,000
2. Wages paid for the installation of factory machinery enhanced by Rs. 15,000
3. An old machine costing Rs. 3,000 (or W. D. V. Rs. 1,800) was sold for Rs. 1,000
4. The cost of removal of stock from old factory to the new one amounted to Rs. 1,000
5. The expenses incurred for white washing the factory building amounted to Rs. 4,000
6. Purchase of patent rights Rs. 4,000 and renewal fee for the next year Rs. 400
7. Cost of repainting the factory building Rs. 800
8. Compensation paid to a retrenched employee for loss of employment amounted to Rs. 2,000.
9. Purchase of new tyre for Rs. 2,000 for an old car
10. Purchase of new tyre for Rs. 20,000 confiscated by customs authorities for non - disclosure of material facts
11. Fees paid to a lawyer for an immovable property amounted to Rs. 1,000
12. Expenses incurred on research work for a particular product which ultimately did not produce any fruitful result amounted to Rs. 10,000

13. Cost of conversion of gas plant to oil fuel plant for the generation of electricity amounted to Rs. 20,000
14. Plant appearing in the book value Rs. 8,000 and stock valued at Rs. 4000 destroyed by fire, amount recovered from the insurance company for Rs. 10,000 and Rs. 5,000 respectively
15. Incurred Rs. 4,000 in re - decorating a cinema hall and Rs. 12,000 in enhancing the sitting accommodation
16. Fire insurance premium of Rs. 1,200 is paid on 30th Nov. for one year. The accounting date is 31st December.
17. A Firm of builders spends Rs. 1, 60,000 in purchasing a plot of land and erects offices for its own use on a quarter of the site. Remaining land is used for building houses, which are sold to the public.
18. A sum of Rs. 2,000 spent on a machine comprises Rs. 400 for replacement of worn out parts and Rs. 1,600 for additions to new devices, which enable the output to be doubled.
19. Visit of sales manager to U. K. total cost of which was Rs. 20,000 for promoting export sales - visit is quite successful.

Solution

1. Rs. 15,000(by which the value of factory is enhanced for remodeling is a capital expenditure since it will increase the earning capacity of the firm and Rs. 5,000 (i.e.20,000 - Rs. 15,000) which are also incurred for remodeling is a revenue expenditure as it does not increase the earning capacity.
2. Wages paid for the installation of machine accounting to Rs. 2,000 and carriage paid for the purpose amounting to Rs. 500 are capital expenditures since they all are incidental to the acquisition of fixed assets and its installation. Moreover, they will also increase the earning capacity.
3. The loss on sale of old machine amounting to rs.800 (i.e. Rs. 1,800 - Rs. 1,000) is a revenue loss since it represents under provision for depreciation already made in the earlier years and the selling price amounting to Rs. 1,000 is a capital receipt as it reveals the proceeds of a sale of fixed assets.
4. The cost of removal of Stock amounting to Rs. 1,000 is a revenue expenditure of special nature which may be written off against the revenue of a number of years i.e. like deferred revenue expenditure since it does not increase the efficiency of the assets or earning capacity.

5. The expenses, which are incurred for white washing the factory building amounted to Rs. 4,000, may be considered as a regular expenditure in order to maintain the factory and as such, the same should be treated as revenue expenditure.

6. The cost of patent rights amounting to Rs. 4,000 is capital expenditure since is a fixed asset (more or less) by nature which helps in earning revenue over a period of few years. But the renewal fee is undoubtedly revenue expenditure since it is designed to supply benefit only for one financial year i.e., the current year.

7. Cost of repainting the factory building amounting to Rs. 800 may be considered as a regular expenditure in order to maintain the building and as such, it must be traded as revenue expenditure. On the contrary, if this is done t the interval of a few years, the expense of such painting may be spread over the period over which the benefit is actually taken.

8. Compensation paid to a retrenched employee amounting to Rs. 2,000 may be treated as revenue expenditure of special type and non - recurring nature which will ultimately be written off against Profit and loss Account over a number of certain periods considering as deferred revenue expenditure. This is because; compensation for loss of service is generally paid against the salary payable to the employee for the period of notice before retrenchment.

9. Purchase of a new tyre for an old card amounting to Rs. 2,000 is a capital expenditure since it is nothing but a cost of replacement of a part of an existing fixed asset.

10. Imported goods amounting to Rs. 20,000 which were confiscated by customs authorities for non - disclosure of material facts is an abnormal revenues loss and non - recurring in nature which are incurred in the regular course of the business. As such it is better to treat the same as deferred revenue expenditure which may be written off against the period of few years.

11. Fees paid to a lawyer for drafting an agreement of lease amounting to Rs. 1,000 is a capital expenditure since it is incidental to the acquisition of such lease which is a part of fixed asset.

12. Expenditure on scientific research, if it is fruitful, may be treated as capital expenditure.

13. In this case, the purpose of conversion is not known to us. It may be happen for two purposes viz.(i) the said conversion may increase the efficiency of

the plant, or (ii) the said conversion may arise since three is non - availability of gas supply in the locality for any other purpose. Needless to say, the former is a capital expenditure whereas the latter is a revenue expenditure, which is written off against the revenue over a number of years by charging profit and loss account.

14. The excess amounts which are realised from insurance company over the book value of plant amounting to Rs. 2,000 (i.e. Rs. 10,000 - Rs. 8,000) is a capital Profit since plant is an item of fixed assets while the excess amounts which are realised from the Insurance company over the value of stock amounting to Rs. 1000 (i.e. Rs. 5000 - Rs. 4,000) is a revenue profit since stock is an item of current assets and which are meant for re-sale.

15. Redecoration of a cinema hall amounting to Rs. 4,000 is revenue expenditure, as it does not enhance the earning capacity. However, if it is a substantiality large amount, the same may be treated as deferred revenue expenditure and may be spread over two or three years. However, enhancement of sitting accommodation increases the earning capacity. As such, it should be capitalised.

16. Fire insurance premium is usually paid in advance and such, Rs. 12000 would have been paid for the following period. As premium is paid on 30 th Nov. and current year closes on 31 st Dec. hence, one moths premium amounting to Rs. 100 (i. e. Rs. 1,200 / 12 x 1) would be charged to revenue and the balance Rs. 1,100 (Rs. 1,200 - Rs. 100) would be carried forward as deferred revenue expenditure as “Prepaid insurance Premium in the assets side of the Balance sheet.

17. Rs 40,000 (i.e. 1, 60,000 x 1/4) which is incurred by the builders while erecting offices for won use should be capitalised and the balance i.e. 1,20,000 0(i.e. Rs. 1,60,000 - Rs. 40,000) which is spent for constructing the building sold out to the public is a revenue expenditure.

18. Rs. 400 which is incurred for replacing worn out parts is a revenue charges since it is a routine expenditure for maintaining the existing earning capacity of the firm and Rs. 1,600 which is incurred for additions to t new device is a capital expenditure since it results in an increase in the earning capacity.

19. Visit of sales manager to U. K. for promoting export sales is expenditure in the nature of advertisement campaign. As the visit is found to be quite successful it likely to render benefit for enhancing export sales over a number of years and as such, it may be treated as deferred revenue

expenditure and may be written off against profit and loss account over the related number of years.

Illustration: 5

Solution

From the following, find out capital or revenue items:

1. An amount of Rs. 50,000 received by a company on the reissue of forfeited shares.
2. A sum of Rs. 1, 00,000 received from government in respect of export promotion scheme.
3. An amount of Rs. 2, 00,000 received from sale of investment by an investment company.
4. Received Rs. 45,000 from sale of import entitlements.
5. Compensation of Rs. 25,000 received in respect of loss of stock.
6. Received Rs. 1,20,000 being the sale proceeds of technical know – how.
7. Received Rs. 56,000 from the insurance company being the cost of machine destroyed by fire.
8. An amount Rs. 2, 00,000 received for issue of debentures and Rs. 10,000 as premium thereon.
9. Income from coal mines Rs. 2, 50,000.
10. Profits on sale of shares authorized by Memorandum of Association.

Check your progress 9

1. Capital loss occurs on:

   a. purchase of fixed asset

   b. sale of fixed asset

   c. cash taken for business

   d. all of above

2.11 Let Us Sum Up

In this unit we have learnt that when a large sum of revenue expenditure is incurred in any particular year, the benefit of such expenditure may carry on to several year, such expenditure is called 'Deferred Revenue' Expenditure.

It is found that an abnormal Loss is a type of loss of exceptional nature arising on account of uninsured risk-say, loss by fire and loss in transit due to accident or confiscation or property in a foreign country. Capital loss is a receipt which involves inflow of money in business showing money received by a business enterprise.

It is found that a revenue receipt is a receipt of money which received from customers for goods supplied, or fees received for services rendered in the ordinary course of business.

Capital Profit is a profit obtained on sale of fixed asset or earned on carrying dues for business while Revenue profit is a profit obtained through business, which can be sale of goods, income from investments or commission earned.

Capital loss is a type of loss which occurred on sale of fixed asset and is serving as an asset in balance sheet while revenue loss is a loss which occurs while trading like loss on sale of goods.

2.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-b)

Check your progress 5

Answers: (1-c)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-d)

Check your progress 8

Answers: (1-c)

Check your progress 9

Answers: (1-b)

2.13 Glossary

1. **Capital loss -** It is a type of loss which occurred on sale of fixed asset or can be obtained by rising of money for business.
2. **Revenue loss -** It is another type of loss which occurs while trading like loss on sale of goods.

2.14 Assignment

What is the difference between capital, revenue and deferred revenue expenditure in terms of benefits derived and purpose for which they are used?

2.15 Activities

Discuss the features of receipts revenue in nature.

2.16 Case Study

What is revenue receipt and list the examples of revenue receipts.

2.17 Further Readings

1. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
2. Accounting for Managers, Jawaharlal.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

Block Summary

In this block, students achieved knowledge about a trial balance and how it is created and what are the essential steps taken to prepare it. The idea about suspense account and its occurrence with benefit is well explained. The block will detail about revenue expenditure which incurred with study of capital and revenue receipts. The knowledge about capital and revenue profit is also well detailed.

After studying this block, students can now design and work on trial balance sheet which will make them to practice for their own or somebody. The concept of suspense account along with illustrations are well detailed which will made the student to gain knowledge as to how such accounts are created. The concepts of capital and revenue profit will allow the students to understand more about capital and revenue incurred in trial balance.

Block Assignment

Short Answer Questions

1. Explain the concept of capital and revenue profits?
2. What is trial balance?
3. What is deferred revenue expenditure?
4. What are the methods of preparing trial balance?
5. What is the treatment of capital and revenue profits?

Long Answer Questions

1. What are the steps in locating errors in trial balance?
2. Discuss the features of revenue expenditure?
3. Discuss with examples the errors disclosed by trial balance?

Enrolment No. _____

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
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ACCOUNTING FOR MANAGERS

PGDBA-103

BLOCK 3:
BANK RECONCILIATION STATEMENT AND FINAL ACCOUNT

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Ahmedabad

ACCOUNTING FOR MANAGERS

Knowledge Management and
Research Organization
Pune

Acknowledgment
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The content is developed by taking reference of online and print publications that are mentioned in Bibliography. The content developed represents the breadth of research excellence in this multidisciplinary academic field. Some of the information, illustrations and examples are taken "as is" and as available in the references mentioned in Bibliography for academic purpose and better understanding by learner.'

ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

ACCOUNTING FOR MANAGERS

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UNIT 3 INTRODUCTION TO SUBSIDIARY BOOKS, CASH BOOK, PETTY CASH BOOK, SALES BOOK

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UNIT 1 **BANK RECONCILIATION STATEMENT**

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ACCOUNTING FOR MANAGERS

BLOCK 3: BANK RECONCILIATION STATEMENT AND FINAL ACCOUNT

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BLOCK 3: BANK RECONCILIATION STATEMENT AND FINAL ACCOUNT

Block Introduction

A bank reconciliation statement is prepared that brings into agreement the cash balance per book and cash balance per bank. Trading along with Profit and Loss account is developed to resolve income received or loss occur at the time of accounting period. Balance sheet shows financial position of an enterprise by developing final account that shows accurate and concise information of firm for beneficiaries of accounting information of that firm.

In this block, students will get knowledge about bank reconciliation statement and its occurrence and will study about debit and credit part of the statement. The concept of finding profit and loss and study of company act 1956 made the student aware about certain standards. The block will detailed about financial statement that occur in a business concern with features along with examples. The knowledge about income with respect to trading account is well explained.

After studying this block, students will be able to understand correctly about how debit and credit appears in bank reconciliation statement and how one can calculate profit and loss of his company. The student will be helped with various financial statement concepts that will help them to create a balance sheet and compares various accounts.

Block Objective

After learning this block, you will be able to understand:

- The need for bank reconciliation statement.
- Different methods of preparation of bank reconciliation statement.
- Design and understand about format of trading account.
- Detailed about trading account items (dr. side) and (cr. side).
- Concept of profit and loss account items (dr. side) and (cr. side).
- Gross loss and profit.

- Profit & loss account as per companies act, 1956.
- Non-trading income.
- Basic of company financial statements.
- Features about financial statements.
- The types of liabilities.
- The format of financial statements.

Block Structure

Unit 1: Bank Reconciliation Statement

Unit 2: Final Accounts

Unit 3: Balance Sheet

UNIT 1: BANK RECONCILIATION STATEMENT

Unit Structure

1.0 Learning Objectives

1.1 Introduction

1.2 Causes of Difference

1.3 Need for Bank Reconciliation Statement

1.4 Method of Preparation

1.5 Let Us Sum Up

1.6 Answers for Check Your Progress

1.7 Glossary

1.8 Assignment

1.9 Activities

1.10 Case Study

1.11 Further Readings

1.0 Learning Objectives

After learning this unit, you will be able to understand:

- Meaning and objectives of preparing a bank reconciliation statement.
- Various causes of difference.
- Methods of preparing bank reconciliation statement.

1.1 Introduction

A bank reconciliation statement is prepared that brings into agreement the cash balance per book and cash balance per bank. It is usually prepared monthly because the bank provides the depositor a bank statement at the end of every month.

For any business firm its cash balance is a very important element of its financial conditions. For exercising greater control over cash, most of the business concerns prefer to operate a Bank Account. The banker acts as a custodian of the funds to be spent by business. Since the banker is the trustee of the customer, the bank provides to its customer a Pass Book or Bank Statement (at regular intervals), which summarizes payments as well as deposits and other charges for the period.

To know the bank balance a firm has two sources of information:

- Bank column of the cash book; and
- Bank Statement

On principal, two balances should be equal and opposite on a stated date. However, usually these two balances do not agree due to various reasons. In view of the above mentioned explanation, it becomes necessary to reconcile the balances.

1.2 Causes of Difference

Sometimes the balance in bank statements does not agree with the bank balance in the cash book of the firm.

The reason for disagreement appears from:

1. **Cheques issued and not shown for payment:** When cheques are issued, the entry in the cash book is made immediately. In the books of the bank, the entry is made only when the cheque is presented for payment. It is possible that at the time when the balances of the two books are being compared, some of the cheques might have been issued but might not have been presented for payment thus causing a disagreement between the two balances.

2. **Cheques paid in bank but not cleared**: As soon as the cheques are deposited into the bank, the entry is passed on the debit side of the bank column in the cash book. The customer's account is credited by the bank only when the cheques are cleared. It is possible that when the cashbook is compared with pass book some of the cheques deposited by the concern will remain uncollected.

3. **Interest allowed by the bank**: Bank might have credited the account of the customer with the interest and may have made the entry in the pass book. It is possible that the entry 10 respect of such interest will not have been made by the customer in the bank column of the cash book thus causing a disagreement between the two balances.

4. **Interest and bank charges debited by bank:** The bank debits the account of the customer by way of interest on overdraft. It also debits the account of the customers by way of incidental charges and collection charges. As soon as these charges are made, the bank debits the customer's account. However, the entries in the cash book are made by the customer. Only when he receives the bank statement or the pass book.

5. **Interest, dividend, etc. collected by the bank:** Sometimes interest on government securities or dividend on shares is collected by the bank and is credited to customer's account.

6. **Direct payment by bank:** Direct payment from the bank means that the customer has authorised the bank to pay payments like insurance premium, club fees, etc. by issuing standing instruction or authorizations.

7. **Direct payment into bank by customer:** Customer deposit cash directly into saving or current account without entering into cash book as of delay by instructions by customers.

8. **Dishonour of bill discounted with the bank:** Sometimes customers get their bills discounted with the bank. If the bank is not able to get payment of these bills on the due date, it will debit the customers accounts with the amount of the bills together with the noting charges, if any. The customer will pass the entry in his books on receipt of the information from the bank.

9. **Any error committed by the bank:** Besides the above reasons if any error is committed either by the bank or by the customer himself while recording the transactions in their respective books it will cause disagreement between the two balances.

Check your progress 1

1. Which is not a cause of disagreement of bank balance?

   a. Direct payment in account

   b. Failure of online cash system

   c. Bill dishonour

   d. Interest collected by Bank

1.3 Need for Bank Reconciliation Statement

1. It reflects the actual bank balance position.
2. It helps to detect any mistake in the cash book and in the pass book.
3. It prevents frauds in recording the banking transactions.
4. It explains any delay in the collection of cheques.

Check your progress 2

1. The need of Bank Reconciliation Statement shows:

   a. Bank balance position.

   b. Prevention of Frauds.

   c. Delay in collection of cheques.

   d. All of above

1.4 Method of Preparation (Without Adjustment)

1. When balance as per cash book (favourable) is given:

When cash book balance is given we have to find out the pass book balance. In that case, we have to ascertain the impact of each item that causing difference, on the pass book favourable balance. In other words, we will have to see whether a particular item increases or decreases the favourable balance as per the passbook.

Add: Items that increase passbook balance more than cash book.

- Cheque issued but not presented for payment
- Interest credited by bank not presented for payment
- Dividend collected by bank not recorded in cash book
- Debtors directly deposited into bank, not entered in cash Book
- Bank Charges recorded twice in cashbook etc.

Less: Items that decreases pass book balance more than cash book.

- Cheque deposited but not presented for payment
- Debit side of the cash book was overcast
- Credit side of the cash book was under cast
- Dishonoured cheque appeared in the pass book but not entered in the cash book
- Bank Charges not recorded in the cash book
- Direct payment by bank as per standing order not recorded in the cashbook etc.

Illustration 1

The particulars show Bank reconciliation Statement of Sri. S. Mazumdar of 31 March 1994:

		Rs.
(a)	Bank balance as per cash book	7,000
(b)	Cheques issued but presented after 31st March	1,000
(c)	Cheques issued for Rs. 500 Rs. 1,000 and Rs. 1,500 but Cheque for 1,000 was presented on 3rd April	
(d)	Cheques issued but not recorded in cash Book	750
(e)	Cheques deposited but credited after 31st March,	250
(f)	Cheques deposited for Rs. 1,000 Rs. 1,200 and Rs. 1,600, but cheque for Rs. 1,600 was credited on 2nd April	
(g)	Cheques deposited into Bank but not recorded in Cash	

	Book	1,000
(h)	Debit side of the cashbook was overcast by	500
(i)	Credit side of the cashbook was undercast by	800
(j)	Bank Interest credited for Rs. 150 and debited for interest Rs. 50 not recorded in cashbook	
(k)	Dividend collected by bank but not recorded in Cash Book	1,000
(i)	A debtor directly deposited into bank not recorded in cash book	500
(m)	Rs. 1,000 in respect of dishonoured cheque appeared in the Pass book but not in the Cash Book	
(n)	Bank met a Bill Payable of the firm for Rs. 1,500 on 30th March, under advice to the firm on 2nd April	
(o)	Bank's Charges for cheque book by Sri Mazumdar Rs. 5, entered in Cash Book twice	
(p)	Cheque for Rs. 50 drawn by Mr. Mukherjee and charged to Sri Mazumdar's account in error in March 1994.	

Solution

In books of Shri S. Mazumdar

Bank Reconciliation Statement

as at 31st March 1994	Rs.	Rs.
Bank Balance as per Cash book		7,000
Add: Cheques issued but not presented	1,000	
Cheques issued but not presented	1,000	
Cheques deposited into bank and not recorded in cash book	1,000	
Interest credited by Bank not recorded in Cash Book	150	
Dividend collected by Bank not recorded in Cash Book	1000	
Dividend deposited in Bank not recorded in cash book	500	
Bank's Charges recorded twice in cash book	5	4,655
		11,655
Less :Cheques issued but not recorded in Cash Book	750	
Cheques deposited but not credited by the Bank	250	
Cheques deposited but not credited by the Bank	1,600	

Debit side of the Cash Book was overcast	500
Credit side of the Cash Book was under cast	800
Bank Charges debited by Bank not recorded in Cash Book	50
Dishonour cheques shown in Pass Book not entered in Cash Book	1,500
Contd. Bank met a Bill Payable but not recorded in Cash Book	1,500
A Cheque drawn by Mr. Mukherjee wrongly debited by	50
Bank to Sri Mazumdar A/c	6,500
Bank Balance as Per Pass Book	**5,155**

2. When Balance as per Pass Book (favourable) is given:

In case we have to ascertain the impact of each, item that causing difference, on the cash book favourable balance. In other words, we will have to see whether a particular item increases or decreases the favourable balance as per the cashbook.

Add: Items, which increase cashbook balance, more than pass book.

- Cheque deposited but not credited
- Bank Charges not recorded in the cash book
- Dishonoured cheque appeared in the pass book but not in the cash book
- Debit side of the cash book was overcast
- Direct payment by bank as per standing order not recorded in the cashbook etc.

Less: Items, which decrease cashbook balance, more than pass book.

- Cheque issued but not presented for payment
- Interest credited by bank not presented for payment
- Dividend collected by bank not recorded in cash book
- Debtors directly deposited into bank, not entered in cash book
- Bank charges recorded twice in cashbook etc.

Illustration 2

From the following Particulars, Prepare a Bank Reconciliation Statement showing the Balance as Per Cash Book on 31st March 1994:

		Rs.
(a)	Balance as per pass book	8,000
(b)	Cheques deposited but not credited by the bank	1,000
(c)	Cheques issued but not presented for Payment	500
(d)	Cheques deposited into Bank without recording in Cash Book	600
(e)	Cheques issued to creditors but not recorded in Cash Book	700
(f)	Dividend collected by Bank, not recorded in Cash Book	100
(g)	Deposits directly deposited into Bank not recorded in Cash Book	2,000
(h)	Debit side of the Cash Book was under cast by	1,000
(i)	Bank charges debited in Pass Book, not recorded in cash Book	50
(j)	Bank met a Bill Payable for Rs. 1,000 on 30 / 3/ 1994 under advice to the firm on 2/4/1994	-
(k)	A bill for Rs. 2,000 discounted for Rs. 1,900 returned dishonoured by Bank noting Charge being	10
(i)	A Bill for Rs. 1,000 discounted with the Bank is entered in the Cash Book without recording the discount charges	100

Solution:

In the Books of

Bank Reconciliation Statement as of 31st March 1994

	Rs.	Rs.
Bank Balance as per Pass Book		8,000
Add : Cheques deposited but not credited by the Bank	1,000	
Cheques issued to creditors but not recorded in Cash Book	700	
Bank charges debited in pass book, not entered in Cash Book	50	
Bank met a Bill Payable, not recorded in Cash Book	1000	
Bills discounted and dishonoured, not entered in Cash Book	2,010	
Bill discount by Bank without recording discounting charges	100	
		4,860
		12,860
Less :Cheques issued but not presented for payment	500	
Cheques deposited in Bank without recording in Cash book	600	
Dividend collected by Bank, not recorded in Cash Book	100	
Debtors directly deposited in Bank not recorded in Cash Book	2,000	
Debit side of the Cash Book was under cast	1,000	
Bank Balance as per Cash Book	4,200	
	8,660	

3. When Bank Overdraft as per Cash Book is given:

If we start Reconciliation Statement with bank overdraft as per the Cash Book, then we are to ascertain the impact of each item (causing difference) on pass book overdraft. In other words, we will have to see whether a particular item increases the overdraft as per the pass book or decreases as per the pass book

Add: The items, which will increase the pass book overdraft more than the cash book overdraft.

- Cheques paid/deposited into bank but not credited
- Bank met a pay order as per standing instruction
- Bank charges debited in the pass book, not in cash book
- Deposited cheque dishonoured, not entered in the cash
- Interest charged on overdraft, not entered in the cashbook etc.

Less: The items, which will decrease the pass book overdraft more than the cash book overdraft.

- Cheque issued but not presented for payment
- Direct deposit by debtor, not recorded in the cash book
- Interest on overdraft recorded in cash book, not in pass book
- Credit side of the cash book is overcast
- Bank collected any income not entered in the cashbook etc.

Illustration 3

Following particulars prepare bank reconciliation statement for Sri S. Sarkar as 31st Dec. 1995:

(a) Bank Balance as per Cash Book (Cr.) Rs. 610

(b) Cheques issued but not presented Rs. 3,000

(c) Cheques deposited but not credited by bank Rs. 2,500

(d) Cheque drawn for Rs. 100 where amount entered as Rs. 10 in Cash Book

(e) Debtor deposited in Sarkar's Bank Account not recorded in Cash Book Rs. 1,000

(f) Credit side of Cash Book was undercast by Rs. 500

(g) Cheque for Rs. 5,000 drawn by Mr. Banerjee charged to Sri Sarkar's Account

(h) Bank paid Bill for Rs. 1,450 but recorded in cash book as Rs. 1540

(i) Receipt column of Cash Book has been overcast by Rs. 1,000

(j) Discount of Rs. 410 entered by mistake with cheque in bank column of cashbook

(k) Pursuant to instruction dated 30 the Dec. 1995, asking the banker to transfer Rs. 10,000 to fixed deposit Account an entry was made in Cash Book but bank acted on Jan. 1996.

(i) The Bank debited the account for Rs. 500 being the amount of a cheque received from a customer and returned dishonoured but not entered in Cash Book.

(m) Cheques of Rs. 300 through actually banked not entered in Cash Book.

Solution

In the books of Sri. S. Sarkar

bank reconciliation statement

As at 31 st Dec. 1995

	Rs.	Rs.
Bank Balanced as per Cash Book (Cr.)		610
Add: Cheques deposited but not credited by the Bank	2,500	
Cheques drawn for Rs. 100 but recoded only Rs. 10 in the Cash Book	90	
Credit side of the Cash Book was undercast	500	
Bank wrongly debited Sarkar's account	5,000	
Bank column of the cash book overcast	1,000	
Discount Allowed Rs. 410 has been entered through mistake with the cheque in the Bank column of the Cash Book	410	
Bank debited for a dishonoured cheque, not entered in cash book	500	
		10,000
		10,610
Less: Cheques issued but not presented	3,000	
A debtor directly deposited into Bank but not recorded in cash book Rs. 1,540	1,000	
Transfer to fixed deposit account not recorded in Pass Book	90	
Transfer to fixed deposit account not recorded in Pass Book	10,000	
Cheques deposited but not recorded in Cash Book	300	14,390
Bank Balance as per Pass Book (Cr.)		3,780

4. When Bank Overdraft as per Pass Book is given:

If we start Reconciliation Statement with bank overdraft as per the Pass Book, then we are to ascertain the impact of each item (causing difference) on cash book overdraft. In other words, we will have to see whether a particular item increases the overdraft as per the cash book or decreases as per the cash book.

Add: the items, which will increase the cash, book overdraft more than the pass book overdraft.

- Cheque issued but not presented for payment
- Direct deposit by debtor, not recorded in the cash book
- Interest on overdraft recorded in cash book, not in pass book
- Credit side of the cash book is overcast
- Bank collected any income not entered in the cash book etc.

Less: The items, which will decrease the cash, book overdraft more than the pass book overdraft.

- Cheques paid/deposited into bank but not credited;
- Bank met a pay order as per standing instruction;
- Bank charges debited in the pass book, not in cash book;
- Deposited cheque dishonoured, not entered in the cash book;
- Interest charged on overdraft, not entered in the cash book etc.

Check your progress 3

1. bank reconciliation statement is prepared:

   a. end of financial year

   b. every month

   c. quarterly

   d. Half yearly

1.5 Let Us Sum Up

In this unit we have learnt that a bank reconciliation statement is prepared that brings into agreement the cash balance per book and cash balance per bank.

It is studied that there are four methods of preparing bank reconciliation statements namely:

- When balance as per cash book (favourable) is given?
- When balance as per pass book (favourable) is given?
- When bank overdraft as per cash book is given?
- When bank overdraft as per pass book is given?

1.6 Answers for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (2-d)

Check your progress 3

Answers: (1-b)

1.7 Glossary

1. **Accounting -** The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.
2. **Balance Sheet -** A summary of all the accounts of a business, usually prepared at the end of each financial year.
3. **Gross loss -** The balance of the trading account, assuming it has a debit balance.
4. **Gross profit** - The balance of the trading account, assuming it has a credit balance.

1.8 Assignment

Discuss the causes of the disagreement between balance in bank statements and bank balance shown by cash book.

1.9 Activities

Discuss the statement, “Bank reconciliation statement reflects actual bank balance position”.

1.10 Case Study

Discuss the items, which increase the passbook balance more than the cash book. In addition, the items which will decrease the passbook balance more than the cash book.

1.11 Further Readings

1. Accounting for Managers, Jawaharlal.
2. Financial Accounting for Management, Ambrish Gupta.
3. Financial Accounting for Business Managers, Ashish K Bhattacharya.

UNIT 2: FINAL ACCOUNTS

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 Trading Account

2.3 Format of a Trading Account

2.4 Trading Account Items (Dr. Side)

2.5 Trading Account Items (Cr. Side)

2.6 Balancing of Trading Account

2.7 Profit and Loss Account

2.8 Format of a Profit and Loss Account

2.9 Profit and Loss Account Items (Dr. Side)

2.10 Profit and Loss Account Items (Cr. Side)

2.11 Balancing the Profit and Loss Accounts

2.12 Adjustments

2.13 Difference between Trading A/c and Profit and Loss A/c

2.14 Let Us Sum Up

2.15 Answers for Check Your Progress

2.16 Glossary

2.17 Assignment

2.18 Activities

2.19 Case Study

2.20 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- The Stages of the accounting cycle.
- Objectives of preparing final accounts.

- Treatment of different items in preparation of the final accounts.
- Preparation of trading, profit and loss account and balance sheet.
- Concept of financial statements.
- Types of financial statements.

2.1 Introduction

The basic objective of accounting is to determine profit or loss of the firm and to ascertain financial position as on a given date. Preparing final accounts or financial statements can do this. Once the Trial Balance is created, then you can create Preparation of Final Accounts. It is known that a Final Account is also called as Financial Statement.

It involves:

a. Preparation of trading account

b. Preparation of a profit and loss account

c. Preparation of a balance sheet

2.2 Trading Account

Trading Account is prepared to know the result of trading operation. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss of a business during an accounting period, usually a year. In accounting parlance, gross profit means overall profit. Gross profit is the difference between sale proceeds of a particular period and the cost of the goods actually sold. Gross profit means overall profit, no deduction of any sort is made, i.e., general, administrative or selling and distribution expenses. Gross Profit is said to be made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of the goods sold, gross loss is incurred.

Check your progress 1

1. Trading Account is prepared to know about:

a. gross profit of business

b. gross loss of business

c. both a and b

d. neither a nor b

2.3 Format of a Trading Account

The format of a trading account and the usually appearing entries therein are shown below:

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock		***	By Sales	***	
To Purchase	***		Less: Returns	***	***
Less: Returns Outwards	***	***	Inwards		
To Direct Expenses			By Abnormal	***	
Freight & Carriage	***		Losses	***	
Customs & Insurance	***		Loss by fire	***	***
Wages	***		Loss by		***
Packing	***		Accident		
(essential)	***		Loss by theft		
Gas & Water	***		By Closing Stock		
Fuel & power	***	***	By Gross Loss c/d		
Factory expenses		***	(Balancing figure)		
Royalty on production					
Dock Dues					
To Gross Profit c/d					
(Balancing figure					
		***			***

Check your progress 2

1. Trading account contains information about:

   a. purchase

   b. expenses

   c. closing stock value

   d. all of above

2.4 Trading Account Items (Dr. Side)

Following are the trading account items in Dr. Side-

Opening Stock: It refers to the value of goods at hand at the end of last accounting year. It becomes the opening stock for the current accounting year. It contains the value of goods in which business deals in.

Purchases: It denotes the value of goods (in which the concern deals in) purchased either for cash or on credit for the purpose of resale. The balance of the purchase account appeared in the Trial Balance, shows the total purchases made during the accounting period. In respect of purchases the following points must be noted:

- Purchase of capital asset should not be added with the purchases. If it is already included in purchases, it should be deducted from there.
- If goods purchased for personal use and added with the purchases, it should be excluded. This type of purchases should be treated as drawings.
- If some of the goods purchased are still in transit at the year-end, it is better to debit Stock-in-transit Account and credit cash or supplier's account.
- If the amounts of purchases include goods received on consignment, or on approval or on hire purchase, these should be excluded from purchases.
- Cost of goods sent on consignment must be deducted from the purchases in case of a trading concern.

Purchases Returns/Returns Outwards: When goods are returned to the supplier, for some reason, in the books of account suppliers is debited and purchases returns or returns outwards is credited. In the trial balance, it appears in the credit side. There are two ways of showing the purchases returns in the trading account. It may be shown by way of deduction from purchases in the trading account. An alternative way to show the purchases returns in the credit side of the trading account.

Direct Expenses: These expenses are incurred in connection with purchase, procurement or production of goods. It also includes expenses, which bring the goods upto the point of sale as shown in trading format above.

Check your progress 3

1. Opening stock is concerned with:

   a. It shows value of goods at hand

   b. It is for previous accounting year

   c. It shows value of goods purchase

   d. All of above

2.5 Trading Account Items (Cr. Side)

Following are the trading account items in Cr. Side-

Sales: It refers to the sale of goods in which the business deals in and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets, which were acquired for use in business. However, goods sent to customers on approval basis, free samples and sales tax, if any, included in the sales figure should be excluded.

Sales Returns / Returns Inward: When goods are returned by the buyers, for some reasons, in the books of account "Returns Inwards Account" or "Sales Returns Account" is debited and buyer is credited. In the Trial Balance, it is appearing in the debit side. There are two ways of showing sales returns in the Trading Account. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns in the debit side of the Trading Account.

Abnormal Loss: It refers to abnormal loss of stock due to fire, theft or accident. Since Trading Account is prepared under normal conditions of the business, abnormal loss if any is credited fully to the Trading Account.

Closing Stock: It refers to the value of goods lying unsold at the end of any accounting year. The stock at the end is valued at either cost or market price whichever less is. Since trial balance generally does not include closing, stock the following entry is recorded to incorporate the effect of closing stock in the Trading Account.

Closing Stock A/c Dr.

To trading A/c

However, if closing stock from the part of trial balance, it will not be transferred to trading account but taken to balance sheet only. In case the goods have been sent to customers on approval basis, such goods should be included in the value of closing stock.

Check your progress 4

1. Abnormal loss of stock results due to:

   a. fire c. accident

   b. theft d. all

2.6 Balancing of Trading Account

Once the above items are noted on particular sides of trading account, then the balance is calculated to find gross profit or gross loss. It is found that when the credit side total value is more than debit side total value then it shows gross profit, while, if debit side total value is more than credit side total value, then it shows gross loss. Under such case, gross profit is transferred to credit side of profit and loss account along with gross loss that is shifted to debit side of profit and loss account.

Check your progress 5

1. In a trading account, when credit side total is more than debit side total then it shows:

   a. gross profit

   b. gross loss

   c. net profit

   d. net loss

2.7 Profit and Loss Account

Profit and loss account shows the net worth of business transactions. It shows the status of account which details about net profit/loss of trader. The profit and loss account is opened with gross profit transferred from the trading account. After this, all expenses and losses are transferred to debit side of profit and loss account. The excess of gain over losses is called as net profit and that of loss over gain is called as net loss. The account is closed by transferring the net profit or loss to capital account of the trader.

The requirements as to profit and loss account can be put into two categories:

- General Requirements
- Special Requirements as per schedule VI, Part II
- General requirements

These basically relate to three matters:

Heading: In case of companies, it is not required to split profit and loss account into three categories:

- Trading Account
- Profit and Loss Account
- Profit And Loss Appropriation

1. Profit & Loss Account can be prepared under two headings:

a. Profit & loss account shows details about gross profit and net profit earned by company at the time of particular period.

b. Profit & loss shows accounting details about Balance of Profit & Loss Account which was brought from previous year, Net Profit trend during year and appropriations during year.

Provision for Taxation: On receiving income, companies charged with heavy income tax at high rate that can be upto 40% or more of taxable profit. It is finding that provision for taxation is appropriation of profits. It is seen that tax is taken-from profit & loss account to profit & loss appropriation account.

Accounting Year: With Companies Act, company need to select period of 12 months, on account of tax laws that becomes obligatory for company to close books of accounts on 31st March, every year.

2. Special Requirements as per Schedule VI, Part II:

The Profit & Loss Account should particularly disclose information in respect of the following items:

a. The turnover of the company

b. Commission paid to sole-selling agents

c. Commission paid to other selling agents

d. Brokerage and discount on sales other than the usual trade discount

e. Opening and dosing of goods, purchases made or cost of goods manufactured or value of services rendered during the period covered by the account

f. Interest on company's debentures and other fixed loans. E.g.- Amount charged as income tax

g. Remuneration payable to the managerial personnel

h. Amount paid to auditor for services rendered as (a) auditor and (b) as advisor in any other capacity viz. taxation matters: company law matters: management services, etc.

i. The details of licensed: installed and actual capacity utilised

j. Value of imports, earnings in foreign exchange and amounts remitted during the year in foreign currencies on account of dividends

Consider below the format of profit & loss account of a company as shown:

….. Company Limited

PROFIT AND LOSS ACCOUNT

For the year . . . . .

* / ** of the two only one figure will appear.

To Opening Stock	…..		By Sales (less return)	…..
To Purchase (less returns)	…..		By Closing Stock	…..
To Wages	…..		By Gross Loss (c/d)*	…..
To Manufacturing Expenses	…..			
To Gross Profit (c/d)*	…..			
	…..			…..
To Gross Loss b/d*	..…		By Gross Profit b/d*	…..
To Salaries	…..		By Dividends	…..
To Rent	…..		By Net Loss c/d**	…..
To Insurance	…..			
To Lighting	…..			
To Auditors' Fees	…..			
To Depreciation	…..			
To Traveling & Conveyance	…..			
To Printing & Stationery	…..			
To Directors' Fees	…..			
To Managing Director's Remuneration	…..			
To Provision for Taxation	…..			
To Net Profit c/d**	…..			
	…..			…..

Profit & Loss Appropriation Account

For the year ending…

	Rs.			**Rs.**
To Net Loss for the year *	…..		By Balance b/d	…..
To Transfer to Reserves	…..		By Net profit for the year *	…..
To Proposed Dividends	…..		By Balance c/d**	…..
To Balance c/d **	…..			
	…..			…..

* / ** of the two only one figure will appear.

Check your progress 6

1. The excess of loss over gain is called as:

   a. gross profit

   b. gross loss

   c. net profit

   d. net loss

2.8 Format of a Profit and Loss Account

The format of Profit and loss account is as follows:

	Particulars	**Amount (Rs.)**		**Particulars**	**Amount (Rs.)**
	Gross Loss b/d	**	By	Gross Profit b/d	**
	Office and Administrative Expenses:	**	By	Interest received	**
	Salaries for Office Staff	**	By	Dividend Received	**
	Office Rent, Rates & Taxes	**	By	Rent Received	**
	Printing and Stationery		By	Discount Received	**
	Books and Periodicals Postage and Telephones	** ** **	By	Profit on sale of fixed assets	**
	Insurance Premium for office	**	By	Profit on sale of investments	**
	Audit Fees	**	By	Dividend from shares Insurance Claims	**
	Repairs & Maintenance	**	By	Duty Drawbacks	**
	Audit Fees	**	By	Apprenticeship	**
	Legal Expenses		By	Premium	**
	Office Lighting		By	Miscellaneous Receipts Bad Debt	**

	Particulars	**Amount (Rs.)**		**Particulars**	**Amount (Rs.)**
				recovered	
	Depreciation of Office Assets	**			
	Other office expenses	**			
	Selling and Distribution Expenses:	**			
	Salesmen's Salaries	**			
	Selling Commission	**			
	Traveling Expenses	**			
	Brokerage	**			
	Trade Expenses	**			
	Advertisement & Publicity	**			
	Sales Promotion Expenses	**			
	Carriage Outward	**			
	Godown rent	**			
	Bad debts	**			
	Provision for Bad Debts	**			
	Repairs of Vehicles	**			
	Godown Insurance	**			

	Particulars	**Amount (Rs.)**		**Particulars**	**Amount (Rs.)**
	Delivery Van Expenses	**			
	Packing Expenses	**			
	Rebate to Customer				
	Royalty (based on units sold)	**			
	Financial Expenses:	**			
	Discount Allowed				
	Interest on Loan paid				
	Interest on Capital				
	Discount on Bills				
	Bank Charges				
	Abnormal Losses:				
	Loss on Sale of machinery				
	Loss on sale of Investment				
	Loss by fire				
To	Misc. Expenses	**			
To	Net Profit transferred to Capital A/c	**			

	Particulars	Amount (Rs.)		Particulars	Amount (Rs.)
	(Balancing figure)				
		**			**

Check your progress 7

1. In profit and loss statement, which among the following is not covered?

a. Gross profit c. Dividend

b. Gross loss d. Discount

2.9 Profit and Loss Account Items (Dr. Side)

The Items that will appear in the debit side of a profit and loss account can broadly be classified as under:

a. **Management Expenses:** These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses, under this head, include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.

b. **Selling and Distribution Expenses:** These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include repairs, renewals, etc.

c. **Maintenance Expenses:** These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include repairs, renewals, etc.

d. **Financial Expenses:** These expenses are incurred for arranging finance necessary for running the business. These include interest on loans, discount on bills, brokerage**,** legal expenses for raising loan, etc.

e. **Abnormal Losses:** Some abnormal losses may occur during the accounting period. All types of abnormal losses are treated as extra ordinary expenses and debited to profit and loss account. Examples are stock lost by fire and not covered by insurance, loss on sale of machinery, cash defalcation, etc. The wages and salaries earned by the worker – whether paid or not – and

rent, electricity, telephone expenses are to be taken into consideration whether paid during the accounting period or not. To ascertain the amount of expenses to be debited to the Profit and Loss Account, four types of event are needed to be considered and the cash payment made in connection with these events.

They are as under:

- **Expenses incurred and paid out in that year:** If expenditure is incurred in one year and also paid in the same year, the same will be debited to the Profit and Loss Account.

- **Expenses incurred but not paid out, partly or fully during the current year:** These expenses become liabilities of the business at the end of the accounting year. In fact, on the date of the final accounts, outstanding expenses, both an expenses and a liability exists without having been recorded in the books of account. For recording it, the following entry is to be passed:

  Expenses A/c Dr. (will be shown in the P & L A/c)

  To Outstanding Expenses A /c (will appear in the liabilities side of balance sheet)

- **Expenses paid for during the current year but not yet incurred, partly or fully:** Sometimes, it happen that some expenses are paid during the current year but yet incurred, partly or fully, are known as "Prepaid Expenses". Prepaid expense is an asset to the business and will be shown in the Balance Sheet. The adjustment entry to be passed"

  Prepaid Expenses A/c Dr. (to be shown as asset in the Balance Sheet)

  To Expenses A/c (balance of this account is to be debited to P&L A/c)

- **Expenses of the current year likely to arise in subsequent period:** Sometimes, an expenses or a loss may arise in the future in connection with current years' business. In such a case, we make a provision of the anticipated loss and a charge is created against the profit for the current period. This provision is shown either as a liability or as a contingent asset, i.e., it appears in the Balance Sheet as a deduction from some other asset. The best example of these anticipated expenses is provision for bad debts.

Check your progress 8

1. In debit side of profit and loss statement, which is not included?

   a. Management Expenses

   b. Selling Expenses

   c. Maintenance Expenses

   d. Non-trading Income

2.10 Profit and Loss Account Items (Cr. Side)

The Items that will appear in the credit side of a Profit and Loss Account can broadly be classified as under:

a. **Gross Profit:** It is basically the leftover of trading account transferred to the Profit and Loss Account. If the trading account shows a gross loss, it will appear on the debit side.

b. **Other Incomes:** During the course of the business, other than income from the sale of goods, the business may have some other income of financial nature. The examples are discount or commission received.

c. **Non-trading Income:** The business may have various transactions with the bank. At the end of the year, the business may earn some amount of interest, which will find a place in the Profit and Loss Account as non-trading income. The business may have some investment outside the business in the form of shares or debentures or units. Any incomes received from these investments are also considered as non-trading income and are treated in the same way.

d. **Abnormal Gains:** There may be capital gains arising during the course of the year, e.g., profit arising out of sale of a fixed asset. The profit is shown as a separate income on the credit side of the Profit and Loss Account.

Check your progress 9

1. In credit side of profit and loss statement, which is not included?

   a. Gross Profit

   b. Selling Expenses

   c. Other Income

   d. Non-trading Income

2.11 Balancing the Profit and Loss Accounts

Once the respective accounts are transferred from trial balance to P&L account, gross profit/loss transferred from trading account and all adjustments are take care of, the next step in preparation of P&L is the balancing of the account. This replicates balancing of trading account. The totals of debit side and credit side are computed and the difference between these totals is either a net profit or net loss. If the total of debit side exceeds the total of credit side, there is a net loss, whereas when the total of credit side exceeds the total of debit side, there is a net profit. Net Profit is the last item to be recorded on debit side; else, net loss is the last item on credit side. After computing net profit/loss, the two sides of P&L match.

When the Profit and Loss Account shows a net profit, we pass the following entry:

Profit & Loss A/c **Dr.**

To Net Profit A/c

If the Profit and Loss Account shows a net loss, the entry will be reversed.

Check your progress 10

1. To balance a profit and loss accounts, the:

   a. credit side of balance should match with debit side of balance

   b. credit side of balance should match with gross profit

   c. debit side of balance should match with net loss

   d. all of these

2.12 Adjustments

1. Outstanding Expenses

Certain expenses relating to a particular period may not have been paid in that accounting period. All such expenses which are due for payment in one accounting year but actually paid in future accounting years or payment of which is postponed are all outstanding or unpaid expenses.

2. Prepaid Expenses

It is the benefit of some expenses that were already spent which made available in next accounting year. This portion of expense is called as pre-paid expense as these are already paid.

3. Accrued Income

Certain income that earned at year which not yet received till end of year. Such income, which serves as interest on investments, rent and merchant normally earns commission during a particular accounting period.

4. Income Received in Advance

In particular trading period certain traders receive amounts that are earned in future periods. This income actually received and recorded and gets credited in profit and loss account of year in which earned.

5. Closing Stock

These are unsold stocks left at end of every year. These stocks are valued and follow entry, which is passed at end of year. During the end of next year, it shows in trial balance in terms of opening stock from where it is debited in trading account.

6. Depreciation

The value of fixed assets diminishes gradually with their use for business purposes. Although this decrease in the value happens every day but its accounting is done only at the end of accounting period with the help of following entry: Depreciation account To Particulars asset.

7. Interest on Capital

The proprietor may wish to ascertain his profit after considering the interest which he losses by investing his money in the firm. Interest to be charged is an expense for the business on one hand and income to the proprietor on the other hand. Following adjusting entry is recorded at the end of accounting period:

Interest on capital a/e To Capital a/c Interest on capital being an expense is debited to profit and loss account and same amount of interest on capital is added to capital.

8. Interest on Drawings

As business allows interest on capital, it also charges interest on drawings made by the proprietor. Interest so charged is an income for the business on one hand and expense for the proprietor on the other hand. Following adjusting entry is passed at the end. Of accounting period: Capital ale Dr. To Interest on drawings a/e The interest on drawings being an income is credited to profit and loss account is shown as a deduction from the capital.

9. Bad Debt to be written off

Bad debts are irrecoverable debts from customers, during the course of the financial year. These are recorded as follows: Bad debts a/c To Sundry Debtors a/c It results in the reductions of customers debit balance and addition to the loss i.e. Bad Debts. At the end of the year when the trial balance is drawn, these two accounts show debit balances.

10. Provision for Bad Debts

At the end of the year, after writing off the bad debts about whom we were sure of becoming irrecoverable, there may still be some customer balances from whom it is doubtful to collect the entire amount. However, it can't be written off as bad because non-recovery of such amount is not certain.

11. Provision for discount on Debtors

It is normal practice in trade to allow discount to customers for prompt payment and it constitutes a substantial sum.

12. Provision for discount on creditors

Prompt payment, if made, enables a business person to receive discount. The question arises whether this discount should be treated as income of the period in which purchases were made or of the period when the payment is made, if both events are in different accounting years, it has been well decided by accountants that it should be treated as income of the period in which purchases are made.

13. Losses by Accidents

Sometimes a business suffers certain losses not because of trading but because of certain accidents. These may destroy some fixed assets of the

merchant. In such a case the asset account is credited and the profit and loss account is debited.

14. Commission to manager payable on profits

Sometimes manager is entitled to a commission on profits.. Such commission may be:

a. Fixed percentage on net profits before charging such commission.

b. Fixed percentage on net profits- after charging such commission.

The commission is an expensive part which gets debited to commission account.

15. Goods used in business

It is found that goods purchased for resale are applied in business giving away for charitable purpose. Under such circumstances, purchases account gets credited with amount which same cost of goods has used in business.

Check your progress 11

1. _____is the type of income which earned at the year but not yet received till end of year.

   a. Prepaid Expenses

   b. Accrued Income

   c. Income Received in Advance

   d. Outstanding Expenses

2.13 Difference between Trading A/c and Profit & Loss A/c

Following are the differences between Trading A/c and Profit & Loss A/c.

Trading A/c	Profit and Loss A/c
Trading account shows result of trading operation of an enterprise	Profit and loss account shows the overall result of the business as a whole
Trading Account takes into account only direct cost involved including direct expenses	Profit and loss account deals with remaining costs and expenses, which are of indirect nature
Trading Account is prepared under normal conditions of business and hence abnormal loss if any, is credited to this account	Profit and loss account accounts for all normal and abnormal losses

Check your progress 12

1. Profit and loss accounts takes care about all:

   a. direct cost

   b. loss due to trading

   c. normal loss

   d. all of these

2.14 Let Us Sum Up

In this unit we have learnt that the main idea of accounting is to determine profit or loss of the firm and to ascertain financial position as on a given date. It involves preparing final accounts or financial statements can do this. It is seen that trading account is prepared to know result of trading operation and to ascertain gross profit or gross loss of a business during an accounting period, usually a year.

It is found that opening stock is that which is at the end of last accounting year. It becomes opening stock for the current accounting year having value of goods in which business deals in. It is also found that purchases are related to value of goods purchased either for cash or on credit for the purpose of resale. The balance of the purchase account appeared in the Trial Balance.

Abnormal Loss refers to abnormal loss of stock due to fire, theft or accident. Since Trading Account is prepared under normal conditions of the business, abnormal loss if any is credited fully to the Trading Account.

Profit and loss account shows the net worth of business transactions. It shows the status of account which details about net profit/loss of trader. The profit and loss account is opened with gross profit transferred from the trading account.

2.15 Answers for Check Your Progress

Check your progress 1

Answers: (1-c)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-d)

Check your progress 5

Answers: (1-a)

Check your progress 6

Answers: (1-d)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-b)

Check your progress 10

Answers: (1-a)

Check your progress 11

Answers: (1-b)

Check your progress 12

Answers: (1-c)

2.16 Glossary

1. **Abnormal Loss -** Losses arising in the production process that should have been avoided.
2. **Accounting -** The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.
3. **Balance Sheet -** A summary of all the accounts of a business, usually prepared at the end of each financial year.
4. **Closing Balance -** The balance of an account at the end (or close), of an accounting period; this figure is then carried forward to the next accounting period.
5. **Closing Stock -** Closing stock is the stock of inventory available with the business at the end of the accounting period.
6. **Gross loss -** The balance of the trading account, assuming it has a debit balance.
7. **Gross profit -** The balance of the trading account, assuming it has a credit balance.

2.17 Assignment

Discuss the features of trading account and its role in preparation of final accounts.

2.18 Activities

Discuss the direct expenses included on the debit side of trading account in detail.

2.19 Case Study

Prepare trading account of any manufacturing concern of your choice.

1. Explain the following:
    a. Return outwards
    b. Opening stock
    c. Purchases

2.20 Further Readings

1. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002
2. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003
5. Modern Accountancy, Hanif & Mukherjee, Law Point, 2006

UNIT 3: BALANCE SHEET

Unit Structure

3.0 Learning Objectives

3.1 Introduction

3.2 Difference between a Trial Balance and Balance Sheet

3.3 Preparation and Presentation of Balance Sheet

3.4 Explanation and Clarification of Certain Items

3.5 Limitations of Balance Sheet

3.6 Illustrations

3.7 Introduction to Company Financial Statements

3.8 Meaning and Type of Financial Statements

3.9 Nature of Financial Statements

3.10 Limitations of Financial Statements

3.11 Preparation of Company Financial Statements

3.12 Profit and Loss Account

3.13 Balance Sheet

3.14 Let Us Sum Up

3.15 Answers for Check Your Progress

3.16 Glossary

3.17 Assignment

3.18 Activities

3.19 Case Study

3.20 Further Readings

3.0 Learning Objectives

After learning this unit, you will be able to understand:

- Presentation of Balance Sheet.
- Basics of Trial Balance.

- The Study of Assets.
- The limitations of financial statements.

3.1 Introduction

As per Section 210 of Companies Act, a company needs to prepare balance sheet at end of every trading period. Section 211 needs balance sheet on particular form. Such type of provision is not applied in case of banking, insurance, electricity and certain other companies that are governed by some different Acts.

Example Company
Balance Sheet
December 31, 2007

ASSETS		**LIABILITIES**	
Current Assets		**Current Liabilities**	
Cash	$ 2,100	Notes Payable	$ 5,000
Petty Cash	100	Accounts Payable	35,900
Temporary Investments	10,000	Wages Payable	8,500
Accounts Receivable - net	40,500	Interest Payable	2,900
Inventory	31,000	Taxes Payable	6,100
Supplies	3,800	Warranty Liability	1,100
Prepaid Insurance	1,500	Unearned Revenues	1,500
Total Current Assets	89,000	Total Current Liabilities	61,000
Investments	36,000	**Long-term Liabilities**	
		Notes Payable	20,000
Property, Plant & Equipment		Bonds Payable	400,000
Land	5,500	Total Long-term Liabilities	420,000
Land Improvements	6,500		
Buildings	180,000		
Equipment	201,000	**Total Liabilities**	481,000
Less: Accum Depreciation	(56,000)		
Prop, Plant & Equip - net	337,000		
Intangible Assets		**STOCKHOLDERS' EQUITY**	
Goodwill	105,000	Common Stock	110,000
Trade Names	200,000	Retained Earnings	229,000
Total Intangible Assets	305,000	Less: Treasury Stock	(50,000)
		Total Stockholders' Equity	289,000
Other Assets	3,000		
Total Assets	$770,000	**Total Liabilities & Stockholders' Equity**	$770,000

Fig 3.1 General format of a Balance Sheet

Schedule VI, Part I shows the prescribed format of company's balance sheet, where notes and instructions in terms of various items mentioned under any of or sub-items. These schedules will be annexed to and form part of balance sheet.

Schedule VI, Part I shows presentation of balance sheet in horizontal and vertical forms.

The balance sheet details out the financial position of the company. It not only lists the items controlled or owned by the company but also includes the debts owned by the organization. A well evaluated balance sheet should have the value of company assets equaling the total of the value of the equity held by stock holders and also the liability of the company.

Balance sheet includes five basic elements. They are current and fixed assets, current and long-term liabilities and also equity.

The word 'current' refers to a period which is one year from the date of preparation of balance sheet or lesser. Hence, if we refer to current assets, it implies hard cash present in the company during the period of one year or the assets that would be turned into cash during this time period. The current assets include accounts receivable and also the inventory. Services companies do not have any inventory and hence it would be a total of cash as well as the accounts receivable.

Fixed assets refer to the equipment invested that affects your accounting process. Typically, this refers to machinery, building as well as vehicles purchased and used on a daily basis. Net fixed assets refer to the value obtained from actual value of purchase minus the depreciated value.

Current liabilities refer to those debts that would be settled within one year of the preparation of balance sheet. Long-term liabilities refer to long-term debts and mortgages of the organization. Equity includes the equity of stock holders, preferred stocks, treasury stock, retained earnings and paid-in capital.

3.2 Difference between a Trial Balance and Balance Sheet

The following are the points of distinction/difference between trial balance and balance sheet:

	Trial Balance		Balance Sheet
1	It is a list of balance extracted from the ledger accounts	1	It is a statement of assets and liabilities
2	It contains the balance of all accounts - real, nominal and personal.	2	It contains the balance of only those accounts, which represents assets and liabilities.
3	It is prepared before the preparation of trading and profit and loss account.	3	It is prepared after the preparation of trading and profit and loss account.
4	It does not contain the value of the closing stock of goods.	4	It contains the value of closing stock, which appears on the assets side.
5	Expenses due but not paid and incomes due but not received do not appear in the trial balance	5	Expenses due but not paid appear on the liability side and income due but not received appear on the asset side of the balance sheet.

Check your progress 1

1. Trial balance is:

   a. extract balance details from ledger

   b. statement of assets

   c. statement of liabilities

   d. prepared after preparation of profit and loss account

3.3 Preparation and Presentation of Balance Sheet

The Process of preparation and presentation of Balance Sheet involves two steps:

- Grouping
- Marshalling

The first step refers to proper grouping of the various items, which are to be shown in the Balance Sheet as assets and liabilities. For this purpose, items of similar nature are ground under one head so that the Balance Sheet could convert true message to its users.

The second step shows marshalling of assets and liabilities which is an orderly arrangements of assets and liabilities as displayed in Balance Sheet.

There are two methods of presentation:

- In the order of liquidity
- In the order of permanence

Following are respective formats of Balance Sheet to bring out the clarity of concept:

- **Liquidity Order**

BALANCE SHEET OF…

As on……..

Liabilities	**Amount Rs.**	**Assets**	**Amount Rs.**
Current Liabilities		Current Assets	
Bank Overdraft		Cash in hand	
Outstanding		Cash at Bank	
		Marketable	
Expenses			
Bills Payable		Securities	
Sundry		Short term Investment	
Creditors		Bills receivables	
Income received in Advance		Sundry Debtors	
		Prepaid	
		Expenses	
Long term Liabilities		Accrued Income	
Mortgaged loan			
Loan of Bank		Long term Investment	

Capital Add Profit Less Loss Less Drawings		Fixed Assets Furniture & Fixtures Motor Vehicles Tools & Equipments Plant & machinery Land and Building Intangible Assets Patents Copy rights Trademarks Goodwill	

- **Order of Permanence**

BALANCE SHEET OF…

As on…

Liabilities	**Amount Rs.**	**Assets**	**Amount Rs.**
Capital Add Profit Or Less Loss Less Drawings Long term Liabilities Mortgaged loan Loan from Bank Current		Fixed Assets Goodwill Land and Building Plant & machinery Tools & Equipments Motor Vehicles Furniture & Fixtures Patents Trademarks Investments (Long term)	

Liabilities Income received in Advance Sundry Creditors Bills Payable Outstanding Expenses Bank Overdraft		Current Assets Stock Sundry Debtors Bills receivables Short term Investment Marketable Securities Cash and Bank Balance Fictitious Assets Advertisement Profit & Loss Account Miscellaneous Expenses	

Check your progress 2

1. Balance sheet contains:

   a. assets

   b. liabilities

   c. capital

   d. all of these

3.4 Explanation and Clarification of Certain Items

In order to understand proper placement of various items it is necessary to know the type and nature of classification of assets and liabilities which are to be arranged in either of two orderly manner discussed earlier. For the purpose of presentation of assets in the Balance Sheet assets are classified as under:

- Fixed assets
- Intangible assets
- Current assets
- Fictitious assets
- Wasting assets
- Contingent assets

1. **Fixed assets:** Fixed assets are those assets, which are acquired for the purposes of producing goods or rendering services. These are not held for resale in normal course of business. Fixed assets are used for the purpose of earning of earning revenue and hence these are held for a longer period of time. These are also treated as 'Gross Block' (Fixed assets after depreciation) and "Net Block" (Fixed assets after depreciation). Investment in these assets is known as 'Sunk Cost'. Examples of fixed assets are Land & Building. Plant and Machinery, Furniture and Fixtures, Tools and Equipment and Motor vehicles, etc. all fixed assets are 'tangible' by nature.

2. **Intangible assets:** Intangible assets are those capital assets, which do not have any physical existence. Though cannot be touched or seen yet they have long life and help to generate income, such assets have value by virtue of the right conferred upon the owner by mere possession. Goodwill trademarks, copyrights and patents are the examples of intangible assets.

3. **Current assets:** Current assets include cash and other assets, which are converted or realised into cash within a normal operating, cycle or say within a year. These are acquired either for the purpose of resale, or assisting and helping process of production or rendering of service or supplying of goods. These assets constantly keep on changing there from and contribute to routine transactions and operations of business. Examples are, Cash, Bank, Bills Receivables, Debtors, Stock, Prepaid expenses, etc. Current assets are also known as floating assets or circulating assets.

4. **Liquid or quick assets:** Those current assets, which can be converted into cash at a very short notice or immediately without incurring much loss or exposing to high risk. Quick assets can be worked out by deducting Stock (Raw-materials, work-in-progress or finished goods) and prepaid expenses out of total current assets.

5. **Fictitious assets:** These are the non-existent worthless items which represent unwritten off losses or cost incurred in the past which cannot be recovered in further or realised in cash. Examples of such assets are preliminary expenses, Advertisement suspense, Underwriting commission, Discount on shares and debentures, Loss on issue of debentures and Debit balance of Profit and Loss Account.

6. **Wasting assets:** Assets with limited useful life by nature deplete over a limited period of time are called wasting assets. These assets become worthless once its utility is over or exhaust fully. Such assets are natural resources like, timber and coal, Oil, mineral deposits, etc.

7. **Contingent assets:** Contingent assets are probable assets, which may or may not become assets as it depends upon occurrence or non-occurrence of a specified event or performance or non-performance of a specified act. For example, a suit is pending in the court of law against ownership title of any disputed property and if the suit is decided in favour of the business concern it becomes the asset of the concern. On the other hand if the decision goes against the company, the company cannot enjoy ownership rights. Thus it remains a contingent asset as long as the judgement is not pronounced by clout. Such assets are shown by means of footnote and hence do not form part of assets shown in the Balance Sheet. Besides this hire-purchase contract, uncalled share capital, etc. are the other example of contingent assets.

Classification of liabilities

1. **Long term liabilities:** These are the obligations which are to be met by the business enterprise after a relatively long period of the time. Such liabilities do not become due for payment in the ordinary course of business operation or within normal operating cycle. Debentures, long term loans from Banks or financial Institutions are the examples of long term liabilities.

2. **Current liabilities:** Current liabilities are those liabilities which are payable within normal operating cycle i.e. within an accounting year. These may arise either out of realisation from current assets or by creating fresh current

liability (obligation). Trade creditors, Bills payable, Bank overdraft, outstanding expenses, short–term loan (payable within twelve months or within accounting year) are examples of current liabilities.

3. **Contingent liability:** It is not an actual liability by an anticipated (probable) liability which may or may not become payable. It depends upon happening of certain events or performance of certain acts. An element of uncertainly is always attached. A contingent liability, thus, may or may not become a sure liability. Examples are, liability for bills discounted, liability for acting as surety, liability arising on a suit for damages pending in the court of law, liability for calls on partly paid shares, etc. Contingent liabilities are shown as footnote under the Balance Sheet.

Check your progress 3

1. Balance Sheet assets are classified as:

a. Fixed assets
c. Current assets
b. Intangible assets
d. all of these

3.5 Limitations of Balance Sheet

It is found that Balance Sheet is prepared by an organisation for showing its financial position and carries certain limitations:

1. Fixed assets shown in Balance Sheet at original cost with less depreciation up to date. Such type of Balance Sheet will not show true value of assets.
2. It is seen that many times a balance sheet contains assets that has no market value like preliminary expenses, debenture discount, etc.
3. It is found that balance sheet will not be able to show value of certain factors like skill and loyalty of staff.
4. A conventional balance sheet may mislead untrained readers in inflationary situations.

Check your progress 4

1. Which is not a part of Balance Sheet?

a. Skills
c. Current assets
b. Intangible assets
d. all of these

3.6 Illustrations

1. From the under noted trial balance of a trader as on 31.12.1990 prepare a trading and Profit and Loss Account for the year ended 31.12.1990 and a Balance Sheet as on that date.

Trail balance

Particulars	**Rs.**	**Particulars**	**Rs.**
Cash in hand	1,200	Capital	80,000
Purchases	1,20,000	4% Bank Loan	20,000
Opening Stock	35,000	Bills Payable	22,000
Sundry Debtors	50,000	Sundry Creditors	24,000
Plant & Machinery	60,000	Sales	2,00,000
Furniture	15,000	Bad Debts Reserve	1,200
Bills Receivable	20,000		
Rent and Taxes	10,000		
Wages	16,000		
Salaries	20,000		
	3,47,200		3,47,200

Additional Information supplied: i) Closing Stock Rs. 40,000 (ii) Provide outstanding liabilities: Rent and Taxes Rs. 2,000; Wages Rs. 3,000; Salaries Rs. 4.000 (iii) Depreciation: On Plant and Machinery @ 5%; On Furniture @ 10% (iv) Write-off Rs 500 as Rs.500 as bed debts (v) Create bed debts reserve @ 2.55 on Sundry debtors.

Solution:

Trading and profit & loss account for the year ended on 31st December 1990

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Opening Stock		35,000	By Sales	2,00,000
To Purchases		1,20,000	By Closing Stock	40,000
To Wages	16,000			2,40,000
Add: Outstanding	3,000	19,000		
To Gross Profit c/d		66,000	By Gross Profit b/d	66,000
To Rent and Taxes	10,000			
Add: Outstanding	2,000	12,000		
To Salaries	20,000			
Add: Outstanding	4,000	24,000		
To Bad Debts		500		
To Reserve for Bad Debts (note 1):				
New	1,238			
Less: Old	1,200	38		
To Interest on Bank Loan @ 4% on Rs 20,000		800		
To Depreciation:				
On plant and Machinery	3,000			
On Furniture	1,500	4,500		
To Net Profit		24,162		
Total		66,000	Total	66,000

Balance Sheet as on 31st December, 1990

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital: Opening Balance	80,000		Plant and Machinery	60,000	
Add: Net Profit	24,162	1,04,162	Less: Depreciation	-3,000	57,000

4% Bank Loan	20,000		Furniture	15,000	
Add: Accrued Interest	800	20,800	Less: Depreciation	-1,500	13,500
Bills Payable		22,000	Bills Receivable		20,000
Sundry Creditors		24,000	Closing Stock		40,000
Outstanding Liabilities:			Sundry Debtors	50,000	
Rent and Taxes	2,000		Less: Bad Debts	-500	
Wages	3,000				
Salaries	4,000	9,000	Less: Reserve for bad debts	-1,238	48,262
			Cash in Hand		1,200
Total		1,79,962	Total		1,79,962

Working note: (i) New provision for bad debts = 2.5% of (Rs.50, 000) = Rs. 1,238. Additional provision required Rs. 1,238 – Rs. 1,200 = Rs. 38.

The Trial Balance of M/s R.S. Corporation as on December 31, 1990 was as under:

	Dr. Rs.	**Cr. Rs.**
Rajeev's capital A/c		80,000
Suresh's Capital A/c		1,00,000
Stock as on 1.1.1990		
Raw materials	2,500	
Finished goods	6,500	
Purchases	64,500	

Balance Sheet

Sales		1,19,000
Sales returns	2,000	
Wages	16,000	
Manufacturing expenses	12,000	
Salaries	8,000	
Insurance	1,500	
Postage	100	
Advertisement	1,000	
Bad Debts	300	
Bills Payable		12,000
Discount		500
Land and Building	90,000	
Plant and Machinery	70,000	
Furniture	1,000	
Sundry Debtors	25,400	
Sundry Creditors		42,000
Drawings		
Rajeev	1,800	
Suresh	1,400	
Cash in Hand	500	
Cash at Bank	49,000	
Total	3,53,500	3,53,500

Rajeev and Suresh share profit and Loss equally. Prepare Trading. Profit & Loss Account for the year ended on 31st December 1990 and also the balance Sheet as on that date after taking into consideration the following adjustments:

1. Stock on 31st December, 1990: Raw materials Rs. 4,000; Finished goods Rs.12,000.
2. Provide depreciation on land and building @ 5%; on furniture @10%; and on plant & machinery @5%.
3. Outstanding expenses: Salaries Rs. 1.500; wages Rs. 2,100.
4. Insurance paid for 15 months up to March 1991.
5. Write-off bad debts of Rs. 400
6. Reserve for doubtful debts @5% of Debtors.
7. Goods withdrawn by Rajeev for personal use Rs.2,000.

Solution

M/s R.S. Corporation

Trading and Profit & Loss Account for the year ended on 31st December 1990

Dr. **Cr.**

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**	**Rs.**
To Opening Stock			By Sales	1,19,000	
Raw materials	2,500		Less: Sales Returns		
Finished goods	6,500	9,000		2,000	1,17,000
To Purchases	64,500		By Closing Stock		
Less: Goods taken for personal use	2,000	62,500	Raw Materials	4,000	
To Wages	16,000		Finished Goods	12,000	16,000
Add: Outstanding	2,100	18,100			
To Manufacturing		12,000			

expenses					
To Gross Profit c/d		31,400			
Total		1,33,000	Total		1,33,000
To Salaries	8,000		By Gross Profit b/d		31,400
Add: Outstanding	1,500	9,500			
To Insurance	1,500		By Discount received		500
Less: Prepaid	300	1,200			
To Postage		100			
To advertisement		1,000			
To Bad Debt	300				
Add: Further Bad Debts	400	700			
To Provision for Doubtful debts		1,250			
To Depreciation:					
On Land & Building @ 5%	4,500				
On Furniture @ 10%	100				
On Plant & machinery @5%	3,500	8,100			
To Net Profit (transferred to partner Capital A/c)					
Rajeev	5,025				
Suresh	5,025	10,050			

Balance Sheet

Total		31,900	Total		31,900

Balance Sheet of M/s R S Corporation as on 31st December 1990

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**	**Rs.**
Capital Accounts:			Fixed Assets		
Rajeev	80,000		Land and Building	90,000	
Add: Share of Profit	5,025		Less: Depreciation	4,500	85,500
Less: Drawings (Rs 1,800 + Rs. 2,000)	3,800	81,225	Plant and machinery	70,000	
	1,00,000		Less: Depreciation	3,500	66,500
Suresh	5,025				
Add: Share of Profit	1,400	1,03,625			
Less: Drawings					
Sundry Creditors		42,000	Furniture	1,000	
			Less: Depreciation	100	900
Bills Payable		12,000	Current Assets		
Outstanding Expenses:			Closing Stock:		
			Raw Materials	4,000	
Salaries	1,500		Finished goods	12,000	16,000
Wages	2,100	3.600			
			Sundry Debtors	25,400	
			Less: Bad Debts	400	
			Less: Provision for bad debts	1,250	23,750
			Cash in hand		500
			Cash at bank		49,000

			Prepaid Insurance		300
Total		2,42,450	Total		2,42,450

3. The following figure have been extracted from the records of fancy stores, a proprietorship concern as at 31st December 1990

Prepare trading, profit and loss account and the balance Sheet after taking into consideration the following further information:

1. The closing stock as on 31st December, 1990 was Rs. 10,000.
2. A sale of Rs. 25,000 made for cash had been credited to the purchases account
3. Salary of Rs. 2,000 paid to an employee had been entered in the cash book as Rs 1,000.
4. Charge depreciation on furniture was at 10%.
5. Furniture had been sold during the year for Rs. 10,000 and the proceeds had been credited to furniture Account. The written down value of furniture sold was Rs. 5,000
6. A sum of Rs.10,000 received from a party who had purchased some stocks belonging to a separate business of the proprietor was credited to the Sundry debtors Account.
7. The proceeds of a manufactured fixed deposit amounting to Rs. 25,400 had been credited to the Fixed Deposits Account. The original amount of the deposit was Rs. 20,000.
8. There was an outstanding liability for rent of Rs. 2,000;
9. An advance of Rs. 1,00 paid to an employee against his salary of January 1991 had been debited to the Salary Account.
10. The office premises were sublet from December 1990 for a monthly rental of Rs. 1,000 but the rent for December has not yet been received.

Solution

M/s Fancy Stores

Trading and Profit & Loss Account for the year ended on 31st December 1990

Dr. **Cr.**

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**	**Rs.**
To Opening Stock		50,000	By Sales	6,00,000	
			Add: Sales wrongly credited to purchases	25,000	6,25,000
To Purchases	3,00,000		By Closing Stock		10,000
Add: Sales wrongly credited to Purchases	25,000	3,25,000			
To Carriage inwards		41,000			
To Gross Profit c/d		2,19,000			
		6,35,000			6,35,000
To Salaries		19,000	By Gross Profit b/d		2,19,000
To Insurance		6,000	By Rent receivable		1,000
To Rent	22,000		By Profit on sale of furniture		
Add: Outstanding	2,000	24,000			5,000

To Advertisements		10,000	By Interest on fixed deposits		5,400
To Postage and Telephone		3,400			
Too Bad Debts		2,000			
To Printing and Stationery		9,000			
To General charges		13,000			
To Depreciation on furniture (10% on Rs. 20,000)		2,000			
To Net Profit (transferred to Capital A/c)		1,42,000			
Total		2,30,400	Total		2,30,400

Balance Sheet of M/s Fancy Stores as on 31st December, 1990

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**	**Rs.**
Sundry Creditors		40,000	Cash in hand		3,000
Deposits from customers		54,000	Cash at bank (Rs. 10,000-1000)		9,000

Outstanding rent		2,000	Closing stock		10,000
Capital: Opening	54,000		Sundry Debtors	60,000	
Add: Net Profit	1,42,000		Add: Proceeds of separate business wrongly credited to Sundry Debtors A/c	10,000	
Add: Receipts from separate business	10,000	2,06,000	Less: Provision for bad debts	-3,000	67,000
Less: Drawings		-5,000 2,01,000	Advance payment of Salary		1,000
			Rent receivable		1,000
			Fixed Deposits (Rs. 1,34,600 + 25,400 – 20,000)		1,40,000
			Furniture (RS. 15,000 + 10,000 – 5,000)	20,000	
			Less: Depreciation	-2,000	18,000
Total		2,49,000	Total		2,49,000

Mr Pranlal is a dealer in fertilizers. He purchases some chemicals and mixes them to manufacturer the fertilizers. He has prepared the following statements. He requires you to examine them and prepare a Trading Account, Profit and Loss Account and the Balance Sheet, after taking into account the additional information:

Trading and Profit and Loss Account for the year ended March 31, 1990

Dr. **Cr.**

Particulars		**Rs.**	**Particulars**		**Rs.**
To Stock as on 31.3.90		8,00,000	By Sales		5,00,000
To Purchases		8,00,000	By Creditors		10,00,000
To Expenses		7,00,000	By Stock as on 1.4.89		2,00,000
			By other income		1,00,000
			By Net Loss		5,00,000
Total		23,00,000	Total		23,00,000

Balance Sheet for the year ending on 31st March, 1990

Liabilities	**Rs.**	**Rs.**	**Assets**		**Rs.**
To Capital on 1.4.89	3,00,000		By Debtors		2,50,000
			By Cash		20,000
Less: Loss	5,00,000	8,00,000	By Bank		80,000
To Loans Taken on 1.4.89 at 12%		1,00,000	By closing Stock		10,00,000
To Surplus (difference)		4,50,000			
Total		13,50,000	Total		13,50,000

On enquiry the following further information is obtained:

a. He is entitled to a rebate of 10% on the listed price of a chemical. The purchase during the year ending March 31, 1990 of the said chemical at the listed price included in the purchases amounted to Rs. 4, 00,000.

b. The details of the expenses are as under: Mixing wages- Rs.2, 00,000; Administration and selling expenses- Rs. 2,00,000; Mixing equipment purchased-Rs. 1,00,000; Construction of factory sheds- Rs.1, 00,000;Advance for raw materials- Rs. 1,00,000; Total = Rs. 7,00,000.

c. A certain raw material was received on April 2, 1990, the invoice for which amounting to Rs.1, 00,000 is included in the purchases.

d. A customer who purchased the goods for Rs.1, 00,000 has not taken delivery. The value of such stock was inadvertently included in the closing stock as on March 31, 1990.

e. He had entered into a joint venture with Mr. Babu Ram. The sale made on account of the joint venture was included in the sales for Rs.2, 00,000. He had paid Rs.1, 00,000 for the purchase of raw materials. It has been included in the expenses. His share of profit in the venture was determined at Rs. 50,000. The amount paid for setting the account was wrongly debited to debtors account.

f. Sums received for cash sales for Rs. 5,00,000 were included in the credits.

g. An invoice for Rs.50, 000 for the goods received on March 25, 1990 and included in the stock was received only on April 1, 1990.

h. Other outstanding as on March 31, 1990 were: Erection of factory sheds-Rs. 50,000 other expenses-Rs. 25,000.

i. Provide depreciation at 5% on the factory sheds and at 10 on the equipment on the closing balance.

j. The bank balance of Rs.80, 000 includes the encashment of his personal deposit of Rs. 50,000 with the bank. He had forgotten to credit his capital account with this amount.

Solution

Mr. Pranlal

Trading and Profit and Loss Account for the year ended on March 31, 1990

Dr. **Cr.**

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**	**Rs.**
To Opening Stock		2,00,000	By Sales (Note 1)		8,00,000
To Purchases (Note 4)		8,10,000	By Closing Stock		
			In Hand	7,00,000	
			In transit	1,00,000	8,00,000
To Mixing wages		2,00,000			
To Gross Profit c/d		3,90,000			
Total		16,00,000	Total		16,00,000
To Administrative & Selling expenses		2,25,000	By Gross profit b/d		3,90,000
To Depreciation on:			By other Income		1,00,000
Equipment		10,000			
Factory Shed		7,500			
To Interest on Loans		12,000			
To Net Profit (transfer to capital A/c)		2,85,500	By Income from joint venture		50,000
Net Total		5,40,000	Net Total		5,40,000

Balance Sheet of Mr. Pranlal for the year ending on 31st March, 1990

Liabilities	**Rs.**	**Rs.**	**Assets**	**Rs.**	**Rs.**
Capital:			Fixed Assets		
Opening Balance			Factory Shed	1,50,000	
Add: Capital introduced	3,00,000		Less: Depreciation	7,500	1,42,500
Add: Profit the year	2,85,500		Mixing Equipment	1,00,000	
	50,000	6,35,500	Less: Depreciation	10,000	90,000
Loans Interest Payable	12,000		Current Assets		
Creditors	1,00,000	1,12,000	Stock-in-trade		8,00,000
Trade Expenses	5,50,000		Sundry Debtors		2,00,000
Capital Expenses:			Rebate receivable		40,000
Other expenses	25,000		Cash in hand		20,000
Erection on factory sheds	50,000	6,25,000	Cash at bank		80,000
Total		13,72,500	Total		13,72,500

Working notes:

Particulars	Rs	Particulars	Rs
(1) Sales as shown in Trading Account	5,00,000	(2) Stock as Shown on 31.3.1990	8,00,000
Add: Credit to Sundry Creditors	5,00,000	Add: Gross purchase in transit	+1,00,000
	10,00,000		9,00,000
Less: Joint Venture sales	-2,00,000	Less: Goods sold but not delivered	-1,00,000
	8,00,000		8,00,000
(3) Profit on joint venture sales	2,00,000	(4) Purchases as given 31.3.1990	8,00,000
Cost of sales	1,00,000	Add: Outstanding	+50,000
Profit	1,00,000		8,50,000
Share of Pranlal	50,000	Less: rebate receivable	-40,000
			8,10,000

3.7 Introduction to Company Financial Statements

The basic objective of accounting is to determine profit or loss of the firm and to ascertain financial position as on a given date. Preparing final accounts or financial statements can do this. After the preparation of Trial Balance, the next step in accounting is "Preparation of Final Accounts". Final Accounts are also called as" Financial Statement".

The financial statement will show details about profit and loss account that gets opened with gross profit transferred from the trading account. After this, all expenses and losses are transferred to the debit side of the profit and loss account. If there are any incomes or gains, these will be credited to the profit and loss account. The excess of the gain over the losses is called the net profit and that of the loss over the gain is called the net loss. The account is closed by transferring the net profit or loss to capital account of the trader.

Check your progress 5

1. Company Financial Statement will carry:

a. profit c. balance

b. loss d. all of these

3.8 Meaning and Type of Financial Statements

Financial statement is a type of statement that is arranged as collection of financial data as per accounting procedures. Its main idea is to develop financial statements, which will confirm financial position of firm with details about profit or loss during an accounting period. It includes the following statements**:**

a. **Income statement:** The Income Statement is useful among all financial statements which show about happening in a business with result of operations that appears among balance sheet dates.

b. **Balance sheet:** It is a detailed description of financial statement of business that describes assets which is owned by business and claims of owner at particular time.

c. **Statement of retained earnings:** It shows accumulated excess of earnings incurred over losses and dividends. It describes about Income Statement which is transferred to Balance Sheet by statement after certain appropriations.

d. **Statement of changes in financial position:** The Balance Sheet shows the financial condition of the business at a particular moment of time while the Income Statement discloses the results of operations of business over a period of time.

Check your progress 6

1. _____will give the detailed description of financial statement.

a. Balance Sheet

b. Income statement

c. Statement of retained earnings

d. None of above

3.9 Nature of Financial Statements

The American Institute of Certified Public Accountants explains "combination of recorded facts, accounting conventions and personal judgments applied affect them materially."

1. **Recorded Facts:** Recorded facts shows recording in accounting books. These are the facts that are recorded in financial books.
2. **Accounting Conventions:** Accounting conventions imply certain fundamental accounting principles, which have been sanctified by long usage.
3. **Personal Judgments:** Personal judgments have also an important bearing on the financial statements.

Check your progress 7

1. Which gives details about fundamental accounting principles?

a. Recorded Facts
b. Accounting Conventions
c. Personal Judgments
d. All of above

3.10 Limitations of Financial Statements

The objectives of financial statements are subject to certain limitations as given below:

1. **Financial Statements are essentially interim reports:** The profit shown by the Profit and Loss Account and the financial position as depicted by the Balance Sheet is not exact. The existence of contingent liabilities, deferred revenue expenditure, etc., make them more imprecise.
2. **Accounting concepts and conventions:** Financial statements are prepared on the basis of certain accounting concepts and conventions. On account of this reason, the financial position as disclosed by these statements may not be realistic. On account of convention of conservatism, the income statement may not disclose true income of the business since probable losses are considered while probable incomes are ignored.

3. **Influence of personal judgment:** Many items are left to the personal judgment of the accountant. For example, the method of depreciation, mode of amortisation of fixed assets, treatment of deferred revenue expenditure all depend upon the personal judgment of the accountant. The soundness of such judgment will necessarily depend upon his competence and integrity.

4. **Disclose only monetary facts:** Financial statements do not depict those facts, which cannot be expressed in terms of money. For example, development of a team of loyal and efficient workers, enlightened management, the reputation and prestige of management with the public, are matters that are of considerable importance for the business but financial statements nowhere depict them.

Check your progress 8

1. Financial statements are prepared on the basis of certain:

   a. accounting concepts

   b. accounting conventions

   c. both a and b

   d. neither a nor b

3.11 Preparation of Company Financial Statements

The financial statements have two important statements:

- income statement
- balance sheet

These are prepared normally at the closing of accounting period as of which they are called as financial accounts of company. Under companies, these financial accounts termed as annual accounts and balance sheet.

The important provisions regarding the preparation of the above accounts are as follows:

1. At every annual general meeting of the company, the Board of Directors of the Company shall lay before the company:

a. the balance sheet as at the end of the accounting period

b. a profit and loss account for that period

In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of profit and loss account.

2. The profit and loss account (or the income and expenditure account) relate to the period –

   a. in the case of first annual general meeting of the company from the date of incorporation of the company to a date not more than 9 months before the meeting and

   b. in the case of any subsequent annual general meeting from the date immediately after the period for which account was last submitted to not more than 6 months before the meeting.

According to Section 211, the profit and loss account and the balance sheet of a company must give a true and fair view of the state affairs of the company. The balance sheet should be in form as given in Part I of schedule VI or as near thereto as the circumstances admitting. The form has been given latter in the unit.

According to Companies Act 1999, every Profit & Loss Account and Balance Sheet has to comply with the accounting standards as issued by Institute of Chartered Accountants of India a consultation with National Advisory Committee on Accounting Standards established under the Companies Act. Where the profit and loss account and balance sheet do not comply with accounting standards, such companies shall disclose in its profit and loss account and balance sheet the following:

a. Deviations from the accounting standards

b. The Reasons for such deviations and

c. The Financial effects arising from such deviations.

The balance sheet and profit and loss account of company duly signed on behalf of company by persons as per provisions of Section 215 of Companies Act. Each balance sheet is accompanied with Directors' and Auditors' report.

Check your progress 9

1. Company Financial Statement will cover:

   a. income details

   b. profit and loss details

   c. expense details

   d. all of above

3.12 Profit and Loss Account

Profit and loss account is the account whereby a trader determines the net result of his business transactions. It is the account which reveals the net profit (or net loss) of the trader.

The profit and loss account is opened with gross profit transferred from the trading account (or with gross loss, which will be debited to profit and loss account). After this, all expenses and losses (which have not been dealt in the trading account) are transferred to the debit side of the profit and loss account. If there are any incomes or gains, these will be credited to the profit and loss account. The excess of the gain over the losses is called the net profit and that of the loss over the gain is called the net loss. The account is closed by transferring the net profit or loss to capital account of the trader.

Check your progress 10

1. Profit and loss account will not show:

   a. net gain

   b. net loss

   c. sale

   d. amount of goods

3.13 Balance Sheet

The balance sheet details out the financial position of the company. It not only lists the items controlled or owned by the company but also includes the debts owned by the organization. A well evaluated balance sheet should have the value of company assets equaling the total of the value of the equity held by stock holders and also the liability of the company.

Balance sheet includes five basic elements. They are current and fixed assets, current and long-term liabilities and also equity.

The word 'current' refers to a period which is one year from the date of preparation of balance sheet or lesser. Hence, if we refer to current assets, it implies hard cash present in the company during the period of one year or the assets that would be turned into cash during this time period. The current assets include accounts receivable and also the inventory. Services companies do not have any inventory and hence it would be a total of cash as well as the accounts receivable.

Fixed assets refer to the equipments invested that affect your accounting process. Typically, this refers to machinery, building as well as vehicles purchased and used on a daily basis. Net fixed assets refer to the value obtained from actual value of purchase minus the depreciated value.

Current liabilities refer to those debts that would be settled within one year of the preparation of balance sheet. Long-term liabilities refer to long-term debts and mortgages of the organization. Equity includes the equity of stock holders, preferred stocks, treasury stock, retained earnings and paid-in capital.

Check your progress 11

1. Balance sheet will include:

a. current assets

b. current liabilities

c. current equity

d. all of these

3.14 Let Us Sum Up

In this unit we have learnt that the basic objective of accounting is to determine profit or loss of the firm and to ascertain financial position as on a given date. Preparing final accounts or financial statements can do this. After the preparation of Trial Balance, the next step in accounting is "Preparation of Final Accounts". Final Accounts are also called as" Financial Statement".

It is studied that a financial statement is an organized collection of financial data as per accounting procedures. Main purpose of preparing financial statements is to ascertain financial position of the firm along with its profit or loss for the accounting period.

Financial statements include following statements:

a. Income statement: The Income Statement (also termed as Profit and Loss Account) is generally considered to be the most useful of all financial statements. It explains what has happened to a business as a result of operations between two balance sheet dates.

b. Balance sheet: It is a statement of financial position of a business at a specified moment of time. It represents all assets owned by the business and the claims (or equities) of the owner or outsiders against those assets at a particular moment of time.

c. Statement of retained earnings: The term retained earnings means the accumulated excess of earnings over losses and dividends. The balance shown by the Income Statement is transferred to the Balance Sheet through this statement, after making necessary appropriations. It is, thus, a connecting link between the Balance sheet and the Income Statement.

d. Statement of changes in financial position: The Balance Sheet shows the financial condition of the business at a particular moment of time while the Income Statement discloses the results of operations of business over a period of time. However, for a better understanding of the affairs of the business, it is essential to identify the movement of working capital or cash in and out of the business. This information is available in the statement of changes in financial position of the business.

3.15 Answers for Check Your Progress

Check your progress 1

Answers: (1-a)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-d)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-d)

Check your progress 6

Answers: (1-b)

Check your progress 7

Answers: (1-b)

Check your progress 8

Answers: (1-c)

Check your progress 9

Answers: (1-d)

Check your progress 10

Answers: (1-d)

Check your progress 11

Answers: (1-d)

3.16 Glossary

1. **Balance Sheet -** A summary of all the accounts of a business, usually prepared at the end of each financial year.
2. **Capital -** An amount of money put into the business.
3. **Closing Balance -** The balance of an account at the end (or close), of an accounting period; this figure is then carried forward to the next accounting period.
4. **Fixed Assets -** Consisting of anything which a business owns or buys for use within the business and which retains a value at year end.
5. **Gross loss -** The balance of the trading account, assuming it has a debit balance.
6. **Gross profit -** The balance of the trading account, assuming it has a credit balance.
7. **Liabilities -** This includes bank overdrafts, loans taken out for the business and money owed by the business to its suppliers.

3.17 Assignment

Discuss the advantages of preparing balance sheet in the process of preparing final accounts.

3.18 Activities

Fill in the blanks:

1. _____ is the statement showing financial strength of the company.
2. _____ is regarded as obligations of the company.
3. Goodwill is an example of _____ asset.
4. _____ assets are liquid in nature.
5. _____ liabilities are payable in normal operating cycle.
6. Wasting assets have _____ life.
7. _____ assets are non-existent in nature.

8. Fixed assets are _____ in nature.
9. Contingent assets are also called as _____assets.
10. Debenture is example of _____ liabilities.

3.19 Case Study

Discuss the significant provisions of Companies Act 1956 in preparation of the financial statements of the company.

3.20 Further Readings

1. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
2. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.

Block Summary

In this block, students have given an idea about design of bank reconciliation statement and its occurrence and will study in details about various debit and credit entries that exist in the statement. The knowledge about calculating profit and loss will help the students to work in an organisation as supervisor. The block will detail about financial statement that occur in a business concern with features along with examples. The knowledge about income with respect to trading account is well explained.

The block is useful for beginners and financial planners as it detailed about entry and posting of entries in balance sheet with proper utilisation of debit and credit procedures. The student will be helped with various financial statement concepts that will help them to create a balance sheet and compares various accounts.

Block Assignment

Short Answer Questions

1. What is bank reconciliation statement?
2. What is trading account?
3. Explain the format of P&L account in brief?
4. What are the features of a balance sheet?
5. What are the assets and liabilities of the firm?

Long Answer Questions

1. What do you mean by favourable and unfavourable balance?
2. Discuss the concept of closing stock and its valuation process.
3. What are the highlights of Sec 210 of Companies Act, 1956?

Enrolment No. _____

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Sarkhej-Gandhinagar Highway, Chharodi,
Ahmedabad-382 481.

ACCOUNTING FOR MANAGERS

PGDBA-103

BLOCK 4:
DEPRECIATION AND INTERPRETATION OF FINANCIAL STATEMENT

Dr. Babasaheb Ambedkar Open University
Ahmedabad

ACCOUNTING FOR MANAGERS

Knowledge Management and
Research Organization
Pune

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The content is developed by taking reference of online and print publications that are mentioned in Bibliography. The content developed represents the breadth of research excellence in this multidisciplinary academic field. Some of the information, illustrations and examples are taken "as is" and as available in the references mentioned in Bibliography for academic purpose and better understanding by learner.'

ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self-instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self-instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual-skills objectives may be met by designing instructions that make use of students' prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face-to-face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this.

Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self-instructional materials, be they print or otherwise. These materials are designed to achieve certain pre-determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure students' performance (continuous assessment)

PREFACE

We have put in lots of hard work to make this book as user-friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included may tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

ACCOUNTING FOR MANAGERS

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Introduction, Meaning of Depreciation, Characteristics of Depreciation, Causes of Depreciation, Objectives of providing Depreciation, Computation of Depreciation, Methods of Charging Depreciation, Change in Method of Charging Depreciation, Salient Features of AS-6: Depreciation Accounting, Illustrations

UNIT 2 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENT

Introduction, Relationship between Analysis and Interpretation, Steps Involved in the Financial Statements Analysis, Ratio Analysis, Classification of Ratios, Profitability Ratios, Turnover Ratios, Financial Ratios, Advantages of Ratio Analysis, Limitations of Accounting Ratios, Computation of Ratios

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PGDBA-103

ACCOUNTING FOR MANAGERS

BLOCK 4: DEPRECIATION AND INTERPRETATION OF FINANCIAL STATEMENT

UNIT 1
DEPRECIATION ACCOUNTING 03

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BLOCK 4: DEPRECIATION AND INTERPRETATION OF FINANCIAL STATEMENT

Block Introduction

Depreciation as a process of allocation of the cost of depreciable assets is useful in a rational and systematic manner. Residual value is the estimated amount which is likely to be recovered when the asset is discarded and sold as scrap. However, the expenses incurred on sale or disposal must be deducted from the sale proceeds of discarded asset. Analysis and Interpretation of financial statements, therefore, refers to such a treatment of the information contained in the Income Statement and the Balance Sheet so as to afford full diagnosis of the profitability and financial soundness of the business.

In this block, you will get knowledge about depreciation and its occurrence and how to initiate and calculate in business. The methods with which the depreciation can be calculated are illustrated with examples. The block will detailed about financial statement that occur in a business concern with features along with examples. The knowledge about financial analysis along with certain ratios is well explained.

After studying this block, you will be able to understand correctly about how to evaluate depreciation on product and what method is more suitable for any business concern. The use of ratio analysis helps them to find certain types of ratios that could of use to them while working as financial analyst in a concern.

Block Objective

After learning this block, you will be able to understand:

- The basic about Depreciation.
- The reasons of occurrence of Depreciation.
- Methods of Charging Depreciation.
- Features of AS-6.
- The relationship among Analysis and Interpretation.
- Basis of Financial Statements Analysis.

- Ratio Analysis and its classification.
- Basic of Financial Ratios.
- Limitations of Accounting Ratios.

Block Structure

Unit 1: Depreciation Accounting

Unit 2: Analysis and Interpretation of Financial Statement

UNIT 1: DEPRECIATION ACCOUNTING

Unit Structure

1.0 Learning Objectives

1.1 Introduction

1.2 Meaning of Depreciation

1.3 Characteristics of Depreciation

1.4 Causes of Depreciation

1.5 Objectives of Providing Depreciation

1.6 Computation of Depreciation

1.7 Methods of Charging Depreciation

1.8 Change in Method of Charging Depreciation

1.9 Salient Features of AS-6: Depreciation Accounting

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1.16 Case Study

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1.0 Learning Objectives

After learning this unit, you will be able to understand:

- The Concept of depreciation.
- Methods of recording depreciation.
- Causes of depreciation.
- Accounting standards for depreciation.

1.1 Introduction

Except for land, most fixed assets, such as building, plant, machinery, office equipments, etc. have a limited useful life. Depreciation is basically lowering value of an asset which appears due to wear and tear, lapse of time, obsolescence, exhaustion and accident. It is an important part of income determination. To get the exact profit in a business, it is necessary to calculate depreciation in terms of product charged on fixed assets of business.

1.2 Meaning of Depreciation

Depreciation is authentically imperceptible compression or dissolution in the approximation of net worth ensuing to operation, infiltration of duration along with conventional wear and tear. This regular fall in the value of the asset is of permanent nature, which cannot be made good by normal repair and maintenance.

Accounting Standard (AS-6) issued by Institute of Chartered Accountants of India defines depreciation as follows:

Depreciation continues a benchmark of grinding out crapulence or other loss of value of depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair portion of the depreciable amount in each accounting period during the expected useful life of the assets.

Whereas International Accounting Standard Committee defines, “Depreciation is the allocation of the depreciable amount of an asset over its estimated life.”

Check your progress 1

1. Depreciation is calculated on the basis of:

   a. net worth ensuing to operation

   b. infiltration of duration

   c. conventional wear and tear

   d. all of these

1.3 Characteristics of Depreciation

The important characteristics of depreciation are noted below:

a. Depreciation is charged on fixed and tangible assets only.

b. Depreciation refers to a permanent / gradual and continuous decrease in the utility value of a fixed asset and it continues till the end of the useful life of the asset.

c. Depreciation is a charge against profit for a particular accounting period.

d. Depreciation is always computed in a systematic and rational manner since it is not a sudden loss.

e. Depreciation is a process of allocation of expired cost and not of valuation of fixed assets.

f. Depreciation represents only an estimate and not the exact amount.

g. Depreciation may be physical and functional.

h. Total depreciation cannot exceed the cost of the depreciable asset.

i. It is non-cash charge and hence does not involve outflow of cash.

j. The basis of charging depreciation is economic life of the asset and the cost thereof. Market value has no relevance for calculating depreciation.

k. Depreciation is different and distinct from amortisation, depletion obsolescence, dilapidation and fluctuation.

Check your progress 2

1. Depreciation is not charged on:

   a. fixed assets

   b. tangible assets

   c. profit

   d. loss

1.4 Causes of Depreciation

There are host of factors contributing to depreciation which are as follows:

a. **Usage:** Normal usage of any tangible fixed asset such as building, plant and machinery, furniture and fixtures, or motor vehicle bring physical deterioration which is caused by friction, movement, strain, vibration or even by weathering and chemical reaction. This physical deterioration of the asset cannot be made good by repairs and maintenance. Thus, depreciation is that part or service potential of the asset, which is expired and cannot be regained or recovered.

b. **Passage of time:** There are certain assets such as patents, copyrights and leasehold assets, which decrease in value with the effluxion of time. These assets generate revenue for a stipulated period of time for which these are acquired or paid for. After such period these assets lose their value even if the same are not used at all. Hence, such assets are written off during its stipulated life.

c. **Obsolescence:** When due to innovation or technological changes an existing asset in use becomes economically unviable it is said to have become obsolete and hence has to be abandoned. Obsolescence is also caused by change in fashion, government policy, customer's demand / taste, which render the asset useless to be discarded.

d. **Exhaustion or depletion:** There are some fixed assets which are wasting in nature and which lose their usefulness due to the extraction of raw materials from them, i.e., they get fully exhausted. They are termed wasting assets, e.g. mines, quarries, oil-well, etc. Actually, natural resources come under this category.

e. **Inadequacy:** When any asset fails to cope with the increasing volume of business activity and considered inadequate to meet the present requirement, such assets lose their usefulness and hence require replacement. However these assets may lose usefulness for the existing company but may be useful for other business having relatively lower volume of business activity. Hence these assets should not be scrapped but sold to other business concern. Again a firm has to use its plant capacity to the optimum level. If production level does not permit to operate at optimum capacity, the plant or machinery or any other asset has to be abandoned for replacement.

Check your progress 3

1. Which is correct about Depreciation?

   a. It is a part or service potential of an asset

   b. It is charges against loss occurred in particular period

   c. It is calculated randomly

   d. It is allocation of valuation of fixed assets

1.5 Objectives of Providing Depreciation

For attaining following objects, depreciation accounting is a must for every business:

- Recovery of cost incurred on fixed assets over their useful life so as to keep owner's capital intact.
- Provision is for replacement cost on the retirement of original assets.
- To include the depreciation in the cost of production to find out the correct cost of production.
- To find out correct profit for the year.
- To find out the correct financial position through balance sheet.

Check your progress 4

1. Depreciation is required for:

   a. recovery of cost which appears on fixed assets

   b. provision for replacement cost on discard of purchase

   c. finding the total output of product

   d. developing balance sheet

1.6 Computation of Depreciation

Calculation of depreciation is not an easy process. There are several factors which affect the computation of depreciation. Some of the factors are given below:

1. Cost of the depreciable asset

Cost of the asset plays a decisive role in determining the amount of depreciation. Cost means historical cost of the assets. This notion is also supported by cost concept which states that the fixed assets should be recorded at cost to the firm. Cost for this purpose includes price (less discount if any), freight or handling charges, legal charges, installation charges or transfer charges, sales tax, insurance in transit, etc. which help in acquisition and putting the asset onto working condition. When a second hand asset is purchased, the initial cost of putting the asset in working position such as expenditure for new parts, repairs/renovation, etc. are added to the cost of assets.

However, interest on loan taken to purchase an asset, will not form part of cost of asset. But interest paid on a loan during construction period will be treated part of cost of an asset.

2. **Useful life of the depreciable asset**

As per AS-6 (7), life of depreciable asset is shorter than its physical life and is:

- Pre-determined through legal limit like expiry dates of lease
- To govern by extraction
- Dependent on use and physical deterioration based on wear and tear

Reduced by obsolescence arising from such factors as:

- a. Technological changes
- b. Improvement in production method
- c. Change in market demand for the product or service output of the asset
- d. Legal or other restrictions

Hence, it is quite clear that the useful or economic life of a depreciable asset depends upon intensity of use, repairs and maintenance policy and other factors such as technological, legal or demand factors causing obsolescence.

3. Residual value

It is the estimated amount which is likely to be recovered when the asset is discarded and sold as scrap. However, the expenses incurred on sale or disposal must be deducted from the sale proceeds of discarded asset. So the amount of depreciation is the function of three variables, the cost of asset, useful or economic life of the depreciating asset and the residual value thereof.

Check your progress 5

1. Cost of the depreciable asset will not include:

   a. discount

   b. selling cost

   c. freight or handling charges

   d. legal charges

1.7 Methods of Charging Depreciation

Fixed assets differ from each other in their nature so widely that the same depreciation methods cannot be applied to each. The following methods have therefore been evolved for depreciating various assets:

- Fixed instalment or straight line or original cost method.
- Diminishing balance method or Written down value method or Reducing Instalment method.
- Annuity method.
- Depreciation fund method or sinking fund amortisation fund method.
- Insurance policy method.

Fixed Instalment or Straight Line or Original Cost Method

Fixed instalment method is also known as straight line method or original cost method. Under this method the expected life of the asset or the period during which a particular asset will render service is then calculated. The cost of the asset less scrap value, if any, at the end of its expected life is divided by the number of years of its expected life and each year a fixed amount is charged in accounts as

depreciation. The amount chargeable in respect of depreciation under this method remains constant from year to year. This method is also known as straight line method because if a graph of the amounts of annual depreciation is drawn, it would be a straight line.

The following formula or equation is used to calculate depreciation under this method:

Annual Depreciation = [(Cost of Assets - Scrap Value)/Estimated Life of Machinery]

The journal entries that will have to be made under this method are very simple. The journal entries will be as under:

Depreciation account

To Asset account

(Being the depreciation of the asset)

Profit and loss account

To Depreciation account

These entries will be passed at the end of each year so long as the asset lasts. In the last year, the scrap will be sold and with the amount that realised by the sale the following entry will be passed:

Cash account

To Asset account

(Being the sale price of scrap realised)

Advantages:

- Fixed installment method of depreciation is simple and easy to work out.
- The book value of the asset can be reduced to zero.

Disadvantages:

- This method, in spite of its being simplest is not very popular because of the fact that whereas each year's depreciation charge is equal, the charge for repairs and renewals goes on increasing as the asset becomes older. The

result is that the profit and loss account has to bear a light burden in the initial years of the asset but later on this burden becomes heavier.

- Interest on money is locked up in the asset is not taken into account as is done in some other methods.
- No provision for the replacement of the asset is made.
- Difficulty is faced in calculation of depreciation on additions made during the year.

On account of the above mentioned advantages and disadvantages of fixed instalment method, it is generally applied in case of those assets which have small value or which do not require many repairs and renewals for example copyright, patents, short leases, etc.

Illustration 1

On 1st January 1991 X purchased a machinery for Rs.21,000. The estimated life of the machine is 10 years. After it its breakup value will be RS. 1,000 only. Calculate the amount of annual depreciation according to fixed instalment method (straight line method or original cost method) and prepare the machinery account for the first three years.

Machinery Account

Debit Side			**Credit Side**	
	Rs.			**Rs.**
1991 Jan. 1 To Bank account	21,000	1991 Dec. 31	By Depreciation account	2,000
		1991 Dec. 31	By Balance c/d	19,000
	21,000			21,000
1992 Jan. 1 To Balance b/d	19,000	1991 Dec. 31	By Depreciation account	2,000

		1991 Dec. 31		17,000
	15,000			15,000
1993 Jan. 1 To Balance b/d	17,000	1991 Dec. 31	By Depreciation account	2,000
		1991 Dec. 31	By Balance c/d	15,000

Diminishing Balance Method or Written Down Value Method or Reducing Installment Method

Diminishing balance method is also known as written down value method or reducing installment method. Under this method the asset is depreciated at fixed percentage calculated on the debit balance of the asset which is diminished year after year on account of depreciation.

The entries in this case will be identical to those discussed in the case of the fixed installment method. Only the amount will be differently calculated.

Advantages of Diminishing Balance Method:

- The strongest point in favor of this method is that under it the total burden imposed on profit and loss account due to depreciation and repairs remains more or less equal year after year since the amount after depreciation goes on diminishing with the passage of time whereas the amount of repairs goes on increasing an asset grow older.
- Separate calculations are unnecessary for additions and extensions, though in the first year some complications usually arise on account of the fact that additions are generally made in the middle of the year.

Disadvantages of Diminishing Balance method:

- This method ignores the question of interest on capital invested in the asset and the replacement of the asset.

- This method cannot reduce the book value of an asset to zero if it is desired.
- Very high rate of depreciation would have to be adopted otherwise it will take a very long time to write an asset down to its residual value

This method is most suited to plant and machinery where additions and extensions take place so often and where the question of repairs is also very important. Written down value method or reducing installments method does not suit the case of lease, whose value has to be reduced to zero.

Illustration 2

On 1st January, 1994, a merchant purchased plant machinery costing Rs.25,000. It has been decided to depreciate it at the rate if 20 percent p.a. on the diminishing valance method (written down value method). Show the plant and machinery account in the first three years.

Plant and Machinery Account

Debit Side			Credit Side		
Date		Rs.	Date		Rs.
1994 Jan. 1	To Cash	25,000	1994 Dec. 31	By Depreciation	5,000*
			"	By Balance c/d	20,000
		25,000			25,000
1995 Jan. 1	To Balance b/d	20,000	1995 Dec. 31	By Depreciation	4,000**
			"	By Balance c/d	16,000
		20,000			20,000

1996 Jan. 1	To Balance b/d	16,000	1996 Dec. 31	By Depreciation	3,200***
				By Balance c/d	12,800
		16,000			16,000

Formula or equation for the above calculation may be written as follows:

*First year: 25,000 × 20% = 5000

**Second Year: (25000 - 5000) × 20% = 4,000

***Third Year: [25000 - (5,000 + 4,000)] × 20% = 3,200

Annuity Method

According to this method, the purchase of the asset concerned is considered an investment of capital, earning interest at certain rate. The cost of the asset and also interest thereon are written down annually by equal installments until the book value of the asset is reduced to nil or its bread up value at the end of its effective life. The annual charge to be made by way of depreciation is found out from annuity tables. The annual charge for depreciation will be credited to asset account and debited to depreciation account, while the interest will be debited to asset account and credited to interest account.

Under annuity method, journal entries have to be made in respect of interest and depreciation. As regards interest, it has to be calculated on the debit balance of the asset account at the commencement of the period, at the given rate. **The entry that is passed:**

Asset account

To Interest account

(Being interest on capital sunk in asset)

With regard to depreciation the amount found out from the depreciation annuity table, the following entry is passed:

Depreciation account

To Asset account

(Being the depreciation of asset)

It should be remembered that the interest is charged on the diminishing balance of the asset account; the amount of interest goes on declining year after year. But the amount of depreciation remains the same during the life time of the asset.

Illustration 3

A firm purchased a 5 years' lease for Rs.40,000 on first January. It decides to write off depreciation on the annuity method, presuming the rate of interest to be 5% per annum.

Show the lease account for the first 3 years. Calculations are to be made to the nearest dollar.

Annuity Table

Amount required writing off Re.1 by the annuity method.

Years	3%	3.5%	4%	4.5%	5%
3	0.353530	0.359634	0.360349	0.363773	0.367209
4	0.269027	0.272251	0.275490	0.278744	0.282012
5	0.218355	0.221418	0.224627	0.227792	0.230975
6	0.184598	0.187668	0.190762	0.193878	0.197017
7	0.160506	0.163544	0.166610	0.169701	0.172820
8	0.142456	0.145477	0.148528	0.151610	0.154722

Solution:

According to the annuity table given above, the annual charge for depreciation reckoning interest at 5 percent p.a. would be:

230975 × 40,000 = $9,239

Lease Account

Debit Side			Credit Side		
Date		$	Date		$
1st Year			1st Year		
Jan. 1	To Cash	40,000	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	2,000		By Balance c/d	32,761
		42,000			42,000
2nd Year			2nd Year		
Jan. 1	To Balance b/d	32,761	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	1,638		By Balance c/d	25,160
		34,399			34,399
3rd Year					
Jan. 1	To Balance b/d	25,160	Dec. 31	By Depreciation	9,239
Dec. 31	To Interest	1,258		By Balance c/d	17,179
		26,418			26,418

3rd Year

Jan. 1 To Balance b/d 17,170

Advantages:

- This method takes interest on capital invested in the asset into account.
- It is regarded as most exact and precise from the point of view of calculations and is therefore most scientific.

Disadvantages:

- The system is complex.
- The increase in profit and loss account rises with passage of time where amount of depreciation charged every year will be fixed.
- When the asset requires frequent additions and extensions, the calculation have to be changed frequently, which is very inconvenient.

This method is best suited to those assets which require considerable investment and which do not call for frequent additions e.g., long lease.

Depreciation Fund Method or Sinking Fund Amortisation Fund Method

Depreciation fund method is also known as sinking fund method or amortization fund method. Under this method, a fund knows as depreciation fund or sinking fund is created. Each year the profit and loss account is debited and the fund account credited with a sum, which is so calculated that the annual sum credited to the fund account and accumulating throughout the life of the asset may be equal to the amount which would be required to replace the old asset. In order that ready funds may be available at the time of replacement of the asset an amount equal to that credited to the fund account is invested outside the business, generally in gilt-edged securities. Following entries shown will record depreciation and replacement of asset by method.

First year:

(1) Debit profit and loss account and credit depreciation fund account with amount of annual depreciation charge

(2) Debit depreciation fund investment account and credit cash account with an equal amount

In subsequent years:

(1) Debit depreciation fund investment account and credit depreciation fund account with the amount of interest earned and reinvested

(2) Debit profit and loss account and credit depreciation fund account with the annual depreciation instalment

(3) Debit depreciation fund investment account and credit cash account with an equal amount

On replacement of asset:

(1) Debit cash account and credit depreciation fund investment account with the amount realized by the sale of investment

(2) Transfer any profit or loss on sale of investment to profit and loss account.

(3) Debit the new asset purchased and credit cash account

(4) Debit depreciation fund account and credit the account of the old asset which has become useless

The amount of annual depreciation to be provided for by the depreciation fund method will be ascertained from sinking fund table.

Sinking Fund Table

Annual sinking fund installment to provide $1.

Years	3%	3.5%	4%	4.5%	5%
3	0.323540	0.321934	0.320349	0.318773	0.317208
4	0.239027	0.237251	0.235490	0.233741	0.232012
5	0.188350	0.186481	0.184627	0.182792	0.180975
6	0.154598	0.152668	0.150762	0.148878	0.147017
7	0.130506	0.128544	0.126610	0.124701	0.122820
8	0.112446	0.110477	0.108528	0.106610	0.104722

Illustration 4

On 1st January, 1990 a four years lease was purchased forRs.20,000 and it is decided to make provision for the replacement of the lease by means of a depreciation fund, the investment yielding 4 percent per annum interest. Show the necessary ledger account.

Solution:

To get Re.1 at the end of 4 years at 4 percent an annual investment of RS.2,35,490 is necessary. Therefore, for Rs.20,000 an annual investment of Rs.4,709.80 i.e., 2,35,490 × 20,000 will be necessary.

Lease Account

1990			1990		
Jan.1	To Cash	20,000	Dec. 31	By Depreciation fund	20,000

Depreciation Fund Account

1990			1990		
Dec. 31	To Balance c/d	4,709.80	Dec. 31	By P & L account	4,709.80
1991			1991		
Dec. 31	To Balance c/d	9607.99	Jan. 1	By Balance c/d	4709.80
			Dec. 31	By Depreciation fund investment	188.39
			"	By P&L account	4709.80
		9607.99			9607.99
1992			1992		

Dec. 31	To Balance c/d	14702.11	Jan. 1	By Balance b/d	9607.99
			Dec. 31	By Depreciation fund investment	384.32
			"	By P & L account	4709.80
		14702.11			14702.11

1993			1993		
Dec. 31	To Lease account	20,000	Jan. 1	By Balance b/d	14702.11
			Dec. 31	By Depreciation fund investment	588.9
				By P & L	4,709.80
		20,000			20,000

Depreciation Fund Account

1990			1990		
Dec. 31	To Cash	4709.80	Dec. 31	By Balance c/d	4709.80
1991			1991		
Jan. 1	To Balance b/d	4709.80	Dec. 31	By Balance c/d	9,607.99
Dec. 31	To Depreciation fund	188.39			

Dec. 31	To Cash	4,709.80			
		9,607.99			9,607.99

1992			1992		
Jan. 1	To Balance b/d	9,607.99	Dec. 31	By Balance c/d	14,702.11
Dec. 31	To Depreciation fund	384.32			
Dec. 31	To Cash	4709.80			

1993			1993		
Jan. 1		14,702.11	Dec. 31	By Cash	20,000.00
Dec. 31		588.9			
Dec. 31		4709.80			
		20,000			20,000

Note: The cash installments at the end of the last year will not be invested because there is no point in buying the investment and selling them on the same date.

Advantages of Depreciation Fund Method or Sinking Fund Method:

The most important advantage of this method is that it makes available a sum of money for the replacement of the asset, which has become useless. If separate provision was not made, the sum required to purchase the new asset will have to be drawn from the business which might affect the financial position of the concern adversely.

Disadvantages of the Depreciation Fund Method or Sinking Fund Method:

- The burden on profit and loss account goes on increasing as years pass by since the amount of depreciation every year remains same but the amount spent on repairs goes on increasing as the asset becomes old.
- It can also be said that the work of investing money is complicated.
- Prices of securities may fall at the time when they are to be realized as a result of which loss may have to be suffered.

This method is found suitable wherever it is desired not only to charge depreciation but also to replace the asset as happens in the case of plant and machinery and other wasting assets.

Insurance Policy Method

It is a slight modification of the depreciation fund method or sinking fund method. Under this method the amount represented by the depreciation fund, instead of being used to buy securities, is paid to an insurance company as premium. The insurance company issues a policy promising to pay a lump sum at the end of the working life of the asset for its replacement.

The advantage of insurance policy method is that risk of loss on the sale of investment and the trouble and expense of buying investment are avoided, while disadvantage lies that the interest received on the premiums paid is comparatively very low.

When insurance policy method is employed, the policy account will take the place of the depreciation fund investment account and no interest will be received at the end of each year but the total interest on the premiums will be received when the policy matures.

Every year's two entries will be made:

1. In the beginning:

Depreciation insurance policy account

To Cash account

2. At the end of the year:

Profit and loss account

To Depreciation fund account

When the policy will mature i.e., to say the amount of the policy will be received. The entry is:

3. Cash account

To Depreciation insurance policy account

(Being the policy amount realized)

The depreciation insurance policy account will show some profit. This will be transferred to depreciation fund account, the entry being.

4. Depreciation insurance policy account

To Depreciation fund account

(Being the policy amount realized)

The asset account will have been shown throughout at its original cost. It now be written off by transfer to depreciation fund account. The entry is:

5. Depreciation fund account

To Asset account

Illustration 5

On 1st January, 1990 a business purchases a three year lease of premises for $20,000 and it is decided to make a provision for replacement of the lease by means o an insurance policy purchased for annual premium.

Show the ledger accounts dealing with this matter.

Solution:

Leasehold Account

Dr. Side			**Cr. Side**		
1990			1990		
Jan. 1	To Cash	20,000	Dec. 31	By Depreciation fund	20,000

Depreciation Fund Account

Dr. Side			**Cr. Side**		
1990			1990		
Dec. 31	To Balance c/d	6,400	Dec. 31	By Profit and loss a/c	6,400
1991					
Dec. 31	To Balance c/d	12,800	Jan. 1	By Balance b/d	6,400
			Dec. 31	By Profit and loss a/c	6,400
		12,800			12,800
1992			1992		
Dec. 31	To Leasehold Property	20,000	Jan. 1	By Balance b/d	12,800
			Dec. 31	By Profit and loss a/c	6,400
			"	By Leasehold	800
		20,000			20,000

Leasehold Policy Account

Dr. Side			**Cr. Side**		
1990			1990		
Dec. 31	To Cash	6,400	Dec. 31	By Balance c/d	6,400
1991			1991		
Jan. 1	To Balance b/d	6,400	Dec. 31	By Balance c/d	12,800
Dec. 31	To Cash	6,400			
		12,800			12,800
	To Balance b/d	12,800		By Cash	20,000
	To Cash	6,400			
		800			
		20,000			20,000

Check your progress 6

1. The correct formula of calculating Annual Depreciation under fixed instalment method is:

   a. [(Cost of Assets + Scrap Value)/Estimated Life of Machinery]

   b. [(Cost of Assets x Scrap Value)/Estimated Life of Machinery]

   c. [(Cost of Assets - Scrap Value)/Estimated Life of Machinery]

   d. [(Cost of Assets/Scrap Value) x Estimated Life of Machinery]

2. Which among the following method is suitable in plant and machinery?

   a. Fixed instalment method

   b. Diminishing balance method

   c. Annuity method

   d. Depreciation fund method

1.8 Changes in Method of Charging Depreciation

The depreciation method once selected should be applied consistently to ensure comparison over the years. AS-6 states that "the method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. When such a change in the method of depreciation is made, the un-amortized depreciable amount of the asset is charged to revenue over the remaining useful life by applying the new method".

Hence it is quite clear that a business enterprise may change the method either:

- To comply with legal requirements or
- To enhance or improve quality of preparation or presentation of financial statements

There are two ways to change the method of the depreciation:

a. **A Change made effective from the current year only:** When a change is made effective form the current year only, the unexpired cost of the asset should be charged to Profit & Loss account over the remaining useful life of the asset by applying the new method of depreciation. Such a change is

treated as a change in accounting policy and as such it is disclosed in the financial statements.

b. A change in method with retrospective effect: When a change in method of depreciation is made with retrospective effect then following steps must be taken.

- Find out the book value / cost of the assets in the beginning of year, from that date change is to be made effective. For example if on 31st March 2001 it is decided to change the method with effect from 1st April 1998, then the book value of the assets on 1st April 1998 has to be worked out. And similarly if the change is to be made from the date of acquiring of such assets then cost of the assets has to be found out.
- Find out total depreciation charged on the assets till date on the basis of old rate i.e. depreciation already provided.
- Calculate the depreciation on the basis of new method with retrospective effect up to the end of previous year.
- Find out the difference between (ii) and (iii) above.
- Debit or Credit the asset account by adjusting the difference. If there is excess of old accumulated depreciation over the total depreciation calculated in accordance with the new rate, assets account will be debited with the difference. And if it is otherwise, asset account will be credited with the differential figure.
- Charge depreciation according to new method for the current year.

Check your progress 7

1. The need of business enterprise to alter the method of depreciation results, due to:

   a. legal requirements

   b. improved quality

   c. preparation of financial statements

   d. all of these

1.9 Salient Features of AS-6: Depreciation Accounting

Following is the synopsis of Depreciation policy as per accounting standards:

a. Standard does not apply to depreciation in respect of forests, plantations and similar regenerative natural resources, wasting assets including expenditure on exploration and extraction of minerals, oils, natural gas and similar non-regenerative resources, expenditure on research and development, goodwill and livestock. Special considerations apply to these assets.

b. Allocate depreciable amount of a depreciable asset on systematic basis to each accounting year over useful life of asset.

c. Useful life may be reviewed periodically after taking into consideration the expected physical wear and tear, obsolescence and legal or other limits on the use of the asset.

d. Basis for providing depreciation must be consistently followed and disclosed. Any change to be quantified and disclosed.

e. On revaluation of asset depreciation should be based on revalue amount over balance useful life. Material impact on depreciation should be disclosed.

f. Deficiency or surplus in case of disposal, destruction, demolition, etc. is disclosed separately, if material.

g. Historical cost, amount substituted for historical cost, depreciation for the year and accumulated depreciation should be disclosed.

Depreciation method used should be disclosed. If rates applied are different from the rates specified in the governing statute then the rates and the useful life be also disclosed.

Check your progress 8

1. Depreciation policy holds good on:

   a. forests

   b. plant and machinery

   c. regenerative natural resources

   d. exploration and extraction of minerals

1.10 Illustrations

1. X Ltd. commenced business on 1st January 1998. On the same date a plant costing Rs.3,50,000 was purchased. Depreciation was charged @15% p.a. on diminishing balance basis and charging full years depreciation on additions. Over the years following additions were made:

   On 1-8-1999 Rs. 75,000

   On 30-9-2002 Rs.1,00,000

   On 1-1-2002 it was decided to change the method and rate of depreciation to 10% on straight line basis with retrospective effect from 1-1-1998, the adjustment being made in the account for the year ending 31st December 2002.

Prepare plant account for the year 2002 only.

Solution:

Dr. Plant A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
2002			2002		
Jan. 1	To Balance c/d (1)	2,28,761	Dec. 31	By Depreciation A/c (3)	52,500
Jan. 1	To Excess depreciation charged adjusted (2)	33,739	Dec. 31	By Balance c/d	3,10,000
Sept. 30	To Bank A/c	1,00,000			
		3,62,500			3,62,500
2003 Jan.1	To Balance b/d	3,10,000			

Working Notes:

1.	Calculation of written down value of the plant on 1-1-2002	Rs.	
	Book Value (cost) as on 1-1-1998	3,50,000	
	Less Depreciation @ 15% on diminishing Balance	52,500	
	W.D.V. as on 1-1-1999	2,97,500	
	Addition made during 1999	75,000	
		3,75,500	
	Less Depreciation for the year 1999 @ 15%	56,325	
	W.D.V. as on 1-1-2000	3,18,675	
	Less Depreciation for the year 2000 @ 15%	4,78,011	
	W.D.V. as on 1-1-2001	2,70,874	
	Less Depreciation for the year 2001 @ 15%	40,631	
	W.D.V. as on 1-1-2002	2,30,243	(1)
2.	Difference in Depreciation		
	Depreciation already charged @ 15 % as per Diminishing Balance Method (52,500 + 55,875 + 47,494 + 40,370)	1,97,257	
	Depreciation as per New method i.e. Straight Line Method @ 10%	1,62,500	*
		33,739	(2)
	* Cost of 1st Plant	3,50,000	
	Depreciation @ 10% for 4 years (i.e., 1998, 1999, 2000 & 2001) on 1st Plant	1,40,000	(a)

	Cost of 2nd Plant	75,000	
	Depreciation @ 10% for 4 years (i.e., 1998, 1999, 2000 & 2001) on 1st Plant	22,500	(b)
	Total Depreciation = (a + b)	1,62,500	*
3	Depreciation for the year 2002		
	Cost of 1st Plant	3,50,000	
	Cost of 2nd Plant	75,000	
	Cost of 3rd Plant	1,00,000	
		5,25,000	
	Depreciation @ 10% on original cost	52,500	(3)

2. On 1st January 1997 a company acquired a lease of building for a period of five years. An amount of Rs.2,00,000 was paid on signing the lease deed. It is proposed to depreciate lease by the Annuity Method by charging interest @5% p.a. A reference to the annuity table shows that an amount of Re.0.230975 invested for a period of 5 years at 5% interest will accumulate Re.1.

Prepare the Lease Account for a period of Five years.

Annual Depreciation = 0.230978 x 2,00,000 = Rs. 46,195 p.a.

Dr. **Lease A/c** **Cr.**

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1997			1997		
Jan. 1	To Bank A/c	2,00,000	Dec. 31	By Depreciation A/c	46,195
Dec. 31	To Interest 5% p.a.	10,000	Dec. 31	By Balance c/d	1,63,805
		2,10,000			2,10,000
1998			1998		
Jan. 1	To Balance b/d	1,65,805	Dec. 31	By Depreciation A/c	46,195
Dec.31	To Interest 5% p.a.	8,190	Dec. 31	By Balance c/d	1,25,800
		1,71,995			1,71,995
1999			1999		
Jan. 1	To Balance b/d	1,25,800	Dec. 31	By Depreciation A/c	46,195
Dec.31	To Interest 5% p.a.	6,290	Dec. 31	By Balance c/d	85,895
		1.32,090			1,32,090
2000			2000		
Jan. 1	To Balance b/d	85,895	Dec. 31	By Depreciation A/c	46,195
Dec.31	To Interest 5% p.a.	4,295	Dec. 31	By Balance c/d	43,995
		90,190			90,190
2001			2001		
Jan. 1	To Balance b/d	43,995	Dec. 31	By Depreciation A/c	46,195
Dec.31	To Interest 5% p.a.	*2,200			
		46,195			46,195

* Balancing figure.

3. On 1st January 1995 a company purchased a plant costing Rs.4,00,000. It is expected to have a useful life of 4 years. In order to provide funds for replacement of the plant it is decided to create a sinking fund. Investments are expected to yield interest @5% p.a.

On 31st December 1998 the bank balance stood at Rs.2,50,000 before the receipt of interest on Sinking Fund Investment. The investments were sold for Rs.2,90,000 and new plant was acquired for Rs.4,50,000.

Give journal entries and prepare necessary ledger accounts. Sinking fund table shows that Re.0.232012 if invested @ 5% p.a. will accumulate Re.1 at the end of four years.

Yearly depreciation = 0.232012 x 4,00,000 = Rs.92,805.

Solution:

Journal Entries

Date	Particulars		L.F.	Rs.	Rs.
1995					
Jan. 1	Plant A/c	Dr.		4,00,000	
	To Bank A/c				4,00,000
	(Being plant purchased)				
Dec. 31	Depreciation A/c	Dr.		92,805	
	To Sinking Fund A/c				92,805
	(Being depreciation transferred to Sinking Fund A/c)				
Dec. 31	Sinking Fund Investments A/c	Dr.		92,805	
	To Bank A/c				92,805

	(Being depreciation fund invested)				

Date	Particulars		L.F.	Rs.	Rs.
1996					
Dec. 31	Bank A/c	Dr.		4,640	
	To Interest of S.F. Investment A/c				4,640
	(Being interest received on Sinking Fund Investment)				
Dec. 31	Interest on S.F. Investment A/c	Dr.		4,640	
	To Sinking Fund A/c				4,640
	(Being interest on S.F. Investment transferred to Sinking Fund A/c)				
Dec. 31	Depreciation A/c	Dr.		92,805	
	To Sinking Fund A/c				92,805
	(Being annual depreciation transferred to Sinking Fund A/c)				
Dec. 31	Sinking Fund Investments A/c	Dr.		97,445	
	To Bank A/c				97,445
	(Being S.F. Investment Purchased)				

Date	Particulars		L.F.	Rs.	Rs.
1997					
Dec. 31	Bank A/c	Dr.		9,513	
	To Interest on S.F. Investment A/c				9,513
	(Being interest on S.F. Investments received)				
Dec. 31	Interest on Sinking Fund Investment A/c	Dr.		9,513	
	To Sinking Fund A/c				9,513
	(Being interest on S.F. Investment transferred to Sinking fund A/c)				
Dec. 31	Depreciation A/c	Dr.		92,805	
	To Sinking Fund A/c				92,805
Dec. 31	Sinking Fund Investment A/c	Dr.		1,02,318	
	To Bank A/c				1,02,318

Date	Particulars		L.F.	Rs.	Rs.
1998					
Dec. 31	Bank A/c	Dr.		14,628	
	To Interest on S.F. Investment A/c				14,628

Date	Particulars		L.F.	Rs.	Rs.
	(Being interest on S.F. Investments received)				
Dec. 31	Interest on Sinking Fund Investment A/c	Dr.		14,628	
	To Sinking Fund A/c				14,628
	(Being interest transferred to Sinking fund A/c)				
Dec. 31	Depreciation A/c	Dr.		92,805	
	To Sinking Fund A/c				92,805
	(Being depreciation credited to Sinking Fund A/c)				
Dec. 31	Bank A/c	Dr.		2,90,000	
	To Sinking Fund Investments A/c				2,90,000
	(Being investments sold)				
Dec. 31	Sinking Fund A/c	Dr.		2,567	
	To Sinking Fund Investment A/c				2,567
	(Being loss on sale of S.F Investment transferred to Sinking Fund A/c)				
Dec. 31	Sinking Fund A/c	Dr.		4,00,000	
	To Plant A/c				4,00,000
	(Being transfer to Plant A/c to				

Date	Particulars		L.F.	Rs.	Rs.
	Sinking Fund A/c)				
Dec. 31	Profit & Loss A/c	Dr.		2,567	
	To Sinking Fund A/c				2,567
	(Being loss transferred to P&L A/c)				
Dec. 31	New Plant A/c	Dr.		4,50,000	
	To Bank A/c				4,50,000
	(Being new plant purchased)				

Dr. Bank A/c Cr.

	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1998			1998		
Dec. 31	To Balance c/d	2,50,000	Dec. 31	By New Plant A/c	4,50,000
Dec. 31	To Interest on S.F. Investment A/c	14,628	Dec. 31	By Balance c/d	1,04,628
Sept. 30	To S.F. Investment A/c	2,90,000			
		5,54,628			5,54,628

Dr. Plant A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1995			1995		
Jan. 1	To Bank A/c	4,00,000	Dec. 31	By Balance c/d	4,00,000
1996			1996		
Jan. 1	To Balance b/d	4,00,000	Dec. 31	By Balance c/d	4,00,000
1997			1997		
Jan. 1	To Balance b/d	4,00,000	Dec. 31	By Balance c/d	4,00,000
1998			1998		
Jan. 1	To Balance b/d	4,00,000	Dec. 31	By Sinking Fund A/c	4,00,000

Dr. Depreciation A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1995			1995		
Dec. 31	To Sinking Fund A/c	92,805	Dec. 31	By Profit & Loss A/c	92,805
1996			1996		
Dec. 31	To Sinking Fund A/c	92,805	Dec. 31	By Profit & Loss A/c	92,805
1997			1997		

Dec. 31	To Sinking Fund A/c	92,805	Dec. 31	By Profit & Loss A/c	92,805
1998			1998		
Dec. 31	To Sinking Fund A/c	92,805	Dec. 31	By Profit & Loss A/c	92,805

Dr. Interest on Sinking Fund A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1996			1996		
Dec. 31	To Sinking Fund A/c	4,640	Dec. 31	By Bank A/c	4,640
1997			1997		
Dec. 31	To Sinking Fund A/c	9,513	Dec. 31	By Bank A/c	9,513
1998			1998		
Dec. 31	To Sinking Fund A/c	14,628	Dec. 31	By Bank A/c	14,628

Dr. New Plant A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1998			1998		
Dec. 31	To Bank A/c	4,50,000	Dec. 31	By Balance c/d	4,50,000

Dr. Sinking Fund A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1995			1998		
Dec. 31	To Balance c/d	92,805	Dec. 31	By Depreciation A/c	92,805

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1996			1998		
Dec. 31	To Balance c/d	1,90,250	Jan. 1	By Balance c/d	92,805
			Dec. 31	By Interest on S.F Investment A/c	4,640
			Dec. 31	By Depreciation A/c	92,805
		1,90,250			1,90,250

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1997			1998		
Dec. 31	To Balance c/d	2,92,568	Jan. 1	By Balance c/d	1,90,250
			Dec. 31	By Interest on S.F Investment A/c	9,513
			Dec. 31	By Depreciation A/c	92,805

		2,92,568			2,92,568

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1998			1998		
Dec. 31	To Sinking Fund Investment A/c (Loss)	2,568	Jan. 1	By Balance b/d	1,90,250
Dec. 31	To Plant A/c	4,00,000	Dec. 31	By Interest on S.F Investment A/c	14,628
			Dec. 31	By Depreciation A/c	92,805
				By Profit & Loss A/c*	2,567
		4,02,568			4,02,568

* Alternatively this can be credited to Asset A/c and balancing figure debited to Asset A/c

Dr. Sinking Fund Investment A/c Cr.

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1995			1995		
Dec. 31	To Bank A/c	92,805	Dec. 31	By Balance c/d	92,805
		92,805			92,805

Date	Particulars	Amount (Rs)	Date	Particulars	Amount (Rs.)
1996			1996		
Jan. 1	To Balance c/d	92,805	Dec. 31	By Balance c/d	1,90,250
Dec. 31	To Bank A/c	97,445			
		1,90,250			1,90,250
1997			1997		
Jan. 1	To Balance c/d	1,90,250	Dec. 31	By Balance c/d	2,92,568
Dec. 31	To Bank A/c	1,02,318			
		2,92,568			2,92,568
1998			1998		
Jan. 1	To Balance c/d	2,92,568	Dec. 31	By Bank A/c	2,90,000
				By Sinking Fund A/c (Loss)	2,568
		2,92,568			2,92,568

1.11 Let Us Sum Up

In this unit we have learnt that depreciation lowers the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. It is one of most important constituents of income determination. It is studied that there are several reasons of depreciation which occur due to usage, time, obsolescence, depletion and inadequacy. It is found that cost of asset plays a decisive role in

determining the amount of depreciation. Simply cost means historical cost of the assets.

Cost for this purpose includes price (less discount if any), freight or handling charges, legal charges, installation charges or transfer charges, sales tax, insurance in transit, etc.

1.12 Answers for Check Your Progress

Check your progress 1

Answers: (1-d)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-b)

Check your progress 6

Answers: (1-c), (1-b)

Check your progress 7

Answers: (1-d)

Check your progress 8

Answers: (1-b)

1.13 Glossary

1. **Depreciation -** It is authentically imperceptible compression in approximation of net worth involves in operation, infiltration of duration with conventional wear and tear.
2. **Obsolescence -** It is a sort of changes that is caused with result of fashion, policies and customers demand that render an asset which cannot be discarded.

1.14 Assignment

State the reasons why a firm would want to change method of depreciation.

1.15 Activities

List the areas where depreciation accounting standards are not applied.

1.16 Case Study

Discuss which is the best method of providing depreciation of the following assets - Loose tools, machinery, livestock, lease, motor vehicles.

1.17 Further Readings

1. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
2. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.
5. Financial Accounting, Naseem Ahmed.

UNIT 2: ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENT

Unit Structure

2.0 Learning Objectives

2.1 Introduction

2.2 Relationship between Analysis and Interpretation

2.3 Steps Involved in Financial Statements Analysis

2.4 Ratio Analysis

2.5 Classification of Ratios

2.6 Profitability Ratios

2.7 Turnover Ratios

2.8 Financial Ratios

2.9 Advantages of Ratio Analysis

2.10 Limitations of Accounting Ratios

2.11 Computation of Ratios

2.12 Let Us Sum Up

2.13 Answers for Check Your Progress

2.14 Glossary

2.15 Assignment

2.16 Activities

2.17 Case Study

2.18 Further Readings

2.0 Learning Objectives

After learning this unit, you will be able to understand:

- Concept of financial statement analysis.
- Analysis and interpretation of financial statements.
- Process of ratio analysis.

- Categorisation of the accounting ratios.

2.1 Introduction

In the preceding unit, we have explained the preparation and presentation of financial statements. Financial statements are prepared with the objective of knowing the profitability and financial soundness of the business. This requires proper analysis and interpretation of financial statements. This aspect has been discussed in detail in this unit.

2.2 Relationship between Analysis and Interpretation

Financial statements are indicators of the two significant factors:

- Profitability
- Financial soundness

Analysis and Interpretation of financial statements, therefore, refers to such a treatment of the information contained in the Income Statement and the Balance Sheet so as to afford full diagnosis of the profitability and financial soundness of the business.

Most of the authors have used the term 'Analysis' only to cover the meanings of both analysis and interpretation, since analysis involves interpretation. For the sake of convenience, we have also used the term 'Financial Statements Analysis' throughout the unit to cover both analysis and interpretation.

Check your progress 1

1. The term analysis shows:

   a. calculation

   b. interpretation

   c. convenience

   d. none of these

2.3 Steps Involved in Financial Statements Analysis

The analysis of the financial statements requires:

1. **Selection:** It involves selection of information, necessary for analysis of financial statements.
2. **Classification:** It is the methodical classification of the data.
3. **Interpretation:** It involves drawing of conclusions and explaining the meaning and significance of the data.

Following are the steps involved in Analysis and Interpretation of Financial Statements:

a. The analyst should know plans and policies of the management so that he may be able to find out whether these policies are properly executed or not.

b. The extent of analysis should be determined. Then only the sphere of work can be decided. For e.g. if the aim is to find out the earning capacity of the firm, then analysis of income statement is made. On the other hand, if financial position is to be studied Balance Sheet analysis is made.

c. The data given in the financial statements should be reorganized and rearranged. Similar data is grouped under same heads and individual components are broken down according to nature, i.e. the data is reduced to standard form.

d. A relationship is established among financial statements with the help of tools and techniques of analysis. The information is interpreted in a simple and understandable way.

e. The conclusions are drawn from interpretation and presented to the management in the form of report.

From the above steps that have been explained, following tools and techniques can be derived:

1. Horizontal and Vertical Analysis:

Comparison of two or more year's financial data is known as horizontal analysis, or trend analysis. Horizontal analysis is facilitated by showing changes between years in both dollar and percentage form as has been done in the example below. Showing changes in dollar form helps the analyst focus on key factors that have affected profitability or financial position. Observe in the example that sales for 2002 were up Rs.4 million over 2001 but that this increase in sales was more than negated by an Rs.4.5million increase in cost of goods sold. Showing changes

between years in percentage form helps the analyst to gain perspective and to gain a feel for the significance of the changes that are taking place. For example a Rs.1 million increase in sales is much more significant if the prior year's sales were Rs.2 million than if the prior year's sales were Rs.20 million. In the first situation, the increase would be 50% that is undoubtedly a significant increase for any firm. In the second situation, the increase would be 5% that is just a reflection of normal progress.

Vertical analysis is the procedure of preparing and presenting common size statements. Common size statement is one that shows the items appearing on it in percentage form as well as in dollar form. Each item is stated as a percentage of some total of which that item is a part. Key financial changes and trends can be highlighted by the use of common size statements. Common size statements are particularly useful when comparing data from different companies. For example, in one year, Wendy's net income was about Rs.110 million, whereas McDonald's was Rs.1,427 million. This comparison is somewhat misleading because of the dramatically different size of the two companies.

2. Ratio Analysis:

Ratio analysis is used as an important tool in analysis of financial statements. Ratios are used as an index or yardstick for evaluating the financial position and performance of a firm. Ratio is the expression of one figure in terms of another. It is the expression of the relationship between mutually independent figures. Ratio analysis uses financial report and data and summarizes the key relationship in order to appraise financial performance. It helps the analysts to make quantitative judgment about the financial position and performance of the firm. There are various ratios, which are used by different parties for different purposes and can be calculated from the information given in financial statements. The comparison of past ratios with future ratios shows the firm’s relative strength and weaknesses between each source.

Operating (Income) Statement

For the year ending

Balance Sheet

As on…

	Particulars	Rs.	Rs.
	Gross Sales	….	….
Less:	Sales Returns Sales Tax / Excise Net Sales (or sales) for the year (1)	 ….	 …. ….
Less:	Cost of Sales: (2) Raw Materials Consumed Direct Wages Manufacturing Expenses	 …. …. ….	 ….
Add:	Opening Stock of Finished Goods		….
Less:	Closing Stock of Finished Goods		….
	Gross Profit (1) – (2) = (3)		….
Less:	Operating Expenses (4) Administration Expenses Selling and Distribution Expenses Net Operating Profit (OPBIT) (3) – (4) = (5)	 …. ….	 …. ….
Add:	Non-trading Income (such as dividends, interest received, etc.)		….
Less:	Non-trading Expenses (such as discount on issue of shares written off)		…. ….
	Income or Earning before Interest and Tax (EBIT) (6)		….
Less:	Interest on Debentures (7)		….
	Net Income or Earning before Tax (EBT) (8)		….
Less:	Tax (9)		….
	Income or Profit After Tax (PAT) (10)		….

Particulars	Rs.
Cash in Hand	….
Cash at Bank	….
Bills Receivable	….
Book Debts (less provision for bad debts)	
Marketable Trade Investment	….
Liquid Assets (1)	….
Inventories (stock of raw materials, finished goods, etc.)	….
Prepaid Expenses	….
Current Assets (2)	….
Bills Payable	….
Trade Creditors	….
Outstanding Expenses	….
Bank Overdraft	….
Other Liabilities Payable within a year	….
Current Liabilities (3)	….
Provision for Tax	….
Proposed Dividends	….
Other Provisions	….
Provisions (4)	….
Current Liabilities and Provisions (3) + (4) = (5)	….
Net Working Capital (2) – (5) = (6) [Current Assets – Current Liabilities and Provisions]	….
Goodwill at Cost *	….
Land and Building	….
Plant and Machinery	….
Loose Tools	….
Furniture and Fixtures	….
Investments in subsidiaries	….
Patents, Copyright, etc. **	….
Fixed Assets (7)	….
Capital Employed (6) + (7) = (8)	….
Other Assets: (9)	
Investment in Government Securities, Unquoted Investments, etc.	….
Other Investment (non-trading)	….
Advance to Directors	….
Company's Net Assets (8) + (9) = (10)	….
Debentures	….
Other Long-term Loans (payable after a year)	….
Long Term Loans (11)	….
Shareholders' Net Worth (10) – (11) = (12) (or total tangible net worth)	….
Preference Share Capital (13)	….
Equity Shareholders' Net Worth (12) – (13) = (14)	….
Equity Shareholders' Net Worth is represented by: Equity Share Capital	….

* Goodwill to be included only when it has been paid for and has the value.

** Patents, Copyrights, etc. should be shown only when they have the value. In case these assets are valueless, they should not be included here but should write off against shareholders' claims with other losses.

Check your progress 2

1. The analysis of financial statements needs:

   a. selection

   b. interpretation

   c. classification

   d. all of above

2.4 Ratio Analysis

Ratio analysis is one of the techniques of financial analysis to evaluate the financial condition and performance of a business concern. Simply, ratio means the comparison of one figure to other relevant figure or figures. Financial analysts take the information off the balance sheets and income statements of a business and calculate ratios that can then be used to make assessments of the operating ability and future prospects of that business.

According to Myers, "Ratio analysis of financial statements is a study of relationship among various financial factors in a business as disclosed by a single set of statements and a study of trend of these factors as shown in a series of statements."

Advantages and Uses of Ratio Analysis

There are various groups of people who are interested in analysis of financial position of a company. They use the ratio analysis to work out a particular financial characteristic of the company in which they are interested. Ratio analysis helps the various groups in the following manner: -

1. **To workout the profitability:** Accounting ratio help to measure the profitability of the business by calculating the various profitability ratios. It helps the management to know about the earning capacity of the business concern. In this way profitability ratios show the actual performance of the business.

2. **To workout the solvency:** With the help of solvency ratios, solvency of the company can be measured. These ratios show the relationship between the liabilities and assets. In case external liabilities are more than that of the assets of the company, it shows the unsound position of the business. In this case the business has to make it possible to repay its loans.

3. **Helpful in analysis of financial statement:** Ratio analysis help the outsiders just like creditors, shareholders, debenture-holders, bankers to know about the profitability and ability of the company to pay them interest and dividend.

4. **Helpful in comparative analysis of the performance:** With the help of ratio analysis a company may have comparative study of its performance to the previous years. In this way company comes to know about its weak point and be able to improve them.

5. **To simplify the accounting information:** Accounting ratios are very useful as they briefly summarise the result of detailed and complicated computations.

Limitations of Ratio Analysis

In spite of many advantages, there are certain limitations of the ratio analysis techniques and they should be kept in mind while using them in interpreting financial statements. The following are the main limitations of accounting ratios:

1. **Limited Comparability:** Different firms apply different accounting policies. Therefore the ratio of one firm cannot always be compared with the ratio of other firm. Some firms may value the closing stock on LIFO basis while some other firms may value on FIFO basis. Similarly there may be difference in providing depreciation of fixed assets or certain of provision for doubtful debts, etc.

2. **False Results:** Accounting ratios are based on data drawn from accounting records. In case that data is correct, then only the ratios will be correct. For example, valuation of stock is based on very high price, the profits of the concern will be inflated and it will indicate a wrong financial position. The data therefore must be absolutely correct.

3. **Effect of Price Level Changes:** Price level changes often make the comparison of figures difficult over a period of time. Changes in price affect the cost of production, sales and also the value of assets. Therefore, it is necessary to make proper adjustment for price-level changes before any comparison.

4. **Qualitative factors are ignored:** Ratio analysis is a technique of quantitative analysis and thus, ignores qualitative factors, which may be important in decision making. For example, average collection period may

be equal to standard credit period, but some debtors may be in the list of doubtful debts, which is not disclosed by ratio analysis.

5. **Effect of window-dressing:** In order to cover up their bad financial position some companies resort to window dressing. They may record the accounting data according to the convenience to show the financial position of the company in a better way.

6. **Costly Technique:** Ratio analysis is a costly technique and can be used by big business houses. Small business units are not able to afford it.

7. **Misleading Results:** In the absence of absolute data, the result may be misleading. For example, the gross profit of two firms is 25%. Whereas the profit earned by one is just Rs. 5,000 and sales are Rs. 20,000 and profit earned by the other one is Rs. 10,00,000 and sales are Rs. 40,00,000. Even the profitability of the two firms is same but the magnitude of their business is quite different.

8. **Absence of standard university accepted terminology:** There are no standard ratios, which are universally accepted for comparison purposes. As such, the significance of ratio analysis technique is reduced.

Check your progress 3

1. Ratio analysis is concerned with:

   a. evaluating financial condition of business

   b. performance of employees in a concern

   c. comparison among management

   d. all of these

2.5 Classification of Ratios

Ratios can be classified into different categories depending upon the basis of classification.

Traditional Classification: Such classification depends on financial statements and can be classified as:

- Profit and loss account ratios
- Balance Sheet Ratio

- Composite ratios or inter-statement ratios

Functional Classification: The traditional classification has been found to be too crude and unsuitable because analysis of balance sheet and Income Statement cannot be done in isolation. They have to be studied together in order to determine the profitability and solvency of the business. In order that ratios serve as a tool for financial analysis, they are classified according to their functions as follows:

- Profitability ratios
- Turnover ratios
- Financial ratios

Check your progress 4

1. Which among the following shows traditional classification of ratios?

   a. Profit and loss account ratios

   b. Profitability ratios

   c. Turnover ratios

   d. Financial ratios

2.6 Profitability Ratios

Profitability is an indication of the efficiency with which the operations of the business are carried on. Poor operational performance may indicate poor sales and hence poor profits. A lower profitability may arise due to the lack of control over the expenses. Bankers, financial institutions and other creditors look at the profitability ratios as an indicator whether or not the firm earns substantially more than it pays interest for the use of borrowed funds and whether the ultimate repayment of their debt appears reasonably certain. Owners are interested to know the profitability as it indicates the return which they can get on their investments.

The following are important profitability ratios:

Overall Profitability Ratio:

Also called as Return on Investment (ROI) which shows percentage of return on total capital used in business which can be calculated as:

$$\frac{\text{Operating Profit}}{\text{Captial Employed}} \times 100$$

In management accounting, the term Capital employed is generally used as Sum-total of long-term funds employed in the business, i.e.:

Share Capital + Reserves and Surplus + Long-term Loans + (Non-Business Assets + Fictitious Assets)

The term 'Operating Profit' means 'Profit before Interest and Tax'. The term 'Interest' means 'Interest on long-term borrowings'. Interest on short-term borrowings will be deducted for computing operating profit. Non-trading incomes such as interest on government securities or non-trading losses or expenses such loss on account of fire, etc, will also be excluded.

Return on Investment (ROI) can be computed for computing the return for different purposes. Some of the ratios that are calculated are as follows:

Return of Shareholders' Funds: In case it is desired to work out the profitability of the company from the shareholders' point of view, it should be computed as follows:

$$\frac{\text{Net Profit after Interest and Tax}}{\text{Shareholders' Fund}} \times 100$$

The term Net Profit here means 'Net Income after interest and Tax'. It is different from the 'Net Operating Profit' which is used for computing the 'Return on Total Capital Employed' in the business. This is because the shareholders are interested in Total Income after Tax including Net-Non-Operating Income

(i.e., Non-operating Income – Non-Operating Expenses).

Return on Equity Shareholders' Fund: The profitability from the point of view of the equity shareholders will be judged after taking into account the amount of dividend payable to the Preference Shareholders. The Return on Equity Shareholders' Funds will, therefore, be computed on the following basis:

$$\frac{\text{Net Profit after Interest, Tax and Preference Dividend}}{\text{Equity Shareholders' Fund}} \times 100$$

Return on Gross Capital Employed: The term Gross Capital employed means the total of Fixed Assets and the Current Assets employed in the business. The formula for its computation can be put as follows:

$$\frac{\text{Net Profit before Interest (on long as well as Short-term borrowings) and Tax}}{\text{Gross Capital employed (i.e., Net Fixed Assets + Current Assets employed in the business)}} \times 100$$

Average Capital employed: Some people prefer to use 'Average Capital employed' (or average total assets, as the case may be in place of only 'Capital employed' (or Total Assets). Average Capital employed is the average of the capital employed at the beginning and at the end of the accounting period.

Significance of ROI: The Return on Capital invested is a concept that measures the profit which a firm earns on investing a unit capital. 'Yield on capital' is another term employed to express the idea. It is desirable to ascertain this periodically. The profit being the net result of all operations, the return on capital expresses all efficiencies or inefficiencies of a business collectively and, thus, is a dependable measure for judging its overall efficiency or inefficiency. On this basis, there can be comparison of the efficiency of one department with that of another, of one plant with that of another, one company with that of another and one industry with that of another. For this purpose, the amount of profits considered is that before making deductions on account of interest, income tax and dividends and capital is the aggregate of all the capital at the disposal of the company, viz., equity capital, preference capital, reserves, debentures, etc.

The Return on capital when calculated in this manner would also show whether the company's borrowing policy was wise economically and whether the capital had been employed fruitfully. Suppose funds have been borrowed at 8 per cent and the Return on capital is 7 ½ per cent, it would have been better not to borrow (unless borrowing was vital for survival). It would also show that the firm had not been employing the funds efficiently.

Return on Capital, as explained, may also be calculated on Equity Shareholders' capital. In that case, the profit after deductions for interest, income tax and preference dividend will have to be compared with Equity Shareholders'

funds. It would not indicate operational efficiency or inefficiency but merely the maximum rate of dividend that might be declared.

A business can survive only when the return on capital employed is more than the cost of capital employed in the business.

Earnings Per Share (EPS):

In order to avoid confusion on account of the varied meanings of the term capital employed, the overall profitability can also be judged by calculating earning per share with the help of the following formula:

$$\text{Earnings Per Share} = \frac{\text{Net Profit after Tax and Preference Dividend}}{\text{Number of Equity Shares}}$$

Significance: The earning per share helps in determining the market price of the equity share of the company a comparison of earning per share of the company. A comparison of earning per share of the company with another will also help in deciding whether the equity share capital is being effectively used or not. It also helps in estimating the company's capacity to pay dividend to its equity shareholders.

Earnings Per Share (EPS – AS 20)

The Institute of chartered Accountants of India (ICAI) has issued AS 20 – Earnings per Share which has become mandatory w.e.f. 1.4.2001 in respect of enterprises whose equity shares or potential equity shares are listed on a recognized stock exchange in India.

The standard makes a distinction between basic and diluted earnings per share. The enterprise has to give both types of earnings as per the standard.

Basic Earnings per Share (BEPS): The basic earnings per share are computed as follows:

$$\frac{\text{Net Profit (or Loss) for the Period Attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Share Outstanding during the year}}$$

The net profit for the above purpose means profit after deducting preference dividend and tax, excluding dividend tax on equity shares. The weighted average number of equity shares are the equality shares outstanding at the beginning of the

period adjusted by the number of equity shares bought back or issued in the period multiplied y the time weighting factor.

Diluted Earnings Per Share (DEPS): Diluted earnings per share are calculated when there are potential equity shares in the capital structures of the enterprise. A potential equity share is a financial instrument or other contract (e.g. Convertible Debentures, Convertible Preference Shares and Option Warrants etc.) that entitles or may entitle its holder to equity shares.

The diluted earnings per share are calculated as follows:

$$\frac{\text{Adjusted Net Profit (or Loss) for the Period Attributable to Equity Shareholders}}{\text{Adjusted Weighted Average Number of Shares}}$$

Price Earnings Ratio (PER):

This ratio indicates the number of times the earning per share is covered by its market price.

This is calculated according to the following formula:

$$\frac{\text{Market Price per Equity Share}}{\text{Earnings per Share}}$$

For example, if the earning per share of AB Limited is Rs.20, its market price Rs.140 and earnings ratio of similar companies is 8, it means that the market value of a share of AB Limited should be Rs.160 (i.e., 8 x 20). The share of AB Limited is, therefore, undervalued in the market by Rs.20. In case the price earnings ratio of similar companies is only 6, the value of share of AB Limited should have been Rs.120 (6 x 20), thus the share is overvalued by Rs.20.

Significance: Price-earnings ratio helps the investor in deciding whether to buy or not to buy the shares of a company at a particular market price.

Gross Profit Ratio:

This ratio expresses relationship between gross profit and net sales. Its formula is:

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Significance: This ratio indicates the degree to which the selling price of goods per unit may decline without resulting in losses from operations to the firm. It also helps in ascertaining whether the average percentage of mark up on the goods is maintained.

There is no norm for judging the Gross Profit Ratio, therefore, the evaluation of the business on its basis is a matter of judgment. However, the gross profits should be adequate to cover operating expenses and to provide for fixed charges, dividends and building up of reserves.

Net Profit Ratio:

This ratio indicates net margin earned on a sale of Rs.100. it is calculated as follows:

$$\frac{\text{Net Operating Profit}}{\text{Net Sales}} \times 100$$

Net operating profit is arrived at by deducting operating expenses from Gross Profit.

Significance: This ratio helps in determining the efficiency with which affairs of the business are being managed. An increase in the ratio over the previous period indicates improvement in the operational efficiency of the business provided the gross profit ratio is constant. The ratio is thus an effective measure to check the profitability of a business.

An investor has to judge the adequacy or otherwise of this ratio by taking into account the cost of capital, the return in the industry as a whole and market conditions such as boom or depression period. No norms can be laid down. However, constant increase in the above ratio year after year is a definite indication of improving conditions of the business.

Operating Ratio:

This ratio is a complementary of net profit ratio. In case the net profit ratio is 20 percent, it means that operation ratio is 80 percent.

It is calculated as follows:

$$\frac{\text{Operating Costs}}{\text{Net Sales}} \times 100$$

Operating costs include the cost of direct materials, direct labour and other overheads, vis., factory, office or selling, financial charges such as interest, provision for taxation, etc. are generally excluded from operating costs.

The ratio can be calculated regarding each element of operating cost to sales, viz.

$$\text{(i) Direct Material Cost to Sales} = \frac{\text{Direct Material Cost}}{\text{Net Sales}} \times 100$$

$$\text{(ii) Direct Labour Cost to Sales} = \frac{\text{Direct Labour Cost}}{\text{Net Sales}} \times 100$$

$$\text{(i) Factory Overhead to Sales} = \frac{\text{Factory Overheads}}{\text{Net Sales}} \times 100$$

Similarly, percentage of other operating costs such a administration and selling costs to sales can be computed.

Significance: This ratio is the test of the operational efficiency with which the business is being carried. The operating ratio should be low enough to leave a portion of sales to give a fair return to the investors.

A comparison of the operating ratio will indicate whether the cost component is high or low in the figure of sales. In case the comparison shows that there is increase in this ratio, the reason for such increase should be found out and management be advised to check the increased.

Fixed Charges Cover:

The ratio is very important from the lender's point of view. It indicates whether the business would earn sufficient profits to pay periodically the interest charges. The higher the number, the more secure the lender is in respect of his periodical interest income.

It is calculated as follows:

$$\frac{\text{Income before Interest and Tax}}{\text{Interest Charges}}$$

This ratio is also called as "Debt Service Ratio".

The standard for this ratio for an industrial company is that interest charges should be covered six to seven times.

Debt Service Coverage Ratio:

The interest coverage ratio, as explained above, does not tell us anything about the ability of a company to make payment of principal amount also on time. For this purpose debt service coverage ratio is calculated as follows:

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest} + \dfrac{\text{Principal Payment Instalment}}{\text{I-tax Rate}}}$$

The principal payment instalment is adjusted for tax effects since such payment is not deductible from net profit for tax purposes.

Payout Ratio:

This ratio indicates what proportion of earning per share has been used for paying dividend. The ratio can be calculated as follows:

$$= \frac{\text{Dividend per Equity Share}}{\text{Earning per Equity Share}}$$

A complementary of this ratio is Retained Earnings Ratio. It is calculated as follows:

$$= \frac{\text{Retained Earnings per Equity Share}}{\text{Earning per Equity Share}}$$

Or

$$= \frac{\text{Retained Earnings}}{\text{Total Earning}} \times 100$$

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest} + \dfrac{\text{Principal Payment Instalment}}{\text{I-tax Rate}}}$$

The principal payment instalment is adjusted for tax effects since such payment is not deductible from net profit for tax purposes.

Significance: The payout ratio and the retained earnings ratio are indicators of the amount of earnings that have been ploughed back in the business. The lower the payout ratio, the higher will be the amount of earnings ploughed back in the business and vice versa. Similarly, the lower the retained earnings ratio, the lower will be the amount of earnings ploughed back into the business and vice versa. A lower payout ratio or a higher re-attained earnings ratio means a stronger financial position of the company.

Dividend Yield Ratio:

This ratio is practically useful for those investors who are interested only in dividend income. The ratio is calculated by comparing the rate of dividend per share with market value.

Its formulae can be put as follows:

$$\frac{\text{Dividend per share}}{\text{Market Price per share}}$$

For example, if a company declares dividend at 20 per cent on its share, each having a paid-up value of Rs.8 and market price of Rs. 25, the dividend yield ratio will be calculated as follows:

$$\frac{\text{Dividend per share}}{\text{Market price per share}}$$

Significance: The ratio helps an intending investor in knowing the effective return he is going to get on the proposed investment. For example, in the above case though the company is paying a dividend of 20 per cent on its shares, a person who purchases the shares of the company from the market will get only an effective return of 6.4 per cent. He, therefore, can decide whether he should opt this investment or not.

Check your progress 5

1. Which is the formula for calculating return of shareholder fund?
   a. [Net Profit after Interest] / [Shareholders' Fund] x 100
   b. [Net Profit after Interest and Tax] / [Shareholders' Fund] x 100
   c. [Profit + Tax] / [Shareholders' Fund] x 100
   d. [Tax] / [Shareholders' Fund] x 100
2. What is gross profit ratio?
   a. [Gross Profit] / [Net Sale] x 100
   b. [Net Sale] / [Gross Profit] x 100
   c. [Profit + Tax] / [Shareholders' Fund] x 100
   d. [Net Operating Profit] / [Net Sale] x 100

2.7 Turnover Ratios

The turnover ratios or activity ratios indicate the efficiency with the capital employed is rotated in the business. The overall profitability of the business depends on two factors:

- The rate of return of capital employed
- The turnover, i.e., the speed at which the capital employed in the business rotates; higher the rate of rotation, greater the profitability

Thus, overall profitability ratio can be classified into:

1. Net Profit ratio
2. Turnover Ratio

As already explained the Net Profit Ratio is calculated as follows:

$$= \frac{\text{Net Operating Profit}}{\text{Sales}} \times 100$$

Turnover ratio is calculated as follows:

$$= \frac{\text{Sales}}{\text{Capital employed}}$$

Turnover ratio indicates the number of times the capital has been rotated in the process of doing business.

When these two ratios are put together, we get the overall profitability ratio.

Overall profitability ratio = Net Profit ratio x Turnover Ratio

$$= 100 \times \frac{\text{Net Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}}$$

$$= \frac{\text{Net Profit}}{\text{Capital employed}} \times 100$$

In order to find out which part of capital is efficiently employed and which part not different turnover ratios are calculated. These ratios are as follows:

1. **Fixed Assets Turnover Ratio:** This ratio indicates the extent to which the investments in fixed assets contributed towards sales. If compared with a previous period, it indicates whether the investments in fixed assets has been judicious or not.

The ratio is calculated as follows:

$$= \frac{\text{Net Sales}}{\text{Fixed Assets (net)}}$$

The fixed assets turnover ratio can further be divided into turnover of each item of fixed assets to find out the extent each fixed assets have been properly used.

For example:

$$\text{Plant and machinery to turnover} = \frac{\text{Net Sales}}{\text{Plant and Machinery (Net)}}$$

$$\text{Land Buildings to Turnover} = \frac{\text{Net Sales}}{\text{Land and Buildings (Net)}}$$

2. **Working Capital Turnover Ratio:** This ratio indicates whether or not working capital has been effectively utilized in marking sales.

The ratio is calculated as follows:

$$\frac{\text{Net Sales}}{\text{Working Capital}}$$

Working capital ratio may take different forms for different forms for different purposes.

Some of them are being explained below:

Debtors 'turnover ratio (Debtors' Velocity): Debtors constitute an important constituent of current assets and therefore the quality of debtors to a great extent determines a firm's liquidity. Financial analysts to judge the liquidity of firm use two ratios. They are (i) Debtors' turnover ratio and (ii) Debt collection period ratio.

The debtors' turnover ratio is calculated as under:

$$\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$$

The term Accounts Receivable includes 'Trade Debtors' and 'Bills Receivable'.

In case details regarding opening and closing receivables and credit sales are not available the ratio may be calculated as follows:

$$\frac{\text{Total Sales}}{\text{Accounts receivable}}$$

Significance: Sales to accounts Receivable Ratio indicates the efficiency of the staff entrusted with collection of book debts. The higher the ratio, the better it is, since it would indicate that debts are being collected more promptly. For measuring the efficiency, it is necessary to set up a standard figure; a ratio lower that the standard will indicate inefficiency.

The ratio helps in cash Budgeting since the flow of cash form customers can be worked out on the basis of sales.

Debt Collection Period Ratio: The ratio gives the average debt collection period. The ratio is very helpful to the lenders because it explains to them whether their borrowers are collecting money within a reasonable time. An increase in the period will result in greater blockage of funds in debtors.

Significance: Debtors' collection period measures the quality of debtors since it measures the rapidity or slowness with money is collected from them. A shorter collection period implies prompt payment by debtors. It reduces the chances of bad debts. A longer collection period implies too liberal and inefficient credit collection performance. However, in order to measure a firm's credit and collection efficiency, its average collection period should be compared with the average of the industry. It should be neither too liberal nor too restrictive. A restrictive policy will result in lower sales, which will reduce profits.

It is difficult to provide a slandered collection period of debtors. It depends upon the nature of the industry, seasonal character of the business and credit policies of the firm. In general, the amount of Receivables should not exceed 3-4 months' credit sales.

Creditors' Turnover Ratio (Creditors' Velocity): It is similar to debtors' Turnover Ratio. It indicates the speed with which the payments for credit purchases are made to the creditors.

The ratio can be computed as follows:

$$\frac{\text{Credit Purchases}}{\text{Average Accounts Payable}}$$

The term Accounts Payable includes 'Trade Creditors' and 'Bills Payable' In case the details regarding credit purchases, opening and closing accounts Payable have not been given, the ratio may be calculated as Follows:

$$\frac{\text{Total Purchases}}{\text{Accounts Payable}}$$

Debt Payment period Enjoyed Ratio: The Ratio Gives the average credit period enjoyed from the creditors.

It can be computed by any of the following methods:

(a) $$\frac{\text{Months (or Days) in a year}}{\text{Creditors' Turnover}}$$

(b) $$\frac{\text{Average Accounts Payable x Months (or Days) in a year}}{\text{Creditors' Turnover}}$$

(c) $$\frac{\text{Average Accounts Payable}}{\text{Average Monthly (or daily) Credit Purchases}}$$

Significance: Both the creditors turnover ratio and the debt payment period enjoyed ratio indicate about the promptness or otherwise in making payment of credit purchases. A higher 'creditors turnover ratio' or a 'lower credit period enjoyed ratio' signifies that the creditors are being promptly, thus enhancing the credit worthiness is not taking full advantage of credit facilities which can be allowed by the creditors.

Stock turnover ratio: This ratio indicates whether investment in inventory is efficiently used or not. It, therefore, explains either investment in inventories is within proper limits or not.

The ratio is calculated as follows:

$$\frac{\text{Cost of Goods Sold during the year}}{\text{Average Inventory}}$$

Average inventory is calculated by taking stock levels of raw materials, work-in-process, finished goods at the end of each month, adding them up and dividing by twelve.

Inventory ratio is calculated regarding each constituent of inventory. It may thus be calculated regarding raw materials, work-in-progress and finished goods:

(a) $$\frac{\text{Cost of Goods Sold}}{\text{Average Stock of finished Goods}}$$

(b) $$\frac{\text{Material Consumed}}{\text{Average Stock of Raw Materials}}$$

(c) $$\frac{\text{Cost of Completed Work}}{\text{Average Work-in-process}}$$

The Method discussed above is as a matter of fact the best basis for computing the Stock. Turnover Ratio however, in the absence of complete information, the Inventory turnover Ratio may also be computed on the following basis:

$$\frac{\text{Net Sales}}{\text{Average Inventory at Selling Price}}$$

Significance of the ratio:

As already standard, the inventory turnover ratio signifies the liquidity of the inventor. A high inventory turnover ratio indicates brisk sales. The ratio is, therefore, a measure to discover the possible trouble in the form of overstocking or overvaluation. The stock position is known as the graveyard of the balance sheet. If the sales are quick a position would not arise unless the stocks consist of unsalable items. A low inventory turnover ratio results in blocking of funds in

inventory which may ultimately result in heavy losses due to inventory becoming absolute or deteriorating in quality.

Check your progress 6

1. What is Net Profit Ratio?

   a. [Gross Profit] / [Net Sale] x 100

   b. [Net Sale] / [Gross Profit] x 100

   c. [Profit + Tax] / [Shareholders' Fund] x 100

   d. [Net Operating Profit] / [Net Sale] x 100

2. Formula for Fixed Assets Turnover Ratio is:

   a. [Gross Profit] / [Net Sale]

   b. [Net Sale] / [Gross Profit]

   c. [Net Sale] / [Fixed Asset]

   d. [Net Operating Profit] / [Net Sale]

2.8 Financial Ratios

Financial ratios indicate about the financial position of the company. A company is deemed to be financially sound if it is in a position to carry on its business smoothly and meet all its obligations-both long-term as well as short-term without strain. Thus, its financial principle of finance that long-term requirements of funds should be met out of long-term funds and short-term requirements should be met out of short-term funds. For example, if fixed assets are purchased out of funds provided by bank overdraft, the company will come to grief because such assets cannot be sold away when the bank will demand payment. We are giving below some of the important ratios, which are calculated in order to judge the financial position of the company.

1. Fixed Assets Ratio: This Ratio is expressed as follows:

- Fixed assets
- Long-term funds

The ratios should not be more than l. If it is less than l., it shows that a part of the working capital has been financed through long-term funds. This is

desirable to some extent because a part of working capital termed as "core working capital" is more less of a fixed nature. The ideal ratio is 0.67.

Fixed assets include "net fixed assets" (i.e., original cost-depreciation to date) and trade investments including shares in subsidiaries. Long-term funds included share capital, reserves and long-term loans.

2. **Current Ratio:** This ratio is an indicator of the firm's commitment to meet its short-term liabilities. It is expressed as follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current assets include cash and other assets convertible or meant to be converted into cash during the operating cycle of the business (which is not more than a year). Current liabilities payable within a year's time either out of existing current assets or by creation of new current liabilities. A list of items included in current assets and current liabilities has already been given in the pro forma analysis balance sheet in the preceding pages.

Book debts outstanding for more than six months and loose tools should not be included in current Assets. Prepaid expenses should be taken into current assets.

An ideal current ratio is 2. The ratio of 2 is considered as a safe margin of solvency due to the fact that if the current assets are reduced to half, i.e., l instead of 2, then also the creditors will be able to get their payments in full. However, a business having seasonal trading activity may show a lower current ratio at certain period in the year. A very high current ratio is also not desirable since it means less efficient use of funds. This is because a high current ratio means excessive dependence on long-term sources of raising funds. Long-term liabilities are costlier than current liabilities and therefore, this will result in considerably lowering down the profitability of the concern.

It is to be noted that the mere fact that current ratios is quite high does not means that the company will be in a position to meat adequately its short-term liabilities. In fact the current ratio should be seen intellections to the components of the current assets and their liquidity. If a large portion of the current assets comprise absolute stocks or debtors outstanding for a long time, company may fail if the current ratio is higher than 2.

3. **Liquidity Ratio:** This ratio is also termed as 'acid test ratio' or 'quick ratio'. This ratio is ascertained by comparing the liquid assets (i.e., Assets

which are immediately convertible into cash without much loss) to current liabilities prepaid expenses and stock are not taken as liquid assets. The ratio may be expressed as under:

$$\frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Some accountants prefer the term "liquid Liabilities" for "Current Liabilities" for the purpose of ascertaining this ratio. Liquid liabilities which are payable within a short period. The bank overdraft (if it became a permanent mode of financing) and cash credit facilities will be excluded from current liabilities in such a case:

$$\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$$

The ratio is also an indicator of short-term solvency of the company.

A comparison of the current ratio to quick ratio shall indicate the inventory hold-ups. For example, if two units have the same current ratio but different liquidity ratios, it indicates over-stocking by the concern having low liquidity ratios as compared to the concern, which has a higher liquidity ratio.

4. **Debt-equity Ratio:** The debt-equity ratio is determined to ascertain the soundness of the long-term financial policies of the company. It is also known as "external-internal" equity ratio. It may be calculated as follows:

$$\text{Debt-equity Ratio} = \frac{\text{External equities}}{\text{Internal equities}}$$

The term external equities refers to total outside liabilities and the term internal equities refers to shareholders' funds or the tangible net worth (as used in the performs a balance sheet given in the preceding pages). In case the ratio is l (i.e., Outsider's funds are equal to shareholders' funds), it is considered to be quite satisfactory.

(i) $$\text{Debt-equity Ratio} = \frac{\text{Total Long-term debt}}{\text{Total Long-term funds}}$$

(ii) Debt-equity Ratio = $\frac{\text{Shareholders fund}}{\text{Total Long-term funds}}$

(iii) debt-equity Ratio = $\frac{\text{Total Long-term debt}}{\text{Shareholders fund}}$

It is to be noted that preference shares redeemable within a period of 12 years from the date of their issue should be taken as a part of debt.

Significance: The ratio indicates the proportion of owners' stake in the business. Excessive liabilities tend to cause insolvency.

5. **Proprietary Ratio:** It is a variant of debt-equity ratio. It established relationship between the proprietors'; or shareholders' funds and the total tangible assets. It may be expressed as under.

$$\frac{\text{Shareholders' Funds}}{\text{Total tangible Assets}}$$

Significance: The ratio focuses the attention on the financial strength of the business enterprise. The ratio is of particular importance to the creditors who can find out the proportion of shareholders' funds in the total assets employed in the business. A high proprietary ratio will indicate a relatively little danger to the creditors, etc., in the event of forced reorganisation or winding up of the company. A low proprietary ratio indicates greater risk to the proprietors of the business. The higher the ratio, the better it is. A ratio below 50 per cent may be alarming for the creditors since they may have to loose heavily in the event of company's liquidation on account of heavy losses.

Check your progress 7

1. The current ratio can be calculated through:

   a. Current Assets/Current Liabilities.

   b. Liquid Assets/Current Assets.

   c. Liquid Assets/Current Liabilities.

   d. External equities/Internal equities.

2.9 Advantages of Ratio Analysis

Following are some of the advantages of ratio analysis:

1. **Simplifies Financial Statements:** Ratio analysis simplifies the comprehension of financial statements. Ratios tell the whole story of changes in the financial condition of the business.

2. **Facilitates Inter-firm Comparison:** Ratio analysis provides data for inter-firm comparison. Ratios highlighting the factors associated with successful and unsuccessful firms. They also reveal strong firms and weak firms, over-valued and under-valued firms.

3. **Makes Intra-firm Comparison Possible:** Ratio analysis also makes possible comparison of the performance of the different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.

4. **Helps in Planning:** Ratio analysis helps in planning and forecasting. Over a period of time a firm or industry develops certain norms that may indicate future success or failure. If relationship changes in firm's data over different time periods, the ratios may provide clues on trends and future problems.

   Thus, "ratios can assist management in its basic functions of forecasting, planning, coordination, control and communications.

Check your progress 8

1. The basic advantage of ratio in terms of management is:

   a. forecasting

   b. planning

   c. coordination

   d. all of above

2.10 Limitations of Accounting Ratios

Accounting ratios are subject to certain limitations. They are given below:

1. **Comparative study required:** Ratio are useful in judging the efficiency of the business only when they are compared with the past results of the business or with the results of a similar business. However, such a comparison only provides a glimpse of the past performance and forecasts for future may not prove correct since several other factors like market conditions, management policies, etc., may affect the future operations.

2. **Based only on financial statements:** Ratios are based only on the information, which has been recorded in the financial statements. As indicated in the preceding pages financial statements suffer from a number of limitations, the derived there from, therefore, are also subject to those limitations. For example, the financial statements do not reveal non-financial charges though important for the business. If the managements of the company changes, it may have ultimately adverse effects on the future profitability of the company but this cannot be judged by having a glance at the financial statements of the company.

   Similarly, the management has a choice about the accounting policies. Different accounting policies may be adopted by management of different expenditure and treatment of deferred revenue expenditure. The comparison of one firm with another on the basis of ratio analysis without taking into account the fact of companies having different accounting policies, will be misleading and meaningless. Moreover, the management of the firm itself may change its accounting policies from one period to another. It is, therefore, absolutely necessary that financial statements are they subjected to close scrutiny before an analysis is attempted on the basis of accounting ratios.

   The growing realisation among accountants all over the world, that the accounting policies should be standardised, has resulted in establishment of International Accounting Slandered Committee, which has issued a number of International Accounting Slandered. In our country, the Institute of Chartered Accountants of India has established Accounting Standards Board of formulation of requisite accounting standards. The Accounting Standards Board has already issued twenty-three accounting Standards including As 1: Disclosure of Accounting Policies. The standard has become mandatory in respect of accounts for periods commencing on or after April 1, 1991.

3. **Ratios alone are not adequate:** Ratios are only indicators; they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen. For example, a high current ratio does not necessarily mean that the concern has a good liquid position in case current assets mostly comprise of outdated stocks. It has been correctly observed, "No ratio may be regarded as good or bad inter se." It may be an indication that a firm is weak or strong but it must never be taken as proof of either one. Ratios may be linked to railroads. They tell the analysis. "Stop, look and listen".

4. **Windows dressing:** The term window dressing means manipulation of accounts in a way so as to cancel vital facts and present the financial statements in a way to show a better position than what it actually is. On account of such a situation, presence of particular ratio may not be a definite indicator of good or bad management. For example, high stock turnover ratio is generally considered to be an indication of operational efficiency of the business. But this might have been achieved by unwarranted price reductions or failure to maintain proper stock of goods.

   Similarly, the current ratio may be improved just before the Balance Sheet date by postponing replenishment of inventory. For example, if a company has current assets of Rs.4, 000 while current liabilities of Rs.2, 000, the current ratio is 2, which is quite satisfactory. In case the company purchases goods of Rs.2, 000 on credit, the current assets would go up to Rs.6,000 and current liabilities to Rs.4,000. Thus reducing the current ratio to 1.5. The Company may, therefore, postpone the purchases for the early next year so that its current ratio continues to remain at 2 on the Balance Sheet date. Similarly, in order to improve the current ratio, the company, may pay off certain pressing current liabilities before the Balance Sheet date. For example, if in the above case the company pays current liabilities of Rs.1,000, the current liabilities would stand reduced to Rs.1, 000, current assets would stand reduced to R.3,000 but the current ratio would go up to 3.

5. **Problem of Price level changes:** Financial analysis based on accounting ratios will give misleading results if the effects of changes in price level are not taken into account. For example, two companies set up in different years, having plant and machinery of different ages, cannot be compared, on the basis of traditional accounting statements. This is because the depreciation charged on plant and machinery in case of old company would

be at a much lower figure as compared to the company, which has been set up recently. The techniques changes if a meaningful comparison is to made through accounting ratios. The techniques of current purchasing power and current cost accounting are quite helpful in this respect.

6. **No fixed standards:** No fixed standards can be laid down for ideal ratios. For example, current ratio is generally considered to be ideal if current assets are twice the current liabilities. However, in case of those concerns, which have adequate arrangements with their bankers for providing funds when they require, it may be perfectly ideal if current assets are equal to or slightly more than current liabilities.

It may, therefore, be concluded that ratio analysis, if done mechanically, is not only misleading but also dangerous. It is indeed a Double-edged sword, which requires a great deal of understanding and sensitivity of the management process rather than mechanical financial skill. It has rightly been observed, "The ratio analysis is an aid to management in taking correct decisions but as a mechanical substitute for thinking and judgment, it is worse than useless. The ratios, if discriminately calculated and wisely interpreted, can be a useful tool of financial analysis".

The computation of different accounting ratios and the analysis of the financial statements on their basis can be very well understood with the help of the illustrations given in the following pages.

Check your progress 9

1. Which is correct in case of ratio analysis?

   a. It is safer

   b. It is easy to understand

   c. It helps management in taking correct decisions

   d. It is not of any use in financial analysis

2.11 Computation of Ratios

To compute ratios we will study the details of profit and loss account and balance sheet of Jai Hind Ltd. Where we will study about following ratios:

- Gross profit ratio
- Overall profitability ratio
- Current Ratio
- Debt-equity ratio
- Stock turnover ratio
- Liquidity ratio

Profit And Loss Account

Particulars	Rs	Particulars	Rs
Opening Stock of Finished Goods	1,00,000	Sales	10,00,000
Opening Stock of raw Materials	50,000	Closing Stock of Raw Materials	1,50,000
Purchase of Raw Materials	3,00,000	Closing Stock of Finished Goods	1,00,000
Direct Wages	2,00,000	Profit on Sale of Shares	50,000
Manufacturing Expenses	1,00,000		
Administration Expenses	50,000		
Selling and Distribution Expenses	55,000		
Loss on Sale of Plant	10,000		
Interest on Debentures	3,85,000		
Net Profit	13,00,000		13,00,000

Balance Sheet

Liabilities	Rs.	Assets	Rs
Share Capital:		Fixed Assets	2,50,000
Equity Share Capital	1,00,000	Stock of Raw Materials	1,50,000
Preference Share Capital	1,00,000	Stock of Finished Goods	1,00,000
Reserves	1,00,000	Sundry Debtors	1,00,000
Debentures	2,00,000	Bank balance	50,000
Sundry Creditors	1,00,000		
Bills Payable	50,000		
	6,50,000		6,50,000

Solution:

Income Statement

		Rs.
Sales		10,00,000
Less: Cost of Sales:		
Raw Materials consumed		
(Opening Stock + Purchases – Closing Stock)	2,00,000	
Direct sages	2,00,000	
Manufacturing Expenses	1,00,000	
Cost of Production	5,00,000	
Add: Opening Stock of Finished Goods	1,00,000	
Less: Closing Stock of Finished Goods	6,00,000	
Cost of goods sold	1,00,000	5,00,000
Gross Profit		5,00,000
Less: Operating expenses:		
Administration Expenses	50,000	
Selling and Distribution Expenses	50,000	1,00,000
Net Operating Profit:		4,00,000
Add: Non-trading Income:		50,000
Profit on Sale of Shares		4,50,000
Less: Non-trading Expenses or Losses:		55,000
Loss on Sale of Plant		
Income before Interest and Tax		3,95,000
Less: Interest on Debentures		10,000
Net Profit Before Tax		3,85,000

Balance Sheet (Or Position Statement)

	Rs
Bank Balance	50,000
Sundry Debtors	1,00,000
Liquid Assets:	1,50,000
Inventories:	1,50,000
Stock of Raw Materials	1,00,000
Stock of Finished Goods	4,00,000
Current Assets	1,00,000
Sundry Creditors	50,000
Bills Payable	1,50,000
Current Liabilities	2,50,000
Working Capital (Rs.4,00,000 – Rs.1,50,000)	2,50,000
Add: Fixed Assets	5,00,000
Capital Employed	2,00,000
Less: Debentures	3,00,000
Shareholders	1,00,000
Less: Preference Share Capital	2,00,000
Equity Shareholders' Net Worth	1,00,000
Equity Shareholders' Net Worth is represented by:	1,00,000
Equity Share Capital	2,00,000
Reserves	

Ratios:

- Gross Profit Ratio:

$$\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{5,00,000}{10,00,000} \times 100 = 50 \text{ per cent}$$

- Overall Profitability Ratio:

$$\frac{\text{Operating Profit}}{\text{Capital employed}} \times 100 = \frac{4,00,000}{5,00,000} \times 100 = 80 \text{ per cent}$$

- Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{4,00,000}{5,00,000} = 2.67$$

- Debt-Equity Ratio:

$$\frac{\text{External Equities}}{\text{Internal Equities}} = \frac{3,50,000}{3,00,000} = 1.17$$

Or

$$= \frac{\text{Total Long = term Debt}}{\text{Total Long = term Funds}} = \frac{2,00,000}{5,00,000} = 0.40$$

Or

$$= \frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}} = \frac{2,00,000}{5,00,000} = 0.67$$

The Balance Sheet of Y Ltd. stood as Follows as on:

Liabilities	31.3.95	31.3.94	Assets	31.3.95	31.3.94
Capital	250	250	Fixed Assets	400	300
Reserves	116	100	Less: Depreciation	140	100
Loans	100	120		260	200
Creditors and Other Current Liabilities	129	25	Investments	40	30
			Stock	120	100
			Debtors	70	50
			Cash/Bank	20	20
			Other Current Assets	25	25
			Misc. Expenditure	60	70
	595	495		595	495

You are given the following information for the year 1994-95:

Sales	600
PBIT	150
Interest	24
Provision for Tax	60
Proposed dividend	50

All the figures given above are rupees in lakhs.

From the above particulars calculate for the year 1994-95:

a. Return on Capital Employed Ratio

b. Stock turnover Ratio

c. Return on Net worth Ratio.

d. Current Ratio

e. Proprietary Ratio

Solution:

(i) Return on Capital Employed

$$\frac{\text{PBIT}}{\text{Average Capital Employed}} \times 100 \quad \text{i.e.,} \frac{150}{403} \times 100 = 37.22\%$$

(ii) Stock Turnover Ratio

$$\frac{\text{Sales}}{\text{Average Stock}} \quad \text{i.e.,} \quad \frac{600}{110} = 5.45 \text{ times}$$

(iii) Return on Net Worth

$$\frac{\text{PAT}}{\text{Average Net Worth}} \times 100 \quad \text{i.e.,} \quad \frac{235}{129} = 22.53\%$$

(iv) Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{i.e., } \frac{135}{129} = 1.82 \text{ times}$$

$$\frac{\text{Proprietary Funds}}{\text{Total Assets – Misc. Expenditure}} = \frac{306}{595 - 60} = 0.57$$

Working Notes:

(i) Average Capital Employed (Rs. In Lakhs)

	31.3.1995	31.3.1994
Total Assets (excluding Misc. expenditure)	535	425
Less: Creditors and Other current Liabilities	129	25
	406	400

Average: 466 + 470 □ 2 = Rs 468 lakhs

(ii) Average Net Worth

Capital	250	250
Reserves	116	100
	366	350
Less: Misc. Expenses	60	70
	306	280

Average: 306 + 280 ÷ 2 = Rs. 468 lakhs

(iii) Average Stock (Rs. In Lakhs)

(120 + 100/2 = 110)

(iv) Profit after Tax (Pat) (Rs. In Lakhs)

PBIT 150

Less: Interest	24
	126
Less: Tax	60
	66

(ii) Current Assets as on 31.3.95 (Rs in lakhs)

Stock	120
Debtors	70
Cash/Bank	20
Other Current Assets	25
	235

Computation of Items of Financial Statements

With the help of the following ratios regarding Indu Films, draw the Balance Sheet of the Company for the year 1995:

Current Ratio	2.5
Liquidity Ratio	1.5
Net Working Capital	Rs. 3,00,000
Stock Turnover Ratio (cost of sales/closing stock)	6 times
Gross Profit Ratio	20 per cent
Fixed Assets Turnover Ratio (on cost of sales)	2 times
Debt Collection Period	2 Months
Fixed Assets to Shareholders Net Worth	0.80
Reserve and Surplus to Capital	0.50

Solution:

Balance Sheet

As on….

Liabilities	Rs.	Assets	Rs.
Share Capital	5,00,000	Fixed Assets	6,00,000
Reserve and Surplus	2,50,000	Debtors	2,50,000
Long-term Borrowings		Stock	2,00,000
(Balancing figure)	1,50,000	Bank	50,000
Current Liabilities	2,00,000		
	11,00,000		11,00,000

Working Notes:

If Current Liabilities =1

Current Assets =2.5

It means the differences or Working Capital =Rs. 3,00,000

Working Capital is 1.5 =Rs. 5,00,000

Therefore, Current Assets =RS.2, 00,000

As Liquidity Ratio =1.5

And Current Liabilities =Rs.2, 00,000

Therefore, the Liquid Assets

(Bank and debtors) (2,00,000 × 1.5) =Rs.3, 00,000

Stock (5,00,000 – 3,00,000, i.e.,

Current assets – liquid assets) =Rs.2, 00,000

Cost of sales (as stock turnover ratio is 6) =Rs.2, 00,000

Sales (as G.P. ratio is 20 per cent,

$$12,00,000 + \frac{20}{80} \times 12,00,000$$ =Rs.15, 00,000

Fixed Assets are Rs.12, 00,000/2 since fixed assets

Turnover ratio is 2 =Rs.6, 00,000

Debtors are Rs.15, 00,000/6 since debt collection

Period is 2 months =Rs.2, 50,000

$$\text{Shareholders' Net Worth} \quad \frac{6,00,00 \times 1}{0.80} = \text{Rs.}7,50,000$$

Out of Shareholders' Net Worth Reserves and Surplus =Rs.2, 50,000

Therefore, share capital =Rs.5, 00,000

The following extract of financial information relate to Curious Ltd.:

Balance Sheet

As on 31st December (Rs. In lakhs)

Particulars	1995	1994
Share Capital	10	10
Reserve and Surplus	30	10
Loan Fund	60	70
	100	90
Fixed Assets (Net)	30	30
Current Assets:	30	20
Stocks	30	30
Debtors	10	20
Cash and Banks balances	30	10
Other Current Assets	100	80
	30	20
Less: Current Liabilities	70	60
Net Working Capital	100	90
Total Assets		
Sales (Rs in lakhs)	270	300

(a) Calculate, for the two years debt equity ratio, quick ratio and working capital turnover ratio.

(b) Find the sales volume that been generated in 1995 if the company were to have maintained its working capital turnover ratio.

Solution:

a. Debt Equity Ratio

$$= \frac{\text{Debt}}{\text{Equity}} = \frac{\text{Loan Funds}}{\text{Share Capital + Reserves}} = \frac{60}{40} \quad \frac{70}{20}$$

(1995 and 1994)

b. Quick Ratio

$$= \frac{\text{Quick Assets}}{\text{Current Liabilities}} \qquad = \frac{30+10}{30} \quad \frac{30+20}{20}$$

$$= 1.33:1 \quad 25:1$$

c. Working Capital Turnover Ratio

$$= \frac{\text{Sales}}{\text{Working Capital}} \qquad = \frac{270}{70} \quad \frac{300}{60}$$

= 3.86 times 5 times

d. Sales volume to be maintained

$$5 = \frac{\text{Required Sales}}{70}$$

Sales required for 1995 = Rs 350 lakhs.

Check your progress 10

1. What is the formula for current ratio?

   a. Current Assets/Current Liabilities

   b. External Equities/Internal Equities

   c. Sales/Average Stock

   d. None of the above

2.12 Let Us Sum Up

In this unit we have learnt that analysis and interpretation of financial statements relates to treatment of information contained in the Income Statement and the Balance Sheet that can be easily diagnosis of the profitability and financial soundness of the business. It is found that comparison of two or more year's financial data is called as horizontal analysis or trend analysis. Horizontal analysis is facilitated by showing changes between years in both dollar and percentage form. On the other hand, Ratio analysis is techniques of financial analysis which will evaluate financial condition and performance of business concern.

It is seen that fixed assets include net fixed assets and trade investments including shares in subsidiaries. Long-term funds included share capital, reserves and long-term loans.

2.13 Answer for Check Your Progress

Check your progress 1

Answers: (1-b)

Check your progress 2

Answers: (1-d)

Check your progress 3

Answers: (1-a)

Check your progress 4

Answers: (1-a)

Check your progress 5

Answers: (1-b), (2-a)

Check your progress 6

Answers: (1-d), (2-c)

Check your progress 7

Answers: (1-a)

Check your progress 8

Answers: (1-d)

Check your progress 9

Answers: (1-c)

Check your progress 10

Answers: (1-a)

2.14 Glossary

1. **Selection -** It refers to choosing something or highlighting.
2. **Classification -** It is the methodical classification of the data.
3. **Interpretation -** It involves drawing of conclusions and explaining the meaning and significance of the data.
4. **Ratio analysis -** It is a financial analysis techniques which involves evaluation of financial condition.
5. **Turnover Ratios -** It is the ratio of efficiency with respect to capital employed which is applied in business.

2.15 Assignment

1. Determine which company is more profitable.

	A Ltd	B Ltd
Net Profit Ratio	5 per cent	8 per cent
Turnover Ratio	6 times	3 times

2.16 Activities

From the following compute the following:

- Current ratio
- Liquid ratio
- Fixed asset ratio

Particulars	Rs.	Particulars	Rs.
Share Capital	1,00,000	Furniture	25,000
Reserves	50,000	Trade Debtors	50,000
12 per cent Debentures	1,00,000	Cash Balance	30,000
Trade Creditors	50,000	Bills Payable	10,000
Plant and Machinery	1,00,000	Stock	40,000
Land Buildings	1,00,000		

2.17 Case Study

Discuss the tools and techniques in financial statement analysis. Provide examples for each.

2.18 Further Readings

1. Advanced Accountancy, Hrishikesh Chakraborty, Oxford University Press, 2002.
2. Accountancy, Shukla & Grewal, S Chand & Company Ltd, 1997.
3. Financial Accounting, S. Kr. Paul, New central book agency (P) LTD, 2003.
4. Fundamentals of Accounting, S. K. Paul, New central book agency (P) LTD, 2003.
5. Financial Accounting, Naseem Ahmed.

Block Summary

In this block, you have gained knowledge about methods and calculation involved in finding the depreciation of certain product. It has detailed regarding various methods of calculating depreciation along with their significance are explained so that you can practice and learn more for future applications. The detailed about financial statement and their occurrence in business concern will be of great help to any financial background you as the complete analysis along with illustrations is explained.

The block detailed about accounting standards for depreciation along with various ratio analysis methods that will help you to learn more and understand correctly about method of calculating various product ratios. The applications about ratio analysis help them to find certain types of ratios that could of use to them while working as financial analyst in a concern.

Block Assignment

Short Answer Questions

1. What do you mean by financial statements analysis?
2. What is depreciation?
3. What is the Need of depreciation?
4. Explain Accounting standards (AS) for depreciation?
5. What is ratio analysis?

Long Answer Questions

1. State the basis for classification of ratios in ratio analysis?
2. Find out the most popular method of depreciation used by any business firm?
3. What are the steps involved in financial statement analysis?

Enrolment No.

1. How many hours did you need for studying the units?

Unit No	**1**	**2**	**3**	**4**
Nos of Hrs				

2. Please give your reactions to the following items based on your reading of the block:

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	_____
Language and Style	☐	☐	☐	☐	_____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	_____
Conceptual Clarity	☐	☐	☐	☐	_____
Check your progress Quest	☐	☐	☐	☐	_____
Feed back to CYP Question	☐	☐	☐	☐	_____

3. Any Other Comments

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Education is something which ought to be brought within the reach of every one.

- Dr. B. R. Ambedkar

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