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Unit–1

Accounting : An Overview

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Structure

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1.1. Introduction

The business today is large in size and complex in nature. There are various groups who are interested in the performance of the business such as shareholders, debenture holders, investors, employees and consumers, etc. Accounting, in this way, is required to report and present the facts of the business in such a way, which can meet the varied requirements of different groups. It is, therefore, necessary that the language and terminology of accounting may be standardised so that there may be uniformity in the presentation of accounts. The idea requires scientific study, analysis and presentation of Accounts.

1.2. Meaning of GAAP

Generally Accepted Accounting Principles (GAAP) are the set of rules and practices that are followed while recording transactions and preparing the financial statements, GAAP build sound theoretical foundation of Accounting.

According to American Institute of Certified Public Accountants (AICPA). GAAP have substantial authoritative support and general acceptability. GAAP must be relevant (meaningful), objective (reliable) and feasible (implemented without much cost and complexity).

Notes

Accounting is the systematised body of knowledge having cause and effect relationship. The subject has certain established concepts, conventions, standard language and terminology to enable the interested parties in the subject to understand it in the same sense as the accountant wants to communicate. These rules are usually called *Generally Accepted Accounting Principles* (GAAP). Accounting assumptions, rule of recording and reporting business transactions are also known by terms like *concepts, principles, conventions, doctrines, tenets, axioms postulates, assumption and modifying principles.*

The Principles of Accounting are not static in nature. These are constantly influenced by changes in legal, social and economic environment as well as the needs of the users. The various terms for principles are inter-changeably used by different authors. Generally the term 'Basic Accounting Concepts' is used to refer all these terms.

1.3. Basic Accounting Concepts

The fundamental ideas or basic concepts underlying the theory and practice of financial accounting and broad working rules for all accounting activities, developed by professionals are listed and discussed below:

Basic Accounting Concepts
1. Business Entity Concept
2. Money Measurement Concept.
3. Going Concern Concept.
4. Accounting Period Concept.
5. Dual Aspect (or Duality) Concept

These concepts are the foundation of systematic and proper accounting. Every business enterprise must adopt these concepts, popularly known as pillars upon which the sound structure of accounting stands. Let us discuss these basic concepts:

1. Business Entity Concept

In accounts, we distinguish between the business and its proprietors. Business is **assumed to have distinct entity** *i.e.,* **existence other than the existence of its proprietors and other business units**. As an accountant, we are concerned with the business not the businessman. We have to record business transactions from firm's point of view and never from the viewpoint of proprietors. We record transactions in the books of shop, establishment, factory, firm, company and enterprise and never in the books of proprietor, partners and shareholders. While making decisions regarding asset, liability, capital, revenue and expense, business viewpoint is taken into consideration.

The capital introduced by the proprietor in its own business is considered liability from business point of view. It will not be a liability if proprietor's viewpoint is taken. The logic behind treatment of capital as liability is that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties. It would have been a liability if the funds would have been borrowed from outside agency, then why not, if it is being invested by the proprietor himself. We also allow interest on capital to the proprietors because capital is supposed to be a liability. Interest on capital is an expense of the business, therefore, it will reduce the profit of the firm. It is at the same time proprietor's claim against the business, so it will increase him capital. Amount withdrawn by the proprietor for personal use, known as drawings is assumed to be the assets of the business and at the same time a liability to the proprietor.

The business as a distinct entity records all business transaction into the books of accounts and reports the result to the proprietor in case of sole trade, partners in case of partnership firms and shareholders in case of company. There is a legal divorce between the ownership and management of a company. The company is owned by shareholders by managed by the elected representatives of the shareholders *i.e.,* directors. Accounts are prepared by the management and a copy of the financial statements is supplied to the shareholders, the owners of the company for information. Every accountant whether he is concerned with a petty shop or a firm or a company or a big business house will have to compulsorily adopt the concept of business entity in his accounting operations.

Legally, a sole proprietor or the partner of a partnership firm are not separate from their business units but in Accounting the business units are assumed to have distinct entity. Accounting entity is different from business entity. Accounting entity is wider term including business, clubs, institutions, public enterprises, local bodies and government, etc.

2. Money Measurement Concept

In accounting, we identify and record only those business transactions which are financial in nature. Accounting transactions must have their monetary value. The worth of the transaction must be measured in terms of money. In all the accounting records, we have amount column showing rupees and paise. There is never any accounting record in metres, litres, kilograms and quintals. We evaluate the value of the commodities in terms of money and accordingly record them in the books of accounts. Recording transactions in monetary terms makes the information more meaningful. For example, statement that the business was started with Rs. 50,000 cash and 20,000 metres of silk is meaningless and fails to tell us the capital of the business. If the value of 20,000 metres of silk is estimated to be Rs. 5,00,000, we can safely say that the business was started with Rs. 50,000 + 5,00,000 = 5,50,000, which will be meaningful.

The concept of money measurement is not free from problems when we integrate the financial statements of an entity having operations in more than one nation.

3. Going Concern Concept

While recording business transactions in the books of accounts, we assume that the **business will be carried on indefinitely.** That is why, the business purchases fixed assets like land and building, plant and machinery, vehicles, furniture, etc. If the concept of going concern is not there, we would have hired these assets and not purchased. These assets have been acquired for use and not for sale, so we maintain individual assets account and charge necessary depreciation on it.

According to **International Accounting Standard** "*The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future"*. It is viewed that the enterprise has an intention to be carried on for longer period. The concept of assets, liabilities, capital, revenue and expenses used in the accounting operation prove that the firm has to last long. Planning, organising and personnel policies substantiate the fact that the business has been assumed to be going entity. It is binding upon every accountant to treat business activity as a continuing process and record transaction accordingly.

4. Accounting Period Concept

Strictly speaking, the result of the business can be estimated at the end of its life. If a firm was started with a capital of ₹ 50,000 and at the end of its life the captial was ₹ 5,00,000 we can say that the firm earned a profit of ₹ 4,50,000 *i.e.,* 5,00,000 – 50,000 during its life. In this way, business as a going entity will continue indefinitely and we will have to wait for a very long period to estimate the financial result of the business. It will be too late to wait for the results, so the life span of accounting should be split into shorter and convenient period. At present, accounting periods are regarded as twelve months. According to the Companies Act and Banking Regulation Act, accounting period should consist of twelve months. The period of twelve months is regarded as ideal and convenient period for accounting.

5. Dual Aspect (or Duality) Concept

Every business transaction has double effect. There are two sides of every transaction. This is evident when we study the accounting term i.e., assets, capital and liabilities.

(*i*) **Assets.** These are the valuable articles owned by the business. Expenditure incurred in acquiring valuable things for the firm is assets. Special features of assets are that they are meant for use in the business and will increase the profit earning capacity of the business. Cash in hand, cash at bank, land and buildings, furniture, vehicles, etc. are the assets of the firm. It has been an established fact that no business can be carried on without assets. Business as a separate entity and going concern must possess certain assets.

(*ii*) Capital. Capital is that part of wealth which is used for further production. In the context of dual aspect concept capital supplies necessary funds to the business to purchase certain assets. In the absence of capital, there will be no funds with the enterprise and thus the question of acquiring assets does not arise. If we take it from business point of view, proprietor's capital is the liability of the business. Capital received in cash represents two accounts, capital and cash. Capital is the proprietor's claim against the assets of the business and the cash is the asset of the business itself. As the amount of the two accounts are the same, we can safely conclude that :

$$\boxed{\textbf{Capital = Assets.}}$$

(*iii*) Liabilities. If the capital invested by the proprietor falls short the business has to borrow funds. Thus the loan on the one side is the liability of the firm and on the other side it will be in the form of cash or other assets. The amount represented by both loan and assets are equal. This transaction enables us to think about the two aspects so it is called dual aspect concept or double entry system. All the assets of the business are acquired by the funds contributed by the funds contributed by the proprietors and creditors, so it is always correct to conclude as under :

Capital = Liabilities = Assets.

The relationship between assets, liabilities and capital is at present known as *Accounting Equation* which can also be expressed as under :

Assets = Capital + Liabilities

or

Capital = Assets – Liabilities

or

Liabilities = Assets – Capital

We record all the business transactions on the basis of dual aspect and call the system as *double entry system*

1.4. Accounting Equation/Cycle

Meaning

There has been a revolution in every field of knowledge. Scientific approach towards every subject has emerged as a basic consideration to decide its utility. Scientific studies were also made in accounting and result was discovery of 'Accounting Equation'. The study revealed that accounting rotates round the three terms I assets, liabilities and capital. The entire accounting structure is based upon these three terms. These terms are inter-related and inter-woven. Before explaining accounting equation let us discuss these terms :

Analysis of Transactions

Assets, liabilities and capital are constituents of business transactions. Let us discuss these elements :

(*a*) **Assets.** The acceptable meaning of assets is the valuable things owned by the firm. Expenditure for acquiring these valuable articles for use in the business is also termed as assets. The assets are acquired for constant future use. They are not meant for sale. These assets increase the profit earning capacity of the business. Some of the assets are listed as under :

(*i*) Cash in hand
(*ii*) Cash at bank
(*iii*) Sundry debtors or Book debts
(*iv*) Bills receivables
(*v*) Investments
(*vi*) Closing stock
(*viii*) Plant and machinery
(*ix*) Equipments and tools
(*x*) Furniture and fittings
(*xi*) Patents, trade marks, etc.
(*xii*) Goodwill
(*xiii*) Prepaid expenses

Notes

(*vii*) Land and building (*xiv*) Accrued income

(*b*) **Liabilities.** Creditors' and proprietors' claim against the assets of business is termed as its liability. Proprietor's claim is termed as capital, which we shall be discussing later on. Liabilities are also known as equities or claims. The term liability means the claim of outsiders against the business such as creditors for goods and expenses. Liability is the account for which the firm is indebted to outside parties. Certain external liabilities are mentioned as under :

(*i*) Creditors for goods–sundry creditors and bills payable

(*ii*) Creditors for expenses :

(*a*) Outstanding salaries

(*b*) Unpaid wages

(*c*) Rent due but not paid

(*iii*) Other liabilities :

(*a*) Bank loan or overdraft

(*b*) Partner's loan

(*c*) Loan from Financial Institution, *i.e.,* IFC, IDBI, etc.

(*d*) Debentures

(*e*) Employees Provident Fund

(*f*) Workmen's Compensation Fund, etc.

Liabilities also go on changing. Their value either increases or decreases. In case of increase the business will have to pay more and in case of decrease the business will have to pay lesser.

(*c*) **Capital.** It is the proprietor's claim against the assets of the business. In case of one man business the capital is contributed by the proprietor himself. In case of partnership, capital is contributed by partners and in case of companies, shareholders contribute for capital is contributed by partners and in case of companies, shareholders contribute for capital. Owners of the business are the contributor of the capital. Owners are the entrepreneurs of the business. They get profit of the business for the risk taken by them. If certain amount of profit remains undistributed or retained as reserve and funds, it is also known as proprietor's claim. Proprietor's claim can be enumerated as under :

(*i*) Capital

(*ii*) Reserve, general reserve or reserve fund

(*iii*) Profit or retained earning

(*iv*) Interest on capital

Explanation of Accounting Equation. Business transaction are financial in nature and so every transaction affects the financial position of the business. These transactions increase or decrease the assets, liabilities or capital. Every business has certain assets. These assets are purchased with the funds supplied to the business by its proprietors or creditors. Proprietors' and creditors' funds, in whatever form they are, create assets. For example, if the business receives ₹ 1,00,000 as capital from the proprietor and retains that in the firm, it will create and asset *i.e.,* cash in hand. If ₹ 80,000 are deposited into the bank, the total capital will be represented by two assets *i.e.,* cash ₹ 20,000 (due to deposit into the bank of ₹ 80,000 out of a cash balance of ₹ 1,00,000) and cash at bank ₹ 80,000. If furniture, worth ₹ 20,000 are purchased and payment is made out of bank deposit, the assets will now consist of cash in hand ₹ 20,000, cash at bank ₹ 60,000 (due to purchase of furniture, bank balance has reduced by ₹ 20,000) and furniture ₹ 20,000. **As such accounting equation is a statement of equality between debits and credits.** These above facts can also be presented in this way :

	Capital		Assets
(*i*)	₹ 1,00,000	=	Cash (₹ 1,00,000)
(*ii*)	₹ 1,00,000	=	Cash (₹ 20,000) + Bank balance (₹ 80,000)
(*iii*)	₹ 1,00,000	=	Cash (20,000) + Bank (60,000) + Furniture (20,000)

The above facts are technically known as Accounting Equations in simple form and reveal that capital which is always equal to assets.

Increase in capital will generally result in the corresponding increase in the assets and in the same way, decrease in capital will result in the decrease of assets. If the proprietor introduces ₹ 40,000 as additional capital there will be corresponding increase in cash balance. As both capital and there will be decrease in the cash, an asset at the same time. If drawings are worth ₹ 10,000 both the capital and assets will decrease simultaneously with ₹ 10,000.

Introduction of Creditors' Liability in Accounting Equations

It has been accepted fact that business does not possess anything of its own. The business receives funds from proprietors and creditors and retains all of them in the form of various assets. This shows that capital + liabilities are always equal to assets. The fact can be presented in terms of accounting equation as under :

Equation.	**Capital + Liabilities = Assets**	**or**	**C + L = A**
or	**Assets = Liabilities + Capital**	**or**	**A = L + C**
or	**Liabilities = Assets – Capital**	**or**	**L = A – C**
or	**Capital = Assets – Liabilities**	**or**	**C = A – L**
or	**Assets – Liabilities – Capital = Zero**	**or**	**A – L – C = Zero**

1.5. Computation–Classification of Transactions

Assets, liabilities and capital are the three basic elements of every business transaction. The relationship between these terms, as mentioned above in the form of Accounting Equation remains unchanged. It has been a mathematical truth. No business transaction can upset the relationship between these items. The inter-relationship of assets, liabilities and capital results into nine transactions. These transactions show that change in one element results in corresponding changes in the same item or in other element. These nine basic transactions are as under :

(*i*) Increase in assets with corresponding increase in capital.

Notes

(*ii*) Increase in assets with corresponding increase in liabilities.

(*iii*) Increase and decrease in assets.

(*iv*) Decrease in assets with corresponding decrease in liabilities.

(*v*) Decrease in assets with corresponding decrease in capital.

(*vi*) Increase and decrease in liabilities.

(*vii*) Increase and decrease in capital.

(*viii*) Increase in liabilities and decrease in capital.

(*ix*) Increase in capital and decrease in liabilities.

(*i*) **Increase in assets with corresponding increase in capital.** Commencement of business with ₹ 20,000 increases both the assets and capital of the firm. At the same time, it will affect the financial position of the business as under :

Financial position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	20,000	Cash	20,000
Creditors	–		
	20,000		20,000

(*ii*) **Increase in assets with corresponding increase in liabilities.** Purchase of goods on credit for ₹ 7,000 will increase stock of goods with ₹ 7,000 and also increase creditors' liabilities. The transaction will affect the financial position as under :

Financial Position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	20,000	Cash	20,000
Creditors	7,000	Stock in trade	7,000
	27,000		27,000

The position can be presented alternatively as under :

Assets = Liabilities + Capital
27,000 = 7,000 + 20,000

(*iii*) **Increase and decrease in assets.** Purchase of furniture worth Rs. 3,000 involves furniture and cash, the two assets. The transaction will increase furniture as an asset and decrease cash, also an asset. Increase and decrease in the assets with the same amount will not upset the equation. The transaction can be expressed as follows :

		Assets			=	*Liabilities*	+	*Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+	Capital
17,000	+	7,000	+	3,000	=	7,000	+	20,000

Notes

(*iv*) **Decrease in assets with corresponding decrease in liabilities.** Payment of ₹ 2,000 to creditors will decrease creditors, the liabilities of the business and at the same time cash an asset will decrease. The decrease in assets and liabilities simultaneously with the same amount will hold the accounting Equation true. The transaction will effect the Accounting Equation as follows :

		Assets			=	*Liabilities*	+	*Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+	Capital
17,000	+	7,000	+	3,000	=	7,000	+	20,000
– 2,000	+	0	+	0	=	(–) 2,000	+	0
15,000	+	7,000	+	3,000	=	5,000	+	20,000

(*v*) **Decrease in assets with corresponding decrease in capital.** ₹ 4,000 withdrawn by the proprietor for personal use will reduce capital and also cash, an asset simultaneously with 4,000. The transaction still proves the validity of accounting Equation as under :

		Assets			=	*Liabilities*	+	*Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+	Capital
15,000	+	7,000	+	3,000	=	5,000	+	20,000
– 4,000	+	0	+	0	=	0	(–)	4,000
11,000	+	7,000	+	3,000	=	5,000	+	16,000

The financial position of the business upto 5 transaction will be as under :

Financial Position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	16,000	Furniture	3,000
Creditors	5,000	Stock	7,000
		Cash	11,000
	21,000		21,000

(*vi*) Increase and decrease in liabilities. Creditors for goods sometimes draw a bill of exchange on us as per the arrangement of the payment. After acceptance of the bill, the payment becomes due for payment. After acceptance of the bill, the payment becomes due for payment after the expiry of certain specified period. Acceptance of the bill reduces creditor's liability and creates another liability, known as bills payable, the bill whose payment has to be made. If we accept a bill for ₹ 1,500 creditors will be reduced to ₹ 5,000 – 1,500 = 3,500 and fresh liability known as Bills Payable will come into our records. The transaction will affect the financial position of the business as under :

Financial Position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	16,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
	21,000		21,000

Notes

The above position can alternatively be presented as under :

		Assets			=	*Liabilities*		+ *Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+ Bills payable	+ Capital
11,000	+	7,000	+	3,000	=	3,500	+ 1,500	+ 16,000

(*vii*) **Increase and decrease in capital.** Certain transactions involve capital only, Such as transfer of share of the Company from one shareholder to another shareholder. In this case the capital of the company will increase and decrease with the same amount and this will remain unchanged. There will be change in the name of shareholder which will be recorded in the transfer register of the company. Interest on capital is another item affecting capital only. Proprietors capital will increase with the amount of interest allowed to him. Interest on capital is the expense of the business, so it will have to be borne by the proprietor and thus charged out of capital account. The net result will be an increase and decrease in capital simultaneously with the same figure and accounting equation will still prove to be true. Financial position of the business will remain unchanged.

(*viii*) Increase in liabilities and decrease in capital. In certain cases, capital may be converted into loan, as a liability. Such transactions may happen, when a partner retires from the firm and the capital refundable to him is transferred to his loan account. In this case, the firm will be showing partner's loan as a liability instead of partner's capital. In case of death of a partner amount payable to the legal inheritor of the decreased partner is transferred to partner's executor's loan account. This transaction will also decrease capital and increase liability. If ₹ 5,00 are transferred from capital account to loan account the financial position will be as under :

Financial Position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	11,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The above position can also be presented as under :

		Assets			=	*Liabilities*		+ *Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+ Bills payable	+ Loan	+ Capital
11,000	+	7,000	+	3,000	=	3,500	+ 1,500	+ 5,000	+ 16,000

Notes

(*ix*) **Increase in capital and decrease in liabilities.** Conversion of loan into capital reduces the liability of the business on one hand and increases capital on the other hand. Conversion of debentures into share capital is an example of such transaction. Creditors may also be converted into share capital. If creditors for ₹1,000 are allotted shares against their loan, the financial position will be affected as under :

Financial Position (*Balance Sheet*)

Liabilities	Amount ₹	Assets	Amount ₹
Capital	12,000	Cash	11,000
Creditors	2,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The financial position shows that capital has increased by Rs. 1,000 and is now Rs. 11,000 + 1,000 = 12,000 and at the same time creditors have been reduced to Rs. 3,500 – 1,000 = 2,500.

The fact can alternatively be presented as under :

		Assets			=	*Liabilities*			+ *Capital*
Cash	+	Stock	+	Furniture	=	Creditors	+ Bills payable	+ Loan	+ Capital
11,000	+	7,000	+	3,000	=	2,500	+ 1,500	+ 5,000	+ 12,000

The basic nine transactions discussed above are summarised through the following illustrations.

Illustration 1: *Develop accounting equation from the following transactions :*

		₹
(*i*)	*Adi commenced business with cash*	*50,000*
(*ii*)	*Purchased goods for cash*	*30,000*
(*iii*)	*Purchased goods on credit*	*20,000*
(*iv*)	*Sold goods (cost ₹ 10,000) for*	*12,000*
(*v*)	*Bought furniture on credit*	*2,000*
(*vi*)	*Paid cash to a creditor*	*15,000*

Solution:

Notes

Accounting Equation

Transactions	Assets			= Liabilities +	Capital
	Cash +	Stock +	Furniture =	Creditors +	Capital
(*i*) Adi commenced business					
with cash Rs. 50, 000	50,000 +	0 +	0 =	0 +	50,000
(*ii*) Purchased goods for cash					
Rs. 30,000	(–)30,000 +	30,000 +	0 =	0 +	0
New Equation	20,000 +	30,000 +	0 =	0 +	50,000
(*iii*) Purchased goods on credit					
Rs. 20,000	+	20,000 +	0 =	20,000 +	0
New Equation	20,000 +	50,000 +	0 =	20,000 +	50,000
(*iv*) Sold goods (cost					
Rs. 10,000) for Rs. 12,000	+ 12,000(–)	10,000 +	0 =	0 +	2,000
New Equation	32,000 +	40,000 +	0 =	20,000 +	52,000
(*v*) Bought furniture on credit					
Rs. 2,000	0 +	0 +	2,000 =	2,000 +	0
New Equation	32,000 +	40,000 +	2,000 =	22,000 +	52,000
(vi) Paid cash to a creditor					
Rs. 15,000	(–)15,000 +	0 +	0 =	(–)15,000 +	0
New Equation	17,000 +	40,000 +	2,000 =	7,000 +	52,000

Treatment of Revenue Payments and Receipts

(a) Revenue Payments

(*i*) **Treatment of expense paid.** The business had to pay certain expenses in its day-to-day operations, such as payment of salaries, rent, insurance premium, office expenses, wages, repairs, etc. These expenses are paid regularly. These business expenses are paid in cash, so cash will reduce and thus payment of expenses are reduced from cash balance. These expenses will also reduce net income of the business. As the income is the reward paid to proprietor for the risk undertaken by him so expenses will reduce proprietor's reward. Proprietor is represented by Capital Account so the payment of expenses will decrease capital.

(*ii*) **Treatment of outstanding expenses.** If expenses relate to accounting period and remain unpaid, they are termed as outstanding expenses. Outstanding salaries, rent unpaid, wages due, repairs due but not paid are its certain examples. As these expenses relate to the accounting period, so they will reduce capital of the proprietor. Both the case of expenses paid and expenses due are treated at par as regards decrease in the capital of the proprietor. They are different in the sense that expenses paid reduce cash balance but expenses outstanding do not reduce cash balance. As these expenses are still payable, it si a liability of the business and thus increase liability.

(*iii*) **Treatment of prepaid or unexpired expenses.** There may be certain cases where expense may have been paid in advance. In certain cases, expenses relating to the next accounting period may be paid during the current year. These expenses are prepaid or unexpired *i.e.,* insurance and rent paid in advance for the next following year. Prepaid expenses increase and decrease assets simultaneously. The payment has been made in cash, so cash will be reduced. As the expenses have been paid during the current year for the next year, it will be an asset for the current year because the amount has to be realised by the current year from the following year :

Illustration 2. *Show the effect of following transactions on accounting equation and also prepare a balance sheet :*

		Rs.
(*i*)	*Started business with cash amounting to Rs. 35,000 and goods...*	*50,000*
(*ii*)	*Salaries paid........................ ....*	*2,000*
(*iii*)	*Wages outstanding ....*	*200*
(*iv*)	*Prepaid insurance ....*	*700*
(*v*)	*Interest due but root paid ....*	*100*
(*vi*)	*Rent paid in advance ....*	*150*

Solution:

Accounting Equation

Transactions	Assets		=	Liabilities +	Capital
	Cash +	Stock +	Prepaid = expenses	Outstanding + expenses	Capital
(*i*) Started business with cash Rs. 35,000 Goods Rs. 15,000	35,000 +	15,000 +	0 =	0 +	50,000
(*ii*) Salaries paid Rs. 2,000	(–) 2,000 +	0 +	0 =	0 (–)	2,000
New Equation	33,000 +	15,000 +	0 =	0 +	48,000
(*iii*) Wages outstanding Rs. 200	0 +	0 +	0 =	200 (–)	200
New Equation	33,000 +	15,000 +	0 =	200 +	47,800
(*iv*) Prepaid Insurance Rs. 700	(–) 700 +	0 +	700 =	0 +	
New Equation	32,300 +	15,000 +	700 =	200 +	47,800
(*v*) Interest due but not paid Rs. 100	0 +	0 +	0 =	100 (–)	100
New Equation	32,300 +	15,000 +	700 =	300 +	47,700
(*vi*) Rent paid in advance Rs. 150	(–) 150 +	0 +	150 =	0 +	0
New Equation	32,150 +	15,000	850 =	300 +	47,700

The accounting facts presented by the above accounting equation can also be verified by the following Balance Sheet :

Notes

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding wages	200	Cash	32,150
Outstanding interest	100	Stock in trade	15,000
Capital	47,700	Prepaid insurance	700
		Rent paid in advance	150
	48,000		48,000

(b) Revenue Receipts

(*i*) **Income received.** The business receives certain income during its day-to-day operations. The income is received regularly. Rent received, commission earned and discount received, etc. are its examples. As the income is received in cash it increases cash balance on the one hand and also increases proprietor's capital. Proprietor's claim against the assets of business increases with every income, so the income earned is added to capital.

(*ii*) **Income due but not received or accrued income.** The income has been earned during the year, so proprietors capital will increase but as income is accrued or still to be received ti will be treated as assets. The income relates to the current year's income. The income has become due from other parties so the concerned party will be the debtor of the firm. Debtor's being assets, accrued income will also be an asset.

(*iii*) **Unearned income or income received in advance.** It is just possible that we may have received certain income in advance. The income has been received during the current year, although it relates to the next year. As the income has been received in cash, it will increase cash balance. The income actually belongs to the next year but has been received by the current year, as such it will be a liability of the current year towards next year.

Illustration 3. *Show the effect of the following transactions on assets, liabilities and capital using accounting equation. Also prepare Balance Sheet.*

Rs.

(*i*) *Started business with cash 60,000*

(*ii*) *Rent received................... .... 2,000*

(*iii*) *Accrued interest 500*

(*iv*) *Commission received in advance 1,000*

Solution:

Accounting Equation

Transactions	Assets		=	Liabilities +	Capital
	Cash +	Accrued interest	=	Commission received in advance +	Capital
(*i*) Started business with cash Rs. 60,000	60,000 +	0	=	0 +	60,000
(*ii*) Rent received Rs. 2,000	+ 2,000 +	0	=	0 +	2,000
New Equation	62,000 +	0	=	0 +	62,000
(*iii*) Accrued interest Rs. 500	0 +	500	=	0 +	62,500
(*iv*) Commission received in advance Rs. 1,000	+ 1,000 +	0	=	1,000 +	0
New Equation	63,000 +	500	=	1,000 +	62,500

Notes

Accounting facts presented by the above accounting equation is also presented in the form of Balance Sheet.

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Commission received in advance	1,000	Cash	63,000
Capital	62,500	Accrued interest	500
	63,500		63,500

Treatment of Purchases and Sales

(a) Purchases

(*i*) **Cash purchases.** Purchases of goods for cash affects assets only. It increases stock of goods with the business and at the same time decreases cash, because the payment for goods has been made in cash.

(*ii*) **Credit purchases.** The transaction increases stock of goods, an asset but also creates a liability. Payments to creditors have not been made so far, as such liability to creditors is still there. Credit purchases, therefore increases both assets and liabilities at the same time.

Payment to creditors in cash will reduce cash, an asset and also creditors, a liability. If creditors draw a bill of exchange, the firm will accept the bill and thus a liability, as Bills Payable will be created in place of creditors. In this way, the transaction will decrease creditors and also create a liability as Bills Payable. In certain cases, if the payment to creditors is made immediately and creditors allow us discount, the transaction will reduce cash with actual amount paid increase capital with the amount of discount received and decrease creditors with the amount of actual payment plus discount. For example, if we purchase goods worth Rs. 1,000 from Anshu on credit and make a payment of Rs. 990 in full settlement. The payment will reduce creditors by Rs. 1,000, cash by Rs. 990 and also increase capital by Rs. 10.

(b) Sales

(*i*) **Cash sales.** It is the sincere effort of every business to sell goods at a price more than its cost price. Excess of sales price over the cost price is profit and will increase capital. For example, if goods costing Rs. 1,740 are sold for Rs. 2,000, it will increase cash by Rs. 2,000, reduce stock of goods by Rs. 1,740 and the resultant profit i.e., Rs. 2,000 – 1,740 = 260 will be added to capital.

(*ii*) **Credit sales.** In case goods costing Rs. 2,700 are sold for Rs. 3,000 on credit, it will increase debtors, the assets of the firm by Rs. 3,000 reduce stock of goods by Rs. 2,700 and also increase capital with Rs. 3,000 – 2,00 = Rs, 300. In this case, if full payment is received from debtors, it will increase cash and decrease debtors. Cash and debtors are both assets, so the effect of th transaction will be restricted to assets only. In the above case, if we receive Rs. 2,900 from debtors and allow them Rs. 100 as discount, the transaction will increase cash by Rs. 2,90, reduce capital with the amount of discount allowed *i.e.,* Rs. 100 and at the same time decrease debtors, by Rs. 3,000.

Treatment of Miscellaneous Transactions

(*a*) **Amount withdrawn by the proprietor.** If the proprietor withdraws Rs. 2,000 for personal use, the transaction will reduce cash by Rs. 2,000 and at the same time reduce proprietor's capital. In case the proprietor takes certain goods for domestic use, it will decrease his capital and the stock of goods.

(*b*) **Depreciation on assets.** Depreciation is the wear and tear or loss in the value of assets due to its use, so it will reduce assets and capital at the same time. For example, if there is a depreciation of Rs. 2,000 on plant, the transaction will reduce plant by Rs. 2,000. As depreciation is a loss it will also reduce capital.

(*c*) **Interest on capital.** Capital is the liability of the business. Interest on a liability is an expense and thus capital will be reduced. Interest on capital is credited to capital account, so capital will be increased. The transaction will increase and also decrease the capital.

(*d*) **Interest on drawings.** Drawings is the amount withdrawn by the proprietor from the business. In other words, it is the amount advanced by the firm to the proprietor and thus interest on drawings will be received by the firm and capital will be increased. Interest on drawings will be changed on proprietor's capital, so the capital will be reduced. This transaction will also result in the increase and decrease of capital.

Illustration 4. *Show the accounting equation on the basis of the following transactions :*

		Rs.
(*i*)	*Ankita started business with cash*	*50,000*
(*ii*)	*Purchased goods on credit*	*4,000*

(*iii*) *Purchased goods For Cash* *1,000*
(*iv*) *Purchased furniture* *500*
(*v*) *Paid rent* *200*
(*vi*) *Withdrew for private use* *700*
(*vii*) *Received interest* *100*
(*viii*) *Sold goods on credit (cost Rs. 500) for* *700*
(*ix*) *Paid to creditors* *400*
(*x*) *Paid salaries* *200*

Notes

Solution:

Accounting Equation

Transactions	Assets			=	Liabilities +	Capital
	Cash +	Stock + of goods	Debtors +	Furniture =	Creditors +	Capital
(*i*) Ankita started business with Rs. 50,000	50,000 +	0 +	0 +	0 =	0 +	50,000
(*ii*) Purchased goods on credit Rs. 4,000	0 +	4,000 +	0 +	0 =	4,000 +	0
New Equation	50,000 +	4,000 +	0 +	0 =	4,000 +	50,000
(*iii*) Purchased goods for cash Rs. 1,000	(–) 1,000 +	1,000 +	0 +	0 =	0 +	0
New Equation	49,000 +	5,000 +	0 +	0 =	4,000 +	50,000
(*iv*) Purchased Furniture Rs. 500	(–) 500 +	0 +	0 +	500 =	0 +	0
New Equation	48,500 +	5,000 +	0 +	500 =	4,000 +	50,000
(*v*) Paid rent Rs. 200	(–) 200 +	0 +	0 +	0 =	0 (–)	200
New Equation	48,300 +	5,000 +	0 +	500 =	4,000 +	49,800
(*vi*) Withdrew for private use Rs. 700	(–) 700 +	0 +	0 +	0 =	0 (–)	700
New Equation	47,600 +	5,000 +	0 +	500 =	4,000 +	49,100
(*vii*) Received interest Rs. 100	+ 100 +	0 +	0 +	0 =	0 +	100
New Equation	47,600 +	5,000 +	0 +	500 =	4,000 +	49,200
(*viii*) Sold goods on credit costing Rs. 500 for Rs. 700	0 (–)	500 +	700 +	0 =	0 +	200
New Equation	47,700 +	4,500 +	700 +	500 =	4,000 +	49,400
(*ix*) Paid to creditors Rs. 400	(–) 400 +	0 +	0 +	0 =	(–) 400 +	0
	47,300 +	4,500 +	700 +	500 =	3,600 +	49,400
(*x*) Paid salaries Rs. 200	(–) 200 +	0 +	0 +	0 =	0 (–)	200
New Equation	47,100 +	4,500 +	700 +	500 =	3,600 +	49,200

The above fact can be presented by a Balance Sheet as under :

Notes

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Creditors	3,600	Cash	47,100
Capital	49,200	Debtors	700
		Stock of goods	4,500
		Furniture	500
	52,800		52,800

Illustration 5. *Show the effect of the following business transactions on assets, liabilities and capital through accounting equation :*

		Rs.
(*i*)	*Commenced business with cash*	*20,000*
(*ii*)	*Goods purchased on credit*	*7,000*
(*iii*)	*Furniture purchased*	*3,000*
(*iv*)	*Paid to creditors*	*2,000*
(*v*)	*Amount withdrawn by the proprietor*	*4,000*
(*vi*)	*Creditors accepted a bill for*	*1,500*
(*vii*)	*Interest on capital*	*1,000*
(*viii*)	*Transfer from capital to loan*	*5,000*
(*ix*)	*Allotted shares to creditors*	*1,000*

Solution: The inter-relationship of nine transactions may be summarised as under :

Transactions	Assets		=	Liabilities +			Capital
	Cash +	Stock +	Furniture =	Creditors +	B/P +	Loan +	Capital
(*i*) Commenced business with cash Rs. 20,000	20,000 +	0 +	0 =	0 +	0 +	0 +	20,000
(*ii*) Furniture purchased on credit Rs. 7,000	0 +	7,000 +	0 =	7,000 +	0 +	0 +	0
New Equation	20,000 +	7,000 +	0 =	7,000 +	0 +	0 +	20,000
(*iii*) Furniture purchased Rs. 3,000	(–)3,000 +	0 +	3,000 =	0 +	0 +	0 +	0
New Equation	17,000 +	7,000 +	3,000 =	7,000 +	0 +	0 +	20,000
(*iv*) Paid to creditors Rs. 2,000	(–)2,000 +	0 +	0 =	(–)2,000 +	0 +	0 +	0
New Equation	15,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	20,000
(*v*) Amount withdrawn by the proprietor Rs. 4,000	(–)4,000 +	0 +	0 =	0 +	0 +	0 +	(–)4000
New Equation	11,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	16,000
(*vi*) Creditors accepted a bill for Rs. 1,500	0 +	0 +	0 =	(–)1,500 +	1,500 +	0 +	0
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000
						0 +	1,000
(*vii*) Interest on capital Rs. 1000	0 +	0 +	0 =	0 +	0 +		(–) 1,000
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000

(*viii*) Transfer from capital to loan							
Rs. 5,000	0 +	0 +	0 =	0 +	0 +	5,000 +	(–)5,000
New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	5,000 +	11,000
(*ix*) Allotted shares to creditors							
Rs. 1,000	0 +	0 +	0 =	(–)1,000 +	0 +	0 +	1,000
New Equation	11,000 +	7,000 +	3,000 =	2,500 +	1,500 +	5,000 +	12,000

Notes

The above accounting equation proves that whatever the transaction, assets are always equal to capital and liabilities. The fact can also be verified by the Previous Financial Position (Balance Sheet).

Illustration 6. *Prove that the accounting equation is satisfied in all the following transactions. Verify the result with Balance Sheet of the last new equation :*

		Rs.
(*i*)	*Rajesh started business with :*	
	Cash	*20,000*
	Goods	*12,000*
	Machine	*8,000*
(*ii*)	*He Purchased goods*	*5,000*
(*iii*)	*Sold goods (Costing Rs. 2,000) for Rs.*	*2,500*
(*iv*)	*Purchased goods on credit*	*7,000*
(*v*)	*Payment made to creditors in full settlement*	*6,900*
(*vi*)	*Sold goods on credit (Costing Rs. 5,400)*	*6000*
(*vii*)	*Payment received from debtors*	*5,800*
	Discount allowed	*200*
(*viii*)	*Salaries paid*	*4,000*
(*ix*)	*Wages outstanding*	*400*
(*x*)	*Prepaid Insurance*	*100*
(*xi*)	*Rent received*	*300*
(*xii*)	*Amount withdrawn*	*3,000*
(*xiii*)	*Interest on drawing*	*200*
(*xiv*)	*Depreciation on machinery*	*800*
(*xv*)	Purchased goods on credit	17,000

Solution:

Accounting Equation

Transactions		Assets					= Liabilities	+	Capital
		Cash +	Stock + of goods	Machine +	Debtors +	Prepaid = expenses	Creditors +	Outstanding + expenses	Capital
(*i*) Started business with:									
Cash	Rs. 20,000								
Goods	Rs. 12,000								
Machine	Rs. 8,000	20,000 +	12,000 +	8,000 +	0 +	0 =	0 +	0 +	40,000
(*ii*) Purchased goods	Rs. 5,000	(–) 5,000 +	5,000 +	0 +	0 +	0 =	0 +	0 +	0
New Equation		15,000 +	17,000 +	8,000 +	0 +	0 =	0 +	0 +	40,000

(*iii*) Sold goods (Costing Rs. 2,000) for Rs. 2,500	+ 2,500 +	(–)2,000 +	0 +	0 +	0 =	0 +	0 +	500
New Equation	17,500 +	15,000 +	8,000 +	0 +	0 =	0 +	0 +	40,500
(*iv*) Purchased goods on credit Rs. 7,000	0 +	7,000 +	0 +	0 +	0 =	7,000 +	0 +	0
New Equation	17,500 +	22,000 +	8,000 +	0 +	0 =	7,000 +	0 +	40,500
(*v*) Payment made to creditors In full settlement Rs. 6,900	(–) 6,900 +	0 +	0 +	0 +	0 =	(–) 7,000 +	0 +	100
New Equation	10,600 +	22,000 +	8,000 +	0 +	0 =	0 +	0 +	40,600
(*vi*) Sold goods no credit (Costing Rs. 5,400) for Rs. 6,000	0 +	– 5,400 +	0 +	6,000 +	0 =	0 +	0 +	600
New Equation	10,600 +	16,600 +	8,000 +	6,000 +	0 =	0 +	0 +	41,200
(*vii*) Payment received from Debtors Rs. 5,800 Discount allowed Rs. 200	+ 5,800 +	0 +	0 +	– 6,000 +	0 =	0 +	0 +	– 200
New Equation	16,400 +	16,600 +	8,000 +	0 +	0 =	0 +	0 +	41,000
(*viii*) Salaries paid Rs. 4,000	(–) 4,000 +	0 +	0 +	0 +	0 =	0 +		(–) 4,000
New Equation	12,400 +	16,600 +	8,000 +	0 +	0 =	0 +	0 +	37,000
(*ix*) Wages outstanding Rs. 400	0 +	0 +	0 +	0 +	0 =	0 +	400 +	(–) 4,000
New Equation	12,300 +	16,600 +	8,000 +	0 +	0 =	0 +	400 +	36,600
(*x*) Prepaid Insurance Rs. 100	(–) 100 +	0 +	0 +	0 +	100 =	0 +	0 +	0
New Equation	12,300 +	16,000 +	8,000 +	0 +	100 =	0 +	400 +	36,600
(*xi*) Rent received Rs. 300	+ 300 +	0 +	0 +	0 +	0 =	0 +	0 +	300
New Equation	12,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +	36,900
(*xii*) Amount withdrawn Rs. 3,000	(–) 3,000 +	0 +	0 +	0 +	0 =	0 +	0 +	– 3,000
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +	33,900
(*xiii*) Interest on drawings	0 +	0 +	0 +	0 +	0 =	0 +	0 +	+ 200
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +	33,900
(*xiv*) Depreciation on machinery Rs. 800	0 +	0 +	– 800 +	0 +	0 =	0 +	0 +	– 800
New Equation	9,600 +	16,600 +	7,200 +	0 +	100 =	0 +	400 +	33,100
(*xv*) Purchased goods on credit Rs. 17,000	0 +	17,000 +	0 +	0 +	0 =	17,000 +	400 +	33,100

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Creditors	17,000	Cash	9,600
Outstanding expenses	400	Stock in trade	33,600
Capital	33,100	Machine	7,200
		Prepaid expenses	100
	50,500		50,500

1.6. National and International Accounting Standards

Notes

Accounting standard is an authoritative pronouncement of code of practice of the regulatory accountancy body to be observed and applied in the preparation and presentation of financial statements. World over, professional bodies of accountants have the authority and the obligation to prescribe "Accounting Standards". International Accounting standards (IASs) are pronounced by the International Accounting Standards Committee (IASC). The IASC was set up in 1973, with headquarters in London (UK).

In India, the Institute of Chartered Accountants of India (ICAI) had established in 1977 the Accounting Standards Board (ASB). The composition of ASB includes (i) elected, (ii) ex-officio, and (iii) co-opted members of the Institute, nominees of RBI, FICCI, Assoc ham, ICSI, ICWAI and special invitees from UGC, ICWAI, and special invitees from UGC, SEBI, IDBI and IIM.

ASB is entrusted with the responsibility of formulating standards on significant accounting matters, keeping in view (a) international developments as also (b) legal requirements in India. According to the preface to the Statement on Accounting Standards issued by the ICAI, Accounting Standards will be issued by the ASB constituted for the purpose of harmonising the different and diverse accounting policies and practices in use in India and propagating the Accounting Standards and persuading the concerned enterprise to adopt them in the preparation and presentation of financial statement.

The Institute of Chartered Accountants of India has issued the following accounting standards.

Accounting Standards (AS)	Title of the Accounting Standards
AS 1	Disclosure of Accounting Policies
AS 2 (Revised)	Valuation of Inventories
AS 3 (Revised)	Cash Flow Statements
AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6 (Revised)	Depreciation Accounting
AS 7 (Revised)	Accounting for Construction Contracts
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11 (Revised 2003)	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments

Notes

AS 14	Accounting for Amalgamations
AS 15	Accounting for Retirement Benefits in the Financial Statements of Employers
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Patty Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investment in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interest in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities & Contingent Assets
AS 30	Financial Instruments: Recognition and Measurement and Limited Revisions to AS 2, AS 11 (revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures, and limited revision to Accounting Standard (AS) 19, Leases

Here we will discuss some important accounting standards in detail.

1.7. AS 1 – Disclosure of Accounting Policies

The Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Introduction

1. This statement deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.
2. The view presented in the financial statements of an enterprise of its

state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

Notes

3. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.
4. The Institute of Chartered Accountants of India has, in Statements issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.
5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.
6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.
7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as supplementary information.
8. The purpose of this Statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

Explanation

Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.
10. The following have been generally accepted as fundamental accounting assumptions:

    (*a*) Going Concern

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

(*b*) Consistency

It is assumed that accounting policies are consistent from one period to another.

(*c*) Accrual

Notes

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Statement.)

Nature of Accounting Policies

11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.
12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.
13. The various statements of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

Areas in which Differing Accounting Policies are Encountered

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.
    (*i*) Methods of depreciation, depletion and amortisation
    (*ii*) Treatment of expenditure during construction
    (*iii*) Conversion or translation of foreign currency items
    (*iv*) Valuation of inventories
    (*v*) Treatment of goodwill
    (*vi*) Valuation of investments
    (*vii*) Treatment of retirement benefits
    (*viii*) Recognition of profit on long-term contracts
    (*ix*) Valuation of fixed assets
    (*x*) Treatment of contingent liabilities.
15. The above list of examples is not intended to be exhaustive.

Considerations in the Selection of Accounting Policies

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

    (*a*) Prudence

    In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

    (*b*) Substance over Form

    The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

    (*c*) Materiality

    Financial statements should disclose all "material" items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements.

Disclosure of Accounting Policies

18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
19. Such disclosure should form part of the financial statements.
20. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.
21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.
22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable.

    Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

Accounting Standard

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24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.
26. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

1.8. AS 2 – Valuation of Inventories

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

1. This Statement should be applied in accounting for inventories other than:
   (*a*) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Accounting for Construction Contracts);
   (*b*) work in progress arising in the ordinary course of business of service providers;
   (*c*) shares, debentures and other financial instruments held as stock-in-trade; and
   (*d*) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.
2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or

a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Statement.

Definitions

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

Inventories are assets:

(*a*) held for sale in the ordinary course of business;

(*b*) in the process of production for such sale; or

(*c*) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Measurement of Inventories

5. Inventories should be valued at the lower of cost and net realisable value.

Cost of Inventories

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and

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maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(*a*) abnormal amounts of wasted materials, labour, or other production costs;

(*b*) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(*c*) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(*d*) selling and distribution costs.

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Cost Formulas

14. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.
15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.
16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.
17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost fan item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which Accounting Standards (AS) were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account

normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.
21. Inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.
22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.
23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.
25. An assessment is made of net realisable value as at each balance sheet date.

Disclosure

26. The financial statements should disclose:
    (*a*) the accounting policies adopted in measuring inventories, including the cost formula used; and
    (*b*) the total carrying amount of inventories and its classification appropriate to the enterprise.
27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

1.9. AS 3 – Cash Flow Statements

Accounting Standard (AS) 3, 'Cash Flow Statements' (revised 1997), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1.4.1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1.4.2004 for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(*a*) Enterprises whose equity or debt securities are listed whether in India or outside India.

(*b*) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(*c*) Banks including co-operative banks.

(*d*) Financial institutions

(*e*) Enterprises carrying on insurance business.

(*f*) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crore. Turnover does not include 'other income'.

(*g*) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 10 crore at any time during the accounting period.

(*h*) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The enterprises which do not fall in any of the above categories are encouraged, but are not required, to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not present a cash flow statement, should disclose the fact.

The following is the text of the Accounting Standard.

Objective

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

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

Scope

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

Benefits of Cash Flow Information

3. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the

changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

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

Cash and Cash Equivalents

5. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).
6. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

7. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.
8. An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.
9. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest

element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

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10. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.
11. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:
    (*a*) cash receipts from the sale of goods and the rendering of services;
    (*b*) cash receipts from royalties, fees, commissions and other revenue;
    (*c*) cash payments to suppliers for goods and services;
    (*d*) cash payments to and on behalf of employees;
    (*e*) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
    (*f*) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
    (*g*) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.
12. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.
13. An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

14. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:
    (*a*) cash payments to acquire fixed assets (including intangibles).

These payments include those relating to capitalized research and development costs and self-constructed fixed assets;

(*b*) cash receipts from disposal of fixed assets (including intangibles);

(*c*) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(*d*) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(*e*) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(*f*) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(*g*) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(*h*) cash receipts from future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

15. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

16. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

(*a*) cash proceeds from issuing shares or other similar instruments;

(*b*) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

(*c*) cash repayments of amounts borrowed.

Reporting Cash Flows from Operating Activities

17. An enterprise should report cash flows from operating activities using either:

(*a*) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(*b*) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

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

    Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Reporting Cash Flows from Investing and Financing Activities

20. An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis.

Reporting Cash Flows on a Net Basis

21. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:
    (*a*) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and
    (*b*) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.
22. Examples of cash receipts and payments referred to in paragraph 22 (a) are:

(*a*) the acceptance and repayment of demand deposits by a bank;

(*b*) funds held for customers by an investment enterprise; and

(*c*) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in paragraph 22 (b) are advances made for, and the repayments of:

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(*a*) principal amounts relating to credit card customers;

(*b*) the purchase and sale of investments; and

(*c*) other short-term borrowings, for example, those which have a maturity period of three months or less.

23. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

(*a*) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(*b*) the placement of deposits with and withdrawal of deposits from other financial enterprises; and

(*c*) cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash Flows

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

25. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

26. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extra-ordinary Items

27. The cash flows associated with extraordinary items should 27. be classified

as arising from operating, investing or financing activities as appropriate and separately disclosed.

28. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

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Interest and Dividends

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

30. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

31. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

32. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income

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

34. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing

or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Subsidiaries, Associates and Joint Ventures

35. When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

36. The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.
37. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
    (*a*) the total purchase or disposal consideration; and
    (*b*) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.
38. The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-cash Transactions

39. Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.
40. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:
    (*a*) the acquisition of assets by assuming directly related liabilities;
    (*b*) the acquisition of an enterprise by means of issue of shares; and
    (*c*) the conversion of debt to equity.

Components of Cash and Cash Equivalents

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

42. In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.
43. The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Other Disclosures

44. An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.
45. There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.
46. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:
    (*a*) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
    (*b*) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.
47. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

1.10. AS 4 – Contingencies and Events Occurring After the Balance Sheet Date

The following is the text of the revised Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1.4.1995, Accounting Standard 4 as originally issued in November 1982 (and subsequently made mandatory) applies.

Introduction

1. This Statement deals with the treatment in financial statements of
   (*a*) contingencies, and
   (*b*) events occurring after the balance sheet date.
2. The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special considerations applicable to them:
   (*a*) liabilities of life assurance and general insurance enterprises arising from policies issued;
   (*b*) obligations under retirement benefit plans; and
   (*c*) commitments arising from long-term lease contracts.

Definitions

3. The following terms are used in this Statement with the meanings specified:
   3.1 A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or nonoccurrence, of one or more uncertain future events.
   3.2 Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

   Two types of events can be identified:
   (*a*) those which provide further evidence of conditions that existed at the balance sheet date; and
   (*b*) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

4. **Contingencies**
   4.1 The term "contingencies" used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.
   4.2 Estimates are required for determining the amounts to be stated in the financial statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which

characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. Accounting Treatment of Contingent Losses

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

Notes

7. Determination of the Amounts at which Contingencies are included in Financial Statements

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated un-collectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. Events Occurring after the Balance Sheet Date

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

Notes

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6. Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. Disclosure

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Notes

Accounting Standard

Contingencies

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:
    (*a*) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and
    (*b*) a reasonable estimate of the amount of the resulting loss can be made.
11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.
12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.
14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.
15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Statement, the following information should be provided:
    (*a*) the nature of the contingency;
    (*b*) the uncertainties which may affect the future outcome;
    (*c*) an estimate of the financial effect, or a statement that such an estimate cannot be made.
17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Statement, the following information should be provided:
    (*a*) the nature of the event;

(*b*) an estimate of the financial effect, or a statement that such an estimate cannot be made.

1.11. AS 5 – Net Profit and Loss for the Period, Period Items and Changes in Accounting Policies

The net profit or loss for a given accounting period comprises essentially of two items – (a) profit or loss from Ordinary activities and (b) extraordinary items. Ordinary activities are undertaken by a business entity as part of its business and include such related activities in which the entity engages. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Both profit or loss from ordinary activities and extraordinary items are to be disclosed on the face of profit and loss statement. It may be noted here that virtually all items of income and expenses included in the determination of net profit or loss arise in the course of ordinary activities of the enterprise. Therefore, occurrence of extra- ordinary items is a rarity. In most of the cases, only losses arising out of natural calamity can be considered as an extra-ordinary item.

Prior Period Items

(*a*) The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

(*b*) The term ‘prior period items’, as defined in this Statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Changes in Accounting Policies

On the other hand, a change in an accounting policy should be made only if the adoption of the new policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of financial statements of the enterprise.

1.12. Depreciation Accounting

The following is the text of the revised Accounting Standard (AS) 6, ‘Depreciation Accounting’, issued by the Council of the Institute of Chartered Accountants of India.

Introduction

1. This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:

   (*i*) forests, plantations and similar regenerative natural resources;

   (*ii*) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(*iii*) expenditure on research and development;

(*iv*) goodwill;

(*v*) live stock.

This statement also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Definitions

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

3.1 Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

3.2 Depreciable assets are assets which

(*i*) are expected to be used during more than one accounting period; and

(*ii*) have a limited useful life; and

(*iii*) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

3.3 Useful life is either (*i*) the period over which a depreciable asset is expected to be used by the enterprise; or (*ii*) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Explanation

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(*i*) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(*ii*) expected useful life of the depreciable asset; and

(*iii*) estimated residual value of the depreciable asset.

Notes

6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.
7. The useful life of a depreciable asset is shorter than its physical life and is:
   (*i*) pre-determined by legal or contractual limits, such as the expiry dates of related leases;
   (*ii*) directly governed by extraction or consumption;
   (*iii*) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
   (*iv*) reduced by obsolescence arising from such factors as:
      (*a*) technological changes;
      (*b*) improvement in production methods;
      (*c*) change in market demand for the product or service output of the asset; or
      (*d*) legal or other restrictions.
8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is never the less required on some reasonable basis.
9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.
10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their

useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.
12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (*i*) type of asset, (*ii*) the nature of the use of such asset, and (*iii*) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.
13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.
14. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.
15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

16. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortized depreciable amount is provided prospectively over the residual useful life of the asset.

Notes

Disclosure

17. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.
18. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.
19. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

Accounting Standard

20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.
21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.
22. The useful life of a depreciable asset should be estimated after considering the following factors:

    (*i*) expected physical wear and tear;

    (*ii*) obsolescence;

(*iii*) legal or other limits on the use of the asset.

23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.
24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.
25. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.
26. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.
27. If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.
28. The following information should be disclosed in the financial statements:
    (*i*) the historical cost or other amount substituted for historical cost of each class of depreciable assets;
    (*ii*) total depreciation for the period for each class of assets; and
    (*iii*) the related accumulated depreciation.
29. The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:
    (*i*) depreciation methods used; and
    (*ii*) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

1.13. AS 9 – Revenue Recognition

Para 4.1 of AS 9 states “Revenue is the gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.” Thus, revenue from ordinary activities may arise under three situations:

(*a*) by sale of goods;

(*b*) by rendering of services; and

(*c*) by allowing others to use enterprise resources yielding interest, royalties and dividends.

Revenue recognition is concerned with the timing of recognition of revenue in the profit and loss statement.

1.14. AS 10 – Accounting for Fixed Assets

The following is the text of the Accounting Standard 10 (AS 10) issued by the Institute of Chartered Accountants of India on 'Accounting for Fixed Assets'. In the initial years, this accounting standard will be recommendatory in character. During this, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

(*a*) Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs. This statement deals with accounting for such fixed assets except as described in paragraphs 2 to 5 below.

(*b*) This statement does not deal with the specialised aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

(*c*) This statement does not deal with accounting for the following items to which special considerations apply:

(*i*) forests, plantations and similar regenerative natural resources;

(*ii*) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar nonregenerative resources;

(*iii*) expenditure on real estate development; and

(*iv*) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (*i*) to (*iv*) above, but separable from those activities, are to be accounted for in accordance with this statement.

(*d*) This statement does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on 'Depreciation Accounting'.

(*e*) This statement does not deal with the treatment of government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalization of borrowing costs and to assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Statement.

1.15. The Effects of Changes in Foreign Exchange Rates

This standard was revised in 2003 and is made mandatory with effect from 1st April 2004. Originally, this accounting standard was titled "Accounting for the effects of changes in foreign exchange rates". AS-11 discusses how to recognize the financial effect of changes in foreign exchange rates in the financial statements of the reporting entity. Two currencies are involved in determining an exchange rate– foreign currency and reporting currency. The reporting currency for business entities in India is INR (Indian Rupee) and hence the foreign currency is any currency other than INR. AS 11 is applicable in accounting for foreign currency transactions and in translating the financial statements of foreign operations. Thus, accounting for transaction exposure and translation exposure in foreign currency is dealt with in AS 11.

1.16. Summary

- **According to American Institute of Certified Public Accountants (AICPA).** GAAP have substantial authoritative support and general acceptability. GAAP must be relevant (meaningful), objective (reliable) and feasible (implemented without much cost and complexity).
- Business is **assumed to have distinct entity i.e., existence other than the existence of its proprietors and other business units.**
- Accounting transactions must have their monetary value. The worth of the transaction must be measured in terms of money.
- According to **International Accounting Standard** *"The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future".* It is viewed that the enterprise has an intention to be carried on for longer period.
- The study revealed that accounting rotates round the three terms *i.e.,* assets, liabilities and capital. The entire accounting structure is based upon these three terms.
- IFRS, previously known as International Accounting Standards (IAS), are standards and interpretations adopted by the International Accounting Standards Board (IASB). IASB adopted IAS in April 2001, and renamed it IFRS. For the proper regulation of the process of accounting, transparency disclosure, consistency and reliability accounting standards are prepared by the Institute of Chartered Accountant of India (ICAI). There is a creative practice to disclose the Information along with the balance sheet and profit and loss account of the company. In spite of usefulness of the financial statements for the various users, these carry some limitations-as incomparable statements, interim report, window dressing, historical records, etc.

1.17. Review Questions

A. Very Short Answer Type Questions:

1. If we receive ₹ 490 from our debtors in full settlement of a debt ₹ 500. What will be the accounting effect of ₹ 10 on assets, liabilities and capital?

2. If creditors worth ₹ 1000 are paid ₹ 980 in full settlement, what will be the accounting effect of ₹ 20?
3. How is income received in advance (unearned income) shown in the accounting equation ?

Notes

4. If goods costing ₹ 9,50 are sold for ₹ 10,000, show how the capital will be affected ?
5. Point out one transaction which will affect capital only.

B. Short Answer Type Questions:

1. Explain accounting equation in about 50 words.
2. What is meant by creditors for goods and creditors for expenses ? How will these transactions affect assets, liabilities and capital ?
3. Calculate total assets of the business if :

   Jacob starts business with ₹ 1,00,000. He earned a profit of ₹ 20,000. He has to pay his creditors for goods ₹ 7000 and outstanding salary amounts to ₹ 1000.

C. Long Answer Type Questions:

1. Describe the fundamental accounting equations. How are the revenue and expenses account related to it ?
2. Discuss any seven basic transactions resulting from the relationship of assets, liabilities and capital.
3. Name the items affecting capital and explain them briefly.
4. How are the following items in accounting equation dealt with ?

   (*a*) Outstanding expenses (*b*) Prepaid expenses

   (*c*) Accrued income (*d*) Unearned income.
5. Accounting equation remains intact under all circumstances. Justify the statement with the help of an example.
6. Accounting Standards: These are norms and guidelines to prepare the financial statements. In India these are framed by ICAI.
7. Disclosure of accounting policies: Giving the information of methods to prepare the accounts.
8. Inventories: It includes work-in-progress, materials and finished goods.

Unit–2

Mechanics of Accounting

Notes

Structure

2.1. Double Entry System
2.2. Books of Original Entry
2.3. Meaning of Journal
2.4. Explanation of Important Journal Entries
2.5. Preparation of Final Accounts
- **2.5.1** Recording of Business Transaction-Basis of Accounting
- **2.5.2** Single Entry System of Book Keeping
- **2.5.3** Double Entry System of Book Keeping
- **2.5.4** Classification of Accounts
- **2.5.5** Rules of Double Entry (or) Accounting Rules
- **2.5.6** Accounting Cycle
- **2.5.7** Books of Accounts : Recording, Posting and Preparation of Trial Balance

2.6. Trial Balance
2.7. Final Accounts
2.8. Adjustment
2.9. Profit and Loss Account
2.10. Balance Sheet
2.11. Review Questions
2.12. Test Problems

2.1. Double Entry System

Business transactions are recorded in the books of account on the basis of Double Entry System. This system of accounting was **invented by 'Lucas Pacioli' of Italy in 1494 in Venice** but developed in England. The system is based upon the fact that there are two aspects of every business transaction. Every transaction involves at least two persons, parties or accounts. According to traditional English approach in there is receiver of goods, there must be giver of goods also. This is an established fact that there cannot be any receiver, unless there is a giver. In the same way, if someone purchases goods there will be definitely some other one to sell it. In other words, there will always be a purchase if there is a sale. The explain it further we can say that if something comes into the business, it will definitely go out from other business. In the same way, if there is loss for someone, it will definitely be gain for someone else. This proves an established truth 'somebody's loss 'is another body's gain'. Every business transaction has two aspects. *Recording dual aspects of business transactions in terms of 'Debit and Credit' is Double Entry System*.

According to modern American approach, every business transaction is concerned with assets, liabilities, capital, expense and revenue individually or collectively. Every business transaction increases or decreases one of them or increases one and decreases the other. Increase in assets and expenses are debited and decrease in assets and expense is credited. In the same way, decrease in capital, liability and revenue is debited and increase in them is credited. Every debit must have its corresponding credit of the same amount. *Recording business transactions in terms of debit and credit is Double entry System*.

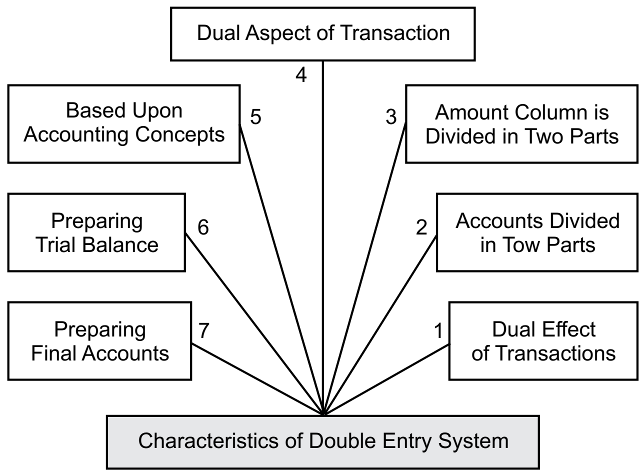

Fig. 2.1.

The Double entry system has got the following important features.

1. **Every Business Transaction Affects Tow or More Accounts:** There are two accounts involved in every business transaction. One of them is debited and the other is credited. Certain transactions may involve more than two accounts but the amounts of the accounts to be debited and credited will always be equal.
2. **Every Account is Divided in Two Parts:** All the ledger accounts prepared on the basis of books of original record i.e., journal and subsidiary books have two sides. Left and side is 'Debit' and the right hand side is 'Credit'.
3. **Division of Amount Column as Debit and Credit:** The amount column is also divided in two parts, i.e., Debit and Credit.
4. **Dual Aspect of Every Transaction:** The system is based upon the accounting truth that every debit has got its corresponding credit. This is why, all the business transactions are recorded simultaneously at the debit and credit side.
5. **Based Upon Accounting Concepts and Conventions:** The double entry system is based upon universally accepted accounting concepts and convention which we follow while maintaining our books of accounts.
6. **Preparing Trial Balance:** According to double entry system, business transactions are recorded first in the subsidiary books and journal proper.

With these books of original record, we prepare ledger accounts, whose balances are used for preparing Trial balance, which is test of arithmetical accuracy in accounting.

2.2. Books of Original Entry

The book in which transactions are recorded for the first time is known as Journal or Book of original entry. All the business transactions may be recorded in the Journal and posting can be made to ledger Accounts therefrom. In practice business transactions are accommodated in the cash book and subsidiary books. If the transaction does not find a place here it is recorded in the Journal Proper. As such Books of original entry as consist of Cash book, Subsidiary books and Journal proper.

2.3. Meaning of Journal

The word 'Journal' has been derived from the Trench word 'JOUR' meaning daily records. Journal is a book of prime record for small firms. Big concerns prepare Cash Book, Purchases Book, Sales Book and other subsidiary books in addition to Journal proper. Small firms record their business transactions in Journal and post them to the concerned ledger accounts. Big concerns record their business transactions in subsidiary books and Journal and post them from these prime books to respective ledger accounts.

According to **Professor Cartor,** *The Journal is originally used, as a book of prime entry in which transactions are copied in order of date from a memorandom or waste book. The entries as they are copied are classified into debits and credits, so as to facilitate them being correctly posted, afterwards in the ledger*.

It should be noted that all debits are listed first in journal as per prescribed rules of debit and credit. Every transaction first recorded in journal and with the help of journal, ledger accounts, trial balance etc. are prepared. Journal entries are passed on the following format:

Format of Journal

Date	Particulars	L.F.	Amount	
			Debit ₹	Credit ₹

2.4. Explanation of Important Journal Entries

Transaction 1

Start or commencer of business with ₹ 20,000.

Journal Entry:

Cash A/c	Dr.	20,000	
To Capital A/c			20,000
(Being commencement of the business)			

Notes

Transaction 2

Goods purchased for ₹ 5,000 Or Cash purchases ₹ 5,000.

Or

Goods purchased from Mohan for Cash ₹ 5,000.

Journal Entry:

Purchases A/c	Dr.	5,000	
To Cash A/c			5,000
(Being goods purchased for cash)			

Transaction 2

Goods purchased for ₹ 5,000. Or Cash purchases ₹ 5,000.

Or

Goods purchased from Mohan for Cash ₹ 5,000.

Journal Entry:

Purchases A/c	Dr.	5,000	
To Cash A/c			5,000
(Being goods purchased for cash)			

Transaction 3

(*a*) *Goods purchased from Mohan ₹ 3,000.* Or
Goods purchased from Mohan an credit ₹ 3,000 Or
Invoice received from Mohan ₹ 3,000.

Journal Entry:

Purchases A/c	Dr.	3,000	
To Mohan's A/c			3,000
(Being goods purchased from Mohan)			

(*b*) *Goods returned to Mohan or Mohan admitted our claim for ₹ 100*

Journal Entry:

Mohan	Dr.	100	
To Purchase Return A/c Or			
Returns outward A/c			100
(Being goods returned to Mohan)			

Transaction 4

Cash sales Or Goods sold for cash ₹ 7,000

Or

Goods sold to Mohan for cash

Journal Entry:

Cash Account	Dr.	7,000	
To Sales A/c			7,000
(Being goods sold for cash)			

Transaction 5

(*a*) *Goods sold to Mohan Or* ₹ *4,000*

Goods sold to Mohan on credit Or ₹ *4,000*

Invoice sent to Mohan ₹ *4,000*

Journal Entry:

Mohan's A/c	Dr.	4,000	
To Sales A/c			4,000
(Being goods sold to Mohan)			

(*b*) *Goods returned by Mohan Or Mohan's claim admitted* ₹ *100*

Journal Entry:

Sales Return A/c	Dr.	100	
Or Returns Inward A/c	Dr.		
To Mohan			
(Being goods returned by Mohan)			

Transaction 6

Furniture purchased for ₹ *3,000*

Journal Entry:

Furniture A/c	Dr.	3,000	
To Cash A/c			3,000
(Being furniture purchased)			

Transaction 7

Machinery sold for ₹ *12,000*

Journal Entry:

Cash A/c	Dr.	12,000	
To Machinery A/c			12,000
(Being machinery sold)			

Transaction 8

Salaries paid ₹ *3,200*

Journal Entry:

Salaries A/c	Dr.	3,200	
To Cash A/c			3,200
(Being salaries paid)			

Transaction 9

Rent received ₹ *2,000*

Journal Entry:

Cash A/c	Dr.	2,000	
To Rent A/c			2,000
(Being rent received)			

Notes

Transaction 10

Amount received from Mohan	*₹ 990*
Discount Allowed	*₹ 10*

Journal Entry:

Cash A/c	Dr.	990	
Discount A/c	Dr.	10	
To Mohan's A/c			1,000

(Being amount received from Mohan and discount allowed)

Transaction 11

Amount paid to Shyam	*₹ 1,980*
Discount allowed	*₹ 20*

Journal Entry:

Shyam's A/c	Dr.	2,000	
To Cash A/c			1,980
To Discount A/c			20

(Being amount paid to Shyam and discount allowed)

Transaction 12

Depreciation on furniture	*₹ 2,000*

Journal Entry:

Depreciation A/c	Dr.	2,000	
To Furniture A/c			2,000

(Being depreciation on furniture)

Transaction 13

Interest on Capital	*₹ 1,000*

Journal Entry:

Interest on Capital A/c	Dr.	1,000	
To Capital A/c			1,000

(Being interest on capital)

Transaction 14

Outstanding salaries *₹ 2,000*

Or

Salaries owing

Journal Entry:

Salaries A/c	Dr.	2,000	
To Outstanding Salaries A/c			2,000

(Being salaries remaining unpaid)

Transaction 15

Prepaid Insurance Or Unexpired Insurance ₹ 1,000

Or

Insurance paid in Advance

Journal Entry:

Prepaid Insurance A/c	Dr.	1,000	
To Insurance A/c			1,000
(Being insurance paid in advance)			

Notes

Transaction 16

Amount withdrawn by the proprietor for personal or domestic or private use *₹ 3,000*

Journal Entry:

Drawings A/c	Dr.	3,000	
To Cash A/c			3,000
(Being amount withdrawn by the proprietor)			

Transaction 17

Goods taken by the proprietor for Personal *₹ 3,000*

Or

Private/Domestic use

Journal Entry:

Drawings A/c	Dr.	3,000	
To Purchases A/c			3,000
(Being goods taken by the proprietor)			

Transaction 18

Goods given as charity *₹ 750*

Journal Entry:

Charity A/c	Dr.	750	
To Purchases A/c			750
(Being goods given as charity)			

Transaction 19

Mohan becomes bankrupt (insolvent). A first and final composition of 40 paise in a rupee is received out of a loan of ₹ 2,000 from official receiver.

Journal Entry:

Cash A/c	Dr.	800	
Bad Debts A/c	Dr.	1,200	
To Mohan			2,000
(Being Mohan became insolvent and a first and final composition @ 40 paise per rupee received)			

Explanation: Cash Account is an asset. It should be debited with the amount actually received i.e., ₹ 800, as per rule. 'Debit increase in assets'. Mohan has been declared insolvent, so full amount cannot be received from his estate. We could receive only at the rate of 40 paise in a rupee. It means that we lost @ 60 paise in a rupee. As Mohan is now insolvent so the irrecoverable amount will be bad debts, which is loss to the business. Increase in loss is debited, so bad debts account will also be debited with ₹ 1,200 i.e., ₹ 2,000 × $\frac{60}{100}$. Mohan, who has been our debtor will no longer remain the debtor after the payment has been made. the transaction will reduce debtors, an asset, as such Mohan's Account (Debtors Account) should be credited for the decrease in assets.

Notes

Transaction 20

An amount previously written off as Bad Debts has now been recovered from Mohan, the old debtor for ₹ 700.

Journal Entry:

Cash A/c	Dr.	700	
To Bad Debts Recovered A/c			700
(Being recovery of Bad debts previously written off)			

Transaction 21

Distribution of goods as free sample ₹ *100*

In order to boost its sales the business distributes certain goods as free sample. No doubt, it is not the sales of the business but an expense. As such, Free Samples or Advertising A/c will be debited because it is the Nominal Account and the rule for Nominal Account goes as "Debit the expenses". Such goods given as charity will be valued at cost price, so purchases account will be credited. The following entry will be passed for this transaction.

Free Samples Or Advertising A/c	Dr.	100	
To Purchases A/c			100
(Being distribution of goods as free samples)			

In case of **distribution of goods among employees,** Salaries A/c will be debited and purchases A/c credited.

Transaction 22

Loss of Goods ₹ *1000*

Business is always subject to risks. Misfortunes and mishappening, such as loss of goods by theft, accident and fire can happen any moment. Such losses of goods may be classified in two parts:

(*i*) *Loss of Goods by Theft:* If theft is committed by the employee or any other person, there will be loss of goods and the business will have to suffer loss for the value of goods lost. Loss belongs to Nominal Account so for debiting or crediting the rules for nominal A/c will be applied. Loss of goods by theft is loss, so it will be debited (Debit all losses). this is definitely not a sale, so the question of crediting Sales A/c does not arise. Goods lost will be valued at Cost price, so Purchases Account will be credited. The following journal entry will be passed for the transaction:

Loss by theft A/c	Dr.	1000	
To Purchases A/c			1000
(Being loss of goods by theft)			

(*ii*) *Loss of Goods by Fire:* It is just possible that some goods may catch fire and result in loss to the business. This is definitely Loss, so Loss of goods by Fire Account will be debited. Such goods have been destroyed, not sold, so their valuation will be made at cost price. So, Purchases Account will be credited. They journal entry for this transaction will be made as under:

Loss of goods by fire A/c	Dr.	1000	
To Purchases A/c			1000
(Being loss of goods by fire)			

(*iii*) *Loss of Cash by Fire:* In this transaction, Loss by Fire A/c will be debited and Cash A/c will be credited. The following journal entry will be passed:

Loss by fire A/c	Dr.	1000	
To Cash A/c			1000
(Being loss of cash by fire)			

(*iv*) *Cashier reported a loss of ₹ 70 from the Cash Box*.

Loss by theft A/c	Dr.	1000	
To Cash A/c			1000
(Being loss of cash by theft)			

Certain Important Facts About Purchases A/c

Purchases Account always shows debit balance. It is debited for both cash and credit purchases. It the following cases, goods are valued at Cost or Purchase price, so Purchases A/c is credited:

(*i*) Goods given as charity.
(*ii*) Goods taken/withdrawn by proprietor.
(*iii*) Loss of goods by theft.
(*iv*) Loss of goods by fire.
(*v*) Free distribution of goods as sample.
(*vi*) Distribution of goods to employees free sample.

Transaction 23

We receive valued order for ₹ 20,000 from Mohan for supply of goods and receive ₹ 12,000 as an advance together with order.

Journal Entry:

Cash A/c	Dr.	12,000	
To Advance from Mohan			12,000
(Being advance received from Mohan against the order)			

Transaction 24

Goods worth ₹ 20,000 supplied to Mohan against the order and advance, previously received from him.

Journal Entry:

Mohan A/c	Dr.	8,000	
Advance from Mohan A/c	Dr.	12,000	
To Sales A/c			20,000
(Being goods sold to Mohan against advance previously received)			

Notes

Transaction 25

(*a*) *Paid Income Tax amounting to ₹ 20,000 through cheque.*

Journal Entry:

Capital A/c	Dr.	20,000	
To Bank A/c			20,000
(Being payment of income tax through cheque vide receipts No. ...... dated ......)			

In case of Proprietorship and Partnership profit earned by the business unit is subject to income tax. Proprietor will bear income tax. This is why, proprietors Capital Accounts are debited.

(*b*) **Refund of Income Tax**

Cash A/c	Dr.		
To Capital			

The amount received will increase Cash and Capital simultaneously. It is just possible that income tax paid in excess is refunded by Income Tax Department.

(*c*) **Interest on Advance Payment of Income Tax Received**

Cash A/c	Dr.	d	d
To Capital			

Interest received on advance payment of tax will increase our Capital, so it will be credited to Capital, because tax was paid out of Capital and on that occassion Capital A/c was debited.

Transaction 26

Writing Back Discount Allowed and Discount Received A/c

(*i*) *Received a cheque from Chandni for ₹ 9,900 against at debt of ₹ 10,000 in full settlement. The cheque was immediately deposited into the bank.*

(*ii*) *Bank intimated that Chandni's cheque has returned dishonoured.*

Journal Entry:

(*i*)	Bank A/c	Dr.	9,900	
	Discount A/c	Dr.	100	
	To Chandni			10,000
	(Being cheque received from Chandni in full Settlement and deposited into the bank)			
(*ii*)	Chandni	Dr.	10,000	
	To Bank A/c			9,900

To Discount A/c 100

(Being Chandni's cheque for ₹ 9,900 has returned

Dishonoured and the Discount allowed, written back)

Transaction 27

Notes

Amount received from sales of newspapers, magazines, scraps and wastes ₹ 200.

Journal Entry:

Cash A/c	Dr.	200	
To Miscellaneous Receipts A/c			200

Transaction 28

Subscribing for newspapers, magazines and periodicals ₹ 150.

Journal Entry:

Miscellaneous Expenses A/c	Dr.	150	
To Cash A/c			150

Transaction 29

Treatment of Sales Tax

Sales tax is an indirect Tax, whose incidence (burden) is shifted by the trader to customers. It is realised by the trader on the sales of those commodities, which are subject to sales tax from the purchaser of the commodity and paid to the Government. As such sales tax received is a liability for the business and this is why, sales tax account should be credited, whenever it is received by the trader. In case, the sales tax collected by the trader on behalf of Government is paid to the Government, Sales Tax A/c will be debited simply because it will reduce our liability (Liabilities are debited on their reduction). If goods worth ₹ 2,000 were sold subject to the sales tax of 10% and later on it was paid to the Government, the following journal entries will be passed. The Sales Tax A/c if appearing in the Trial Balance means Sales Tax collected but not yet paid to the Government. So, it will be shown at the Liabilities side of Balance Sheet.

(*a*) On Receipt of Sales Proceeds Including Sales Tax

Cash A/c	Dr.	2,200	
To Sales A/c			2,000
To Sales Tax A/c			200

(*b*)

Sales Tax	Dr.	200	
To Cash			200

Transaction 30

Value Added Tax (VAT)

Recently the Government of India has introduced Value Added Tax (VAT). It is optional for the state government to replace Sales Tax with the value added tax. Many states have introduced value added tax.

It is an indirect Tax like sales tax and its burden is passed onto the purchaser. The simple difference between sales tax and value added tax is that sales tax collected i paid to the government on due dates. On the other hand, VAT paid on purchases is *adjusted on VAT collected on sales. the balance of VAT collected account is a liability payable to the government.*

Notes

Let us explain journal entry regarding value added tax:

1. *When VAT is Paid at the Time of Purchases*

Purchases A/c	Dr.		
VAT paid A/c	Dr.		
To Cash/Bank A/c/Creditor			

2. *When VAT is Collected at the Time of Sales*

Cash/Bank/Debtors A/c	Dr.	×××	
To Sales			×××
To VAT Collected A/c			×××

3. *When VAT Paid is Adjusted Against VAT Collected*

(*i*) VAT Collected A/c	Dr.	×××	
To VAT paid			×××

(This entry will be made with full amount of VAT paid)

4. *When VAT is Paid to the Government*

VAT Collected A/c	Dr.		
To Cash/Bank A/c			

Transaction 31

Received a VPP for goods wroth ₹ 490. Sent an employee with ₹ 500 for collection of goods. The employee paid ₹ 5 for rickshaw charges and returned the balance.

Journal Entry:

Purchases A/c	Dr.	490	
Cartage A/c	Dr.	5	
To Cash A/c			495

Compound or Composite Journal Entries

Sometimes a particular transaction involves more than two accounts. Many transactions are related to specific account on a particular date. There amy be certain transactions of the same nature on a certain date. In these cases, we prefer to pass only one entry instead of passing two or more entries. Such entries can be passed in either of the following three ways:

(*a*) By debiting one account and crediting two or more accounts.

(*b*) By crediting one account and debiting two or more accounts.

(*c*) by debiting two or more accounts and crediting two or more accounts.

Illustrations and Solutions

Illustration 1. *Pass necessary journal entries in the following cases:*

(*i*)	Amount received from Mohan	₹ 980
	Discount allowed	₹ 20

(*ii*) Amount paid to Azhar ₹ 2,920
Discount allowed ₹ 80

(*iii*) Salaries amounting to ₹ 3,000 and wages amounting to ₹ 5,000 were paid on 31st Dec. 2001.

Notes

Journal Entries :

(*i*)	Cash A/c	Dr.	1,980	
	Discount A/c	Dr.	20	
	To Mohan			2,000
	(Being amount received from Mohan and discount allowed)			
(*ii*)	Azhar	Dr.	3,000	
	To Cash A/c			2,920
	To Discount A/c			80
	(Being amount paid to Azhar and discount allowed by him)			
(*iii*)	Salaries A/c	Dr.	3,000	
	Wages A/c	Dr.	5,000	
	To Cash A/c			8,000
	(Being payment of salaries and wages)			

Opening Journal Entry

Business, According to going concern concept is supposed to be carried on indefinitely. A the end of the accounting year different accounts are closed bu the business has to be current year. Passing journal entry in the beginning of the current year with the balances of assets and liabilities of the previous year is opening journal entry. In this entry assets accounts are debited because assets always show debit balance. Liabilities and capital accounts are credited because they show credit balance.

Calculation of Hidden Capital/goodwill

In certain cases the balance of certain assets and liabilities are hidden. In case, the total of liabilities fall short of the assets, the excess of assets over liabilities is supposed to be capital. If liabilities exceed the assets, the excess of liabilities over assets as termed as Goodwill. It indicates that the debit and credit total of opening entry has also to be made equal either by debiting Goodwill A/c (if the value of assets are lesser) or by crediting Capital A/c (if the total of liabilities side is lesser than the total of assets side).

It should be noted that opening Journal entries are made for personal and real accounts only, because the closing balances of these accounts are brought forward to the current year from the previous year.

Calculation of Hidden Closing Stock

In certain cases closing stock may not be given. Closing stock is must in case of continuing business. If it is hidden, we will have to apply the following formula to dig it out.

Notes

(*a*)	**Closing Stock**	= Opening stock
	(In case of Gross Profit)	+ Net purchases
		+ Direct expenses
		+ Gross Profit
		(–) Sales

Or

(*b*)	**Closing Stock**	= Opening stock
	(In case of Gross Profit)	+ Net purchases
		+ Direct expenses
		(–) Sales
		(–) Gross Loss

It should be noted that stock is valued at cost price or market price, whichever is lesser. Generally, it is valued at cost price, because in most of the cases, sales are made at price higher than cost price. It is, therefore, necessary that in the absence of Gross Profit or Gross Loss, the margin of Gross Profit/Loss on the sales or cost of goods must be given.

Illustration 2. *The firm of M/s Simple and Dimple has the following balances in their different ledger accounts on January 1, 2008.*

Cash	*₹ 20,000*
Closing Stock	*₹ 20,000*
Building	*₹ 60,000*
Debtors	*₹ 20,000*
Creditors	*₹ 16,000*
Capital	*₹ 1,08,000*

Pass the Opening Journal Entry.

Solution: **Journal Entry**

Date	Particulars		L.F.	Debit ₹	Credit ₹
1.1.08	Cash A/c	Dr.		20,000	
	Goodwill A/c	Dr.		4,000	
	Stock A/c	Dr.		20,000	
	Building A/c	Dr.		60,000	
	Debtors A/c	Dr.		20,000	
	To Creditors A/c				16,000
	To Capital A/c				1,08,000
	(Being previous year's balance brought into books)				

Note: Excess of credit over debit has been assumed to be Goodwill.

Ledger Posting of Opening Journal Entries

Opening Journal entries as we know consist of assets and liabilities. Assets always have debit balance and liabilities have credit balance. As such, while preparing Assets accounts from the opening Journal entry, we shall record 'To Balance b/d' at the debit side of every asset's A/c as the first item. After this, all the other entries relating to individual asset will be posted in it. In the same way, while preparing liabilities A/c from the opening journal entry, we shall write 'By Balance b/d' as the first item at the credit side of respective liabilities A/c. After this all the other relevant entries relating to specific liabilities will be recorded.

Notes

Closing Journal Entries

At the end of the accounting period, all ledger accounts pertaining to goods i.e., purchases, sales, purchases return, sales return, stock and other accounts concerning expenses, losses, income and gain are closed by transfer to Trading and Profit and Loss Accounts. These transfer entries are termed as closing entries. In other words, the closing entries concern all the items of the debit and credit side of Trading and Profit and Loss A/c i.e., Nominal Accounts.

These entries are based upon Trial Balance and can be summarised as under:

1. *For Closing items appearing at the debit side of Trading A/c*

   Trading A/c Dr.

   To Opening Stock

   To Purchases

   To Sales Return

   To Direct expenses (*individually by name*)

2. *For Closing items Appearing at the Credit Side of Trading A/c*

   Sales A/c Dr.

   Purchases Return A/c Dr.

   Closing Stock A/c Dr.

   To Trading A/c

3. *For Transfer of Gross Profit ot P/L A/c*

   Trading A/c Dr.

   To Profit and Loss A/c

4. *For Transfer of Gross Loss to P/L A/c*

   Profit and Loss A/c Dr.

   To Trading A/c

5. *For Closing Items (Indirect Expenses and Losses) Appearing at the Debit Side of P/L A/c*

   P/L A/c Dr.

   To Indirect expenses and losses A/c

   (*Individual expenses A/c by name*)

6. *For Transfer of Income and Gains A/c*

Individual Incomes and Gains A/c Dr.
  To Profit and Loss A/c

7. *For Transfer of Net Profit*
   Profit and Loss A/c Dr.
     To Capital A/c (*In case of Proprietorship and Partnership*)
       Or
   P/L Appropriation A/c (*In case of Company*)

8. *For Transfer of Net Loss*
   Capital A/c or Dr.
   P/L Appropriation A/c Dr.
     To P/L A/c

Notes

Illustration 3. *Classify the following under three different types of accounts:*

(i) Stock, (ii) Loan, (iii) Fixture, (iv) Cash, (v) Drawings, (vi) Salaries, (vii) Current Accounts of a partner, (viii) Insurance, (ix) Banks.

Solution:

Personal Account :

(*i*) Loan,	(*ii*) Drawings,
(*iii*) Bank A/c	(*vi*) Current A/c of a Partner.

Real Account :

(*i*) Stock A/c	(*ii*) Fixture A/c
(*iii*) Cash A/c	

Nominal Account :

(*i*) Salaries A/c	(*ii*) Insurance A/c

Illustration 4. *On 1st January, 2001 the following were the balances of Rajan & Co. : Cash in hand ₹ 900; Cash at bank, ₹ 21,000; Soni (Cr.) ₹ 3,000 Zahir (Dr.), ₹ 2,400; Stock, ₹ 12,000; Prasad (Cr.), ₹ 6,000; Sharma (Dr.), ₹ 4,500; Lall (Cr.), ₹ 2,700.*

Transactions during the month were—

2001		₹
Jan. 2	*Bought Goods from Prasad*	*2,700*
Jan. 3	*Sold to Sharma*	*3,000*
Jan. 5	*Sold to Lall goods for cash*	*3,600*
Jan. 7	*Took goods for personal use*	*200*
Jan. 13	*Received from Zahir in full settlement*	*2,350*
Jan. 17	*Paid to Soni in full settlement*	*2,920*
Jan. 22	*paid cash for stationery*	*50*
Jan. 29	*Paid to Prasad by cheque*	*2,650*
	Discount allowed	*50*
Jan. 30	*Provide interest on capital*	*100*

Rent due to landlord... *200*

Journalise the Above Transactions.

Solution: **Journal Entries**

Date	Particulars		L.F.	Debit ₹	Credit ₹
1.1.01	Cash A/c	Dr.		900	
	Bank A/c	Dr.		21,000	
	Zahir	Dr.		2,400	
	Sharma	Dr.		4,500	
	Stock A/c	Dr.		12,000	
	To Soni				3,000
	To Prasad				6,000
	To Lall				2,700
	To Capital A/c				29,100*
	(Being the various Assets and Liabilities are brought to new books)				
Jan. 2	Purchases A/c	Dr.		2,700	
	To Prasad A/c				2,700
	(Being goods purchased from Prasad)				
Jan. 3	Sharma	Dr.		3,000	
	To Sales A/c				3,000
	(Being goods sold to Sharma)				
Jan. 5	Cash A/c	Dr.		3,600	
	To Sales A/c				3,600
	(Being goods sold to Lall for cash)				
Jan. 7	Drawings A/c	Dr.		200	
	To Purchases A/c				200
	(Being goods taken for personal use)				
Jan. 13	Cash	Dr.		2.350	
	Discount A/c	Dr.		50	
	To Zahir				2,400
	(Being cash received from Zahir in full settlement of the account)				
Jan. 17	Soni A/c	Dr.		3,000	
	To Cash A/c				2,920
	To Discount A/c				80
	(Being cash paid to Soni in full settlement of the account)				
Jan. 22	Stationery A/c	Dr.		50	

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	To Cash A/c			50
	(Being stationery purchased)			
Jan. 29	Prasad Dr.		2,700	
	To Bank A/c			2,650
	To Discount A/c			50
	(Being amount paid to Prasad by cheque and he allowed discount)			
Jan. 30	Interest on Capital A/c Dr.		100	
	To Capital A/c			100
	(Being interest on capital is provided)			
Jan. 30	Rent A/c Dr.		200	
	To Rent Outstanding A/c			200
	(Being rent due to landlord)			

*Excess of debit opening balances over credit opening balances will be assumed to be capital.

Advantages of Journal

Journal has got the following advantages:

1. **Reducing the Chances of Error:** The double effect of every transaction is recorded in the same journal entry at the same place. It becomes easier to check and compare it. In case, direct positing is made, there is possibility of omission, posting at the wrong side and writing wrong amount in the two accounts.
2. **Permanent Record:** *The Journal has permanent record* : It has date-wise record of every transaction and can be used for auditing, whenever required.
3. **Narration:** Journal entries bear narration, which provides complete information about the transaction. It enables us to understand the entry.
4. **Convenient Distribution of Work:** Division of Journal into subsidiary books helps the administration in the distribution of work among employees.
5. **Location of Errors:** Errors can be easily located through journal.

Limitations of Journal

Journal inspite of its above advantages suffers from the following limitations:

1. **Huge and Bulky Size:** A single journal for the entire business will be bulky and difficult to operate and handle.
2. **Balance of Accounts at a Glance not available:** the actual position of ledger balances as purchases, sales, returns, bills etc. is not known on a particular date from journal.
3. **Difficulty in reconciling Cash Balance:** In case all transaction including cash transactions are recorded in the journal and no cash book is maintained, it will be very difficult to reconcile daily cash balance.

2.5. Preparation of Final Accounts

The scope and importance of accounting is to provide variable information about a business enterprise to those persons who are directly or indirectly interested in the progress, performance and financial position of the concern.

Information is the basis for decision making in an organization. The efficiency and soundness of the management depends upon the availability of regular and correct information to those who exercise the managerial functions. Such persons may include owners, creditors, investors, employees, government, public, research scholars and the managers.

1. **Owners:** The owners of a business could contribute capital to be used for the purpose of starting and running the business. The ultimate aim of accounting is to provide necessary information to the owners relating to their business. They want to evaluate the past financial performance and also assess the future prospects through the accounting reports.
2. **Creditors:** Creditors, debenture holders, bankers and other financial institutions are interested in knowing about the short term as well as long term financial position of the company. Because, they want to find out the ability of the firm to pay interest and principal as and when it becomes due for payment.
3. **Potential Investors:** Any investor, before making investment in any particular company shares, wants to know not only the earning capacity of the organisation but also its solvency position. For this purpose, investors take information from accounting reports to a great extent in order to determine the relative merits of the available investment opportunities.
4. **Employees:** Employees are the backbone of the organisation. They are interested in the earning capacity of a concern because their salaries, bonus, and pension schemes are dependent on the size of the profit earned.
5. **Government:** Government is the sole authority for the country's economic development. For the purpose of finding out overall economic growth point of view, the government is very much interested in accounting statements and reports in order to see the financial position of a particular unit. With the help of the accounting information, government is not only to prepare national account but also to impose tax and excise duty.
6. **Public:** The public as consumers is interested in accounting information in order to testify whether the control is properly exercised on production, selling and distribution for the purpose of reducing the prices of the goods they buy. And also they are interested to know, whether all the available economic resources of the concern are being properly utilised for the benefit of the common man or not. And at the same time, they want to examine any of the aspects of the business which can be detrimental to the public interest.
7. **Research Scholars:** Financial statements are very helpful to the research scholars. Enormous information are available from the accounting reports. Depending upon their research area, the researcher could get the data for

Notes

providing their thesis on which they are working and hence to complete their research projects.

8. **Regulatory Agencies:** In order to protect the public from the fraudulent activities of the business, various governments, voluntary service institutions, and other agencies use accounting information not only for the tax assessment purpose but also in evaluating how well various business concerns are operating under legal framework.

9. **Managers:** The foremost responsibility of the managers of the organisation is to obtain maximum return over the capital invested without causing any harm to the interest of the share holders. The manager would like to have a data regarding sales, expenses, assets, liabilities etc. relating to next year and also the flow of fund for the purpose of the activities of a business. He also takes a decision and alters the decision in best way. In all these aspects, relevant accounting information is needed.

2.5.1 Recording of Business Transaction-Basis of Accounting

There are three different Basis systems of accounting for recording of business transaction. They are (*i*) cash basis accounting, (*ii*) mercantile basis or Accrual basis of accounting, and (*iii*) mixed-basis of accounting.

(i) Cash Basis of Accounting

Under this system of accounting, actual cash received and actual cash payments are recorded. Credit transactions are not recorded at all until the cash is actually received or paid. Non trading concerns such as charitable institution, a club, a college etc and a professional man like a lawyer, a doctor, a chartered accountant etc maintains accounts under this system only. This basis of accounting is not a complete record of financial transactions of a trading period, because all outstanding transactions are not recorded.

(ii) Mercantile Basis of Accounting or Accrual Basis of Accounting

According to mercantile system of accounting, entries are made not only for actual receipt or payment of cash but also for the amount having been due for payment or receipt. Simply, both cash transactions and credit transactions are recorded and even non-trading concerns follow this type of accounting. Financial transaction discloses correct profit or loss for a particular period and also exhibits true financial position of the business on a particular day.

Normally, trading organisations, to prepare final account for the purpose of finding out profit or loss during a particular period, use the mercantile system of accounting.

(iii) Mixed System of Accounting

Under this basis of accounting, both cash system and mercantile system are followed. Simply, combination of cash system and mercantile system is called mixed system. Some of the records are maintained under the cash system and remaining others are maintained under mercantile system.

Apart from the basis of accounting, following are the methods of accounting to be followed in a normal practice. They are (*i*) Single entry method and (*ii*) Double entry method.

2.5.2 Single Entry System of Book Keeping

Under the single entry system, the principles of Double entry book keeping are not followed. Normally, every transaction has a two fold aspect. But in the single entry system of accounting only one aspect is recorded. So, it is called incomplete method of Book keeping. Trial Balance, Trading Account, Profit and Loss account, and Balance Sheet cannot be prepared with the help of the single entry system. This system is mainly followed by those organisations that have only limited number of transactions.

2.5.3 Double Entry System of Book Keeping

Double entry system of book keeping refers to particular transactions which are entered in two aspects. It is based on the dual aspect concept. Posting of each transaction in two different accounts on opposite sides for equal value is known as the double entry system of book keeping. [Normally it is the most accurate, complete and scientific method of accounting].

Simply, every debit must have a corresponding credit and vice versa. Most of the trading organisations follow the double entry system of accounting.

Advantages of Double Entry System

(*i*) It provides a complete record of the financial transactions which is maintained.

(*ii*) It supplies complete information about the business.

(*iii*) It provides a check on the arithmetical accuracy of books of accounts by preparing a trial balance by taking balances of all ledger accounts.

(*iv*) It is helpful in ascertaining profit or loss of a particular period by preparing the trading and profit and loss account.

(*v*) It helps the businessman to evaluate the progress of his business through meaningful comparison of operating and financial performance over a period of time.

(*vi*) It helps in preventing frauds and errors.

(*vii*) It helps income tax and sales tax authorities.

(*viii*) It is helpful in preparing accurate claim for loss of stock as a result of fire to the insurance company.

Disadvantages of Double Entry System

(*i*) This system requires to maintain wider number of books of accounts, which is not convenient to small concerns.

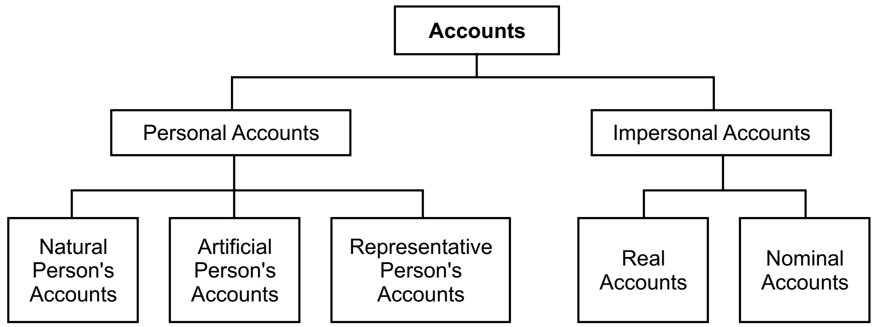
(*ii*) There is no guarantee of absolute accuracy of the books of account which are maintained.

(*iii*) It requires more clerical labour, so the system is costly.

Notes

2.5.4 Classification of Accounts

Normally, Accounts are classified into mainly two classes viz. (1) Personal accounts and (2) Impersonal accounts. These impersonal accounts are further subdivided into (*i*) Real account and (*ii*) Nominal account. But usually three types of accounts namely Personal Accounts, Real or Property Accounts and Nominal or Fictitious Accounts are opened to keep a complete record of business transactions.



1. Personal Accounts

Personal Accounts are those which are related to persons. A separate account is prepared for each person, because the firm deals its transactions with a number of persons. Such accounts can take the following forms :

(*i*) Natural person's accounts e.g., Kumar's account

(*ii*) Artificial persons' or body of persons' accounts e.g., Bank account, any company's account

(*iii*) Representative person's accounts e.g., salaries outstanding account, prepaid expenses account.

2. Impersonal Accounts

(*i*) Real Accounts or Property Accounts. Real Accounts are those accounts which can be related to a property, an asset or possession e.g., plant account, machinery account, cash account etc. Separate account is prepared for each class of assets of the organisation.

(*ii*) Nominal Accounts. Nominal accounts are those which are related to the business expenses or losses and incomes or gains. For example : Wages account, discount account, commission account.

2.5.5 Rules of Double Entry (or) Accounting Rules

Normally, most of the organisations follow the double entry system of accounting. The rules of double entry are as follows.

(*i*) **Personal Accounts**

Rules : Debit the Receiver
Credit the giver

(*ii*) **Real or property Accounts**

Rules : Debit what comes in
Credit what goes out.

(*iii*) **Nominal Accounts**

Rules : Debit all expenses and losses.
Credit all incomes and gains.

2.5.6 Accounting Cycle

Accounting cycle refers to an order of accounting procedures which are needed to be repeated in the same order during each accounting period.

Recording
↓
Classifying
↓
Summarising

(*i*) Recording. First and foremost activity of accounting is recording of business transactions in the journal.

(*ii*) Classifying. Classifying the transactions in the journal by posting them to the appropriate ledger accounts to find out at a glance the total effect of such transactions in a particular account.

(*iii*) Summarising. Summarising simply refers to consolidation of one year transactions with the help of ledger Balances. Based upon these Balances, Trial Balance, and final accounts are to be prepared with a view to ascertaining profit or loss made during the particular financial year or trading period.

2.5.7 Books of Accounts : Recording, Posting and Preparation of Trial Balance

Journal

Journal is derived from the French word "Jour" which means a day. Journal therefore means day to day transactions which are recorded in the books. It is in the form of debit and credit and is maintained with the help of accounting rules. The process of recording the transactions in a journal is called journalising.

A journal may be defined as the book of original or prime entry containing a chronological record of the business transactions.

Journal Format

1 Date		2 Particulars	3 L.F.	4 Debit (Dr.) ₹	5 Credit (Cr.) ₹
Year Month	Date	Name of the Account to be debited Name of the Account to be credited To Narration		*xx*	*xx*

Explanation

Notes

1. **Date:** The date on which the transaction takes place is entered in the journal.
2. **Particulars:** Under the particulars column, the names of the account to be debited is written in the first line, and in the second line, the account to be credited is written preceded by the word 'To Narration' which also explains briefly about the transaction.
3. **L.F:** It stands for ledger folio. It means the page number in the ledger in which the entry is posted.
4. **Debit:** Name of the account to be debited against the 'Dr' account is entered.
5. **Credit:** Name of the account to be credited against the 'Cr' account is entered.

Procedure for Journalising

In any particular transaction first of all we have to identify the receiving aspect and giving aspect of the transaction. All the transactions affect at least two of the basic accounting.

The rule for journalizing should be selected as follows.

Nature of Account	Rules for debiting an account	Rule for Crediting an account
1. Personal Account	Debit the Receiver	Credit the giver
2. Real Account	Debit what comes in	Credit what goes out
3. Nominal Account	Debit all expenses and losses	Credit all incomes and gains

Illustrations 1. *Journalise the following transaction in the journal of Mr. T.R. Ramu.*

2019, Jan 1 Ramu commenced business with a capital of ₹ 50,000

↓ ↓

Personal A/c Real A/c

The above transaction has to affect the two accounts i.e., (i) Real A/c and (ii) Personal A/c. After finding out the affected accounts, we have to apply the accounting rules as against the particular transaction. Here, cash is coming to the business and Ramu is the giver.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2019, Jan 1	Cash A/c Dr.		50,000	
	To Ramu's Capital A/c			
	(Being the amount invested in business)			50,000

2. Amount Deposited in Canara Bank ₹ 20,000

↓ ↓

Personal A/c Real A/c

Affected Accounts in the above transaction :

(*i*) Personal Account

(*ii*) Real Account

Notes

The above transaction has to affect the two accounts *i.e.,* (*i*) Real A/c and (*ii*) Personal A/c. After finding out the affected accounts, we have to apply the accounting rules as against the particular transaction. Here, cash is coming to the business and Ramu is the giver.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2019, Jan 2	Canara Bank A/c Dr.		20,000	
	To Cash A/c			
	(Being the amount invested in business)			20,000

3. Goods Purchased for cash ₹ 10,000

↓ ↓

Real A/c Real A/c

This is the cash transaction. The two aspects to be recorded are goods or purchase account and cash account. Both are related to Real Account. Now, we apply Real Account rules.

Date	Particulars	Amount Dr.	Amount Cr.
2019, Jan 3	Purchase or goods A/c Dr.	10,000	
	To Cash		10,000

4. Purchase of goods worth ₹ 5,000 from Murali

↓ ↓ ↓

Real A/c Real A/c Personal A/c

This is the credit transaction. But, the above transaction affects three accounts.

Namely, (*i*) Good ⟶ Real Account

(*ii*) Amount ⟶ Real Account

(*iii*) Murali ⟶ Personal Account

Here, there is no need to give the effect on one Real Account [i.e., Amount – Real Account]. Because, at the time of purchase, there is no settlement of money.

Goods Account relates to the Real Account. As per the Real Account rules, Goods Account is to be debited.

Murali is the Personal Account. As per the Personal Account rules Murali is the giver. So, his account is to be credited.

Date	Particulars	Amount Dr.	Amount *Cr.*
2019, Jan 4	Goods or Purchase A/c Dr.	5,000	
	To Murali Account		5,000

Notes

Credit Transaction and Cash Transaction

If purchase and Sales Transaction bears a name means it is treated as credit transaction. And at the same time, even though there is a name, specifically mentioned cash means, it is treated as cash transaction.

5. Sold goods to Rajan Brothers for ₹ 10,000

↓ ↓ ↓

Real A/c Personal A/c Real A/c

This is a credit transaction for two reasons :

(*i*) Purchaser's name is given.

(*ii*) There is no mention that it is cash transaction.

The above transaction affects the three Accounts. i.e.,

(*i*) Real Account (goods)

(*ii*) Personal Account (Rajan Brothers)

(*iii*) Real Account (Amount).

In the three accounts, we have to give the effect on only two accounts

i.e., Goods account and Personal account.

Here, Rajan Brothers receives the goods, and goods go out from the business. So, the journal entry will be

Date	Particulars	Amount Dr.	Amount Cr.
2019, Jan 4	Rajan Brothers A/c Dr.	10,000	
	To Goods or Sales A/c		10,000

6. Sold goods worth ₹ 2,500

↓ ↓

Real A/c Real A/c

This is the cash transaction. The above transaction affects two accounts. i.e.,

(*i*) Real Account → goods

(*ii*) Real Account → Amount.

Amount of ` 2,500 is coming to the business. As per the Real Account rules, Debit when comes in. Here cash comes in. So, cash account is debited and goods go out from the business. It is also a real account. As per the Real Account rules, Credit what goes out. Here, goods go out from the business, so cash account is credited.

Date	Particulars	Amount Dr.	Amount Cr.
2019, Jan 6	Cash A/c Dr.	2,500	
	To Goods A/c		2,500

Notes

7. Amount of ₹ 9,000 Received from Rajan Brothers as full settlement

↓ ↓

Real A/c Real A/c

This transaction directly affects two accounts.

(*i*) Real Account (Amount)

(*ii*) (Personal Account) Rajan Brothers

Indirectly, it affects one account *i.e.,* Nominal Account (Discount Account).

Actual sale of goods worth to Rajan Brothers	₹ 10,000
Amount Received from Rajan Brothers	₹ 9,000
The Amount treated as Discount A/c	₹ 1,000

Here, we allow the discount to Rajan Brothers.

For receiving cash ₹ 9,000, Cash Account is to be debited. Discount is the Nominal Account. As per the Nominal Account rules Debit all expenses and losses. Here, Discount is the Expenses. So, Discount Account is to be debited in the value of ₹ 1,000. Rajan brother is the giver, so his account is to be credited. The journal entry will be

Date	Particulars	Amount Dr.	Amount *Cr.*
2019, Jan 7	Cash A/c Dr.	9,000	
	Discount A/c Dr.	1,000	
	To Rajan Brothers A/c		10,000

8. Paid Salaries ₹ 25,000

↓ ↓

Normal A/c Real A/c

The transaction has to affect the two accounts. *i.e.,* (*i*) Salaries account relates to Nominal Account. Its rule is debit all expenses and losses and accordingly it is to be debited. (*ii*) Cash account relates to real account. Its rule is credit what goes out. Accordingly it is to be credited. Therefore, the journal entry will be.

Date	Particulars	Amount Dr.	Amount Cr.
2019, Jan 8	Salaries A/c Dr.	25,000	
	To Cash A/c		25,000

Notes

9. Commission Received ₹ 3,500

↓ ↓

Normal A/c Real A/c

The transaction is obviously by cash and is an income. So, the two important aspects are commission and cash. (*i*) Commission account relates to Nominal Account. As per the Nominal account rules credit all incomes and gains, accordingly it is to be credited. (*ii*) Cash account relates to Real Account. As per the Real account rules Debit what comes in. Accordingly cash account is to be debited. The journal entry will be.

Date	Particulars		Amount Dr.	Amount *Cr.*
2019, Jan 9	Cash A/c	Dr.	3,500	
	To Commission A/c			3,500

10. Entertainment expenses ₹ 1,000 paid

↓ ↓

Normal A/c Real A/c

This is a cash transaction. Cash is going out and the entertainment is the expenditure. Cash relates to Real Account. As per Real Account Rules credit what goes out and accordingly it is to be credited. Entertainment relates to Nominal Account. Its rule is Debit all expenses and Losses. Accordingly, it is to be Debited. So, the journal entry will be.

Date	Particulars		Amount Dr.	Amount *Cr.*
2019, Jan 10	Entertainment Expn. A/c	Dr.	1,000	
	To Cash A/c			1,000

Ledger

Ledger is a register having a number of pages which are numbered consecutively. Simply, ledger means consolidation of similar types of transactions under one head. In other words, a ledger may be defined as a summary statement of all the transactions relating to a person, asset, expenses or income which have taken place during a given period of time and show their net effect.

The process of preparation of accounts from the journal into ledger is called posting in the ledger. Examples of ledger accounts include sales account, purchase account, sales returns account, cash account, and so on.

Format of Ledger

Ledger can be divided into two parts (*i*) left hand side called debit side (Dr) and (*ii*) right hand side called credit side (Cr). Debit side starts with 'To' and credit side starts with 'By'. Most of the authors follow these practices.

Debit (Dr.)				Ledger			Credit (Cr.)
Date	Particulars	Folio	Amount	Date	Particulars	Folio	

Posting of Journal Entry into Ledger

Illustration 2. *Given the following journal entry, how do you post in into relevant ledger accounts.*

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
2019, jan 1	Cash A/c	Dr.		75,000	
	To Raju's Capital A/c				75,000
	[Being the business started]				

Solution : **Cash Account**

Dr. **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
1.1.19	To Raju Capital A/c		75,000				

Capital Account

Dr. **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				1.1.19	By Cash A/c		75,000

How to Balance an Account?

First we have to compute the total on each side separately. Next the side which has the highest value, should be put on both side. Then, we have to find the difference from the lower value side. This value is called Balance c/d. This is the closing balance for the end of the given period. This is called Balance Brought down.

Illustration 3. *Journalise the following transaction in the books of Kumar and prepare necessary ledger accounts :*

2019, Jan. 1. Kumar started a Business with the capital of ₹ 60,000.
3. Amount Received from Bank ₹ 10,000.
4. Purchased goods from Ravi for ₹ 5,000.
5. Returned goods to Ravi for ₹ 1,000.
6. Sold goods for cash ₹ 5,000.
9. Sold goods to Lakshman for ₹ 3,500.
10. Amount of ₹ 3,750 paid to Ravi as full settlement.
12. Lakshman returned the goods worth ₹ 500. Complaint about damages.
20. Paid Salaries ₹ 2,500.

21. Dividend Received ₹ 1,000.
22. Amount paid to Mohan through a bank at ₹ 1,500.
24. Withdraw money from business for private use ₹ 1,000.
30. Withdraw money from Bank for Business use ₹ 3,000.

Notes

Solution : **Journalisation (In the books of Kumar)**

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2019, jan 1	Cash A/c Dr. To Kumar Capital A/c [Being the business started]		60,000	60,000
3	Cash A/c Dr. To Bank A/c [Being the cash received from Bank]		10,000	10,000
4	Goods A/c Dr. To Ravi A/c [Being Goods purchased from Ravi on credit basis]		5,000	5,000
5	Ravi A/c Dr. To Purchase Return A/c [Being the goods returned to Ravi on account of damages]		1,000	1,000
6.	Cash A/c Dr. To Goods A/c [Being the goods sold for cash]		5,000	5,000
9	Lakshman A/c Dr. To Goods A/c [Being the goods sold to Lakshman on the credit Basis]		3,500	3,500
10	Ravi A/c Dr. To Cash A/c To Discount A/c [Being the payment of full Settlement]		4,000	3,750 250
12	Sales Return A/c or Goods A/c Dr. To Lakshman A/c [Being the goods returned to Lakshman]		500	500
20	Salaries A/c Dr. To Cash A/c [Being Salaries Paid]		2,500	2,500
21	Cash A/c Dr. To Dividend A/c [Being Dividend Received]		1,000	1,000

22	Mohan A/c Dr. To Bank A/c [Being amount paid to Mohan through bank]		1,500	1,500
24	Drawing A/c Dr. To Cash A/c [Being withdrawn money from Business for private use]		1,000	1,000
30	Cash A/c Dr. To Bank A/c [Being Withdrawn money from bank for business use]		3,000	3,000

Notes

Preparation of ledger Accounts

Cash Account

Dr. **Cr.**

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
1.1.04	To Capital A/c		60,000	20.1.04	By Salaries		2,500
3.1.04	To Bank A/c		10,000	24.1.04	By Drawings		1,000
6.1.04	To Goods A/c		5,000	31.1.04	By Balance c/d		79,250
10.1.04	To Ravi A/c		3,750				
21.1.04	To Dividend A/c		1,000				
30.1.04	To Bank A/c		3,000				
			82,750				82,750
1.2.04	To Balance b/d		79,250				

Kumar Capital Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
31.1.04	To Balance c/d		60,000	1.1.04	By Cash A/c		60,000
			60,000				60,000
				1.1.04	By Balance b/d		60,000

Bank Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
31.1.04	To Balance c/d		14,500	3.1.04	By Cash A/c		10,000
				22.1.04	By Mohan A/c		1,500
				30.1.04	By Cash A/c		3,000
			14,500				14,500
				1.2.04	By Balance b/d		14,500

Goods Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
4.1.04	To Ravi A/c		5,000	6.1.04	By Cash A/c		5,000

31.1.04	To Balance c/d		3,500	9.1.04	By Lakshman A/c		3,500
			8,500				8,500
				1.2.04	By Balance b/d		3,500

Notes

Ravi Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
5.1.04	To Purchase			4.1.04	By Goods A/c		5,000
10.1.04	Return A/c		1,000				
	To Cash A/c		3,750				
	To Discount		250				
			5,000				5,000

Lakshman Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
9.1.04	To Goods A/c		3,500	12.1.04	By Sales Return A/c		500
				31.1.04	By Balance c/d		3,000
			3,500				3,500
1.2.19	By Balance b/d		3,000				

Discount Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
1.1.04	To Balance c/d		250	10.1.04	By Ravi		250
			250				250
				1.2.04	By Balance b/d		250

Sales Return Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
12.1.04	To Lakshman A/c		500	31.1.04	By Balance c/d		500
			500				500
1.2.04	To Balance b/d		500				

Salaries Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
20.1.04	To Cash A/c		2,500	31.1.04	By Balance c/d		2,500
			2,500				2,500
1.2.04	To Balance b/d		2,500				

Mohan Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
21.1.04	To Balance c/d		1,500	31.1.04	By Balance c/d		1,500
			1,500				1,500
1.2.04	To Balance b/d		1,500				

Notes

Drawing Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
24.1.04	To Cash A/c		1,000	31.1.04	By Balance c/d		1,000
			1,000				1,000
1.2.04	To Balance c/d		1,000				

Dividend Account

Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
31.1.04	To Balance c/d		1,000	21.1.04	By Cash		1,000
			1,000				1,000
				1.2.04	By Balance b/d		1,000

From the above ledger accounts it can be noticed that

(*i*) Ravi Account is settled.

(*ii*) Some Accounts showing debit balances.

(*iii*) Some Accounts showing credit balances.

2.6. Trial Balance

Every transaction is recorded under double entry system. The fundamental Principle of Double entry system is that for every debit there must be a corresponding credit. All the ledger accounts are balanced. After arriving at the figures, total of all debit balances must be equaled to the total of credit balances if the accounts are arithmetically accurate.

At the end of the financial year, or at any time the balances of all the ledger accounts are extracted and written up, a statement is prepared which is known as Trial Balance.

Simply, Trial Balance is a settlement which is prepared in order to testify the arithmetical accuracy of entire financial transaction. Agreement of the Trial Balance exposes both the aspects of each transaction which have been recorded and that the books are arithmetically accurate. Suppose Trial Balance does not agree, it means there are errors which must be detected and rectified before preparing the final account. Trial Balance creates a link between ledger accounts and final accounts.

Aim of Trial Balance

1. To avoid unnecessary verification of all the pages of ledger.
2. It is a suitable and easy method of verifying the arithmetical accuracy of the entire transaction.
3. Trial Balance agrees only when the Debit side total is equal to credit side total. Otherwise, there are some errors.
4. It helps in the preparation of final Account. *i.e.,* Trading Accounts, Profit and Loss Account and Balance sheet.

Methods of Preparing Trial Balance

There are two methods available for preparing Trial Balance.

Notes

1. Total Method
2. Balances Method

Under the total method, without balancing the ledgers, Debit and credit totals of each account are shown in the two columns i.e., debit side total in the debit column of Trial balance and credit side total is put in the credit column of Trial Balance.

Under the Balances method, the balances are extracted from various ledgers. Simply Debit side of the ledger balance is transferred to Debit side of trial balance, credit side of the ledger balance is transferred to credit side of Trial Balance. The nil balance accounts are not taken into account in this method. So, this method is more convenient to adopt and to be followed at regular practice.

Rules

Debit side = Either Asset Account balances or Expenses Account balances

Credit side = Either Liability Account balances or Income Account balances

Format of Trial Balance

Trial Balance of …………………… as on ……………………

S.No.	Particulars	Debit Balance Amount (₹)	Credit Balance Amount (₹)

NOTE:	Generally, whenever we prepare the Trial Balance, if it tallies, it is an indication that all the transactions recorded in the books are correct. Suppose if the trial balance disagrees, beyond our attention the difference amount is placed as in the suspense Account. Do attempt suspense account only in few cases.

Illustration 4. *Prepare Trial Balance as on 31.03.2002 from the following balances of Mr. Ravi.*

Capital 1,00,000
Sales 1,50,000
Plant & Machinery 60,000
Purchases 50,000
Sales Returns 5,000
Wages 10,000
Sundry Creditors 60,000
Bad Debts 7,000
Bad Debts Provision 3,000
Land & Build 1,00,000
Debenture 45,000
Drawings 10,000
Commission Rece.......... 7,500
Auditor’s Fees 6,500
Purchase Return 10,000

Bills Payable 9,000
Carriage Inwards 2,000
Goodwill 10,000
Reserve Fund 25,000
Wages & Salary 5,500
Carriage Outwards 1,500
Stock on 01.04.2001 25,000
Debtors 49,000
Interest Received 4,000
Travelling Expenses 5,000
Bank Overdraft 3,000
Trade Expenses 3,400
Motor Vehicle 8,000
Rent Received 2,000
Lease hold Property 60,600

Notes

Solution :

Trial Balance of Mr. Ravi as on 31st March 2002

Particulars	Debit (₹)	Credit (₹)
Capital	–	1,00,000
Sales	–	1,50,000
Plants & Machinery	60,000	–
Purchases	50,000	–
Sales Returns	5,000	–
Wages	10,000	–
Sundry Creditors	–	60,000
Bad Debts	7,000	–
Bad Debts Provision	–	3,000
Land & Buildings	1,00,000	–
Debentures	–	45,000
Drawings	10,000	–
Commission Received	–	7,500
Auditors's Fees	6,500	–
Purchases Return	–	10,000
Bills Payable	–	9,000
Carriage Inwards	2,000	–
Goodwill	10,000	–
Reserve Fund	–	25,000
Wages & Salary	5,500	–
Carriage Outwards	1,500	–

Notes

Stock 1.4.2001	25,000	–
Debtors	49,000	–
Interest Received	–	4,000
Travelling Expenses	3,400	–
Bank Overdraft	–	3,000
Trade Expenses	3,400	–
Motor Vehicle	8,000	–
Rent Received	–	2,000
Lease hold property	60,600	–
	4,18,500	4,18,500

Illustration 5. *Prepare Trial Balance as on 31.03.2002 from the balances of Mr. Raju.*

Cash in Hand	*1,70,000*
Building	*1,60,000*
Stock on 01.04.2001	*70,000*
Purchases	*3,20,000*
Sales Return	*5,000*
Commission Received	*7,000*
Interest on Drawingsr	*5,000*
Director's Fees	*2,000*
Carriage Inwards	*4,000*
Carriage Outwards	*3,000*
Wages	*2,000*
Salaries Wages	*3,000*
Investments	*75,000*
Sales	*7,30,000*
Preliminary Expenses	*5,000*
Sundry Creditors	*60,000*
Bills Payable	*30,000*
Insurance	*2,500*
Income from Investment	*3,500*
Printing & Advertisement	*15,000*
Bank Loanr	*40,000*
Freight on Purchase	*5,000*
Furniture & Fittings	*18,000*
Drawings Accounts	*5,500*
Deposits	*86,000*
Sundry Debtors	*90,000*
Bills Receivables	*35,000*

Office Expenses	*3,000*
Motor Van	*63,000*
Loan on Mortgage	*1,02,000*
Interest on Loan	*4,500*
General Expenses	*6,500*
Dividend Received	*2,500*
Interest (Cr)	1,000

Solution :

Trial Balance of Mr. Raju as on 31st March 2002

Particulars	Debit (₹)	Credit (₹)
Cash in Hand	1,70,000	–
Building	1,60,000	–
Stock 1.4.2001	70,000	–
Purchase	3,20,000	–
Sales Return	5,000	–
Commission Received	–	7,000
Interest on Drawings	–	5,000
Director's Fees	2,000	–
Carriage Inwards	4,000	–
Carriage Outwards	3,000	–
Wages	2,000	–
Salaries Wages	3,000	–
Investments	75,000	–
Sales	–	7,30,000
Preliminary Expenses	5,000	–
Sundry Creditors	–	60,000
Bills Payable	–	30,000
Insurance	2,500	–
Income from Investment	–	3,500
Printings and Advertisement	15,000	–
Bank Loan	–	40,000
Freight on Purchase	5,000	–
Furniture & Fittings	18,000	–
Deposits	–	86,000
Drawings Account	5,500	–
Sundry Debtors	90,000	–
Bills Receivables	35,000	–
Office Expenses	63,000	–
Loan on Mortgage	–	1,02,000

Interest on Loan	4,500	–
General Expenses	6,500	–
Dividend Received	–	2,500
Interest (Cr.)	–	1,000
	10,67,000	10,67,000

NOTE: Before the preparation of the Final Account, we have to know the following concepts and their specifications. Because these four concepts are the fundamentals to all the proceedings of Accounting, either for Trial Balance or for Final Account.

I. Income

Money earned by the concern due to rendering of services or sale of goods.

Example/Specification :

Commission Received	Interest on Investment Received
Rent Received	Apprentice Premium Received
Dividend Received	Rent Received on sub letting
Interest on Drawings	Rent from Tenants
Sales	Income from any other sources
Bad Debts Recovered	Miscellaneous Revenue Receipt
Interest Received	Salary Received

II. Expenses

Expenses are those which can be incurred *i.e.,* amount paid for the purpose of purchasing of goods or those who render services in our organisation.

Wages paid	Carriage inwards
Salaries paid	Carriage outwards
Commission paid	Freight on purchases
Rent Paid	Customs Duty
Interest Paid	Advertisement Expenses paid
Oil, water	Interest on Bank loan
Gas, Electricity Charges Paid	Interest on Capital

Drawings	Discount on Bills
Office Salaries	Loss of Fire not covered by the
Telephone Charges	Insurance company
Legal Charges	Manager's remuneration
Audit Fees	Insurance
General Expenses	Bad Debts
Discount Allowed	Agents Commission
Selling and Distribution Expenses	

III. Assets

Anything which possesses certain monetary value is called Assets.

Example :

Current Assets	Fixed Assets	Others
Cash in hand and at Bank	Land & Buildings	Preliminary Expenses
Sundry Debtors	Machinery	Goodwill
Bills Receivable	Furniture & Fittings	Patents and Trade Mark
Stock in Trade	Loose tools and spares	Prepaid Expenses
Short Term Investments	Investments	
Marketable Securities	Motor van	
Accrued Incomes		
Prepaid Expenses		

IV. Liabilities

A Business organisation which is liable to pay a certain sum of money to the outsiders is called liabilities.

Example :

Capital	Bank Overdraft
Reserve Fund	Outstanding expenses
Debenture	Deposits
Bank loan	Incomes received in advance
Mortgage loan	Expenses due but not paid
Sundry Creditors	Proposed Dividend
Bills Payable	Provision for Taxation

2.7. Final Accounts

Final Accounts are otherwise called Annual accounts. Normally Final Accounts are prepared at the end of the financial year or Accounting year. The purpose of preparing Final Accounts is to enable one to know the progress of the business, profit or loss and financial position of the firm at the right time.

The preparation of Final Account is not the first step of the Accounting process but it is the final product of the accounting process. It will give valuable information to the management and outsiders at the end of the Accounting period. Only after the preparation of Trial Balance it is possible to prepare Final Account. Final Account consists of the following parts.

1. Trading Account, 2. Profit and Loss Account, 3. Balance Sheet.

1. Trading Account

Trading Account is prepared to know the trading results or gross profit on trading of the business. Simply, it is to find out the gross profit from business due to buying and selling of goods or services during a particular period. In other words, Gross profit is the difference between the sales and the cost of goods sold.

In business, the expenditure and incomes are classified into Direct and Indirect. All the direct expenditure are debited into the debit side of the Trading Account and all the indirect incomes are credited into the credit side of the Trading Account. After transferring all the above details, we have to balance the Trading Account. If the balance is in the debit side it means the business is getting profit and named as Gross profit. Suppose the balance is in the credit side, it shows Loss and it is called Gross Loss. The Gross Profit or Gross Loss is transferred to the profit and Loss Account either on the Credit side or Debit side.

2. Profit and Loss Account

Notes

Profit and Loss Account is prepared to find out the net profit or net loss of the business. All the indirect incomes and expenditure are transferred to the Profit and Loss Account on the credit side and debit side respectively. After transferring all details to the Profit and Loss Account, we balance this account. If the balance is in debit side it is called Net profit. Suppose, the balance is in the credit side it is called as Net Loss. Net profit is transferred to the balance sheet Liabilities side and added to the capital. If it is Net Loss it will be deducted from the capital.

3. Balance Sheet

A Balance Sheet is a statement which is prepared for the purpose of finding out the Assets and liability position of the concern for the particular period. A Balance Sheet is also described as "Statement showing the sources and application of funds." It is a statement and not an account and prepared from real and personal Accounts. It has two sides. The left side of the balance sheet describes the Liabilities and Capital position. The right hand side of the balance sheet describes all the assets and investments.

Trading, Profit & Loss Account disclose the financial results of the concern at the end of the year. But the Balance Sheet discloses the Assets and Liability Position of the Concern as on the date.

Specimen for of Final Account Trading Account for the year ended ...31.3.

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock		XX	By Sales	XX	
To Purchase	XX		*Less* : Sales Return	XX	XX
Less : Purchase Return	XX	XX	By Closing Stock		XX
To Wages		XX	By Goods destroyed by fire		XX
To Carriage inward			By Gross Loss [Transferred		XX
		XX	to P & L A/c debit side]		
Expenses		XX			
To Fuel and Power		XX			
To Motive Power		XX			
To Coal, Water, Gas & Electricity		XX			
To Clearing Charges		XX			
To Import Duty		XX			
To Customs Duty		XX			
To Freight on Purchase		XX			
To Factory Rent and Insurance		XX			
To Works Managers Salary		XX			
To Gross Profit (B/f) (Transferred					
to P & L A/c Credit Side)		XX			XX

Profit and Loss Account for the year ended 31.3

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Gross Loss (Transferred from			By Gross Profit (Transferred		
Trading A/c)		XX	from Trading A/c)		XX
To Advertisement Expenses		XX	By Rent received		XX
To Carriage outwards		XX	By Commission received		XX
To Bank Charges			By Incomes from		XX
		XX	Investments		
To Salaries		XX	By Interest received		XX
To Rent and Taxes		XX	By Discount received		XX
To Stationeries			By Income from another		
		XX	source		XX
To Insurance		XX	By Discount on Creditors		XX
To Trade Expenses		XX	By Interest on Drawings		XX
To Interest on Capital			By All Business income		XX
		XX	Other than that		
To Interest on Loan		XX			
To Establishment Expenses			appeared in Trading account		XX
		XX	credit side		
To Selling & Distribution Expn.		XX	By Net Loss		XX
To Sundry Expenses			(Transferred to Balance		
		XX	sheet assets side)		
To Audit Fees		XX			
To Telephone Charges		XX			
To Depreciation		XX			
To Repair and Maintenances		XX			
To Bad Debts		XX			
To Loss on sale of fixed Assets		XX			
To Loss on stock by fire		XX			
To Agents Commission		XX			
To Discount on Debtors		XX			
To All Business Expenses (Other than that appeared in Trading Account debit side)					
By Net Profit		XX			
(Transferred to Balance sheet					XX
Liability side)		XX			

Balance Sheet as on 31.3

Dr. **Cr.**

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
Capital		XX	Cash in Hand		XX
Add : Net Profit		XX	Cash at Bank		XX

Notes

Notes

		XX	Sundry Debtors		XX
(–) *Less :* Drawings + Interest on	XX				
Drawings	XX	XX	Investments		XX
		XX	Marketable Securities		XX
Add : Interest on Capital		XX	Bills Receivable		XX
Less : Income Tax		XX	Prepaid Expenses		XX
		XX	Machinery		XX
Sundry Creditors		XX	Building		XX
Bills Payable		XX	Furniture and Fittings		XX
Bank Overdraft		XX	Loose tools		XX
Outstanding expenses		XX	Motor Car		XX
Loan from Banks		XX	House & Carts		XX
Mortgages		XX	Goodwill Patents &		
Debenture		XX	Trade Mark		XX
Reserve fund		XX	Preliminary Expenses		XX
Income Received in			Profit & Loss A/c		
advance		XX	(Net Loss)		XX
			Closing Stock		XX

2.8. Adjustment

The ultimate aim of the Trading and Profit and Loss Account is to know the real Profit or Loss of the concern during a given period. The purpose of the Balance sheet is to know the financial position at a given period. True profit can be arrived at after adjusting all pending bills and outstanding expenses and incomes through entries. These entries which are passed at the end of the accounting period are called adjustment entries. The following important adjustments which are to be made at the end of the year are as follows.

Important Adjustments

1. Closing stock.
2. Outstanding expenses.
3. Prepaid or unexpired expenses.
4. Income earned but not received or Accrued income.
5. Income received in advance.
6. Depreciation.
7. Interest on capital.
8. Interest on drawings.
9. Interest on loan.
10. Bad debts.
11. Provision for bad and doubtful debts.
12. Provision for discount on debtors.
13. Provision for discount on creditors.
14. Goods distributed as free of sample.

15. Loss of stock by fire.

In the actual sense all the above adjustments are given outside the Trial Balance. While preparing the Final accounts all the adjustments are to be considered. Normally, all the adjustments will appear at two places in the final accounts *i.e.,* either

(*i*) Trading Account and Balance Sheet or

(*ii*) Profit & Loss Account and Balance Sheet.

Notes

Adjustment and their Treatment

1. *Closing Stock*

   Trading Account - Credit side

   Balance Sheet - Asset side

2. *Outstanding Expenses*

   Trading or Profit & Loss A/c - Debit side

   Balance Sheet - Liability side

3. *Prepaid Expenses*

   Profit & Loss Account - Credit side

   (subtract from respective expenses)

   Balance Sheet - Asset side

4. *Income Due but not Received*

   Profit & Loss Account - Credit side

   (Add with respective incomes)

   Balance Sheet - Asset side

5. *Income Received in Advance*

   Profit and Loss Account - Credit side

   (Subtract from respective incomes)

   Balance sheet - Liability side

6. *Depreciation*

   Profit and Loss Account - Debit side

   Balance Sheet - Liability side

   (Subtract from respective Assets)

7. *Interest on Capital*

   Profit and Loss Account - Debit side

   Balance Sheet - Liability side (Add the capital)

8. *Interest on Drawings*

   Profit and Loss Account - Credit side

   Balance Sheet - Liability side (Subtract from the capital)

9. *Interest on Loan*

   Profit and Loss Account - Debit side

   Balance Sheet - Liability side

   (Add with the respective loan)

Notes

10. *Bad Debts*

Profit and Loss Account	-	Debit side
Balance Sheet	-	Asset side

(Subtract from the sundry debtors)

11. *Provision for Bad and Doubtful Debts*

Regarding the Bad debts and provision for Bad and doubtful debts we have to apply the following formula.

BD + NR – OR

BD : It refers to the bad debts. It should be given either Trial Balance or Adjustments or both. The value of bad debts is transferred to formula for calculation. The calculated value should be transferred either to debit side or credit side of the P.L & A/c.

Bad Debts (Adjustment)

Treatment :

(*i*) B/S Asset side [Subtract from Debtors], (ii) Transfer to formula [P.L & A/c]

NR : It refers to New Reserve. Normally, it should be give in the adjustment, in the name of provision for doubtful debts or reserves on debtors and so on.

Treatment :

(*i*) Transfer to formula, (*ii*) Balance Sheet : Asset side (Subtract from the Debtors) **OR :** It represents old reserve. Normally, bad debts provision *i.e.,* old reserve is given in the Trial Balance. The treatment is that it should be transferred to the formula for calculating new bad debts provision.

After finding the value, to apply the formula it should be transferred to P.L & A/c either debit side or credit side.

12. *Provision for Discount on Debtors*

- Profit & Loss Accounts Debit Side
- Balance Sheet Asset side [Deduct from sundry debtors]

13. *Provision for Discount on Creditors*

- Profit & Loss Accounts Credit Side
- Balance Sheet Liability side [Deduct from sundry creditors]

14. *Goods Distributed as free of samples*

- Trading Accounts Debit Side [Deduct Purchases]
- Profit & Loss Accounts Debit Side (treated as advertisement expenditure).

15. *Loss of Stock by fire*

(*a*) **If Insurance Company admitted the full claim**

Trading Account credit side (Total stock value destroyed by fire)

Balance Sheet Asset side (Insurance Company Accounts)

(*b*) **If Insurance Company admitted the part of the claim : (for example 60%)**

Trading Account credit side (Total stock value Destroyed by fire) (100%)

Profit and Loss Account Debit side (Loss by fire) (40%)

Balance Sheet Asset side (Insurance Company Account) (60%)

16. *Managers Commission*

In an organisation earn higher amount of profit it may given at certain percentage of commission on the net profit to their manager. It may calculated as follows :

$$\text{Commission Payable} = \frac{\text{\% of Commission}}{100 + \text{Rate of Commission}} \times \text{Residual Profit}$$

Treatment :

— Profit and Loss Account Debit Side.

— Balance Sheet Liabilities Side.

Illustration 5. *The following figures are available relating to the business of Shri Vel for the year 2019.*

	₹
Opening stock	25,000
Purchases	92,000
Direct expenses	4,000
Closing stock	29,600
Sales	1,38,000

Calculate (*i*) Cost of goods sold and (*ii*) Gross Profit.

Solution :

(*i*) Cost of goods sold = Opening stock + Purchases + Direct Expen − Closing Stock

= ₹ 25,000 + 92,000 + 4,000 − 29,600

= **₹ 91,400**

(*ii*) Gross Profit = Sales − Cost of goods sold

= 1,38,000 − 91,400

= ₹ 46,600

Illustration 7. *Prepare Trading Account from the following Balances :*

	₹
Opening stock	*80,000*
Purchases	*3,00,000*
Sales	*4,50,000*
Purchase Returns	*10,000*
Sales Returns	*20,000*
Wages	*5,000*
Carriage & Freight	*15,000*
Freight on purchases	*12,000*

Notes

Solution : **Trading Account**

Dr. *Cr.*

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Opening Stock		80,000	By Sales	4,50,000	
To Purchases	3,00,000		Less : Sales Returns	20,000	4,30,000
Less : Purchase Returns	10,000	2,90,000			
To Wages		5,000			
To Carriage & Freight		15,000			
To Freight on Purchase		12,000			
To Gross Profit		28,000			
		4,30,000			4,30,000

Illustration 7. *From the following balances extracted at the close of trading period ended on 31.3.2003, prepare profit and Loss Account as on that date.*

	₹		₹
Gross Profit	90,000	Discount Dr	1,000
Carriage outward	5,000	Apprentice Premium (cr)	3,000
Salaries	11,000	Advertisement	1,000
Rent & Taxes	4,000	Travelling expenses	750
Fire Insurance Premium	3,000	Sundry Trade expenses	500
Bad debts	2,500		

Solution : **Trading Account**

Dr. *Cr.*

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
To Carriage outwards		5,000	By Gross Profit		90,000
To Salaries		11,000	By Apprentice		
To Rent & Taxes		4,000	Premium		3,000
To Fire Insurance					
Premium		3,000			
To Bad Debts		2,500			
To Discount		1,000			
To Travelling Expenses		750			
To Sundry Trade					
Expenses		500			
To Advertisement		1,000			
To Net Profit		64,250			
		93,000			93,000

Illustrate 8. *From the following Trial balances of Mr. Gagunath for the year ending on 31.12.2019, prepare Final Accounts with the closing stock of ₹ 15,000.*

Particulars	*Debit* ₹	*Credit* ₹
Stock (1.1.2019)	*46,800*	-
Returns inwards	*10,000*	-
Purchases	*2,40,000*	-
Rents & Rates	*4,000*	-
Sales	-	*3,21,900*
Debenture	-	*25,000*
Reserve fund	-	*45,000*
Sundry Debtors	*60,000*	-
Salaries	*3,000*	-
Commission Received	-	*4,900*
Bad debts	*2,000*	-
Bad debts provision	-	*6,000*
Wages	*6,000*	-
Return outwards	-	*2,000*
Bills receivable	*25,000*	-
Investments	*60,000*	-
Sundry Creditors	-	*20,000*
Bank overdraft	-	*5,000*
Cash in hand	*11,000*	-
Goodwill	*26,000*	-
Capital	-	*63,000*
Furniture	*15,000*	-
General expenses	*2,000*	-
Discount (cr)	-	*18,000*
	5,10,800	*5,10,800*

Notes

Solution : Trading Account for the year ended 31.12.2003

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		46,000	By Sales		3,21,900
To Purchases	2,40,000		*Less :* Sales Returns		10,000
Less : Return Outwards	2,000	2,38,000			3,11,900
To Wages		6,000	By Closing Stock		15,000
To Gross Profit		36,100			
		3,26,900			3,26,900

Notes

Profit and Loss Account for the year ended 31.12.2003

Particulars	₹	₹	Particulars	₹	₹
To Rent & Rates		4,000	By Gross Profit		36,100
To Salaries		3,000	By Commission		
To Bad Debts		2,000	Received		4,900
To General Expenses		2,000	By Discount (Cr.)		18,000
To Net Profit		48,000			
		59,000			59,000

Balance Sheet as on 31.12.2003

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Capital		63,000	Sundry Debtors		60,000
Debenture		25,000	Bills Receivable		25,000
Reserve Fund		45,000	Investments		60,000
Bad Debts Provision		6,000	Cash in Hand		11,000
Sundry Creditors		20,000	Goodwill		26,000
Bank Overdraft		5,000	Furniture		15,000
Profit Loss A/c		48,000	Closing Stock		15,000
		2,12,000			2,12,000

***Illustrate* 9.** *The following balances are drawn from the books of M/s Arvind Mills as on 31.12.1997.*

Account	*Amount ₹*
Land	*1,00,000*
Building	*2,00,000*
Sales	*3,00,000*
Purchases	*1,75,000*
Sales returns	*10,000*
Purchase returns	*5,000*
Stock (1.1.97)	*25,000*
Debtors	*50,000*
Bank overdraft	*15,200*
Cash on hand	*5,000*
Creditors	*20,000*
Salaries	*10,000*
Wages	*12,000*
Goodwill	*15,000*
General Expenses	*5,000*
Selling expenses	*12,000*
Bad debts	*1,000*

Insurance *1,200*

Capital *2,81,000*

Notes

The following adjustments are to be made :

(*a*) Closing stock is ₹ 30,000.

(*b*) Provide depreciation at the rate of 10% on buildings.

(*c*) Write off further bad debts ₹ 1,000.

(*d*) Salaries yet to be paid ₹ 3,000.

(*e*) Insurance prepaid ₹ 300.

You are required to prepare a Trading and Profit and loss account and balance sheet of M/s Arvind Mills.

Solution : Trading Account of M/s. Arvind Mills for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		25,000	By Sales		3,00,000
To Purchases	1,75,000		(–) Sales Returns		10,000
(–) Purchase Returns	5,000	1,70,000			2,90,000
To Wages		12,000	By Closing Stock		30,000
To Gross Profit		1,13,000			
		3,20,000			3,20,000

Profit and Loss Account of M/s. Arvind Mills for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Salaries	10,000		By Gross Profit		1,13,000
(+) Outstanding	3,000	13,000			
To General Expenses		5,000			
To Selling Expenses		12,000			
To Bad Debts					
(1000 + 1000)		2,000			
To Insurance	1,200				
(–) Prepaid	300	900			
To Depreciation on					
Building 10%		20,000			
To Net Profit		60,100			
		1,13,000			1,13,000

Balance Sheet of M/s. Arvind Mills as on 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
Capital	2,81,000		Cash on Hand		5,000
(+) Net Profit	60,100	3,41,100	Land		1,00,000
Bank Overdraft		15,200	Building	2,00,000	
Creditors		20,000	(–) Depreciation	20,000	1,80,000

Outstanding Salary		3,000	Debtors	50,000	
			(–) Further Bad debts	1,000	49,000
			Goodwill		15,000
			Closing Stock		30,000
			Prepaid Insurance		300
		3,79,300			3,79,300

Illustration 10. *From the following Trial Balance and given information, you are requested to prepare Final Account for the year ended on 31.12.1997.*

Dr.	₹	Dr.	₹
Purchases	11,870	Capital	8,000
Debtors	7,580	Bad Debts recovered	250
Return inwards	450	Creditors	1,250
Bank Deposit	2,750	Return outwards	350
Rent	360	Bank Overdraft	1,570
Salaries	850	Sales	14,690
Travelling Expenses	300	Bills Payable	1,350
Cash	210		
Stock	2,450		
Discount allowed	40		
Drawings	600		
	27,460		27,460

The following adjustments are to be made:

(*a*) The closing stock on 31.12.2019 was ₹ 4,200.

(*b*) Write off ₹ 80 as bad debts and create a reserve for bad debts at 5% on sundry debtors.

(*c*) Three months rent is outstanding.

(*d*) Interest on Bank deposit ₹ 135 credited by the bankers and interest on overdraft ₹ 157 debited by them in the pass book have not been entered in the books.

Solution: Trading Account for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		2,450	By Sales	14,690	
To Purchases	11870		Less : Sales Returns	450	14,240
Less : Return Outwards	350	11,520			
			By Closing Stock		4,200
To Gross Profit		4,470			
		18,440			18,440

Profit and Loss Account for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Rent	360		By Gross Profit		4,470
(+) Outstanding (3x30)	90	450	By Bad Debts		250
			Recovered		
To Salaries		850	By Interest on Bank		
To Travelling Expenses		300	Deposit		135
To Discount Allowed		40			
To Bad Debts &		455			
Provisions (80 + 375)					
To Interest on Overdraft		157			
To Net Profit		2,603			
		4,855			4,855

Balance Sheet as on 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
Capital	8,000		Cash		210
(–) Drawings	600		Debtors	7,580	
	7,400		(–) Bad Debts	80	
(+) Net Profit	2,603	10,003		7,500	
			(–) New Reserve	375	7,125
Creditors		1,250			
Bank Overdraft	1,570		Bank Deposit	2,750	
+ Interest Outstanding	157	1,727	+ Outstanding Interest	135	2,885
Bills Payable		1,350	Closing Stock		4,200
Rent Outstanding		90	Prepaid Insurance		
		14,420			14,420

Note for bad debts :	Drs :	7,580
	(–) Bad Debts	80
BD + NR – OR		7,500
	(–) NR (7500 × 5/100)	375
80 + 375 – 0 = 455		7,125

Illustration 11. *Following are the balances extracted from the books of Mohammad as on 31st December 2019. Prepare Final Account as on the date.*

	₹		₹
Capital	20,000	Drawings	5,000
Cash on Hand	5,000	Cash at Bank	8,000
Buildings	20,000	Machinery	6,000

Notes

Notes

Stock on 01.01.2019	3,000	Sundry Debtors	8,000
Sundry Creditors	6,000	Repairs	400
Commission paid	700	Wages	1,700
Rent and Rates	300	Insurance Premium	300
Purchases	60,000	Sales	96,000
Purchases Returns	750	Sales Returns	400
Furniture & Fixtures	1,600	Carriage	200
Loan To Ram	1,000	Telephone Charges	250
Discount allowed	50	Salaries	600
Bad Debts	350	Discount earned	100

Solution : Trading Account of Mr. Mohammad for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		3,000	By Sales	96,000	
To Purchases	60,000		(–) Sales Returns	400	96,600
(–) Purchase Returns	750	59,250			
To Wages		1,700			
To Carriage		200			
To Gross Profit		31,450			
		95,600			95,600

Profit and Loss Account of Mr. Mohammad for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Repairs		400	By Gross Profit		31,450
To Commission Paid		700	By Discount earned		100
To Rent & Rates		300			
To Discount allowed		50			
To Bad Debts		350			
To Insurance Premium		300			
To Telephone Charges		250			
To Salaries		600			
To Net Profit		28,600			
		31,550			31,550

Balance Sheet of Mr. Mohammad as on 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
Capital	20,000		Cash on Hand		5,000
(–) Drawings	5,000	15,000	Cash at Bank		8,000
			Building		20,000
Sundry Creditors		6,000	Machinery		6,000

Net Profit		28,600	Sundry Debtors		8,000
(Profit & Loss A/c)			Furniture Fixtures		1,600
			Loan to Ram		1,000
		49,600			49,600

Notes

Illustration 12. *From the following trial balance extracted from the books of a merchant on 31.12.2019*

	₹		₹
Furniture and Fittings	640	Purchases	5,475
Motor vehicles	6,250	Sales	15,450
Buildings	7,500	Bank Overdraft	2,850
Capital Account	12,500	Sales Returns	200
Provision for Bad Debts	20	Purchase Returns	125
Bad debts	125	Advertising	450
Sundry creditors	3,800	Interest A/c (Dr.)	118
Sundry Creditors	2,680	Commission (Cr.)	375
Stock on 1.1.1998	3,460	Cash	650
General Insurance	782	Taxes & Insurance	1,250
Salaries	3,300		

The following adjustments are to be made :

(*a*) Closing stock was valued at ₹ 3250.

(*b*) Depreciate building @ 5%, furniture and fitting @ 10% and motor vehicle @ 20%.

(*c*) ₹ 85 is due for interest on Bank overdraft.

(*d*) Salaries ₹ 300 and Taxes ₹ 120 are outstanding.

(*e*) Insurance amounting to ₹ 100 is prepaid.

(*f*) One third of the commission received is in respect of work to be done next year.

(*g*) Write off further ₹ 100 as Bad debt and provision for bad debts is to be made equal to 5% on sundry Debtors.

Prepare Final Account for the year ended 31.12.2019.

Solution : Trading Account for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		3,460	By Sales	15,450	
To Purchases	5,475		(–) Sales Returns	200	15,250
(–) Purchase Returns	125	5,350			
			By Closing Stock		3,250
To Gross Profit		9,690			
		18,500			18,500

Notes

Profit and Loss Account of for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Salaries	3,300		By Gross Profit		9,690
(+) Outstanding	300	3,600	By Commission	375	
To Insurance	782		(–) Received in		
(–) Prepaid	100	682	Advance	125	250
To Advertising		450			
To Bad Debts provisions		390			
To Interest	118				
(+) Outstanding	85	203			
To Taxes & Insurance	1,250				
(+) Outstanding	120	1,370			
To Depreciation :					
Building	375				
Furniture & Fittings	64				
Motor Vehicle	1,250				
Net Profit	1,556				
	9,940				9,940

Balance Sheet of as on 31.12.2019

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
Capital	12,500		Cash		650
(+) Net Profit	1,556	14,056	Furniture & Fittings	640	
Sundry Creditors		2,680	(–) Depreciation	64	576
Bank Overdraft	2,850		Motor Vehicles	6,250	
(+) Interest Due	85	2,935	(–) Depreciation	1,250	5,000
			Buildings	7,500	
Outstanding Salary		300	(–) Depreciation	375	7,125
Outstanding Taxes			Sundry Debtors	3,800	
Insurance		120	(–) Bad Debts	100	
Commission received				3,700	
In advance		125	(–) Provision	185	3,515
			Closing Stock		3,250
			Prepaid Insurance		100
		20,216			20,216

NOTE : BD + NR – OR = 255 + 185 – 20 = 390.

Illustration 13. *From the following balance, prepare Final Account of Mr. Kumar for the year ended on 31.12.2019.*

	₹	₹
Capital Account		*60,000*
Plant & Machinery	*18,000*	
Depreciation on Plant & Machinery	*2,000*	
Repair to Plant	*1,600*	
Wages	*28,000*	
Salaries	*4,000*	
Income Tax	*500*	
Cash in hand	*2,000*	
Furniture	*24,500*	
Depreciation on Motor car	*2,500*	
Purchase Less returns (Adjusted)	*93,500*	
Sales		*2,49,000*
Bank Overdraft		*13,800*
Accrued Income	*1,500*	
Salaries outstanding		*2,000*
Bills Receivable	*30,000*	
Bills payable		*3,000*
Provisions for Bad debts		*6,000*
Bad debts	*1,000*	
Discount on Purchases		*4,000*
Sundry Debtors	*35,000*	
Sundry Creditors		*23,300*
Stock on Hand 01.01.2019	*37,000*	
Motor Car	*50,000*	
Stock on 31.12.2019	*30,000*	
	3,61,100	*3,61,100*

Write off ₹ 3,000 as bad debts and maintain a provision for bad debts at 5% Sundry Debtors.

Solution : Trading Account of Mr. Kumar for the year ended 31.12.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		37,000	By Sales		2,49,000
To Purchases (Adjusted)	93,500				
(–) Discount on Purchases	4,000	89,500			
To Wages		28,000			

To Gross Profit		94,500			
		2,49,000			2,49,000

Profit and Loss Account of Mr. Kumar for the year ended 31.12.2019

Notes

Particulars	₹	₹	Particulars	₹	₹
To Depreciation on			By Gross Profit		94,500
Plant & Machinery		2,000	By Bad Debts &		
To Repairs		1,600	Provisions		400
To Salaries		4,000			
To Depreciation on Motor Car		2,500			
To Net Profit		84,800			
		94,900			94,900

Balance Sheet of as on 31.12.2019

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
Capital Account	60,000		Plant & Machinery		18,000
(–) Income Tax	500	59,500	Cash in Hand		2,000
Bank overdraft		13,800	Furniture		24,500
			Accrued Income		1,500
Salaries Outstanding		2,000	Bills receivable		30,000
Bills Payable		3,000	Sundry Debtors	35,000	
Sundry Creditors		23,300	(–) Bad debts	3,000	
Profit & Loss Account		84,800		32,000	
			(–) New Reserve	1,600	30,400
			Motor Car		50,000
			Closing Stock		30,000
		1,86,400			1,86,400

NOTE :

BD + NR – OR	Debtors	35,000
$\left.\begin{matrix}1{,}000\\+\\3{,}000\end{matrix}\right\} + 1{,}600 - 6{,}000 = -400$	(–) Bad Debts	3,000
$= 5{,}600 - 6{,}000 = -400$		32,000

New Reserve = $32{,}000 \times \frac{5}{100} = \mathbf{1{,}600}$.

Illustration 14. *From the following balance extracted from the books of Shri Madhavan, prepare Final accounts for the year ended on 30th Sep. 1998 and a*

	₹		₹
Drawings	*6,480*	*Cash on Hand*	*850*
Land & Building	*25,000*	*Cast at bank*	*13,000*
Investments	*30,000*	*Capital Account*	*1,20,000*
Sundry Debtors	*37,800*	*Bad Debts provision*	*2,470*
Plant & Machinery	*14,270*	*Sales*	*91,230*
Furniture & Fixtures	*1,250*	*Discount Account*	*120*
Carriage Inwards	*4,370*	*Purchase Returns*	*8,460*
Wages	*21,470*	*Sundry Creditors*	*12,170*
Salaries	*4,670*	*Apprentice premium*	*500*
Bank Charges	*140*	*Sales Returns*	*1,760*
Coal Gas & Water	*720*		
Rates and Taxes	*840*		
Purchases	*42,160*		
Bills Receivable	*1,270*		
Trade Expenses	*1,990*		
Stock (01.10.2019)	*26,420*		
Fire Insurance	*490*		

Notes

The following adjustments are to be made :

(*a*) Charge Depreciation on land & building Account at 2½ % , plant and machinery at 10% , Furniture and fixtures at 10%.

(*b*) Make provision of 5% on Sundry Debtors for Doubtful Debts.

(*c*) Carry forward the unexpired amounts for fire insurance of ₹ 125, Rates and Taxes ₹ 240 and Apprentice premium ₹ 400.

(*d*) Charge 5% interest on capital and interest on Drawings is ₹ 300/-.

(*e*) The value of stock as on 30.09.2019 was ₹ 29,390/-.

(*f*) Outstanding wages are ₹ 530.

(*g*) Interest on investment ₹ 3,000 is accrued.

Solution : Trading Account of Mr. madhavan for the year ended 31.9.2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		26,420	By Sales	91,230	
To Purchases	42,160		(–) Sales Returns	1,760	89,470
(–) Purchase Returns	8,460	33,700	By Closing Stock		29,390
To Carriage inwards		4,370			
To Wages	21,470				
(+) Outstanding	530	22,000			
To Coal, Gas and Water		720			
To Gross Profit		31,650			
		1,18,860			1,18,860

Notes

Profit and Loss Account of Mr. Madhavan for the year ended 31.9.2019

Particulars	₹	₹	Particulars	₹	₹
To Salaries		4,670	By Gross Profit		31,650
To Bank Charges		140	By Discount		120
To Rate and Taxes	840		By Apprentice		
(–) Prepaid	240	600	Premium	500	
To Trade Expenses		1,990	(–) Received in		
To Fire Insurance	490		Advance	400	100
(–) Prepaid	125	365			
To Depreciation :			By Bad Debts		
Land & Building 2½%		625	Provision	2,470	
Plant & Machinery 10%		1,427	(–) New Provision	1,890	580
Furniture & Fixtures 10%		125			
To Interest on Capital		6,000	By Interest on		
To Net Profit			Drawings		300
(Transferred to Capital A/c)		19,800	Investments		3,000
		35,750			35,750

Balance Sheet of Mr. Madhavan as on 31.09.2019

Particulars	Amount ₹	Amount ₹	Particulars	Amount ₹	Amount ₹
Capital		1,20,000	Cash in Hand		850
(+) Net Profit		19,808	Cash at bank		13,000
Interest on Capital		6,000	Bills Receivables		1,270
		1,45,808	Sundry Debtors	37,800	
(–) Drawings	6,480		(–) Provision for		
(+) Interest on			Bad Debts	1,890	35,910
Drawings	300	6,780	Investments		30,000
		1,39,028			
Sundry Creditors		12,170	Accrued Interest		3,000
Apprentice premium			Prepaid Insurance		125
Received in Advance		400	Prepaid Rates & Taxes		240
Outstanding Wages		530	Land & Building	25,000	
			(–) Depreciation	625	24,375
			Plant & Machinery	14,270	
			(–) Depreciation	1,427	12,843
			Furniture & Fixtures	1,250	
			(–) Depreciation	125	1,125

			Closing stock		29,390
		1,52,128			1,52,128

NOTE : BD + NR – OR = 0 + 1890 – 2470 = – 580.

Notes

Illustration 15. *From the following Ledger Balances extracted at the close of trading year ended 31st March 2019. Prepare Trading and Profit and Loss account and Balance Sheet at that date, after giving effect to the under mentioned adjustments:*

	₹		₹
Capital on 1-4-2018	*50,000*	*Business Premises*	*55,000*
Stock on 1-4-2018	*8,000*	*Furniture and Fixtures*	*2,500*
Purchase	*20,000*	*Bills Receivable*	*3,500*
Sales	*80,000*	*Bills Payable*	*2,500*
Return Inwards	*1,500*	*Sundry Creditors*	*15,800*
Return Outwards	*400*	*Packing Machinery*	*4,500*
Wages	*6,900*	*Smith's Loan (Dr) @*	
Advertisement	*5,500*	*10% on 1-4-2018*	*5,000*
Apprenticeship Premium	*1,200*	*Investment*	*3,000*
Interest on Smith's Loan	*300*	*Cash-in-Hand*	*250*
Proprietor's Withdrawals	*3,000*	*Cash-at-Bank*	*3,500*
Office Expenses	*8,050*	*Sundry Debtors*	*20,000*

Adjustments to be made for the current period are :

(1) Stock-in-hand at 31st March 2008 ₹ 7,000; (2) Apprenticeship premium is for three years, paid advance on 1st April, 2018; (3) Interest on Capital to be allowed at 5% for the year; (4) Interest on Drawings to be charged to him as ascertained for the year ₹ 80; (5) ₹ 5,000 out of the Advertisement expenses are to be carried forward; (6) Stock valued at ₹ 3,000 destroyed by the fire on 25-3-2019 but the insurance company admitted a claim of ₹ 2,000 only and paid it in April 2019; (7) The manager is entitled to a commission of 10% of the Net profit calculated after charging such commission; (8) Included in sales is an amount of ₹ 10,000 representing goods on "sales or return". The customer still having the right to return the goods. The goods were invoiced charging a profit of 20% on sales; (9) The stock included material worth ₹ 1,000 for which bills had not been received and therefore, not yet accounted for.

Solution : Trading and Profit and Loss Account For the year ended 31st March 2019

Particulars	₹	₹	Particulars	₹	₹
To Opening Stock		8,000	By Sales	80,000	
To Purchases	20,000		Less : Sales Returns	1,500	
Less : Return	400			78,500	
	19,600		Less : Goods Sold on		
Add : Material not			Return Basis	10,000	68,500

Notes

accounted for	1000	20,600	By closing stock	7,000	
To Wages		6,900	*Add :* Stock lying with		
To Gross profit c/d		51,000	customers sold on		
			return basis	8,000	15,000
			By Loss of stock by fire		3,000
		86,500			86,500
To Interest on capital		2,500	By Gross profit b/d		51,000
To Advertisement	5,500		By Apprentice Premium	1,200	
Less : Carried Forward	5,000	500	*Less :* Received in advance	800	400
To Loss of stock by fire		1,000	By Interest on drawings		80
To Office expenses		8,050	By Interest on Smith's loan	300	
		12,050	*Add :* Accrued Interest	200	500
To Managers's commission					
1/11 of ₹ 39,930 *i.e.,*					
(51980-12,050))		3,630			
To Net profit transferred to					
capital account		36,300			
		51,980			51,980

Balance Sheet of as on 31.04.2019

Liabilities	Amount ₹	Amount ₹	Assets	Amount ₹	Amount ₹
Sundry creditors	15,800		Cash in Hand		250
Add : Purchase of material			Cash at bank		3,500
not accounted for	1,000	16,800	Investment		3,000
Bills payable		2,500	Sundry debtors	20,000	
Apprentice premium received in advance		800	Less : Goods sold on return basis	10,000	10,000
Manager's commission due		3,630	Insurance company A/c		2,000
Capital	50,000		Closing stock (7,000 + 8,000)		15,000
Add : Interest	2,500		Bills receivable		3,500
Add : Net profit	36,300		Smith's loan	5,000	
	88,800		*Add :* Accrued interest	200	5,200
Less : Drawings and			Packing Machinery		4,500
Interest	3,080	85,20	Furniture and Fittings		2,500
			Business Premises	625	55,000
			Advertisement (carried forward)		5,000
		1,09,450			1,09,450

Illustration 24. *The following is the Trial Balance of Mr. Nandhu as on 31.12.2007. Prepare a Trading and Profit and Loss A/c for the year 2007 and Balance Sheet as at 31-12-2007 from it.*

	***Debit* (₹)**	***Credit* (₹)**
Purchases	*2,80,000*	
Opening Stock	*10,000*	
Salaries less P. F	*5,400*	
P.F. remittance including Proprietor's contribution @ 50%	*1,200*	
Rent @ ₹ 250 P.M.	*2,750*	
Machinery	*29,000*	
Wages	*3,000*	
Furniture and Fittings	*5,000*	
Electricity	*550*	
Trade Expenses	*1,500*	
Debtors	*10,500*	
Interest on Loan	*900*	
Commission	*200*	
Buildings	*30,000*	
Sales		*3,05,000*
Loan (10% Interest)		*10,000*
Creditors		*15,000*
Capital		*55,000*
Drawings	*5,000*	
	3,85,000	*3,85,000*

On 1.1.2007 Machinery worth ₹ 5,000 was sold for ₹ 4,000 and credited to machinery account. Wages include ₹ 1,000 paid for machinery erection charges. Purchases included cost of Scooter for ₹ 5,000. Proprietor has taken goods costing ₹ 1,000 for which no entry has been made. Sundry debtors include ₹ 500 which have become bad. Provide 10% for bad debts. Electricity bill is outstanding ₹ 50. Goods costing ₹ 5,000 were destroyed by fire, and insurance claim was received for ₹ 4,000. Provide depreciation at 10% on machinery, furniture and moped. Provide depreciation @ 5% on buildings. Closing stock is ₹ 12,000.

Solution : Trading and Profit and Loss A/c Mr. Nandhu

For the year ended 31st March Dec. 2019

		₹		₹
To Opening stock		10,000	By Sales	3,05,000
To Purchases	2,80,000		By Goods destroyed by fire	5,000
Less : Cost of Scooter	5,000		By Closing stock	12,000
	2,75,000			

Notes

Less : Goods taken away				
by the Proprietor	1,000	2,74,000		
To Wages	3,000			
Less : Transferred to				
Machinery A/c	1,000	2,000		
To Gross profit c/d		36,000		
		3,22,000		3,22,000
To salaries	5,400		By Gross Profit b/d	36,000
Add : Provident Fund				
(50% of ₹ 1,200)	600	6,000		
To Employer's contribution to provident fund	600			
To Rent	2,750			
Add : Rent outstanding	250	3,000		
To Electricity	550			
Add : Outstanding	50	600		
To Trade expenses		1,500		
To Interest on loan	900			
Add : Outstanding	100	1,000		
To Commission		200		
To Bad debts	500			
Add : Provision for bad debts (10% of ₹ 10,000)	1,000	1,500		
To Loss of stock of fire		1,000		
To Depreciation on machinery	1,000			
To Loss on sale of machinery	1,000			
To Depreciation on machinery	2,900			
To Depreciation on Building	1,500			
To Depreciation on Moped	500			
To Depreciation on furniture	500			
To Net profit transferred to Capital Account	14,200			
	36,000			36,000

Balance Sheet as on 31st December 2007

		₹			₹
Creditors		15,000	Bank (Insurance Claim)		4,000
Loan	10,000		Debtors	10,500	
Add : Outstanding interest	100	10,100	*Less :* Bad debts	500	
Rent outstanding		250		10,000	
Electricity outstanding		50	*Less :* Provision for bad debts	1,000	9,000
Capital	55,000		Closing stock		12,000
Add : Net profit	14,200				
	69,200		Furniture	5,000	

			Less : Depreciation	500	4,500
(5,000 flat)	6,000	63,200	Scooter	5,000	
			Less : Depreciation	500	4,500
			Machinery	29,000	
			Add : Erection charges	1,000	
				30,000	
			Less : Loss on sale	1,000	
				29,000	
			Less : Depreciation	2,900	26,100
			Buildings	30,000	
			Less : Depreciation	1,500	28,500
		88,600			88,600

Notes

Illustration 25. *From the following Trial Balance of Mr. Subith prepare Profit and Loss A/c for the year 2007 and Balance Sheet as on 31.12.2007 after giving effect to the under mentioned adjustments.*

Debit Balance :

	₹		₹
Drawings	*3,250*	*Bad Debts*	*400*
Stock (1,1,2007)	*17,445*	*Patents*	*500*
Return Inwards	*554*	*Cash*	*62*
Carriage Inwards	*1,240*	*Discount Allowed*	*330*
Deposit with Anand Gupta	*1,375*	*Wages*	*754*
Carriage outwards	*725*	***Credit Balances :***	
Loan to Ashok @ 5%		*Capital*	*15,000*
giving on 1.1.2007	*1,000*	*Interest on loan to Ashok*	*25*
Rent	*820*	*Rent outstanding*	*130*
Purchases	*19,970*	*Creditors*	*3,000*
Goodwill	*1,730*	*Provision for Doubtful Debts*	*1,200*
Advertisement Expenses	*954*	*Sales*	*27,914*
Debtors	*4,000*	*Return*	*840*

Adjustments :

(1) The Manager of Mr. Subith is entitled to Commission 10% of the Net Profit calculated after charging such commission. (2) Increase Bad Debts by ₹ 600. Make Provision for Doubtful Debts @ 10% and provision for Discount on Debtors 5%. (3) Stock valued at ₹ 1,500 destroyed by fire on 25.12.2007 but the insurance co. admitted a claim for ₹ 950 only and paid it in 2008. (4) ₹ 200 out of the advertisement expenses are to be carried forward to the next year. (5) The value of Closing Stock is ₹ 18,792.

Solution : Trading and Profit and Loss A/c of Shri Subith

Notes

For the year ended 31st December 2007

		₹			₹
To Opening stock		17,445	By Sales	27,914	
To Purchases	12,970		*Less :* Returns	554	27,360
Less : Returns	840	12,130	By Stock in Trade [closing stock]		18,792
To Wages		754	By Stock destroyed by fire		1,500
To Carriage Inwards		1,240			
To Gross profit c/d		16,083			
		47,652			47,652
To Rent		820	By Gross profit b/d		16,083
To Advertisement exp	954		By Interest on Loan	25	
Less : Prepaid	200	754	*Add :* Accrued interest	25	50
To Bad Debts	400				
Add : Additional bad debts	600				
Add : New provision	340				
	1,340				
Less : Old provision	1,200	140			
To Loss on stock by fire		550			
To Carriage outwards		725			
To Discount		330			
To Provision for Discount on Debtors		153			
To Commission to Manager					
$\left(\frac{10}{100}/\text{Rs. } 12,661\right)$	1,151				
To Net Profit transferred to Capita A/c	11,510				
	16,133				16,133

Balance Sheet of Shri Subith

As on 31st December 2007

Liabilities		₹	*Assets*		₹
Outstanding rent		130	Cash		62
Commission payable to Manager		1,151	Deposit with Anand Gupta		1,375
Creditors		3,000	Loan to Ashok		1,000
Capital	15,000		Interest accrued thereon		25
Add : Net profit	11,510		Insurance company		950
	26,510		Debtors	4,000	
Less : Drawings	3,250	23,260	Less : Further bad debts	600	
				3,400	
			Less : Provision for bad debts	340	
				3,060	

			Less : Provision for discount on debts	153	2,907
			Stock		18,792
			Prepaid advertisement		200
			Plant and patents		500
			Goodwill		1,730
		27,541			27,541

Notes

2.9. Profit and Loss Account

Meaning

The income statement prepared with the items of expenses, losses, income and gain with a view to ascertain the amount of Net Profit or Loss in the business is known as Profit and Loss Account.

Need/Purpose and Importance of Profit and Loss Account

1. **Knowledge of net profit or net loss.** The purpose of preparing profit and loss account is to ascertain the amount of net profit or loss This is the actual profit available to the proprietor and credited to his capital account. In case of net loss proprietor's capital account will be debited. The net profit is calculated after charging all indirect expenses.
2. **Ascertaining ratio between net profit and net sales.** We get net profit from profit and loss account. This net profit is matched with the net sales to calculate net profit ratio. This ratio is compared with the desired net profit ratio and if there is any short coming, that will be removed. This ratio can also be compared with the ratio of previous years and effective future line of action can be taken.
3. **Calculation of expenses ratio to sales.** Expenses ratio to sales is calculated. We can calculate individual expenses to sales ratio and compare it with desired expenses ratio and with the ratio of previous years. It will always be in the interest of the firm that the expenses ratio should be the minimum.
4. **Comparison of actual performance with desired performance.** The actual performance of the business is available with the profit and loss account as regards net profit, individual expenses and individual income. We compare our actual performance with our planned and desired performance, identify weaknesses and try to remove them.
5. **Maintaining provision and reserves.** We have to maintain certain reserves and provision to meet our future uncertainties. The amount of provisions, reserves and funds to be maintained depends upon net profit earned by the firm. It is necessary to prepare profit and loss account to determine the net profit, so that effective provision for uncertain future cold be maintained.

Notes

Proforma
Profit and Loss Account
for the year ending ......

Expenses/Losses	*Amount* ₹	*Revenue/Gain*	*Amount* ₹
To Gross loss–transferred from trading A/c (If any)		By Gross profit transferred from trading A/c	
To Salaries *Or* Salaries and wages		By Interest received	
To Rent, rates and taxes or office rent		Or	
To Godown rent or storage or ware-housing		Interest (credit)	
		Or	
To Office expenses or establishment		Interest on Investment	
To Miscellaneous, or sundry expenses		Or	
To Insurance		Interest on fixed deposit	
To Stationery		Or	
To Printing and stationery		Interest on Loans and advanced	
To Staff Welfare Expenses		Or	
To Lighting		By Rent received	
To Water and Electricity		Or	
To Establishment expenses		Rent (credit)	
To Postage and telegrams		Or	
To E-mail and Fax charges		Rent form tenant	
To Courier Services charges		By Discount received	
To Telephone expenses		Or	
To Law charges or law cost or litigation expenses or legal charges		Discount (credit)	
To Repairs and renewal or Maintenance or upkeep		By Commission received	
To Distribution expenses		By Dividends Received	
To Travelling expenses/Conveyance		By Profit from sale of assets	
To General expenses		By Refund of tax	
To Stable expenses		By Compensation received	
To Selling expenses		By Apprenticeship premium	
To Carriage or freight Outward		By Difference in exchange (credit)	
To Carriage on sales		By Interest on drawings	
To Indirect or unproductive wages		By Discount on creditors	
To Audit fee		By Bad debts recovered	
To Entertainment expenses		By Miscellaneous receipts	
To Interest paid or interest (debit) or interest on overdraft or interest on loans borrowed		By Appreciation or increase in the value of assets	
To Discount allowed or discount on debtors		By Income from Investment	

To Bad debts or Bad debts written off		By Reserve for bad and doubtful debts (old reserve–if not treated at the debit side of P/L A/c)	
To Reserve or provision for bad and doubtful debts (New reserve–in adjustment)		By *Net loss*–Transferred to Capital	
To Depreciation		A/c (If debit side exceeds credit side)	
To Interest on Capital		–Balancing figure	
To Discounting charges			
To Bank charges or Collection charges			
To Export charges			
To Trade expenses			
To Administrative expenses			
To Financial expenses			
To Commission paid			
To Advertisement			
To Charity and Donation			
To Sample expenses			
To Licence fee			
To Delivery charges			
To Brokerage			
To Sales tax paid			
To Loss on sale of assets			
To Loss by fire/theft/accident			
To Upkeep or Maintenance of assets			
To Commission			
To Net Profit–Transferred to Capital A/c (If credit side exceeds debit side–Balancing Figure)			

Illustration 4. *Prepare Profit and Loss A/c from the following information :*

	₹		₹
Carriage on Purchase	*2,000*	*Salaries-factory's manager*	*2,200*
Carriage on Sales	*1,000*	*Office manager*	*1,500*
Duty on Exports	*2020*	*Gross Profit*	*15,200*
Lighting	*1,050*	*Rent received*	*1,500*
Water and electricity	*2,120*	*Rent paid*	*500*
Advertisement	*100*	*Commission (Cr.)*	*1,200*

Solution.

Notes

Profit & Loss A/c

Expenses/Losses	*Amount*	*Revenue/Gain*	*Amount*
To carriage on sales	1,000	By Gross Profit	15,200
To Duty on Exports	2,020	By Rent received	1,500
To Lighting	1,050	By Commission	1,200
To Water and electricity	2,120		
To Advertisement	100		
To Salaries–Office	1,500		
To Rent paid	500		
To Net Profit transferred to Capital A/c			

Illustration 5. From the following Trial balance of Shri Ram & Sons, prepare the Trading and profit and loss account for the year ended 31st March, 2002.

Trial Balance
as on 31st March, 2002

Name of Account	*Debit*	*Credit*
	₹	₹
Ram's Capital		*29,000*
Ram's Drawings	*760*	
Purchases and Sales	*8,900*	*15,000*
Sales and Purchases Return	*280*	*450*
Stock (1-4-2001)	*1,200*	
Wages	*800*	
Building	*22,000*	
Freight and Carriage	*2,000*	
Trade Expenses	*200*	
Advertisement	*240*	
Interest		*350*
Taxed and Insurance	*130*	
Debtors and Creditors	*6,500*	*1,200*
Bills Receivable and Bills Payable	*1,500*	*700*
Cash at bank	*1,200*	
Cash in hand	*190*	
Salaries	*800*	
	46,700	*46,700*

Adjustments. (i) Stock on 31st March, 2002 valued at Rs. 1,500

Solution.

Trading and Profit and Loss Account of Sri Ram & Sons

for the year ended 31st March, 2002

Expenses/Losses		*Amount*	*Revenue/Gain*		*Amount*
To Stock (1-4-2001)		1,200	By Sales	15,000	
To Purchases	8,900		*Less :* Returns	280	14,720
Less : Returns	450	8,450	By Closing Stock		1,500
To Wages		800			
To Freight & Carriage		2,000			
To Gross Profit c/d		3,770			
		16,220			16,200
To Trade Expenses		200	By Gross Profit b/d		3,770
To Advertisement		240	By Interest		350
To Taxes and Insurance		130			
To Salaries		800			
To Net Profit transferred to Capital A/c		2,750			
		4,120			4,120

Notes

Explanation. Purchases and sales have been given under one head purchases have debit balance, so ₹ 8,900 Placed at the debit side of Trial balance is purchases and ₹ 15,000 will be the amount of sales, because it is given at the credit side of Trial balance (sales have credit balance) sales and purchases return have also been given under one head. Purchases return shows credit balance and sales return shows debit balance. This is why, ₹ 280 represents sales return and ₹ 450 is purchases return.

2.10. Balance Sheet

Meaning

Balance sheet is a mirror which reflects the true position of assets and liabilities on a particular date. Trading and profit and loss account shows gross profit or gross loss and net profit or net loss respectively. These accounts deal with expenses, income and receipts, *i.e.,* revenue receipts and payment. The firm also makes certain capital expenditure and gets capital receipts. It owns certain assets and also certain liabilities. These assets and liabilities show that the financial position of the firm. This is why, Balance sheet is also known as position statement. We adopt double entry system of accounting, where every debit has got its corresponding credit. According to our accounting equation also :

Assets = Liabilities + Capital.

It means that the total of the assets side of Balance sheet must be equal to the total of liabilities. Liabilities consists of creditors equity (liability) and proprietor's equity. In other words, creditors and proprietor's claim against the firm must be equal to its assets. If assets and liabilities of Balance sheet do not tally, there is definitely certain mistake. According to *freeman "A Balance sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date".*

Balance sheet is the position statement which shows the position of assets and liabilities. It has got the following special features :

1. **Balance sheet is a statement.** Though Balance sheet is an integral part of double entry system, but it is not an account. It has got the balance of certain ledger accounts. The balance of all ledger accounts are not shown in it.
2. **Prepared on a specified date.** Balance Sheet is prepared on a specific date, *i.e.,* at the end of accounting period. It is common practice and also legal requirement to prepare Balance sheet together with Trading and profit and loss account at the end of the accounting year. It may be prepared after every six months is if the proprietors so desire. Accounting year may consist of calender year or assessment year or its own accounting year. Companies are required to adopt assessment year (April 1 to 31st March) as per legal requirement. Sole proprietorship and partnership can adopt accounting year which suits them, i.e., Diwali or Dussehra to Dussehra or assessment or calender year.
3. **It is a statement of assets and liabilities.** Though the Balance sheet has debit and credit balance but its sides are named as assets and liabilities. The left hand side is a liability representing credit balance. Right hand side is assets representing debit balances.
4. **Knowledge about the nature of assets and liabilities.** Balance sheet categorise assets as liquid assets, current assets, fixed assets and fictitious assets. Knowledge of liabilities as current liabilities, fixed liabilities and funds can be gained from Balance sheet.
5. **Knowledge of financial position.** Balance sheet depicts true financial position of the business. The position can be ascertained by study of the Balance sheet. We can calculate short-term and long-term financial ratios, proprietary and other ratios to have the knowledge of the financial soundness of the business.
6. **Assets and liabilities tally each other.** The total of assets must be equal to liabilities. According to accounting equation, assets are always equal to creditors, and proprietor's equity. If the total of assets and liabilities are not equal, there is likely to be certain mistake.

Need and Purpose of Balance Sheet

Balance sheet is a vital part of final account. It has to be compulsorily prepared as per legal provisions. Objects of the Balance sheet have been summarised as under:

Main objectives of Balance Sheet

The main object of Balance sheet is to assess the financial position of the firm. It is the list of assets and liabilities of the firm on a specific date. The short-term and long-term financial position of the firm can be obtained from the analysis of the Balance sheet.

Balance sheet is rightly said to be a mirror reflecting the true value of assets and liabilities on a particular date.

Difference between profit and loss accounts (Income Statement) and Balance sheet (Position Statement).

Income statement (Trading and profit and loss account) and position statements (Balance sheet) can be differentiated as under:

Notes

Points of Difference	Profit and Loss Account	Balance Sheet
1. Types of account	Only nominal accounts are entered in profit and loss account	It records personal and real accounts.
2. Objective	The objective of preparing profit and loss account is to ascertain the net profit or loss of the business.	The purpose of preparing balance sheet is to understand the financial position of the firm.
3. Sides	The left hand side of the profit and loss account is the debit and the right hand side is credit	Balance sheet is not an account, it is a statement. We do not use 'To' or 'By' in it.
4. Nature	Profit and loss account is an account. We use the wort 'To' before accounts at the debit side and 'By' at the credit side.	Balance sheet is not an account, it is a statement. We do not use 'To' or 'By' in it.
5. Balancing figure	The balancing figure of the profit and loss account is either net profit or net loss. Excess of credit side is net profit and the excess of debit side is net loss.	It does not show any balancing figure. The total of assets and liabilities are always equal.
6. Specific date/ period	Profit and loss account show the position of the accounting period, generally a year.	Balance sheet shows the position of assets and liabilities on a particular date
7. Types of expenditure	Revenue expenditures are recorded in the profit and loss account.	Capital expenditures are entered at the assets side of the Balance Sheet.

Preforms

Balance Sheet as on.....

Liabilities		₹	*Assets*		₹
Current Liabilities			**Current Assets**		
Creditors			Cash in hand		
Bills payable			Cash at bank		
Bank overdraft			Debtors or sundry Debtors or book debts		
Outstanding expenses			Stock or inventory		

Notes

Income received in advance			Goods sent on consignment		
Short-term loans			Bills or Notes Receivable		
Fixed Liabilities			Short-term or Trade		
Loan			Investment		
Mortgage			Prepaid expenses		
Loan from financial institution			Accrued income		
Debentures					
Capital			**Investments**		
Add : Net Profit			Details of investment:		
Add : Interest on capital (if in adjustment)			Long-term investment		
Add : Remuneration, i.e., salaries, commission, fee payable to proprietors (if in adjustment)			Loans granted		
Less : Drawings			**Fixed Assets**		
Less : Interest on drawings			Land and building		
Less : Net loss			*Or*		
Less : Income tax			Freehold premises Machinery		
Reserves and Funds			*Or*		
General reserve			Plant and Machinery Equipments		
Reserve funds			*Or*		
Contingency reserve			Tools and Equipments or loose tools		
Provident fund			Furniture or Fixtures		
Employees compensation fund			*Or*		
Provision for taxation			Furniture and fittings		
			Fixtures and fittings		
			Vehicles—truck, car, vans, tempo, scooter, cycle etc.		
			Horses and carts		
			Live-stock (animals)		
			Goodwill		
			Patents and Trade Mark		
			Miscellaneous Expenses		
			Advertising suspense		
			Discount on issue of shares		
			Discount on issue of debentures		

2.11. Review Questions

1. Distinguish between accountancy, accounting and book-keeping.
2. Write a short on the following:
   (*i*) Assets (*ii*) Capital (*iii*) Business Transaction
3. What is the matching principle? Why should this principle be followed by the business entity?

4. What do you mean by accounting concepts? Explain the following concepts:
   (*a*) Accounting period concept (*b*) Going concern concept
   (*c*) Historical cost concept.

5. Explain the meaning and significance of the following:
   (*a*) Modifying principles of full disclosure
   (*b*) Revenue realisation concept
   (*c*) Dual concept
   (*d*) Principle of matching revenue with cost.
6. What do you mean by 'Double Entry System' of Book-Keeping? Explain it clearly. Enumerate its advantages and disadvantages.
7. Explain the rules of debit and credit in regards to the expenses and income with two examples each.
8. What are the different types of accounts? Explain with examples their rules of debit and credit.
9. Explain the following terms:
   (*a*) Opening journal entry (*b*) Compound journal entry
   (*c*) Narration (*c*) Ledger folio

A. Very Short Answer Type Questions:

1. How will you show the following items:
   (*i*) Drawing; (*ii*) Returns Inward (Bills returned); (*iii*) Returns outward.
2. Mention the stages of Final Accounts.
3. How will you treat expenses on acquiring goods?
4. Where will you show goods in transit A/c?
5. Give any two difference between Profit & Loss A/c and a Balance sheet.

B. Short Answer Type Questions:

1. Point out any three pints of difference between Profit and Loss Account and Balance Sheet.
2. Mention the two formulae (except the preparation of trading Account) for the calculation of Gross Profit.
3. Explain briefly the object of Trading Account.
4. Describe briefly three objectives of preparing Profit and Loss A/c.
5. Explain briefly the two characteristics of position statement.

C. Long Answer Type Questions:

1. What do you mean by Final accounts? What are its constituents? Name them and briefly explain the purpose of each of them.
2. Explain the importance and purpose of final accounts.
3. Explain : (*a*) Current assets ; (*b*) Current liabilities; and (c) Working capital

4. Explain the following statements:
   (*a*) Balance sheet is not an account but it is the list of assets and liabilities.
   (*b*) Balance sheet and profit and loss account are inter-dependent.

Notes

2.12. Test Problems

1. Pass the opening journal entry with the following information:

(*a*)	Cash in hand	5,000	(*b*)	Debtors	15,000
(*c*)	Closing stock	20,000	(*d*)	Furniture	3,000
(*e*)	Building	40,000	(*f*)	Creditors	12,000
(*g*)	Bank overdraft	8,000	(*h*)	Capital	63,000

2. Ascertain goodwill with the following information and pass the opening journal entry:

(*a*)	Capital	1,00,000	(*b*)	Creditors	20,000
(*c*)	Bank overdraft	10,000	(*d*)	Building	50,000
(*e*)	Cash	5,000	(*f*)	Debtors	15,000
(*g*)	Closing stock	25,000	(*h*)	Furniture	12,000

[**Ans.** ₹ 23,000]

3. Calculate closing stock the following information :

(*a*)	Opening Stock	20,000	(*b*)	Purchases	60,000
(*c*)	Sales	1,50,000	(*d*)	Wages	16,000
(*e*)	Carriage	14,000	(*f*)	Fuel	10,000
(*g*)	Gross Profit	37,000			

[**Ans.** ₹ 7,000]

4. Pass the necessary journal entries with the following information

2007

Jan. 1	Started business with cash	20,000
Jan. 3	Deposited into bank	10,000
Jan. 5	Purchased machinery for cash	5,000
Jan. 9	Purchased goods from C. & W. Ltd. at the list price of ₹ 5,000 The allowed 5% trade discount. Payment made by cheque.	
Jan. 11	Paid for electric charges	35
Jan. 11	Paid rent for January, 2007	125
Jan. 11	Stationery purchased	65
Jan. 11	Drew for private use	100
	(Payment in all cases made by cheque)	
Jan. 20	Sold goods to M/s Roy & Co	3,500
Jan. 26	Paid rent for next three months up to April, 1999..	375
Jan. 28	Received a cheque from M/s Roy & Co. for ₹ 3,275 in full settlement and sent the cheque to bank	

Jan. 29	Cheque of M/s Roy & Co. dishonoured	
Jan. 30	Salaries due to Clerk..	125
Jan. 31	Received a new cheque from M/s Roy & Co. of ₹ 3,275	
Jan. 31	Interest on capital	15

Notes

5. From the following Trail Balance of Mrs. Arun for the period of 31.3.2009.

Particulars	Debit (₹)	Credit (₹)
Capital	–	2,50,000
Machinery	1,60,000	–
Furniture	65,000	–
Sundry Creditors	–	74,000
Sundry Debtors	71,000	–
Bills Payable	–	10,000
Bills Receivable	30,000	–
Stock	61,000	–
Purchases	1,22,000	–
Sales	–	2,73,000
Bad Debts	2,000	–
Wages	3,000	???
Salaries & Wages	2,000	–
Land & Buildings	66,000	–
Investments	70,000	–
Commission (Cr)	–	5,000
Cash in Hand	2,500	–
Cash at Bank	7,000	–
Bank Overdraft	–	25,000
Loan from Ramu @ 10% Interest	1,00,000	–
Interest Paid on above	5,000	–
Drawings	6,000	–
Manufacturing Expenses	2,000	–
Insurance	3,900	–
Trade Expenses	2,000	–
Advertisement	4,500	–
Goodwill	60,000	–
Carriage Inwards	2,900	–
Carriage Outwards	6,500	–
Returns	3,000	2,000
Interest (Cr)	–	4,500
Debentures	–	52,300
	8,57,300	**8,57,300**

Notes

The following adjustment are to be considered:

(*i*) The closing stock was valued at ₹ 52,000.

(*ii*) Wages due but not paid ₹ 1,000.

(*iii*) Insurance prepaid ₹ 900.

(*iv*) Commission earned but not received ₹ 600.

(*v*) Write off further bad debts ₹ 1,000 and create a reserve for bad debts @ 5% on sundry debtors.

(*vi*) Provide discount @ 2½ on sundry debtors.

(*vii*) Allow discount @ 5% on sundry creditors.

(*viii*) Allow interest on capital @ 10%.

(*ix*) Charge interest on drawings ₹ 1,000.

(*x*) Charge depreciation on machinery at 5% and furniture 10%.

(*xi*) Interest on investment ₹ 2,500 is accorded.

(*xii*) Stock valued at ₹ 5,000 destroyed by fire on 25.3.2009, but the insurance company admitted only 80% of the claim and paid it on April 2009.

[**Ans.** Gross Profit: ₹ 1,37,100, Net Profit: ₹ 82,273, B/S Total: ₹ 5,70,873]

6. The following is the trial balance of M/s Krishna Agencies as on 31st March, 2009. Prepare Trading and Profit and Loss account for the year ended 31.3.2009 and a Balance Sheet on that date.

Particulars	**Debit (₹)**	**Credit (₹)**
Capital	–	1,00,000
Drawings	18,000	–
Buildings	15,000	–
Furniture and Fittings	7,500	–
Motor van	25,000	–
Loan from Hari @ 12% interest (1.4.2008)	–	15,000
Interest paid on above	900	–
Sales	–	1,00,000
Purchases	75,000	–
Opening stock	25,000	–
Establishment expenses	15,000	–
Wages	2,000	–
Insurance	1,000	–
Commission received	–	4,500
Sundry debtors	25,100	–
Bank balance	20,000	–
Sundry creditors	–	10,000

Interest	–	3,000
	2,32,500	2,32,500

Notes

Adjustments:

(*i*) The value of closing stock on 31st March, 2009 was ₹ 32,000.

(*ii*) Outstanding wages ₹ 500.

(*iii*) Prepaid insurance ₹ 300.

(*iv*) Commission received in advance ₹ 1,300.

(*v*) Depreciate: Building 2½%, Furniture and Fittings 10%, Motor van 10%.

(*vi*) Charge interest on drawings ₹ 500.

(*vii*) Accrued interest ₹ 500.

[**Ans.** Gross Profit: ₹ 29,500, Net Profit: ₹ 5,575, B/S Total: ₹ 1,24,775]

7. What is meant by Trading Account?
8. Explain the meaning of Profit and Loss Account.
9. What is meant Balance Sheet?
10. What is cash basis of Accounting?
11. What is Mixed System of Accounting?
12. Explain the meaning of Single Entry System of Book keeping.
13. What is meant by Double Entry System of Book keeping?
14. What is book keeping?
15. What are the classification of Accounts?
16. Explain the concept of accounting rules with suitable illustration.
17. Explain the concept of accounting cycle. Give its Coverage.
18. What is meant by Trail Balance? Explain the objectives of Trail Balance.
19. What are the methods available for preparing Trial Balance?
20. What is meant by Final Accounts. Explain the procedure for preparation of Final Accounts.
21. What is accounting equation? Illustrate its mechanism by imaginary figures to prove that the two sides equation are always equal.
22. Discuss briefly the relationship of accounting with other subjects.
23. Describe accounting as an information system.
24. Describe briefly the role of accountant in a society.
25. What do you mean by Journal? Why is it called the book of original entry. Give the rules and advantages of Journalizing.
26. Define a ledger. Why is know as the principal book of accounts. Also give its rules.
27. Distinguish between Trading, Profit and Loss A/c and Balance Sheet.
28. Why is closing stock valued at cost or market price whichever is lower?
29. Explain the concept of cost of goods sold.

Notes

30. What is Balance Sheet? Why is it prepared? Give a specimen of the Balance Sheet.
31. What are adjusting entries? Why are these necessary for preparing final accounts.
32. How is the account relating to provision for doubtful debts kept? What is the object of this account? What it the influence of actual bad debts on it. How is it shown in the balance Sheet?
33. Discuss the various adjustment entries while preparing final accounts.

Unit–3

Intangible Assets and Depreciation

Notes

Structure

3.1. Intangible Assets
3.2. Types of Intangible Assets
3.3. Meaning of Depreciation
3.4. Causes of Depreciation
3.5. Objectives or Need for Providing Depreciation
3.6. Basic Factors for Calculating Depreciation
3.7. Methods for Providing Depreciation
3.8. Test Problems

3.1. Intangible Assets

An intangible assets is an asset that does not have any physical existence. Like tangible assets, you cannot touch or feel them but they have a current and future value.

An intangible asset is a useful resource without any physical presence. Patents, copyrights, trademarks, and goodwill etc are intangible assets. Such assets produce economic benefits but you can't touch them like other physical assets like property Plants and Equipment (PPE).

Assets can be classified into different types based on:

(*i*) Convertibility-Current Assets and Fixed Assets.

(*ii*) Physical Existence-Tangible Assets and intangible Assets.

(*iii*) Usage-operating Assets and non-operating Assets.

To learn more about the types of Assets refer to the article meaning and different types of Assets.

3.2. Types of Intangible Assets

1. Goodwill
2. Franchise Agreements
3. Patents
4. Copyrights
5. Trademarks
6. Licence
7. Non-Competition Agreement
8. Backlog of Orders
9. Works of Artistic Importance

Intangible Assets are long-term assets of company having a useful life greater than one year. A business can either develop these assets internally or can acquire them in a business combination.

Goodwill: It is a type of intangible assets that is recognized when one business acquires another business. Goodwill equals the cost of purchase of the business by the purchasing company minus the value of net assets of the purchased company. It represents the business reputation of a company. Lets say A Ltd. acquires B Ltd. for ₹ 10 crore. At the time of purchases the fair value of net assets (assets minus liabilities) of B Ltd. is ₹ 7 crore. Here the difference between the cost of purchase ₹ 10 crore paid by A Ltd. and ₹ 7 crore fair value of the assets of B Ltd. is the value of goodwill which amounts of ₹ 3 crore.

Franchise Agreements: Franchise agreements are another type of intangible assets that grants the legal right to a business to operate using the name of another company or sell a product or service developed by another company. These are classified as assets because the business owners reap monetary gains with the help of these intangible assets.

For example, many fast good restaurants like KFC, McDonald's, Subway, Dominos, etc. operate using a franchise system. Here the franchisor grants varying amount of autonomy to the franchisees to use the brand name and benefit from franchisor's extensive marketing.

Patents : A patent is a type of intangible asset that grands a business the exclusive right to manufacture, sell or use a specific invention. A company can purchase that patent from another company or it can invent a new product and receive a patent for it.

Copyrights : Copyright grants an extensive right to the business to reproduce and sell a software, book, journal, magazine, etc. It is an intangible assets used to secure legal protection by preventing others from reproducing or publishing a work of authorship.

Trademarks : A trademark is an intangible assets which legally prevents others from using a business's name, logo or other branding items. It is a design, symbol or a logo used in connection with a particular product or a business.

Licences : A license can permit a licence to use a trademark, patent, or copyright through a licence in exchange for a fee or a charge. Such licenses usually have fixed time validity, and may even set geographical validity or restrictions. Intellectual property licensing, such as transfer of technology, franchising, and publication rights, are very important in present-day business. Violation of the licenses terms by the licensee or a third-party is also a punishable offense under the law.

Non-Competition Agreement : A non-competition agreement is an agreement between two parties that prohibit one party to work or become a competitor in a certain field. Such agreements are usually for a fixed interval of time. Such agreements may be entered to protect one's market or a product and are legally binding.

A non-competition agreement is ery worthy in cases where only two or three players are present in the market. Hence, these agreements are considered an important intangible asset for any company.

Backlog of Orders : The main goals of any business is to generate orders for its products and services which in turn will generate revenue for it. A business may have a huge backlog of orders that can be treated as intangible assets. These becomes a boon especially at the time of sale or takeover of business.

Works of Artistic Importance : There are many intangibles of artistic importance that are very valuable from an owner's point of view. Such intangibles are primarily related to the entertainment sector and include musical or dramatic stage works of pictorial art, and photographic works.

Such assets may also include geographical and other maps, plans and sketches etc. that are useful in sectors other than entertainment industry too.

3.3. Meaning of Depreciation

The concept of depreciation is related to fixed assets only. Current assets are never depreciated rather these are valued. Simply, Depreciation means it is a permanent and gradual shrinkage in the book value of fixed asset. Depreciation is charged on the book value only. Once,Depreciation is charged, it should gradually reduce the value of fixed assets.

The Institute of Chartered Accountants of India defines depreciation as "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, affluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined".

According to the International Accounting Standard Committee "depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly".

3.4. Causes of Depreciation

The following are the main causes of depreciation:

(*i*) *Physical Cause.* It is caused mainly from the wear and tear due to friction, pull, impact, fatigue, twisting etc. And also it includes lack of maintenance and repairs in time.

(*ii*) *Time Factors.* Some assets lose its value simply with passage of time in the practical business life. There are certain assets with a fixed period of legal life such as lease, patents and copyrights. Here, instead of depreciation, provision for the consumption of these assets is created. This is called amortisation.

(*iii*) *Economic Factors.* Depreciation arises due to the changes in Fashion and Technology. In the real sense, new model and new technology may make the asset become obsolete even if it is in good physical condition. Some times, due to organisational growth, usage of assets are to be stopped or inadequacy of existing equipment due to the expansion of the business.

(*iv*) *Abnormal Occurrences.* The value of asset may be decreased because of accidents due to some wrong operations or some loose component which may result in heavy damages to the industry. Inferior quality of materials also decreases the value of asset.

(*v*) *Depletion.* Certain assets are of wasting character perhaps due to the extraction of raw materials from them. In lieu of writing off depreciation to provide for the consumption or utilisation of an asset of a wasting character is called provision for depletion.

Notes

3.5. Objectives or Need for Providing Depreciation

(*i*) To ascertain correct profits of the organisation

(*ii*) To show the accurate financial position of the organisation

(*iii*) To make provision for replacement of assets

(*iv*) To determine the correct tax liability

(*v*) To provide guidance to the management for important financial matters

(*vi*) To keep the capital intact

(*vii*) To provide depreciation is a statutory need - statutory obligation.

3.6. Basic Factors for Calculating Depreciation

(*i*) The cost of the asset

(*ii*) The estimated number of years of its life

(*iii*) The estimated residual or scrap value at the end of its life.

3.7. Methods for Providing Depreciation

(*i*) Fixed Instalment or Straight Line Method.

(*ii*) Fixed Percentage on Diminishing Balance Method.

(*iii*) Sum of the years Digits Method.

(*iv*) Annuity Method.

(*v*) Depreciation Fund Method.

(*vi*) Insurance Policy Method.

(*vii*) Revaluation Method.

(*viii*) Machine Hour Rate Method.

(*ix*) Depletion Method.

(*x*) Repairs Provision Method.

(*i*) *Fixed Instalment or Straight Line or Fixed Percentage on Original Cost.* Under this method, the Depreciation is calculated on the basis of either a fixed percentage of the original value of the asset or divide the original value of asset by the number of years of its estimated life. Every year, the same amount is written off as Depreciation so as to reduce the asset account to nil.

Depreciation =

$$\frac{\text{Cost of the Asset} + \text{Installation Charges} - \text{Scrap Value} + \text{Removal Cost}}{\text{Estimated useful Life of the Asset}}$$

(*ii*) *Diminishing Balance Method.* Under the diminishing Balance method, depreciation is calculated at a fixed percentage on the opening balance of each year. Each year the opening balance may be decreasing in value. This decreasing book value is commonly known as written down value of the asset. While applying the depreciation rate both salvage or scrap value and removal costs are ignored. There are no possibilities to reduce the book value to zero.

(*iii*) *Sum of the Years Digits Method.* It gives decreasing depreciation charge year by year. For the purpose of obtaining yearly depreciation diminishing percentages to the cost of the asset, less salvage value is applied. Under this method, the rate of depreciation is a fraction having the sum of the digits representing the useful life of the asset as its denominator and individual year as its numerator.

(*iv*) *Annuity Method.* Under the Annuity method, the annual depreciation charges would be ascertained with the help of Annuity table. This method gives importance to interest factor. Other methods do not take into account the interest factor while investing the assets. Fixed interest rate is charged on the opening balance of each year and then cost of asset together with interest thereon is written off equally over the life of the asset.

(*v*) *Depreciation Fund Method.* Depreciation fund method provides an adequate financial requirement for the replacement of the asset when the asset is replaced by a new one. Depreciation fund account is opened and the amount of depreciation is credited to that account. The asset account stands year after year at its original cost. At the end of each year, the amount of depreciation is debited and depreciation fund account is credited and the corresponding amount is invested in securities of some reputed companies, for the purpose of mobilising funds for replacement.

(*vi*) *Insurance Policy Method.* Under this method, an insurance policy is taken from the insurance company for the purpose of replacement of an asset. At the end of the definite period, the insurance company will pay the assured sum with the help of which asset can be repurchased.

(*vii*) *Revaluation Method.* This method is suitable for small and diverse items of asset such as bottles, corks, trade marks, loose tools, livestock etc. Under this method the amount of depreciation is ascertained to find the difference between the book value of the asset and the real value of the asset. At the end of the year the difference is taken as depreciation.

(*viii*) Machine Hour Rate Method. The Economic Life of the asset is estimated in terms of working hours. Hourly rate is determined by dividing total cost of the asset by total number of hours to be operated in its life time. The annual depreciation charge is calculated by applying this rate to the actual number of hours operated in the particular accounting period.

$$\text{Machine hour rate} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Total hours (whole lifetime)}}$$

Depreciation for the year = Machine Hour value × Estimated Hours in a year.

(*ix*) *Depletion Method.* The Economic Life of the asset is determined by geographical survey methods in terms of total units of resource deposits.

The depletion rate per unit is calculated by dividing the total cost of the asset by the estimated available number of units.

(*x*) *Repairs Provision Method.* Under this method, first the total repair and renewal costs are determined for the whole life of the asset and then it is added to the capital cost to get a total value. Then, this value is divided by its estimated life. The resultant value is treated as Repair, Renewals and depreciation. It has to be charged to the profit and loss Account each year. The corresponding Credit is given to provision for depreciation and Repairs account.

Notes

Illustration and Solution

Illustration 1: *On 1.1.1998 X Ltd. purchased a machinery for ₹ 58,000 and spent ₹ 2,000 on its execution. On 1.7.1998 an additional ₹ 20,000 worth of machinery was purchased. On 1.7.2000 the machine was purchased and on 1.1.1998 was sold for ₹ 28,600 and on the same date a new machine was purchased at a cost of ₹ 40,000. Show the machinery account for the first four calendar years according to written down value method taking the rate of depreciation @ 10%.*

Solution:

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.98	To Cash	60,000	31.12.98	By Depreciation	6,000
1.7.98	To Cash	20,000	31.12.98	By Depreciation $\left[20,000 \times \frac{10}{100} \times \frac{6}{12}\right]$	1,000
			31.12.98	By Balance c/d	73,000
		80,000			80,000
1.1.99	To Balance b/d	73,000	31.12.99	By Depreciation	7,300
			31.12.99	By Balance c/d	66,700
		73,000			73,000
1.1.00	To Balance b/d	66,700	1.7.00	By Depreciation for 6 months	2,430
1.7.00	To Cash	40,000	1.7.00	By P&L A/c (Loss on sale)	17,570
			1.7.00	By Cash	28,600
			31.12.00	By Depreciation on Balance machinery (80,000 – 60,000 = 20,000)	1,710
			31.12.00	By Depreciation	2,000

				$\left[40,000 \times \frac{10}{100} \times \frac{6}{12}\right]$	
			31.12.00	By Balance c/d	53,390
		1,05,700			1,05,700
1.1.01	To Balance b/d	53,390	31.12.01	By Depreciation	5,339
			31.12.01	By Balance c/d	48,051
		53,390			53,390

1. Workings:

Value of machinery on the date of purchase 1.1.98		60,000
Less:	Depreciation for 1.1.98 to 31.12.98	6,000
Less:	Depreciation for 1.1.99 to 31.12.98	54,000
		5,400
Less:	Depreciation for 6 month	
	1.1.2000 to 1.7.2000 (48,600 × 10/100 × 6/12)	2,430
Value of Machinery as on the date of sale		46,170
Sale price of the machinery		28,600
Loss on sale of Machinery		17,570

2. Depreciation on Balance Machinery :

Total	80,000
Sold	60,000
Balance Machinery	20,000

Value of Machinery on 1.7.98		
Depreciation for 6 months 1.7.98 to 31.12.98		20,000
		1,000
		19,000
Less:	Depreciation for 1.1.99 to 31.12.99	1,900
		17,100
Less:	Depreciation for 1.1.2000 to 31.12.2000	1,710
		15,390
Less:	Depreciation for 1.1.2001 to 31.12.2001	1,539
		13851

3. Total Depreciation for 2001

Depreciation for new machinery i.e. purchased on 1.7.200	
(40,000 – 2,000 = 38,000 × 10/100)	3,800
Depreciation on old machinery	1,539
	5,339

Illustration 2. *X Ltd. purchased a machine for ₹ 60,000 on 1.1.1998. Depreciation is provided @ 10% p.a. on diminishing Balance method. Prepare machinery account for the year 2000 in each of the following alternative cases.*

(*i*) *If the machine is sold on 1.7.2000 for ₹ 28,600.*

(*ii*) *surrendering the old one and paying cash ₹ 35,000.*

Solution. (*i*) If the Machine is sold on 1.7.2000 for ₹ 28,600

Notes

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.98	To Bank	60,000	31.12.98	By Depreciation	6,000
			31.12.98	By Balance c/d	54,000
		60,000			60,000
1.1.99	To Balance b/d	54,000	31.12.99	By Depreciation	5,400
			31.12.98	By Balance c/d	48,600
		54,000			54,000
1.1.00	To Balance b/d	48,600	1.7.2000	By Depreciation (48,600 × 10/100 × 6/12)	2,430
				By Cash	28,600
				By Loss on Sale of machinery	17,570
		48,600			48,600

Workings :	₹
Cost of the Machinery	60,000
Less: Depreciation [6,000 + 5,400 + 2,430]	13,830
Value of Machinery as on the date of Sale	46,170
Sale Price of the machinery	28,600
Loss on Sale of machinery	17,570

(*ii*) If the new machine costing ₹ 60,000 is purchased on 1.7.2000 after surrendering the old one and paying cash ₹ 35,000.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.98	To Cash	60,000	31.12.98	By Depreciation	6,000
			31.12.98	By Balance c/d	54,000
		60,000			60,000
1.1.99	To Balance b/d	54,000	31.12.99	By Depreciation	5,400
			31.12.98	By Balance c/d	48,600
		54,000			54,000

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.7.2000	To Cash (35,000 cash 25,000 adjustment from old machine)	60,000		By Depreciation on old machine (49,600 × 10/100 × 6/12)	2,430
				By Depreciation on new machine (60,000 × 10/100 × 6/12)	3,000
				By Balance c/d	54,570
		60,000			60,000

Illustration 3. *Mr. Kumar purchased a machine for ₹ 1,60,000 on 1.1.2000. Its probable working life was estimated as 10 years and its probable scrap value at the end of that time is ₹ 10,000. You are required to prepare necessary accounts based on straight line method of depreciation for three years.*

Solution :

$$\text{Annual Depreciation} = \frac{\text{Cost of the Asset} - \text{Scrap Value}}{\text{Life of the Asset}}$$

$$= \frac{₹\,1,60,000 - 10,000}{10 \text{ years}} = \frac{1,50,000}{10 \text{ years}} = ₹\ 15,000.$$

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.2000	To Cash	1,60,000	31.12.2000	By Depreciation	15,000
			31.12.2000	By Balance c/d	1,45,000
		1,60,000			1,60,000
1.1.2001	To Balance b/d	1,45,000	31.12.2001	By Depreciation	15,000
			31.12.2001	By Balance c/d	1,30,000
		1,45,000			1,45,000
1.1.2002	To Balance b/d	1,30,000	31.12.2002	By Depreciation	15,000
			31.12.2002	By Balance c/d	1,15,000
		1,30,000			1,30,000

Depreciation Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.2000	To Machinery A/c	15,000	31.12.2000	By P.L A/c	15,000
		15,000			15,000
31.12.2001	To Machinery A/c	15,000	31.12.2001	By P.L A/c	15,000
		15,000			15,000

31.12.2002	To machinery A/c	15,000	31.12.2002	By P.L A/c	15,000
		15,000			15,000

Notes

Illustration 4. *On 1.1.1999 machinery was purchased by Mr. X for ₹ 50,000. On 1.7.2000 additions were made to the extent of ` 10,000. On 1.4.2001 further additions were made to the extent of ₹ 6,400.*

On 30.6.2002 machinery, the original value of which was ₹ 8,000 on 1.1.1999 was sold for ₹ 6,000. Depreciation is charged at 10% p.a. on original cost.

Show the machinery account for the years from 1999 to 2002 in the books of Mr. X. Closes his books on 31st December every year.

Solution :

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.1999	To Cash	50,000	31.12.1999	By Depreciation	5,000
			31.12.1999	By Balance c/d	45,000
		50,000			50,000
1.1.2000	To Balance b/d	45,000	31.12.2000	By Depreciation	5,500
1.7.2000	To Cash	10,000		(50,000 × 10/100 = 5,000) (10,000 × 10/100 × 6/12 = 500)	
		55,000			55,000
1.1.2001	To Balance b/d	49,500	31.12.2001	By Depreciation	6,480
1.4.2001	To Cash	6,400	31.12.2001	By Balance c/d	49,420
		55,900			55,900
1.1.2002	To Balance c/d	49,420	30.6.2002	By Bank	6,000
30.6.2002	To Profit on Sale		31.12.2002	By Depreciation	6,240
	of Machinery	800	31.12.2002	By Balance c/d	37,980
		50,220			50,220
1.1.2003	To Balance c/d	37,980			

Workings :

(*i*) Depreciation for 2001

10% on ₹ 50,000 for one year 50,000 × 10/100	=	5,000
10% on ₹ 50,000 for one year 50,000 × 10/100	=	1,000
10% on ₹ 64,000 for 9 months (6,400 × 10/100 × 9/12)	=	480
		6,480

(*ii*) Depreciation for 2002

10% on ₹ 42,000 for one year 42,000 × 10/100	=	4,200
(*i.e.,* 50,000 – 8,000)		
10% on ₹ 10,000 for one year 10,000 × 10/100	=	1,000
10% on ₹ 6,400 for one year 6,400 × 10/100	=	640
10% on ₹ 8,000 for 6 months 8,000 × 10/1000 × 6/12	=	400
		6,240

(*iii*) Computation of Profit on Sale of Machinery

Original value of Machinery	8,000
Less : Depreciation for 3½ years @ 10% i.e., 800 × 3.5	2,800
Written down value of machinery on 30.6.2002	5,200
Amount realised on Sale	6,000
Profit on Sale of Machinery	800

Illustration 5. *On 1.1.1999 ABC Ltd. purchased five machines for ₹ 20,000 each. Depreciation is charged at the rate of 10% p.a on cost. The accounting year ends on 31st December each year. On 31.3.2000 one machine was sold for ₹ 16,000 and on 30.9.2001 another machine was sold for ₹ 15,000. A new machine was purchased on 30.6.2002 for ₹ 24,000. Prepare machinery account and provision for depreciation account for four years.*

Solution :

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.1999	To Cash	1,00,000	31.12.1999	By Cash	16,000
				By Provision for Depreciation Account	2,500
				By P & L A/c	1,500
			31.12.1999	By Balance c/d	80,000
		1,00,000			1,00,00
1.1.2000	To Balance b/d	80,000	30.9.2000	By Bank A/c	15,000
30.9.2000	To P.L A/c	500		By Provision for Depreciation A/c	5,500
			30.12.2000	By Balance c/d	60,000
		80,500			80,500
1.1.2001	To Balance b/d	60,000	31.12.2001	By Balance c/d	84,000
30.6.2001	To Bank A/c	24,000			
		84,000			84,000
1.1.2002	To Balance b/d	84,000			

Notes

Provision for Depreciation Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.1998	To Balance c/d	10,000	31.12.1998	By Depreciation	10,000
		10,000			10,000
			1.1.1999	By Balance b/d	10,000
31.3.1999	To Machinery A/c	2,500	31.3.1999	By Depreciation (on 20,000 for 3 months)	500
31.12.1998	To Balance c/d	16,000	31.12.1999	By Depreciation (on 80,000 for one year)	8,000
		18,500			18,500
30.9.2000	To Machinery A/c	5,500	1.1.2000	By Balance b/d	16,000
31.12.2000	To Balance c/d	18,000	30.9.2000	By Depreciation (on 20,000 for 9 months)	1,500
			31.12.2000	By Depreciation	6,000
		23,500			23,500
31.12.2001	To Balance c/d	25,200	1.1.2001	By Balance b/d	18,000
			31.12.2001	By Depreciation (on 60,000 for one year)	6,000
				By Depreciation (on 24,000 for 6 months)	1,200
		25,200			25,200

Illustration 6. *India Ltd. charges depreciation on plant and machinery under Reducing Balance System @ 15% per annum. On 1.4.1998, the Balance in Ledger stood at ₹ 4,60,000. The following particulars are given relating to plant and machinery during the four years 31.3.2002.*

	Date		***Particulars***
1.	*1.9.1998*	:	*A machine Purchased for ₹ 20,000 (Installation Expenses ₹ 1,000) on 1.5.96 was fully destroyed in an accident.*
2.	*1.7.1999*	:	*Purchased a new machine costing ₹ 50,000 (Installation Expenses ₹ 2,500). A sum of ₹ 30,000 was paid on the same date and the Balance was paid in May 2000.*
3.	*31.8.2000*	:	*Plant purchased on 1.4.97 for ₹ 30,000 (Installation Expenses ₹ 1,500) was disposed off for ₹ 36,000.*
4.	*1.11.2001*	:	*Some old machineries (Book value on 1.4.98 at ₹ 10,000) were sold for ₹ 4,000.*

Show the plant & machinery Account as would appear in the books of the company for the four years ended 31.3.2002 assuming depreciation is charged proportionately even if the asset is sold is sold or destroyed.

Solution:

Plant and Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.4.1998	To Balance b/d	4,60,000	1.1.1998	By Profit & Loss Account	14,434
			31.3.1999	By Depreciation for 5 months (1)	962
			31.3.1999	By Depreciation Account @ 15% on ₹ 4,44,604	66,691

			31.3.1999	By Balance c/d	3,77,913
		4,60,000			4,60,000
1.4.1999	To Balance B/d	3,77,913	31.3.2000	By Depreciation A/c	62,593
1.7.1999	To Bank	32,500		(56,687 + 5,906)	
1.7.1999	To Creditors	20,000	31.3.2000	By Balance c/d	3,67,820
		4,30,413			4,30,413
1.4.2000	To Balance B/d	3,67,820	31.8.2000	By Bank A/c (Sale)	36,000
31.8.2000	To P & L A/c (2) (Profit on sale of machinery)	17,864	31.3.2001	By Depreciation (2)	1,209
			31.3.2001	By Depreciation A/c 15% on 3,48,475 (*i.e.,* 3,67,820 – 19,345)	52,271
				By Balance c/d	2,96,204
		3,85,684			3,85,684
1.4.2001	Balance B/d	2,96,204	1.11.2001	By Bank A/c (Sale)	4,000
			1.11.2001	By Depreciation (for 7 months on ₹ 6,141)	537
			1.11.2001	By P & L A/c (3) (Loss)	1,604
			31.3.2002	By Depreciation A/c (15% 2,90,063 full year)	43,509
			31.3.2002	By Balance c/d	2,46,554
		2,96,204			2,96,204

Workings :

1. *Calculation of Loss on Accident*

		₹
	Cost on 1.5.1996	21,000
Less:	Depreciation for 11 months in 1996-97	2,887
	Value on 1.4.1997	18,113
Less:	Depreciation for 1997-98	2,717
	Value on 1.4.98	15,396
Less:	Depreciation for 5 months	962
	Loss on accident	14,434

2. *Calculation of Profit on Sale for Machinery on 31.8.2000*

		₹
	Cost on 1.4.1997	31,500
Less:	Depreciation for 11 months in 1997-98	4,725
	Value on 1.4.1998	26,775
Less:	Depreciation for 1998-2000	4,016
	Value on 1.4.99	22,759
Less:	Depreciation for 1999-2000	3,414
	Value on 1.4.2000	19,345
Less:	Depreciation for 5 months	1,209

	Value on 31.8.2000	18,136
Less:	Amount realised on Sale	36,000
	Profit on Sale of Machinery	17,864

3. *Calculation of Loss on Sale of Machinery on 1.11.2001*

Notes

		₹
	Book value on 1.4.98	10,000
Less:	Depreciation for 1998-99	1,500
	Value on 1.4.99	8,500
Less:	Depreciation for 1999-2000	1,275
	Value on 1.4.2000	7,225
Less:	Depreciation for 2000-2001	1,084
	Value on 1.4.2001	6,141
Less:	Depreciation for 7 months	537
	Value on 1.11.2001	5,604
Less:	Amount realised on Sale	4,000
	Loss on Sale of Machinery	1,604

Illustration 7. *A firm purchases a 5 year lease for ₹ 30,000. It is decided to write off depreciation on the annuity method, presuming the rate of interest to be 5% per annum. If annuity of ₹ 1 for 5 years at 5% is 0.230975. Show the lease account for the full period of 5 years.*

Solution :

The amount of depreciation to be charged every year

$$= 0.230975 \times 30{,}000 = ₹\ 6{,}929.25$$

Plant and Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1st year	To Bank	30,000.00	1st year	By Depreciation	6,929.25
	To Interest (30,000 × 5/100)	1,500		By Balance c/d	24,570.75
		31,500.00			31,500.00
2nd year	To Balance B/d	24,570.75	2nd year	By Depreciation	6,929.25
	To Interest (24,570.75 × 5/100)	1,228.54		By Balance c/d	18,870.04
		25,799.29			25,799.29
3rd year	To Balance B/d	18,870.04	3rd year	By Depreciation	6,929.25
	To Interest (18,870.04 × 5/100)	943.50		By Balance c/d	12,884.29
		19,813.54			19,813.54
4th year	To Balance B/d	12,884.29	4th year	By Depreciation	6,929.25
	To Interest (12,884.29 × 5/100)	644.21		By Balance c/d	6,599.25
		13,528.50			13,528.50
5th year	To Balance B/d	6,599.25	5th year	By Depreciation	6,929.25

	To Interest (6,599.25 × 5/100)	330.00			
		6,929.25			6,929.25

Notes

Illustration 8. *Ramu & Co., purchased a machine at a cost of ₹ 99,600. It was expected to last for 6 years with a scrap value of ₹ 3,000. Find out the depreciation for each of the six years under*

(*i*) *Production units method and*

(*ii*) *Machine Hour Rate method.*

Total estimated life in units of production is 87,380 units and total estimated life in machine is 20,900 hours.

Additional Data are:

Year	*1*	*2*	*3*	*4*	*5*	*6*	*Total*
Units produced	*11,900*	*14,000*	*13,000*	*12,500*	*16,250*	*19,730*	*87,380*
Working Hours	*3,400*	*3,800*	*3,000*	*2,800*	*3,900*	*4,000*	*20,900*

Solution.

Production Units method

$$\text{Depreciation Rate per unit} = \frac{\text{Cost – Salvage Value}}{\text{Estimated Life in Hours}} = \frac{99{,}600 - 3{,}000}{87{,}380}$$

$$= \text{“}\frac{96{,}600}{87{,}380} = ₹\ 1.10$$

Computation of Annual Depreciation

Year	Units Produced	Rate Per Unit	Annual Depreciation (₹) (Unit Produced × Rate Per Unit)
1	11,900	1.10	13,090
2	14,000	1.10	15,400
3	13,000	1.10	14,300
4	12,500	1.10	13,750
5	16,250	1.10	17,875
6	19,730	1.10	21,703

Machine Hours or Working Hours Method:

$$\text{Depreciation Rate per Hour} = \frac{\text{Cost – Scrap value}}{\text{Estimated life in hours}} = \frac{99.600 - 3{,}000}{20{,}900}$$

$$= ₹\ 4.62$$

Computation of Annual Depreciation

Year	Units Produced	Rate Per Unit	Depreciation (Working Hour × Rate Per Hour) ₹
1	3400	4.62	15,708
2	3800	4.62	17,556
3	3000	4.62	13,860

4	2800	4.60	12,936
5	3900	4.62	18,018
6	4000	4.62	18,480

Notes

Illustration 9. *ABC Ltd. purchased a car at a cost of ₹ 3,00,000 and its estimated life is 60,000 running hours. The car runs for 2000 miles in the first year. 3,000 miles for the second year, 2,500 miles for the third year. Compute per mile and yearly Depreciation.*

Solution.

$$\text{Depreciation} = \frac{\text{Cost} - \text{Scrap}}{\text{Estimated Life in Running Miles}} = \frac{3,00,000}{60,000} = ₹\ 5$$

Computation of Annual Depreciation

Year	Units Produced	Depreciation (Running Miles × Rate Per Running Miles) ₹
1	2000	10,000
2	3000	15,000
3	2500	12,500

Illustration 10. *KLP Ltd. leased a manganese ore mine on 30th June 2000 for a sum of ₹ 6,00,000. It is estimated that the total Quantity of ore in the mine is 60,000 tonne of which 80% may be raised. The annual output is as follows.*

Year	*2000*	*2001*	*2002*	*2003*	*2004*
Output (Tonnes)	*2,500*	*7,500*	*5,000*	*9,000*	*10,000*

Solution.

Depreciation charge per tonne = Total cost/Effective production [80% of 60,000]

i.e., $\frac{6,00,000}{48,000}$ [60,000 × 80/100 = 48,000]

= ₹ 12.5

Mine Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
30.6.2000	To Cash	6,00,000	31.12.2000	By Depreciation (2,500 × 12.5)	31,250
				By Balance c/d	4,68,750
		6,00,000			6,00,000
1.1.2001	To Balance B/d	4,68,750	31.12.2001	By Depreciation (7,500 × 12.5)	93,750
			31.12.2001	By Balance c/d	3,75,000
		4,68,750			4,68,750
1.1.2002	To Balance B/d	3,75,000	31.12.2002	By Depreciation (5,000 × 12.5)	62,500
			31.12.2002	By Balance c/d	3,12,500

		3,75,000			3,75,000
1.1.2003	To Balance B/d	3,12,500	31.12.2003	By Depreciation (9,000 × 12.5)	1,12,500
			31.12.2003	By Balance c/d	2,00,000
		3,12,500			3,12,500
1.1.2004	To Balance B/d	2,00,000	31.12.2004	By Depreciation (10,000 × 12.5)	1,25,000
			31.12.2004	By Balance c/d	75,000
		2,00,000			2,00,000
1.1.2005	To Balance B/d	75,000			

Illustration 11. *On 1.1.2002 Rahim Ltd. had a stock of bottles valued at ₹ 12,000. On 1.7.2002 the company purchased additional bottles for ₹ 4,000. On 31.12.2002 the entire stock of bottles was revalued at ₹ 15,000. Calculate the amount of Depreciation.*

Solution.

Bottles Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.2002	To Balance B/d	12,000	31.12.2002	By Depreciation (16,000 – 15,000)	1,000
1.7.2002	To Cash	4,000	31.12.2002	By Balance c/d	15,000
		16,000			16,000
1.1.2003	To Balance B/d	15,000			

Illustration 12. *On 1.1.99 Nasma Ltd. purchased a machine for ₹ 60,000 which was expected to last for 4 years. The repairs and maintenance charges were estimated to be ₹ 19,000 during the life time of the asset. Actual expenses for repair and maintenance during 1999, 2000, 2001, 2002, had been ₹ 2,000, ₹ 5,000, ₹ 6,500, ₹ 7,000 respectively. At the end of the fourth year, the machine is sold at ₹ 11,500. Prepare necessary accounts using an equitable method of charging depreciation and maintenance expenses.*

Solution :

Provision for Depreciation and Repair Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.12.1999	To Repair & maintenance A/c	2,000	31.12.199	By P.L Account	17,500
	To Balance c/d	15,500			
		17,500			17,500
31.12.2000	To Repair and maintenance A/c	5,000	1.1.2000	By Balance B/d	15,500
	To Balanced c/d	28,000	31.12.2000	By P.L A/c	17,500
		33,000			33,000
31.12.2001	To Repair and maintenance A/c	6,500	1.1.2001	By Balance B/d	28,000
	To Balance c/d	39,000	31.12.2001	By P.L A/c	17,500

		45,500			45,500
31.12.2002	To Repair and maintenance A/c	7,000	1.1.2002	By Balance B/d	39,000
	To Balance c/d	49,500	31.12.2003	By P.L A/c	17,500

Notes

Workings :

Cost of the machine		60,000
Less:	Scrap Value	9,000
		51,000
Add:	Estimated Repairs and Maintenance Expenses	19,000
Composite cost		70,000

Annual cost of Depreciation and Repairs

$$\frac{\text{Composite cost}}{\text{Nuber of years}} = \frac{70,000}{4} = ₹\ 17,500$$

Illustration 13. *KRN & Co. purchased a machinery at a cost of ₹ 80,000 on 1.1.1997. On 1.1.1998 additions were made to the amount of ₹ 40,000. On 31.3.1999 machinery purchased on 1.1.1998 costing ₹ 12,000 was sold for ₹ 11,000 and on 30.6.1999 machinery purchased on 1.1.1997 costing ₹ 32,000 was sold for ₹ 26,700. On 1.10.1999 additions were made to the amount of ₹ 20,000. Depreciation was provided at 10% p.a. on Diminishing Balance method. Show the machinery account for the three years from 1997 to 1999. [Year ended on Dec. 31].*

Solution.

Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.1997	To Bank A/c	80,000	31.12.1997	By Depreciation	8,000
			31.12.1997	Balance c/d	72,000
		80,000			80,000
1.1.1998	To Balance B/d	72,000	31.12.1998	By Depreciation	11,200
1.1.1998	To Bank A/c	40,000	31.12.1998	By Balance c/d	1,00,800
		1,12,000			1,12,000
1.1.1999	To Balance B/d	1,00,800	31.3.1998	By Depreciation	270
	To P & L A/c			By Bank A/c	11,000
	(Profit Transferred)	470		By Depreciation	1,296
	To P & L A/c			By Bank A/c	26,700
	(Profit Transferred)	2,076	31.12.1999	By Depreciation	6,908
1.10.1999	To Bank A/c	20,000		By Balance c/d	77,172
		1,23,346			1,23,346
1.1.2000	To Balance B/d	77,172			

Workings Notes :

		₹
1.	Machinery Purchased on 1.1.1998	12,000

Less:	Depreciation for 1998 @ 10%	1,200
	Balance as on 1.1.99	10,800
	Depreciation for 3 months in 1999	270
	Book Value as on 31.3.99	10,530
	Profit (Balancing Figure)	470
	Amount realised	11,000
2.	Cost of Machinery on 1.1.1997	32,000
Less:	Depreciation for 1997	3,200
	Balance on 1.1.1998	28,800
Less:	Depreciation for 1998	2,880
	Balance on 1.1.1999	25,920
Less:	Depreciation for 6 months in 1999	1,296
	Book Value on 30.6.99	24,920
	Profit (Balancing Figure)	2,076
	Sold for	26,700

3. Depreciation for the Remaining Machines

Book value of machines on 1.1.99	1,00,800
Book value of machines on 1.1.99 sold in 1999	36,720
	64,080
Depreciation for 1999 on 64,080 @ 10%	6,408
Depreciation for New Machine for 3 months on ₹ 20,000	500
Total	6,908

Illustration 14. *On 1.4.1995 a firm purchased a machinery worth ₹ 3,00,000. On 1.10.1997 it buys additional machinery worth ₹ 60,000/- and spends ₹ 6,000 on its erection. The accounts are closed each year on 31st March. Assuming the annual depreciation to be 10%, show the machinery account for 5 years under straight line method and written down value method.*

Solution.

Straight Line Method : Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.1995	To Cash	3,00,000	31.3.1996	By Depreciation	30,000
			31.3.1996	By Balance c/d	2,70,000
		3,00,000			3,00,000
1.4.1996	To Balance B/d	2,70,000	31.3.1997	By Depreciation	30,000
			31.3.1997	By Balance c/d	2,40,000
		2,70,000			2,70,000
1.4.1997	To Balance B/d	2,40,000	31.3.1998	By Depreciation (30,000 + 3,300)	33,330
1.10.1997	To Cash	66,000	31.3.1998	By Balance c/d	2,72,700
		3,06,000			3,06,000

Notes

1.4.1998	To Balance B/d	2,72,700	31.3.1998	By Depreciation	36,600
			31.3.1998	By Balance c/d	2,36,100
		2,72,700			2,72,700
1.4.1999	To Balance B/d	2,36,100	31.3.1999	By Depreciation	36,600
			31.3.1999	By Balance c/d	1,99,500
		2,36,100			2,36,100
1.4.2000	To Balance B/d	1,99,500			

Written Down Value Method : Machinery Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
1.1.1995	To Cash	3,00,000	31.3.1996	By Depreciation	30,000
			31.3.1996	By Balance c/d	2,70,000
		3,00,000			3,00,000
1.4.1996	To Balance B/d	2,70,000	31.3.1997	By Depreciation	27,000
			31.3.1997	By Balance c/d	2,75,700
		2,70,000			2,70,000
1.4.1997	To Balance B/d	2,43,000	31.3.1998	By Depreciation	27,300
1.10.1997	To Cash	60,000	31.3.1998	By Balance c/d	2,75,700
		3,03,000			3,03,000
1.4.1998	To Cash	2,75,700	31.3.1998	By Depreciation	27,570
			31.3.1999	By Balance c/d	2,48,130
		2,75,700			2,75,700
1.4.1999	To Balance B/d	2,48,130	31.3.2000	By Depreciation	24,813
			31.3.2000	By Balance c/d	2,23,317
		2,48,130			2,48,130
1.4.2000	To Balance B/d	2,23,317			

Depreciation for 1997:

Depreciation on ₹ 2,43,000 @ 10% for one year	24,300
Depreciation on 60,000 @ 10% for 6 months	3,000
	27,300

Illustration 15. *From the following data find out the depreciation for period of 5 years. The cost of machine is ₹ 2,00,000. The scrap value after a period of 5 years is estimated at ₹ 40,000. Using the sum of the digits method, calculate the depreciation for every year.*

Solution :

The sum of the years digits	= 5 + 4 + 3 + 2 + 1 = 5
Cost of the machine	= 2,00,000
Scrap value	= 40,000
Therefore, cost of machine – Scrap value	= 2,00,000 – 40,000 = 1,60,000

Now, Depreciation charge for each year can be calculated as follows :

Depreciation charge for the I year	= 5/15 × 1,60,000 =	53,334
Depreciation charge for the IInd year	= 4/15 × 1,60,000 =	42,667
Depreciation charge for the IIIrd year	= 3/15 × 1,60,000 =	32,000
Depreciation charge for the IVth year	= 2/15 × 1,60,000 =	21,334
Depreciation charge for the Vth year	= 1/15 × 1,60,000 =	10,667

3.8. Test Problems

1. Vijay & Co. purchased a Grinding machine on 1st January 1995 for ₹ 9,250 and immediately spent ₹ 750 on 1st July, 1996, it purchased another machine for ₹ 2,500 and on 1st July, 1997, it sold off the first machine purchased in 1995 for ₹ 7,000 and on the same date it purchased another machine for ` 6,250. On 1st July, 1998, the second machine purchased for ₹ 2,500 was also sold off for ₹ 500. Depreciation was provided on the machinery on written down value basis at 10% p.a. Give the machinery account for four years commencing from Jan. 1, 1995. Calculations are to be made to the nearest rupee.

   [Ans: Machinery A/c Closing Balance 1995: ₹ 10,000
   Machinery A/c Closing Balance 1996: ₹ 11,500
   Machinery A/c Closing Balance 1997: ₹ 16,725
   Machinery A/c Closing Balance 1998: ₹ 8,075]

2. A firm purchases a 5 years lease for ` 1,60,000 on 1st January 1995. It decides to write off depreciation on the Annuity Method, presuming the rate of interest to be 5% per annum. the annuity table shows that a sum of ` 36,956 should be written off every year. Show the Lease Account for five years. Calculations are to be made to the nearest rupee.

   [Ans: Lease A/c Closing Balance 1995: ₹ 1,68,000
   Lease A/c Closing Balance 1996: ₹ 1,37,596
   Lease A/c Closing Balance 1997: ₹ 1,05,672
   Lease A/c Closing Balance 1998: ₹ 72,152
   Lease A/c Closing Balance 1999: ₹ 36,956]

3. A company purchased a 3 years lease on January 1995 for ₹ 1,00,000. It is decided to provide for the replacement of lease at the end of 3 years by setting up a sinking fund. It is expected that the investments will fetch interest at 5%. Sinking Fund Table shows that to provide the requisite sum at 5% at the end of 3 years an investment at ₹ 31,728,88 is required every year. Investments are made to nearest rupee. On 31st December, 1997, the investments were sold for ₹ 61,000. On 1st January 1998, the same lease was renewed for a further period of 3 years by paying ₹ 1,20,000.

   Show the journal entries and give the lease account, depreciation account, depreciation fund account, depreciation fund investment account and new lease account.

   [Ans: Lease A/c Closing Balance: ₹ 1,00,000

Sinking Fund A/c Closing Balance: ₹ 1,04,045.00
Depreciation: ₹ 31,728.88
Sinking Fund A/c Closing Balance: ₹ 1,04,045.00
Sinking Fund Investment A/c Closing Balance: ₹ 65,045
Interest on Sinking Fund Investment A/c Closing Balance: ₹ 3,252.25
New Lease A/c Closing Balance: ₹ 1,20,000]

4. What is meant by Depreciation ?
5. Define Depreciation.
6. What is meant by Fixed Assets ?
7. What are the causes of providing Depreciation ?
8. Briefly explain the various objectives of Depreciation.
9. Describe the basic factors for calculating Depreciation.
10. Describe the various methods for providing Depreciation.
11. What is meant by straight line method of calculating Depreciation ?
12. Depreciation is an apportionment of cost. Discusses and give the main problems which are faced in calculating the amount of Depreciation.
13. Discusses the merits and demerits of various methods of calculating Depreciation.
14. Depreciation is a source of fund. Explain.
15. ‘Depreciation Accounting is a process of allocation and not of valuation’ – Comment.

Unit–4

Analysis of Financial Statement

Structure

4.1. Meaning
4.2. Significance of Ratio Analysis
4.3. Advantages of Ratio Analysis
4.4. Limitations of Ratio Analysis
4.5. Classification of Ratios
4.6. Financial Analysis
4.7. Comparative Statements
4.8. Common Size Statements
4.9. Test Problems

4.1. Meaning

Ratio is simply a number expressed in terms of another. It refers to the numerical or quantitative relationship between two variables that are comparable. It is a comparison of the numerator with the denominator.

In other words, the ratio means relationship between two figures expressed mathematically. It can be expressed in terms of percentage proportions and quotient too.

4.2. Significance of Ratio Analysis

Ratio analysis is an effective and suitable tool of financial analysis. Analysis of financial statement with the support of ratios would guide the management in important decision making, implementation and control. Ratio analysis is an instrument for diagnosing the financial health of an enterprise. The usefulness of the ratio analysis is not only for the financial manager, but also to various parties who are interested to know different purposes of financial information. In the real sense, ratio analysis is based on the accounting data contained in the financial statements. Various classifications of ratios are used for different purposes.

4.3. Advantages of Ratio Analysis

1. *Simplifies financial statement.* Financial Statement contains the summary of oneyear's financial activities that is, application of Ratio as against the financial statements. The interested people can know the information without any difficulty because the entire financial statement is simplified in an easy manner.

Notes

2. *Facilitates intra-firm comparison.* Analysis and interpretation of a particular firm over a period of year can be made. And also comparison among different divisions of the organisation is made easy with the help of various ratios.
3. *Planning and Forecasting.* Actually ratios are derived from the past financial statements. Ratios give suitable guidance to management for formulating various budgets and construct relevant policies and also to prepare the future plan of action etc.
4. *Aid to inter firm comparison.* Comparison between two or more firms is more essential. In this regard, absolute figures are not sufficient to determine the correct comparison of firms. With the help of the ratios, one firm is able to compare with another firm and also find out their position.
5. *Facilitates decision making.* Ratios throw light on the degree of efficiency of the management and utilisation of the assets. That is why it is called surveyor of efficiency. They help the management in the aspect of decision making.
6. *Helps in corrective action.* Ratio analysis facilitates the inter-firm comparison. It exposes the successful and unsuccessful firms. At the time of comparison, if any of the unfavourable variations are identified, immediately the corrective actions should be taken.
7. *Aid to co-ordination.* The management wants to establish harmonious and cordial relationship among all the departments in the organisation. Meanwhile, the strength and weakness of the organisation should be communicated in an easily understandable manner. This type of quick and clear communication can achieve better co-ordination.

4.4. Limitations of Ratio Analysis

1. *Limitations of financial statements.* Ratios are usually calculated on the past year's financial data contained in the financial statement. In the real sense, financial statements suffer a number of limitations. When ratios are derived from the financial statements, they also suffer from the same limitations.
2. *Differences in Definition.* There is no clear cut formula for computing ratios. Each and every company follows a separate formula for computing different ratios. Due to these different types of formulas, comparison of different industries becomes difficult.
3. *Ratios alone are not adequate.* Various tools are available for evaluating the financial performance of a company. Under this aspect, ratios are tools of quantitative analysis only. Normally qualitative factors which may generally influence the arrival of conclusion are ignored while computing ratios.
4. *Problems of price level changes.* Even though there are certain limitations, inflation is utmost important for industrial and economic development of the country. Due to this aspect, price fluctuation could not be eliminated. Ratios fail to reflect the price level changes as they are based on Historical

data. Hence, they may give misleading results when inflationary conditions are ignored.

5. *It is not substitute for personal judgement.* It is only a beginning and gives limited information for decision making. It is just an aid and cannot replace thinking and personal judgement employed in the decision making aspect.
6. *Ratios can be manipulated.* There will be a great demand for goods during the festival season when compared to previous periods. Suppose this inventory turnover ratio is considered for decision making, the results get distorted. It is necessary to take the average inventories to present a fair view of the business activity. Despite certain limitations, ratio analysis continues to be a powerful tool for analysis and interpretation of financial statements.

4.5. Classification of Ratios

For the purpose of financial performance analysis, ratios are classified into the following categories.

A. Liquidity (Short-term Solvency) Ratios

Formula

1. *Current Ratio* = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

   Current Assets

   Cash in hand and Bank, Stock, sundry Debtors, bills receivable, short term investments, marketable securities, accrued incomes, prepaid expenses.

   Current Liabilities

   Sundry creditors, bills payable, Bank overdraft, outstanding expenses, income received in advance, income tax provisions, bad debts provisions, dividend payable, any other account which is payable in short period.

2. Quick Ratio or Liquid Ratio or Acid test ratio

   Acid Test Ratio = $\frac{\text{Quick Assets}}{\text{Quick Liabilites}}$ (or) $\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$ (or) $\frac{\text{LA}}{\text{CL}}$

   Quick assets or liquid assets = All current assets except stock

   Quick Liabilities or liquid liabilities = All current liabilities except bank overdraft

3. *Cash Position Ratio* = $\frac{\text{Cash + Marketable Securities}}{\text{Current Liablilities}}$

4. *Net working Capital Ratio* = $\frac{\text{Net working Capital}}{\text{Net Assets}}$

   Net working Capital = Current assets – Current liabilities

5. *Solvency Ratio* = $\frac{\text{Outside Liabilities}}{\text{Total Assets}}$

B. Long-term Solvency Ratios

1. Debt-Equity Ratio = $\frac{\text{Debt}}{\text{Equity}}$ (or) $\frac{\text{External Equities}}{\text{Internal Equities}}$

(or) $\frac{\text{Outsider's Fund}}{\text{Shareholder's Fund}}$

Notes

External Equities refer to the total outside liabilities. The term internal equities refers to all claims of preference shareholders and equity share holders such as share capital reserves and surplus. Outsider’s fund refers to all short term debts like mortgage, bills etc.

Computation of long term financial ratios, the term debt, like debentures are to be considered.

Acceptable norm for this ratio is considered to be 2:1.

2. *Proprietary Ratio* = $\frac{\text{Shareholder's Fund}}{\text{Total Assets}}$ or $\frac{\text{Shareholder's Fund}}{\text{Total Tangible Assets}}$

   Shareholders's fund includes preference share capital, Equity share capital, Reserves surplus, Profit & Loss Account Balance if any.

   Total Assets

   Total assets represent all assets including goodwill. But total tangible assets means total assets minus goodwill, Profit & Loss A/c (Debit) Balance, Preliminary Expenses.

3. *Ratio of fixed assets to proprietor's fund* = $\frac{\text{Fixed Assets}}{\text{Proprietor's Fund}}$

   [Fixed assets are valued at original cost of the assets less depreciation].

4. *Current assets to proprietor's fund Ratio* = $\frac{\text{Current Assets}}{\text{Proprietor's Fund}}$

C. Profitability Ratios

1. *Gross Profit Ratio* = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$
2. *Net Profit Ratio* = $\frac{\text{Net Profit}}{\text{Sales}} \times 100$

   Operating Ratio =

$$\frac{\text{Cost of Goods Sold} + \text{Operating Expenses}}{\text{Sales}} \times 100$$

Cost of Goods Sold = Sales – Gross Profit

Operating Expenses = All the expensed debited in the profit & Loss A/c except financial expenses *i.e.,* Administrative Expenses, Selling & Distribution Expenses, Financial Expenses.

Financial expenses may or may not include the operating expenses

4. *Return on Capital Employed* = $\frac{\text{Return}}{\text{Capital Employed}} \times 100$

   Return : Net profit

   Capital employed : Share holders fund + long term liabilities

(or)

Fixed assets + Current Assets – Current Liabilities

$$\frac{\text{Profit Before Tax and Interest}}{\text{Capital Employed}}$$

Notes

5. *Operating Profit Ratio* $= \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$

Operating Profit = Net Profit + Non-Operating Expenses-Non-Operating Income

6. *Return on Total Assets* $= \frac{\text{Return}}{\text{Total Assets}} \times 100$

[Return = PAT]

7. *Return on Shareholder Return* $= \frac{\text{Return}}{\text{Shareholder's Fund}} \times 100$

8. *Dividend Payout Ratio* $= \frac{\text{Dividend Per Share}}{\text{Earning Per Share}}$

9. *Dividend Per Share* =

$$\frac{\text{Dividend Paid to Equity Shareholders}}{\text{No. of Equity Shares}}$$

10. *Earning Per Equity Share* $= \frac{\text{Profit Available to Equity Shares}}{\text{No. of Equity Shares}}$

11. *Dividend Yield* $= \frac{\text{Dividend Per Share}}{\text{Market Price Per Share}}$

12. *Price Earning Ratio* $= \frac{\text{Market Price of a Share}}{\text{Earning Per Share}}$

13. *Fixed Interest Coverage* $= \frac{\text{Operating Income}}{\text{Annual Interest Expenses}}$

14. *Interest Coverage Ratio* $= \frac{\text{EBIT}}{\text{Fixed Interest Expenses}}$

D. Activity or Turnover Ratios

1. *Stock Turnover Ratio* $= \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$

2. *Debtors Turnover Ratio or Debtors Velocity*

$$= \frac{\text{Debtors} + \text{Bills Receivable}}{\text{Credit Sales}} \times \text{No. of Working Days}$$

3. *Creditors Turnover Ratio* $= \frac{\text{Creditors} + \text{Bills Payable}}{\text{Credit Purchase}} \times 365$

4. *Average Payment Period* $= \frac{\text{Account Payable}}{\text{Net Credit Purchase}} \times 365$

5. *Working Capital Turnover Ratio* $= \frac{\text{Cost of Sales}}{\text{Net Working Capital}}$

6. *Fixed Assets Turnover Ratio* $= \frac{\text{Cost of Sales}}{\text{Net Fixed Assets}}$

7. *Total Capital Turnover Ratio* $= \dfrac{\text{Cost of Sales}}{\text{Total Capital Employed}}$

8. *Capital Turnover Ratio* $= \dfrac{\text{Cost of Sales}}{\text{Net Working Capital}}$

Notes

9. Current Assets Turnover Ratio $= \dfrac{\text{Cost of Sales}}{\text{Current Assets}}$

10. *Sales to Net worth Ratio* $= \dfrac{\text{Cost of Sales}}{\text{Net worth}}$

11. Expenses Ratio $= \dfrac{\text{Individual Expenses}}{\text{Sales}}$

E. Leverage or Capital Structure Ratios

1. *Debt-Equity Ratio* $= \dfrac{\text{Debt}}{\text{Equity}}$

2. *Proprietary Ratio* $= \dfrac{\text{Shareholder's Fund}}{\text{Total Assets}}$

3. *Capital Gearing Ratio* =

$$\frac{\text{Fixed Interest Bearing Securities}}{\text{Equity Share Capital}}$$

$$= \frac{\text{Pre Share Capital} + \text{Debentures} + \text{Other Borrowed Funds}}{\text{Equity}}$$

4. *Reserves to Equity Capital Ratio* $= \dfrac{\text{Revenue Reserve}}{\text{Equity Capital}}$

5. *Fixed Assets to Net worth Ratio* $= \dfrac{\text{Fixed Assets}}{\text{Net worth}}$

6. *Current Assets to Net worth Ratio* $= \dfrac{\text{Current Assets}}{\text{Net worth}}$

7. *Current Liabilities to Net worth Ratio* $= \dfrac{\text{Current Liabilities}}{\text{Net worth}}$

8. *Fixed Assets to Current Assets Ratio* $= \dfrac{\text{Fixed Assets}}{\text{Current Assets}}$

9. Fixed Assets Ratio $= \dfrac{\text{Fixed Assets}}{\text{Long – Term Funds}}$

Illustration and Solution

Illustration 1. *From the data calculate :*

(*i*) *Gross Profit Ratio* (*ii*) *Net Profit Ratio*
(*iii*) *Return on Total Assets* (*iv*) *Inventory Turnover*
(*v*) *Working Capital Turnover* (*vi*) *Net worth to Debt*

Sales	*25,20,000*	*Other Current Assets*	*7,60,000*
Cost of sale	*19,20,000*	*Fixed Assets*	*14,40,000*
Net profit	*3,60,000*	*Net worth*	*15,00,000*

Inventory	*8,00,000*	*Debt.*	*9,00,000*
		Current Liabilities	*6,00,000*

Solution.

(*i*) Gross Profit Ratio $= \dfrac{\text{GP}}{\text{Sales}} \times 100 = \dfrac{6,00,000}{25,20,000} \times 100 = 23.81\%$

Sales – Cost of Sales = Gross Profit

25,20,000 – 19,20,000 = 6,00,000

(*ii*) Net Profit Ratio $= \dfrac{\text{NP}}{\text{Sales}} \times 100 = \dfrac{3,60,000}{25,20,000}$

$= 14.28\%$

(*iii*) Inventory Turnover Ratio $= \dfrac{\text{Turnover}}{\text{Inventory}} \times 100 = \dfrac{19,20,000}{8,00,000}$

= 2.4 times

Turnover Refers Cost of Sales

(*iv*) Return on Total Assets $= \dfrac{\text{NP}}{\text{Total Assets}} = \dfrac{3,60,000}{30,00,000} \times 100$

$= 12\%$

FA + CA + inventory [14,40,000 + 7,60,000 + 8,00,000] = 30,00,000

(*v*) Net worth to Debt $= \dfrac{\text{Net worth}}{\text{Debt}} = \dfrac{15,00,000}{9,00,000} \times 100$

= 1.66 times

(*vi*) Working Capital Turnover $= \dfrac{\text{Turnover}}{\text{Working Capital}}$

Working Capital = Current Assets – Current Liabilities

= 8,00,000 + 7,60,000– 6,00,000

15,60,000 – 6,00,000 = 9,60,000

Working Capital Turnover Ratio $= \dfrac{19,20,000}{9,60,000} = 2$ times.

Illustration 2. *Perfect Ltd. gives the following Balance sheet. You are required to compute the following ratios.*

(*a*) *Liquid Ratio* (*c*) *Debt-Equity Ratio*

(*b*) *Solvency Ratio* (*d*) *Stock of Working Capital Ratio*

Balance Sheet

	₹		₹
Equity share capital	*15,00,000*	*Fixed Assets*	*14,00,000*
Reserve fund	*1,00,000*	*Stock*	*5,00,000*
6% Debentures	*3,00,000*	*Debtors*	*2,00,000*
Overdraft	*1,00,000*	*Cash*	*1,00,000*
Creditors	*2,00,000*		
	22,00,000		*22,00,000*

Notes

Solution.

(*a*) $$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} \text{ (or) } \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

$$\text{LA Debtors} = 2,00,000 \quad \text{i.e.,} \quad \frac{3,00,000}{2,00,000} = 1.5$$

$$\text{Cash} = 1,00,000$$

$$= 3,00,000$$

Liquid Liabilities : Creditors = 2,00,000

(*b*) $$\text{Debt – Equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

External Equities:

All outsiders loan Including current liabilities

$$3,00,000 + 1,00,000 + 2,00,000 = 6,00,000$$

Internal Equities :

It Includes share holders fund + Reserves

$$15,00,000 + 1,00,000 = 16,00,000$$

$$\text{Debt – Equity Ratio} = \frac{6,00,000}{16,00,000} = 0.375$$

(*c*) $$\text{Solvency Ratio} = \frac{\text{Outside Liabilities}}{\text{Total Assets}}$$

$$\text{Outsides Liabilities} = \text{Debenture + Overdraft + Creditors}$$

$$= 3,00,000 + 1,00,000 + 2,00,000 = 6,00,000$$

$$\therefore \quad \text{Solvency Ratio} = \frac{6,00,000}{22,00,000} \times 100 = 27.27\%$$

(*d*) $$\text{Stock of Working Capital Ratio} = \frac{\text{Stock}}{\text{Working Capital}}$$

$$\text{Working Capital} = \text{Current Assets – Current Liabilities}$$

$$= 8,00,000 – 3,00,00 = 5,00,000$$

$$\text{Stock of Working Capital Ratio} = \frac{5,00,000}{5,00,000} \times 100$$

Illustration 3. *Calculate the following ratios from the balance sheet given below :*

(*i*) *Debt-Equity Ratio* (*ii*) *Liquidity Ratio*

(*iii*) *Fixed Assets to Current Assets* (*d*) *Fixed Assets Turnover*

Balance Sheet

	₹		₹
Equity shares of ₹ 10 each	*1,00,000*	*Goodwill*	*60,000*
Reserves	*20,000*	*Fixed Assets*	*1,40,000*
P.L. A/c	*30,000*	*Stock*	*30,000*
Secured loan	*80,000*	*Sundry Debtors*	*30,000*
Sundry Creditors	*50,000*	*Advance*	*10,000*

Provision for taxation	*20,000*	*Cash Balance*	*30,000*
	3,00,000		*3,00,000*

Solution.

(*i*) Debt–Equity Ratio $= \dfrac{\text{Long – Term Debt}}{\text{Shareholders Fund}}$

Long-term Debt = Secured loan ₹ 80,000

Shareholder's Fund = Equity Share Capital + Reserves + P.L. A/c

= 1,00,000 + 20,000 + 30,000 = 1,50,000

Debt-Equity Ratio $= \dfrac{80,000}{1,50,000} = .53$

(*ii*) Liquidity Ratio $= \dfrac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$

Liquid Assets = Sundry Debtors + Advances + Cash Balance

= 30,000 + 10,000 + 30,000 = 70,000

Liquid Liabilities = Provision for Taxation + sundry creditors

= 20,000 + 50,000 = 70,000

Liquid Ratio $= \dfrac{70,000}{70,000} = 1$

(*iii*) Fixed Assets to Current Assets

$= \dfrac{\text{Fixed Assets}}{\text{Current Assets}} = \dfrac{1,40,000}{1,00,000} = 1.4$

(*iv*) Fixed Assets Turnover $= \dfrac{\text{Turnover}}{\text{Fixed Assets}} = \dfrac{5,60,000}{1,40,000} = 4$

Illustration 4. *The Balance sheet of Naronath & Co. as on 31.12.2000 shows as follows :*

Liabilities	₹	*Assets*	₹
Equity capital	*1,00,000*	*Fixed Assets*	*1,80,000*
15% Preference shares	*50,000*	*Stores*	*25,000*
12% Debentures	*50,000*	*Debtors*	*55,000*
Retained Earnings	*20,000*	*Bills Receivable*	*3,000*
Creditors	*45,000*	*Bank*	*2,000*
	2,65,000		*2,65,000*

Comment on the Financial position of the Company i.e., Debt-Equity Ratio, Fixed Assets Ratio, Current Ratio, Liquidity.

Solution.

(*i*) Debt–Equity Ratio $= \dfrac{\text{Debt - Equity Ratio}}{\text{Long - Term Debt}}$

Long-term Debt = Debentures = 50,000

Shareholder's Fund = Equity Share Capital + Retained Earnings

= 1,00,000 + 50,000 + 20,000

$= \dfrac{50,000}{1,70,000} = .29$

Notes

Notes

(*ii*) Fixed Assets Ratio $= \dfrac{\text{Fixed Assets}}{\text{Proprietor's Fund}} = 1{,}80{,}000$

Proprietor's Fund = Equity Share Capital + Preference Share Capital + Retained Earnings

= 1,00,000 + 50,000 + 20,000 = 1,70,000

Fixed Assets Ratio $= \dfrac{1{,}80{,}000}{1{,}70{,}000} = 1.05$

(*iii*) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Assets = Stores + Debtors + BR + Bank

= 25,000 + 55,000 + 3,000 2,000 = 85,000

Current Liabilities = 45,000

Current Ratio $= \dfrac{85{,}000}{45{,}000} = 1.88$

(*iv*) Liquid Ratio $= \dfrac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$

Liquid Assets = Debtors + Bill Receivable + Cash

= 55,000 + 3,000 + 2,000 = 60,000

Liquid Liabilities = 45,000

Liquid Ratio $= \dfrac{60{,}000}{45{,}000} = 1.33$

Illustration 5. *From the following particulars pertaining to Assets and Liabilities of a company calculate :*

(*a*) *Current Ratio* (*b*) *Liquidity Ratio*

(*c*) *Proprietary Ratio* (*d*) *Debt-equity Ratio*

(*e*) *Capital Gearing Ratio*

Liabilities	₹	*Assets*	₹
5000 equity shares ₹ 10 each	*5,00,000*	*Land & Building*	*6,00,000*
8% 2000 per shares ₹ 100 each	*2,00,000*	*Plant & Machinery*	*5,00,000*
9% 4000 Debentures of ₹ 100 each	*4,00,000*	*Debtors*	*2,00,000*
Reserves	*3,00,000*	*Stock*	*2,40,000*
Creditors	*1,50,000*	*Cash and Bank*	*55,000*
Bank over draft	*50,000*	*Prepaid Expenses*	*5,000*
	16,00,000		*16,00,000*

Solution.

(*i*) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Assets = Stock + Cash + Prepaid Expenses + Debtors

= 2,40,000 + 55,000 + 5,000 + 2,00,000

= 5,00,000

Current Liabilities = Creditors + Bank Overdraft

$$= 1{,}50{,}000 + 50{,}000 = 2{,}00{,}000$$

$$= \frac{5{,}00{,}000}{2{,}00{,}000} = 2.5 : 1$$

(*ii*) $$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$$

Liquid Assets = Cash and Bank + Debtors

= 55,000 + 2,00,000 = 2,55,000

Liquid Liabilities: Creditors

= 1,50,000

$$\text{Liquid Ratio} = \frac{2{,}55{,}000}{1{,}50{,}000} = 1.7 : 1$$

(*iii*) $$\text{Proprietary Ratio} = \frac{\text{Proprietor's Fund}}{\text{Total Tangible Assets}}$$

Proprietor's Funds = Equity Share Capital + Preference Share Capital + Reserves and Surplus

= 5,00,000 + 2,00,000 + 3,00,000

$$\text{Proprietary Ratio} = \frac{10{,}00{,}000}{16{,}00{,}000} = 0.625 : 1$$

(*iv*) $$\text{Debt-Equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

External Equities = Long-term Liabilities + Short-term Liabilities

= 4,00,000 + 2,00,000 = 6,00,000

Internal Equities = Proprietor's funds

$$= \frac{6{,}00{,}000}{10{,}00{,}000} = 0.6 : 1$$

(*iv*) $$\text{Capital Gearing Ratio} = \frac{\text{Fixed Interest Bearing Securities}}{\text{Equity Share Capital} + \text{Reserves}}$$

Fixed Interest Bearing Securities	= Preference Shares	2,00,000
	= Debentures	4,00,000
		6,00,000

$$= \frac{6{,}00{,}000}{8{,}00{,}000} = 0.75 : 1$$

Illustration 6. *From the following details of a trader you are required to calculate :*

(*i*) *Purchase for the year* (*ii*) *Rate of stock turnover*

(*c*) *Percentage of Gross profit to turnover*

Sales ₹	*33,984*	*Stock at the close at cost price*	*1,814*
Sales Returns	*380*	*G.P. for the year*	*8068*
Stock at the beginning at cost price	*1,378*		

Notes

Solution. **Trading Account**

To Opening stock	1,378	By Sales	33,984
To Purchase (Bf)	25,972	(–) Sales Returns	380
To gross profit	8,068		33,604
		By Closing stock	1,814
	35,418		35,418

(*i*) Purchase for the year ₹ 25,972

(*ii*)
$$\text{Stock Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\text{Cost of Goods Sold} = \text{Sales} - \text{GP} = 33{,}984 - 8{,}068 = 25{,}916$$

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Clo sin g Stock}}{2}$$

$$= \frac{1,372 + 1,814}{2} = 1,596$$

$$= \frac{25,916}{1,596} = 16.23 \text{ times}$$

(*iii*) Percentage of Gross Profit to Turnover

$$= \frac{\text{GP}}{\text{Sales}} \times 100 = \frac{8,068}{33,984} \times 100 = 23.74\%$$

Problem 7. *Calculate stock turnover ratio from the following information :*

Opening Stock	*58,000*
Purchases	*4,84,000*
Sales	*6,40,000*
Gross Profit Rate - 25% on Sales	

Solution.

(*i*)
$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\text{Cost of Goods Sold} = \text{Sales} - \text{GP}$$

$$= 6{,}40{,}000 - 1{,}60{,}000 = 4{,}80{,}000$$

$$\text{Stock Turnover Ratio} = \frac{4,80,000}{58,000} = 8.27 \text{ times } \textbf{Ans.}$$

Here, there is no closing stock. So, there is no need to calculate the average stock.

Illustration 8. *Calculate the operating Ratio from the following figures.*

Items	*(₹ in Lakhs)*
Sales	*17,874*
Sales Returns	*4*
Other Incomes	*53*
Cost of Sales	*15,440*

Administration and Selling Exp.	*1,843*
Depreciation	*63*
Interest Expenses (Non-operating)	

Solution.

$$\text{Operating Ratio} = \frac{\text{Cost of Goods Sold} + \text{Operating Expenses}}{\text{Sales}} \times 100$$

$$= \frac{15,440 + 1,843}{17,870} \times 100 = 97\%$$

Illustration 9. *The following is the Trading and Profit and loss account of Mathan Bros Private Limited for the year ended June 30,2001.*

		₹			₹
To Stock in hand		*76,250*	*By sales*		*5,00,000*
To Purchases		*3,15,250*	*By Stock in hand*		*98,500*
To Carriage and Freight		*2,000*			
To Wages		*5,000*			
To Gross Profit		*2,00,000*			
		5,98,500			*5,98,500*
To Administration					
Expenses		*1,01,000*	*By Gross profit*		*2,00,000*
To Finance Expenses :			*By Non-operating Incomes*		
Interest	*1,200*		*Interest on Securities*	*1,500*	
Discount	*2,400*		*Dividend on Shares*	*3,750*	
Bad Debts	*3,400*	*7,000*	*Profit on Sale of Shares*	*750*	*6,000*
To Selling Distribution Expenses		*12,000*			
To Non-operating expenses					
Loss on sale of securities	*350*				
Provision for legal suit	*1,650*	*2,000*			
To Net profit		*84,000*			
		2,06,000			*2,06,000*

You are required to calculate:

(*i*) *Gross profit Ratio* (*ii*) *Expenses Ratio (individual)*
(*iii*) *Net profit Ratio* (*iv*) *Operating profit Ratio*
(*v*) *Operating Ratio* (*vi*) *Stock turnover Ratio*

Solution.

(*i*) $$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{2,00,000}{5,00,000} \times 100$$

(*ii*) $$\text{Expenses Ratio} = \frac{\text{Individual Expenses}}{\text{Sales}}$$

(*a*) $$\frac{\text{Administration Epenses}}{\text{Sales}} \times 100 = \frac{1,01,000}{5,00,000} \times 100 = 2.02\%$$

(*b*) $$\frac{\text{Finance Expenses}}{\text{Sales}} \times 100 = \frac{7,000}{5,00,000} \times 100 = 1.40\%$$

(c) $\dfrac{\text{Selling and Distribution Expenses}}{\text{Sales}} \times 100$

$$= \frac{12,000}{5,00,000} \times 100 = 2.40\%$$

Notes

(d) $\dfrac{\text{Non - Operating Expenses}}{\text{Sales}} \times 100 = \dfrac{2,000}{5,00,000} \times 100 = 0.4\%$

(iii) *Net Profit Ratio :*

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100 = \frac{84,000}{5,00,000} \times 100 = 16.8\%$$

(iv) Operating Profit Ratio $= \dfrac{\text{Operating Profit}}{\text{Sales}} \times 100$

Operating Profit = Net Profit + Non-Operating Expenses – Non Operating Incomes

= 84,000 + 2,000 – 6,000 = 80,000

$$= \frac{80,000}{50,00,000} \times 100 = 16\%$$

(v) Operating Ratio

$$= \frac{\text{Cost of Goods Sold} + \text{Operating Expenses}}{\text{Sales}} \times 100$$

Cost of Goods Sold = Sales – Gross profit

i.e., 5,00,000 – 2,00,000 = 3,00,000

Operating Expenses

All Expenses Debited in the Profit & Loss A/c Except Non-operating Expenses [including Finance expense]

1,01,000 + 7,000 + 12,000 = 1,20,000

Operating Ratio $= \dfrac{3,00,000 + 1,20,000}{5,00,000} \times 84\%$

(vi) Stock Turnover Ratio $= \dfrac{\text{Cost of Goods Sold}}{\text{Average Stock}}$

Cost of Goods Sold = 3,00,000

Average Stock $= \dfrac{\text{Opening Stock} + \text{Clo sin g Stock}}{2}$

$$= \frac{76,250 + 95,500}{2} = 85,875$$

$$= \frac{3,00,000}{85,875} = 3.49 \text{ times}$$

Problem 10. *Suraj & Co. sells goods on cash as well as credit (though not on deferred instalment terms). The following particulars are extracted from their books of account for the calendar year 2004.*

Total Gross sales	=	1,00,000
Cash sales (included in above)	=	20,000
Sales Returns	=	7,000
Total Debtors for Sales on 31.12.2004	=	9,000
Bills Receivable on 31.12.2004	=	1,000

Provision for Doubtful Debts on 31.12.2004 = 1,000

Total Creditors 31.12.2004 = 10,000

Calculate the Average Collection Period.

Solution.

Average Collection Period

$$= \frac{\text{Debtors} + \text{Bills Receivable} + \text{Provision for Doubtful Debts}}{\text{Net Credit Sales}} \times 365$$

$$= \frac{9,000 + 1,000 + 1,000}{73,000} \times 365 = 55 \text{ days}$$

Workings:

Net Credit Sales = Total Gross Sales – Cash Sales – Sales Returns

= 1,00,000 – 20,000 – 7,000 = 73,000

Illustration 11. *The following is the Trading account of M/s SKC Ltd. You are required to calculate the stock turnover Ratio.*

To Opening Stock	*7,960*	*By Sales*	*39,000*
To Purchases	*19,500*	*By Closing Stock*	*7,200*
To Carriage inwards	*500*		
To gross profit	*18,240*		
	46,200		*46,200*

Solution.

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

Cost of Goods Sold = Sales – Gross Profit

= 39,000 – 18,240 = 20,760

$$\text{Average Stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$= \frac{7,960 + 7,200}{2}$$

= 7,580

$$= \frac{20,760}{7,580} = 2.73 \text{ times}$$

Illustration 12. *The Balance Sheet of Lal and Co. on 31.12.2000 shows the following details :*

	₹
Cash	*9,500*
Marketable Securities	*15,000*
Inventories	*1,00,000*
Debtors	*85,000*
Prepaid Expenses	*5,000*
Long-term Loans	*1,06,000*
Trade Creditors	*64,000*

Income Tax Payable 9,000

Accrued Expenses 12,000

You are required to compute

(*i*) *Current Ratio* (*ii*) *Acid-Test Ratio.*

Notes

Solution.

(*i*) $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Current Assets} &= \text{Cash + Marketable Securities + Debtors} \\ &\quad + \text{Prepaid Expenses} \\ &= 9{,}500 + 15{,}000 + 1{,}00{,}000 + 85{,}000 + 5{,}000 \\ &= 2{,}14{,}500\end{aligned}$$

$$\begin{aligned}\text{Current Liabilities} &= \text{Trade Creditors + Income Tax Payable} \\ &\quad + \text{Accrued Expenses} \\ &= 64{,}000 + 9{,}000 + 12{,}000 = 85{,}000\end{aligned}$$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\therefore \quad \frac{2{,}14{,}500}{85{,}000} = 2.52 : 1$$

(*ii*) $$\text{Acid Test Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$$

$$\begin{aligned}\text{Liquid Assets} &= \text{Cash + Marketable Securities + Debtors} \\ &\quad + \text{Prepaid Expenses} \\ &= 9{,}500 + 15{,}000 + 85{,}000 + 5{,}000 = 1{,}14{,}500\end{aligned}$$

$$\begin{aligned}\text{Liquid Liabilities} &= \text{Trade Creditors + Income Tax Payable} \\ &\quad + \text{Accrued Expenses} \\ &= 64{,}000 + 9{,}000 + 12{,}000 = 85{,}000\end{aligned}$$

$$\therefore \quad \frac{1{,}14{,}500}{85{,}000} = 1.34 : 1$$

Illustration 13. *From the following figures calculate the creditors turnover ratio and the average age of accounts payable.*

	₹
Credit Purchase During the year 1998	*1,00,000*
Creditors on 01.01.1998	*20,000*
Creditors on 31.12.1998	*10,000*
Bills Payable on 01.01.1998	*4,000*
Bills Payable on 31.12.1998	*6,000*

Solution.

$$\text{Creditor's Turnover Ratio} = \frac{\text{Net Credit Purchase}}{\text{Average Account Payable}} = \frac{1{,}00{,}000}{20{,}000}$$

$$= 5 \text{ times}$$

$$\text{Average Payment Period} = \frac{\text{Months}}{\text{Creditors Turnover}} = \frac{12}{5} = 2.4 \text{ months}$$

Notes

Problem 14. *From the data given below compute :*

(*a*) *Working Capital* (*b*) *Net Capital Employed*

(*c*) *Current Ratio* (*d*) *Acid Test Ratio*

(*e*) *Debt-Equity Ratio* (*f*) *Fixed Assets Ratio*

Balance Sheet of Butterfly Ltd. as on 31st December

Liabilities	₹	Assets	₹
Equity Share Capital	*25,000*	*Fixed Assets*	*30,000*
Preference Share Capital	*5,000*	*Current Assets : Stores*	*2,000*
Reserve and Surplus	*4,000*	*Sundry Debtors*	*1,000*
Debentures	*8,000*	*Cash*	*500*
Bank loan	*4,000*	*Bank*	*2,500*
Sundry creditors	*1,000*	*Preliminary expenses*	*8,000*
Proposed Dividends	*1,000*	*Brokerage on shares*	*2,000*
Provision for Taxation	*2,000*	*Stock*	*4,000*
	50,000		*50,000*

Solution

Working Capital = Current Assets – Current Liabilities

Current Assets = Stores + Sundry Debtors + Cash + Bank + Stock

= 2,000 + 1,000 + 2,500 + 4,000 + 500 = 10,000

Current Liabilities = Sundry Creditors + Proposed Dividends + Provision for Taxation

= 1,000 1,000 + 2,000 = 4,000

(*a*) Working Capital = 1,000 – 4,000 = 6,000

(*b*) Net Capital Employed

All assets excluding fictitious assets – Current liabilities *i.e.,*

₹ 40,000 – 4,000 = 36,000

(*c*) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{10,000}{4,000} = 2.5 : 1$

(*d*) Acid Test Ratio $= \dfrac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$

Liquid Assets = 2,500 + 500 + 1,000 = *i.e.,* 4,000

Liquid Liabilities = 2,000 + 1,000 + 1,000 = *i.e.,* 4,000

$= \dfrac{4,000}{4,000} = 1$

(*e*) Debt–Equity Ratio $= \dfrac{\text{Outsider's Fund}}{\text{Shareholder's Fund}} = \dfrac{16,000}{34,000} = .47 : 1$

Outsider's Fund 16,000

Outsider's Fund = Debentures + Bank Loan + Sundry Creditors + Proposed Dividends + Provision for Taxation

= 8,000 + 4,000 + 1,000 + 1,000 + 2,000 = 16,000

Notes

Shareholder's Fund = Equity Share Capital + Preference Share Capital + Reserves and Surplus

= 25,000 + 5,000 + 4,000 = 34,000

Debt-Equity Ratio = 0.47 : 1

(*f*) Fixed Assets Ratio = $\dfrac{\text{Fixed Assets}}{\text{Long - term Funds}} = \dfrac{30,000}{46,000}$ = .65 : 1

Long-term Funds = Equity Share Capital, Preference Share Capital, Reserves and Surplus, Debentures, Bank Loan.

= 25,000 + 5,000 + 4,000 + 8,000 + 4,000 = 46,000

Illustration. You have been asked by the management of a firm to project a Trading, Profit and Loss A/c and the Balance Sheet on the basis of the following estimated figures and ratios, for the next financial year.

Ratio to gross profit	*20%*
Stock turnover ratio	*5 times*
Average debt collection period	*3 Months*
Creditors	*3 Months*
Current ratio	*2*
Proprietary ratio (fixed assets to capital employed)	*75%*
Capital gearing ratio (Preference shares and debentures to equity)	*30%*
Net profit to issued equity capital	*10%*
General Reserve and Profit and Loss to issued equity capital	*25%*
Preference share capital to debentures	*2*
Cost of sales consists of 50% for materials	
Gross profit	₹ *6,25,000*

Solution : Projected Trading and Profit Loss Account

Liabilities	Amount ₹	Incomes	Amount ₹
To Cost of materials	*12,50,000*	*By Sales*	*31,25,000*
To Direct expenses	*12,50,000*		
To Gross profit	*6,25,000*		
	31,25,000		*31,25,000*
To Indirect expenses	*4,81,500*	*By Gross profit*	*6,25,000*
(Balancing figure)			
To Net Profit	*1,43,5000*		
	6,25,000		*6,25,000*

Projected Balance Sheet

Preference Share Capital	5,12,500	Fixed Assets	19,21,875
Equity Share Capital	14,35,000	Current Assets :	
Debentures	2,56,250	Stock	5,00,000
General Reserve	2,15,250	Debtors	7,81,250
Profit and Loss A/c	1,43,500		
Current Liabilities:			
Overdraft	3,28,125		
Creditors	3,12,500		
	32,03,125		32,03,125

Workings :

1. **Sales :**

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$(i.e.)\ 20 = \frac{₹\ 6,25,000}{\text{Sales}} \times 100$$

$$20\ \text{Sales} = ₹\ 6,25,000 \times 100$$

$$\text{Sales} = \frac{`\ 6,25,000}{20} \times 100$$

$$= \mathbf{₹\ 31,25,00}$$

2. **Cost of Sales :**

$$\text{Cost of Sales} = \text{Sales} - \text{Gross Profit}$$

$$= ₹\ 31,25,000 - ₹\ 6,25,000$$

$$= \mathbf{₹\ 25,00,000}$$

3. **Materials :**

$$50\% \text{ of Cost of Sales} = 50\% \text{ of } ₹\ 25,00,000$$

$$= \mathbf{₹\ 12,50,000}$$

4. **Direct Expenses :**

$$\text{Direct Expenses} = \text{Cost of Sales} - \text{Cost of Materials}$$

$$= ₹\ 25,00,000 - ₹\ 12,50,000$$

$$= \mathbf{₹\ 12,50,000}$$

5. **Stock :**

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Stock}} = 5$$

$$i.e.\ 5 = \frac{₹\ 25,00,000}{\text{Stock}}$$

$$\textbf{Stock} = \mathbf{₹\ 5,00,000\ (25,00,000/5)}$$

6. **Debtors :**

$$\text{Debtors Turnover} = \frac{\text{Debtors}}{\text{Credit Sales}} \times 12$$

Notes

$$(i.e.)\ 3 = \frac{\text{Debtors}}{₹\ 31,25,000} \times 12$$

Debtors = **₹ 7,81,250**

7. **Total Current Assets** = Stock + Debtors

= ₹ 5,00,000 + ₹ 7,81,250

= **₹ 12,81,250**

8. **Current Liabilities :** $= \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2$

(i.e.) 2 Current Liabilities = Current Assets

$$\text{Current Liabilities} = \frac{₹\ 12,81,250}{2}$$

= ₹ 6,40,625

9. **Creditors :**

$$\text{Creditors Turnover Ratio} = \frac{\text{Creditors}}{\text{Credit Purchases}} \times 12 = 3$$

$$(i.e.)\ 3 = \frac{\text{Creditors}}{₹\ 12,50,000} \times 12$$

Creditors = **₹ 3,12,500**

(Materials have been purchased on credit)

10. **Overdraft :**

Overdraft = Current Liabilities – Creditors

= ₹ 6,40,625 – ₹ 3,12,500

= ₹ 3,28,125

11. **Fixed Assets :**

$$\frac{\text{Fixed Assets}}{\text{Capital Employed}} = \frac{75}{100}$$

$$\frac{\text{Working Capital}}{\text{Capital Employed}} = \frac{25}{100}$$

Working Capital = Current Assets – Current Liabilities

= ₹ 12,81,250 – ₹ 6,40,625

= **₹ 6,40,625**

Fixed Assets = ₹ 6,40,625 × 3

= **₹ 19,21,875**

12. **Capital Employed :**

Capital Employed = Fixed Assets + Current Assets – Current Liabilities

= ₹ 19,21,875 + ₹ 12,81,250 – ₹ 6,40,625

= ₹ 25,62,500

13. Capital Gearing Ratio :

$$= \frac{\text{Pref. Share Capital + Debenture}}{\text{Total Capital Employed}} = 30\%$$

Pref. Share Capital + Debentures = 30% of ₹ 25,62,500

= **₹ 7,68,750**

Equity Shareholder's Fund = Capital Fund – (Pref. Share Capital and Debentures)

= ₹ 25,62,500 – ₹ 7,68,750

= **₹ 17,93,750**

Preference Share Capital = $₹\,7,68,750 \times \frac{2}{3}$ = ₹ **5,12,500**

Debentures = $₹\,7,68,750 \times \frac{1}{3}$ = ₹ **2,56,250**

14. General Reserve and Profit and Loss :

25% of Equity Share Capital = $₹\,17,93,750 \times \frac{25}{125}$ = ₹ 3,58,750

(Shareholders Fund include General Reserve and Profit)

15. Equity Share Capital :

Equity Shareholders Fund – (Reserve and Profit)

₹ 17,93,750 – ₹ 3,58,750 = ₹ **14,35,000**

16. Profit :

10% of Equity Share Capital

10% of ₹ 14,35,000 = ₹ **1,43,500**

17. General Reserve :

General Reserve and Profit – Profit

₹ 3,58,750 – ₹ 1,43,500 = ₹ **2,15,250**

Type II : Ratio to Balance Sheet

Illustration 1. *From the following details find out*

(*i*) *Current Assets* (*ii*) *Current Liabilities*

(*iii*) *Liquid Assets* (*iv*) *Stock*

Current Ratio	*2.5*
Liquidity Ratio	*1.5*
Working Capital	₹ *60,000*

Solution. :

1	Current Assets	–	Current Liabilities	=	Working Capital
	↓		↓		↓
	2.5	–	1.0	=	1.5
	↓		↓		↓
	1,00,000	–	40,000	=	60,000
2	Liquid Ratio	:	Liquid Assets	:	Liquid Liabilities
			↓		↓
			1.5	=	1.00
			↓		↓
			60,000	=	40,000

Notes

	₹
Current Assets	1,00,000
Current Liabilities	40,000
Liquid Assets	60,000
Stock	40,000

NOTE :

(*i*) Here, all Current Liabilities have been taken as Liquid Liabilities

(*ii*) Difference between Current Assets and Liquid Assets is the stock.

Illustration 2. *From the following details, prepare Balance sheet of Moorthy Ltd., with as many details as possible.*

(*i*) *Stock Velocity : 6.*

(*ii*) *Capital Turnover Ratio : 2.*

(*iii*) *Fixed Asset Turnover Ratio : 4.*

(*iv*) *Gross Profit Turnover Ratio : 20%.*

(*v*) *Debtor's Velocity : 2 months.*

(*vi*) *Creditors Velocity : 73 days.*

(*vii*) *Gross Profit was ₹ 60,000.*

(*viii*) *Reserves and Surplus ₹ 20,000.*

(*ix*) *Closing Stock was ₹ 5,000 in Excess of Opening Stock.*

Solution.

Workings :

(*i*)

Cost of Goods Sold	+	GP	=	Sales
↓		↓		↓
80%		20%		100%
2,40,000	+	60,000	=	3,00,000

(*ii*)

$$\text{Stock turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}}$$

$$= \text{Stock Velocity (6)}$$

$$X = \frac{2,40,000}{6}$$

Average Stock = 40,000

Total Stock value = 40,000 × 2 = 80,000

Less : Excess = 5,000

75,000

Opening Stock = 37,500

Closing Stock = 37,500 + 5,000 = 42,500

(*iii*) Debtor's Velocity = 2 months

$$\frac{\text{Debtors (X)}}{\text{Sales}} \times 12 = 2, \text{ i.e., } X = 3,00,000 \times \frac{2}{12}$$

Debtors = ₹ 50,000

(*iv*) Creditor's Velocity = 73 days.

$$\frac{\text{Creditors (X)}}{\text{Purchase}} \times 365 = 73$$

$$X = 2,45,000 \times \frac{73}{365} = 49,000$$

NOTE : Purchase = Cost of Sales + Increase in Stock = 2,40,000 + 5,000 = 2,45,000

(*v*) Fixed Assets Turnover Ratio $= \frac{\text{Turnover}}{\text{Fixed Assets (X)}}$

$$X = \frac{2,40,000}{4} = 60,000$$

(*vi*) Capital Turnover Ratio = 2

$$\frac{\text{Turnover}}{\text{Capital (X)}} = 2$$

$$X = \frac{2,40,000}{2} = 2 \qquad 1,20,000$$

(*vii*) Total Capital	=	1,20,000
Creditors	=	49,000
Total Liabilities	=	1,69,000
All Assets (42,500 + 50,000 + 60,000)	=	1,52,500
Cash (1,69,000 – 1,52,500)	=	16,500
		1,69,000

Statement of Proprietary Funds :

Fixed Assets	=	60,000
Working Capital		
(Current Assets – CL)		
Closing Stock	42,500	
Debtors	50,000	
Cash	16,500	
	1,09,000	
Less : Creditors	49,000	
		60,000
Proprietor's Fund		1,20,000

It consists of share capital and Reserves and Surplus.

Share Capital	1,00,000
Reserves and Surplus	20,000
	1,20,000

Illustration 3*. Calculate the current assets of a company from the following information :*

(*i*) *Stock Turnover 5 times*

(*ii*) *Stock at the end is ₹ 5,000; more than the stock in the beginning*

(*iii*) *Sales (all credit) ₹ 2,00,000*

(*iv*) *Gross Profit Ratio 20%*

(*v*) *Current Liabilities ₹ 60,000*

(*vi*) *Quick Ratio 0.75.*

Solution. :

1.

Cost of Goods Sold	+	GP	=	Sales
↓		↓		↓
80%	+	20%	=	100%
↓		↓		↓
1,60,000	+	40,000	=	2,00,000

2. Stock Turnover Ratio = 5 times

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} = 5 \text{ times}$$

$$X = \frac{1,60,000}{5} = 32,000$$

Average Stock = ₹ 32,000

Full Stock Value = 32,000 × 2 = 64,000

Less : Excess Value = 5,000

59,000

$$\frac{59,000}{2} = 29,500$$

Opening Stock = 29,500

Closing Stock = 29,500 + 5,000 = 34,000

3. Quick Ratio

Quick Assets	:	Quick Liabilities
↓		↓
0.75	:	1.00
↓		↓
45,000	:	60,000

Quick Ratio

Closing Stock = 34,500

Quick Assets = 45,000

79,500

Illustration 4. *From the following information, prepare a Balance sheet as on 31.3.2003 :*

(*i*) *Working Capital ₹ 1,20,000*

(*ii*) *Reserves and Surplus 80,000*

(*iii*) *Bank Overdraft 20,000 (vi) Current Ratio 2.5.*

(*iv*) *Assets (Fixed) − Proprietary Ratio 0.75 : 1*

(*v*) *Liquid Ratio 1.5*

Notes

Solution. :

1. Current Assets	–	Current Liabilities	=	Working Capital
↓		↓		↓
2.5	–	1.00	=	1.5
↓		↓		↓
2,00,000	–	80,000	=	1,20,000

2. Proprietor's Fund	–	Fixed Assets	=	Working Capital
↓		↓		↓
1.00	–	.75	=	.25
↓		↓		↓
4,80,00	–	3,60,000	=	1,20,000

3. Liquid Ratio

Liquid Assets	:	Liquid Liabilities
1.5	:	1.00
90,000	:	60,000

Current Liabilities	80,000	Current Assets	2,00,000
Less : BOD	20,000	Liquid Assets	90,000
Liquid Liabilities	60,000	Stock	1,10,000

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital (4,8,000 – 80,000)	4,00,000	Fixed Assets	3,60,000
Reserves and Surplus	80,000	Stock	1,10,000
Bank Overdraft	20,000	Other Current Assets	90,000
Sundry Creditors	60,000		
	5,60,000		5,60,000

Illustration 5. *From the following information prepare a Balance sheet and show the working.*

(*i*) *Working Capital ₹ 75,000 (v) Liquid Ratio : 1.15*

(*ii*) *Reserves and Surplus ₹ 1,00,000 (vi) Long-term Liabilities Nil*

(*iii*) *Bank Overdraft ₹ 60,000 (vii) Fixed Assets to Proprietor's Fund : 0.75*

(*iv*) *Current Ratio : 1.75.*

Notes

Solution. :

1. Current Assets	–	Current Liabilities	=	Working Capital
1.75	–	1.00	=	.75
↓		↓		↓
1,75,000	–	1,00,000	=	75,000

2. Proprietor's Fund	–	Fixed Assets	=	Working Capital
↓		↓		↓
1.00	–	.75	=	.25
↓		↓		↓
3,00,000	–	2,25,000	=	75,000

3. Liquid Ratio

Liquid Assets	:	Liquid Liabilities
1.15	:	1.00
↓		↓
46,000	–	40,000

Current Liabilities	1,00,000	Current Assets	1,75,000
Less : BOD	60,000	Liquid Assets	46,000
Liquid Liabilities	40,000	Stock	1,29,000

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital (3,00,000 – 1,00,000)	2,00,000	Fixed Assets	2,25,000
Reserves and Surplus	1,00,000	Stock	1,29,000
Bank Overdraft	60,000	Other Current Assets	46,000
Sundry Creditors (1,00,000 – 60,000)	40,000		
	4,00,000		4,00,000

Illustration 6. *From the following particulars prepare the balance sheet of ABC Limited.*

(*i*) *Sales for the year ₹ 20,00,000*

(*ii*) *Gross Profit Ratio 25%*

(*iii*) *Current Ratio : 1.50*

(*iv*) *Quick (cash Drs) Ratio : 1.25*

(*v*) *Stock Turnover Ratio : 15*

(*vi*) *Debt Collection Period : 1 ½ months*

(*vii*) *Turnover to Fixed Assets : 1.5*

(*viii*) *Fixed Assets to Networth : 5/6 (.83)*

(*ix*) *Ratio of Reserves to Share Capital 1/3 (0.33) [The term turnover refers to cost of sales and stock refers to closing stock].*

Solution. :

(*i*) Cost of Goods Sold + GP = Sales

↓ ↓ ↓

75% + 25% = 100%

↓ ↓ ↓

1,50,000 + 5,00,000 = 20,00,000

(*ii*) Stock Turnover Ratio

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} = 15 \qquad \frac{15,00,000}{\text{X}} = 15$$

$$\text{X} = \frac{15,00,000}{\text{X}}$$

$$\text{Average Stock} = 1,00,000$$

(*iii*) Current Ratio	:	1.50	6,00,000
Quick Ratio	:	1.25	5,00,000
Stock		.25	1,00,000

(*iv*) Current Ratio

Current Assets : Current Liabilities

↓ ↓

1.50 1.00

6,00,000 4,00,000

(*v*) Debt Collection Period : 1½ months

$$\frac{\text{Debtors}}{\text{Sales}} \times 12 = 1.5 \qquad \frac{\text{X}}{20,00,000} \times 12 = 1.5$$

$$\text{X} = 20,00,000 \times \frac{1.5}{12}$$

$$\text{Debtors} = 2,50,000$$

(*vi*) Turnover to Fixed Assets : 1.5

$$\frac{\text{Cost of Goods Sold}}{\text{Fixed Assets (X)}} = 1.5$$

$$\text{X} = \frac{15,00,000}{1.5}$$

$$\text{Fixed Assets} = 10,00,000$$

(*vii*) Fixed Assets to : Networth = 5/6

↓ ↓

5 : 6

10,00,000 : 12,00,000

$$\left[\frac{10,00,000}{5} \times 6 = 12,00,000\right]$$

Notes

(*viii*) Ratio of Reserves to Share Capital = 1/3

Reserves	+	Share Capital	=	Net Worth
1	+	3	=	4
3,00,000	+	9,00,000	=	12,00,000
$\left[\dfrac{12,00,000}{4} \times 3 = 9,00,000\right]$		↓		↓

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	9,00,000	Fixed Assets	10,00,000
Reserves	3,00,000	Current Assets	6,00,000
Current Liabilities	4,00,000		
	16,00,000		16,00,000

Illustration 7. *From the following information you are required to prepare a balance sheet :*

Current Ratio	–	*1.75*
Liquid Ratio	–	*1.25*
Stock Turnover Ratio (Cost of Sales /Closing Stock)	–	*9*
Gross Profit Ratio	–	*25%*
Debt Collection Period	–	*1 ½ months*
Reserves and Surplus to Capital	–	*0.2*
Turnover of Fixed Assets	–	*1.2*
Capital Gearing Ratio	–	*0.6*
Fixed Assets to Net worth	–	*1.25*
Sales for the year	–	*₹ 12,00,000*

Solution. :

(*i*) Cost of Goods Sold	+	GP	=	Sales
↓		↓		↓
75%	–	25%	=	100%
9,00,000	+	3,00,000	=	12,00,000

(*ii*) Stock Turnover Ratio = 9

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} = 9 \qquad \frac{9,00,000}{X} = 9$$

$$X = \frac{9,00,000}{9}$$

$$\text{Stock} = 1,00,000$$

(*iii*) Current Ratio 1.75 3,50,000

Quick Ratio	1.25	2,50,000
Stock	0.50	1,00,000

(*iv*) Debt Collection Period = 1 ½ months

$$\frac{\text{Debtors}}{\text{Sales}} \times 12 = 1.5$$

Debtors = 1,50,000

$$X = 12,00,000 \times \frac{1.5}{12}$$

Debtors = 1,50,000

(*v*) Turnover of Fixed Assets 1.2

$$\frac{\text{Turnover}}{\text{(X) Fixed Assets}} = 1.2 = \frac{9,00,000}{X} = 1.2$$

$$X = \frac{9,00,000}{1.2}$$

Fixed Assets = 7,50,000

(*vi*) Fixed Assets to : Networth = 1.25 : 1

↓ ↓

1.25 : 1.00

7,50,000 : 6,00,000

(*vii*) Reserves and Surplus to Capital : 0.2 : 1

Reserves	+	Share Capital	=	Net Worth
0.2	+	1.00	=	1.2
↓		↓		↓
1,00,000	+	5,00,000	=	6,00,000

$$\left[\frac{6,00,000}{1.2} \times 1 = 5,00,000\right]$$

(*viii*) Capital Gearing Ratio

$$\frac{(X)\ \text{Fixed Interest Bering}}{\text{Equity Share Capital}} = 0.6$$

X = 5,00,000 × 0.6

Long-term Debt = ₹ 3,00,000

Balance Sheet

Liabilities	₹	Assets	₹
Equity Share Capital	5,00,000	Fixed Assets	7,50,000
Long-term Debt	3,00,000	Current Assets	3,50,000
Reserves	1,00,000		

Current Liabilities	2,00,000		
	11,00,000		11,00,000

Notes

NOTE : Current Ratio

Current Assets	:	Current Liabilities
1.75		1.00
3,50,000		2,00,000

Illustration 8. *Using the information and the form given below compute the balance sheet items for a firm having a sale of ₹ 36 lakhs.*

Sales/Total Assets	*3*	*Sales/Debtors*	*15*
Sales/Fixed Assets	*5*	*Current Ratio*	*2*
Sales/Current Assets	*7.5*	*Total Assets/Net worth*	*2.5*
Sales/Inventories	*20*	*Debt Equity*	*1*

Balance Sheet

Liabilities	₹	Assets	₹
Networth	***	*Fixed Assets*	***
Long-term Debt	***	*Inventories*	***
Current Liabilities	***	*Debtors*	***
		Liquid Assets	***
		Current Assets	***

Solution.

1.	Sales	:	Total assets = 3
	↓		↓
	3	:	1
	36,00,000	:	12,00,000
2.	Sales	:	Fixed assets = 5
	5	:	1
	36,00,000	:	7,20,000
3.	Sales	:	Current assets = 7.5
	7.5	:	1.00
	36,00,000	:	4,80,000
4.	Sales	:	Inventories
	20	:	1
	36,00,000	:	1,80,000
5.	Sales	:	Debtors
	15	:	1.00

36,00,000	:	2,40,000
6. Current Ratio	:	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
2	:	1.00
4,80,000	:	2,40,000
7. Total Assets	:	Net worth = 2.5
↓		↓
2.5	:	1.00
12,00,000	:	4,80,000
8. Debt	:	Equity
1.0	:	1.0
4,80,000	:	4,80,000

Balance Sheet

Liabilities	₹	Assets	₹
Net worth	4,80,000	Fixed Assets	7,20,000
Long-term Debt	4,80,000	Inventories	1,80,000
Current Liabilities	2,40,000	Debtors	2,40,000
		Liquid Assets	60,000
	12,00,000		12,00,000

Current Assets		4,80,000
Debtors	2,40,000	
Stock	1,80,000	
		4,20,000
Liquid Assets		60,000

Illustration 9. *From the following information compute the Balance sheet*

Total Assets/Net worth	=	3.5
Sales to fixed Assets	=	6
Sales to current Assets	=	8
Sales to inventory	=	15
Sales to Debtors	=	18
Current Ratio	=	2.5
Annual sales	=	₹ 25,00,000

Solution.

(*i*) Sales to Fixed Assets = 6 :1

↓ ↓

25,00,00 4,16,667

(*ii*) Sales to Current Assets = 8

Notes

$$\frac{\text{Sales}}{(\text{X})\ \text{Current Assets}} = 8$$

$$\text{X} = \frac{25,00,000}{8}$$

$$\text{Current Assets} = 3,12,500$$

(*iii*) $$\text{Debtors} = \frac{\text{Sales}}{(\text{X})\ \text{Debtors}} = 18$$

$$\text{X} = \frac{25,00,000}{18} = 1,38,889$$

(*iv*) Sales : Inventory = 15 : 1

15 : 1

↓ ↓

25,00,000 : 1,66,667

(*v*) Current Ratio

Current Assets : Current Liabilities

2.5 : 1.0

↓ ↓

3,12,500 : 1,25,000

(*vi*) Total Assets : Net worth = 3.5

3.5 : 1.00

↓ ↓

7,29,167 : 2,08,333

$$\left[\frac{7,29,167}{3.5} \times 1.00 = 2,08,333\right]$$

Total Assets	=	Fixed Assets	4,16,667
		Current Assets	3,12,500
			7,29,167

Long Term Debt :

Total Assets = [Net worth + Current Liabilities]

7,29,167 = [1,78,667 + 1,25,000]

Long-term Debt = ₹ 4,25,500

Balance Sheet

Liabilities	₹	Assets	₹
Net worth	1,78,667	Fixed Assets	4,16,667
Long-term Debt	4,25,500	Current Assets	3,12,500
Current Liabilities	1,25,000		
	7,29,000		7,29,167

Current Assets :

Inventory	1,66,667
Debtors	1,38,889
Liquid Assets	6,944
Current Assets	3,12,500

Illustration 10. Following are the ratios to the trading activities of Indian Traders Ltd.

Debtor's Velocity	*3 months*
Stock Velocity	*8 months*
Creditors Velocity	*2 months*
Gross Profit Ratio	*25%*

Gross Profit for the year ended 31.12.2001 amounts to ₹ 4,00,000. Closing stock of the year is ₹ 10,000 above the opening stock. Bills receivable are worth ₹ 25,000 and bills payable ₹ 10,000.

Find out (a) Sales (b) Sundry Debtors (c) Closing Stock and (d) Sundry Creditors.

Solution.

1.

Cost of Goods Sold	+	GP	=	Sales
75%	+	25%	=	100%
↓		↓		↓
12,00,000	+	4,00,000	=	16,00,000

2. Debtor's Velocity : 3 months

$$\frac{\text{Debtors}}{\text{Sales}} \times 12 = 3, \textit{ i.e.,} \ \frac{X}{16,00,000} \times 12 = 3$$

$$= 4,00,000$$

Less : Bills receivable = 25,000

Sundry Debtors = 3,75,000

3. Stock Velocity : 8 months

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} \times 12 = 8 = \frac{12,00,000}{X} \times 12 = 8$$

$$X = 12,00,000 \square \frac{8}{12}$$

Average Stock = 8,00,000

Total Stock Value 8,00,000 × 2 = 16,00,000

Excess Stock = 10,000

15,90,000

Opening Stock = 7,95,000

7,95,000

Closing Stock = 7,95,000

Notes

Excess Value	=	10,000	8,05,000
			16,00,000

4. Sundry Creditors

Opening Stock	+	Purchase – Closing Stock	=	Cost of Goods Sold
7,95,000	+	x – 8,05,000	=	12,00,000
x = 12,00,000	+	8,05,000 – 7,95,000	=	12,10,000

5. Creditor's Velocity = 2 months

$$\frac{\text{Creditors} + \text{Bills Payable}}{\text{Purchase}} \times 12 = 2, \text{ i.e., } \frac{X}{12,00,000} \times 12 = 2$$

Account Payable = 2,01,667

Less : Bills Payable = 10,000

Creditors = 1,91,667

Illustration 11. *From the following information prepare a Balance Sheet with as many details as possible.*

Gross Profit	*₹ 80,000*	*Current Assets*	*₹ 1,50,000*
Gross Profit to Cost of Goods Sold Ratio	*1/3*	*Account Payable Velocity*	*90 days*
Stock Velocity	*6 times*	*Bills Receivable*	*₹ 20,000*
Opening Stock	*₹ 36,000*	*Bills Payable*	*₹ 5,000*
Account Receivable Velocity (Year 360 days)	*72 days*	*Fixed Assets Turnover Ratio*	*8 times*

Note : *Turnover refer to Cost of Sales.*

Solution.

1.

Cost of Goods Sold	+	GP	=	Sales
↓		↓		↓
3	+	1	=	4
2,40,000	+	80,000	=	3,20,000

2. Stock Velocity = 6 times

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} = \frac{2,40,000}{X} = 6$$

∴ Average Stock = 40,000

3. Average Stock = ₹ 40,000

Full Stock Value = 40,000 × 2 = 80,000

Less : Opening Stock = 36,000

Closing Stock = 44,000

4. Debtors Velocity

$$\frac{\text{Debtors} + \text{Bill Receivable}}{\text{Sales}} \times 360 = 72$$

$$X = 3,20,000 \times \frac{72}{360} = 64,000$$

$\therefore$ Drs + Bills Receivable = 64,000

Less : Bills Receivable = 20,000

Debtors = 44,000

5. Creditor's Velocity or Accounts Payable Velocity

$$\frac{\text{Creditors} + \text{Bills Payable}}{\text{Purchase}} \times 360 = 90, \textit{ i.e., } \frac{X}{12,48,000} \times 360 = 90$$

$$X = 2,48,000 \times \frac{90}{360}$$

Bills Payable + Creditors = 62,000

Less : Bills payable = 5,000

Creditors = 57,000

Find out the Purchases

Opening Stock	+	Purchase	–	Closing Stock	=	Cost of Goods Sold
↓		↓		↓		↓
36,000	+	x	–	44,000	=	2,40,000
x = 2,40,000	+	44,000 – 36,000				
Purchase ₹	=	2,48,000				

6. Fixed Assets Turnover Ratio

$$\frac{\text{Turnover}}{\text{Fixed Assets}\,(X)} = 8, \textit{ i.e., } X = \frac{2,40,000}{8}$$

Fixed Assets = 30,000

Balance Sheet

Liabilities	₹	Assets	₹
Capital (B/F)	1,18,000	Fixed Assets	30,000
Creditors	57,000	Closing Stock	44,000
Bills Payable	5,000	Debtors	44,000
		Bills Receivable	20,000
		Other Current Assets	42,000
	1,80,000		1,80,000

Total Current Assets given :		1,50,000
Stock	44,000	
Debtors	44,000	
B.R.	20,000	1,08,000
Other Current Assets		42,000

Notes

Illustration 12. *From the following information presented by a firm for the year ended 31st December, find out :*

(i)	*Net worth*	*(ii)*	*Current Liabilities*
(iii)	*Total Debt to Net worth*	*(iv)*	*Long-term Debt*
(v)	*Current Assets*	*(vi)*	*Stock*
(vii)	*Debtors and*	*(viii)*	*Fixed Assets*

Sales to Net worth	:	*5 times*
Current Liabilities to Net worth	:	*50%*
Total Debts to Net worth	:	*60%*
Current Ratio	:	*2*
Sales to Stock	:	*10 times*
Debtor's Velocity	:	*9 times*
Annual Sales	:	*₹ 15,00,000*
Cash Sales	:	*40% of Sales*

Solution.

(*i*) Sales to Net worth : 5 times

Sales : Net worth

5 : 1

15,00,000 : 3,00,000

$$\left[\frac{15,00,000}{5}\times 1 = 3,00,000\right]$$

(*ii*) Current Liabilities to Net worth

Current Liabilities = 50% of ₹ 3,00,000

= 1,50,000

(*iii*) Total Debt to Net worth = 60%

Total Debt is 60% of 3,00,000 = 1,80,000 (or)

Total Debt : Net worth

60% : 100%

↓ ↓

1,80,000 : 3,00,000

(*iv*) Long-term Debt

Long term Debt = Total Debt – Current Liabilities

= 1,80,000 – 1,50,000 = 30,000

(*v*) Current Assets

Current Ratio

Current Assets : Current Liabilities

2.0 : 1.00

3,00,000 : 1,50,000

Notes

(*vi*) Stock

Sales to Stock = 10 times

Sales	:	Stock
10.0	:	1.00
15,00,000	:	1,50,000

(*vii*) Debtor's Velocity : 9 times

$$\text{Credit Sales} = 15{,}00{,}000 \times \frac{60}{100}$$

$$= 9{,}00{,}000$$

$$\text{Debtor's Turnover Ratio} = \frac{\text{Debtors}\,(X)}{\text{Sales}} = 9,$$

$$\textit{i.e.,} \quad \frac{X}{9{,}00{,}000} = 9$$

$$X = \frac{9{,}00{,}000}{9}$$

$$\text{Debtors} = 1{,}00{,}000$$

(*viii*) Fixed Assets

Fixed Assets to Net worth Ratio = 60%

$$\left[\frac{3{,}00{,}000}{100} \times 60 = 1{,}80{,}000\right]$$

i.e., Fixed Assets	:	Net worth
↓		↓
60%	:	100%
1,80,000	:	3,00,000

Illustration 13. *With the help of the following Ratios regarding Narmatha Tex, draw the Trading, Profit and Loss A/c and Balance Sheet of the company for the year 2004.*

(i)	*Current Ratio*	:	*2.5*
(ii)	*Liquidity Ratio*	:	*1.5*
(iii)	*Net working capital*	:	*₹ 3,00,000*
(iv)	*Stock Turnover Ratio*	:	*6 times (Cost of Sales/ Closing Stock)*
(v)	*Gross Profit Ratio*	:	*20%*
(vi)	*Fixed Assets Turnover Ratio (on Cost of Sales)*	:	*2 times*
(vii)	*Debt Collection Period*	:	*2 months*
(viii)	*Fixed Assets to Shareholder's Net worth*	:	*0.80*
(ix)	*Reserves and Surplus to Capital*	:	*0.5*

Notes

Solution. :

1. Current Assets – Current Liabilities = Working Capital

$$\begin{array}{cccc} \text{Current Assets} & - \ \text{Current Liabilities} & = & \text{Working Capital} \\ \downarrow & \downarrow & & \downarrow \\ 2.5 & - \ 1.00 & & 1.5 \\ \downarrow & \downarrow & & \downarrow \\ 5{,}00{,}000 & \downarrow \ 2{,}00{,}000 & = & 3{,}00{,}000 \end{array}$$

2. Stock Velocity 2.5 → 5,00,000

   Liquidity Ratio 1.5 → 3,00,000

   Stock 1.0 → 2,00,000

3. Stock Turnover Ratio : 6 times

$$\frac{(X)\text{ Cost of Goods Sold}}{\text{Closing Stock}} = 6, \textit{ i.e., } \frac{X}{2,00,000} = 6$$

$$\text{Cost of Goods Sold} = 12,00,000$$

4.

Cost of Goods Sold	+	GP	=	Sales
80%	+	20%	=	100%
12,00,000	+	3,00,000	=	15,00,000

$$\left[\frac{12,00,000}{80} \times 20\right] = 3,00,000$$

5.

$$\text{Debt Collection Period} = 2 \text{ months}$$

$$\frac{X \text{ Drs} + \text{BR}}{\text{Sales}} \times 12 = 2, \textit{ i.e., } \frac{X}{15,00,000} \times 12 = 2$$

$$X = 15,00,000 \times \frac{2}{12}$$

$$\text{Debtors} + \text{BR} = 2,50,000$$

6. Fixed Assets Turnover Ratio

$$\frac{\text{Turnover}}{\text{Fixed Assets}} = 2, \textit{ i.e., } \frac{12,00,000}{X} = 2$$

$$X = \frac{12,00,000}{2} = 6,00,000$$

7. Fixed Assets to Shareholder's Net worth = .80

$$\frac{\text{Fixed Assets }(6,00,000)}{\text{Shareholder's Net worth (X)}} = .80$$

$$X = \frac{6,00,000}{.80}$$

$$\text{Shareholder's Net worth} = 7,50,000$$

8. Reserves and Surplus to capital : 0.5

Reserves	+	Share Capital	=	Net Worth
.50	+	1.00	=	1.50
↓		↓		↓
2,50,000	+	5,00,000	=	7,50,000

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	5,00,000	Fixed Assets	6,00,000
Reserves and Surplus	2,50,000	Current Assets	5,00,000
Current Liabilities	2,00,000		
Long-term Loan	1,50,000		
	11,00,000		11,00,000

Total Current Assets given :		5,00,000
Stock	2,00,000	
Debtors	2,50,000	4,50,000
Cash		50,000

Illustration 14. From the following figures and ratios draw out trading, profit and loss account and balance sheet.

Share capital = 1,80,000

Working capital = 63,000

Bank overdraft = 10,000

There is no fictitious asset. In current assets there is no asset other than Stock debtors and cash. Closing stock is 20% higher than the opening stock.

Current Ratio : 2.5

Proprietary Ratio : 0.7

Stock Velocity : 4

Net Profit Ratio : 10% (to average Capital employed)

Quick Ratio : 1.5

Gross Profit Ratio : 20% to Sales

Debtor's Velocity : 365 days

Solution. Gross Profit ₹ 38,500, NP 23,950 B/s total 2,22,000.

Illustration 15. *With the following Ratios and further information given below, prepare Trading, Profit and Loss A/c and a Balance Sheet of Shri Surjit & Co.*

(i) Gross Profit Ratio : 25%

(ii) Net Profit/Sales : 20%

(iii) Stock Turnover Ratio : 10

(iv) Net Profit Capital : 1/5

(v) Capital to Total Liabilities : 1/2

(vi)	*Fixed Assets/Capital*	*: 5/4*
(vii)	*Fixed Assets/Total Current Assets*	*: 5/7*
(viii)	*Fixed Assets*	*: ₹ 10,00,000*
(ix)	*Closing Stock*	*: ₹ 1,00,000*

Notes

Solution.

(*i*) Capital

Fixed Assets	:	Capital
5	:	4
10,00,000	:	8,00,000

$$\left[\frac{5}{10,00,000}\times 4\right] = 8,00,000$$

(*ii*) Net Profit Ratio

Net Profit	:	Capital
1.00	:	5.00
↓		↓
1,60,000		8,00,000

(*iii*) Net Profit/Sales : 20%

$$\frac{\text{Net Profit } (1,60,000)}{\text{Sales}(X)}\times 100 = 20\%$$

$$X = 1,60,000\times\frac{100}{20}$$

$$\text{Sales} = ₹\ 8,00,000$$

(*iv*)

Cost of Goods Sold	+	GP	=	Sales
75%	+	25%		100%
6,00,000	+	2,00,000		8,00,000

(*v*) Stock Turnover Ration

$$\frac{\text{Cost of goods sold } (6,00,000)}{\text{Average Stock } (X)} = 10$$

$$X = \frac{6,00,000}{10}$$

$$\text{Average stock} = 60,000$$

Actual/Full stock value 60,000 × 2	1,20,000
Less : Closing Stock	1,00,000
Opening Stock	20,000

(*vi*) Total Liabilities : Capital to total liabilities $\frac{1}{2}$

$$\frac{\text{Capital}}{(X)\ \text{Total Liabilities}} = \frac{1}{2}$$

$$\frac{8,00,000}{\text{Total Liabilities}}$$

$$X = 8,00,000 \times 2 = 16,00,000$$

(*vii*) Total Current Assets

Fixed Assets to Total Current Assets : 5/7

Notes

$$\text{Fixed Assets} = ₹\ 10,00,000$$

$$\frac{\text{Fixed Assets}}{(X)\ \text{Total Current Assets}} = 5/7$$

$$X = 10,00,000 \times \frac{7}{5}$$

$$= 14,00,000$$

Less : Closing Stock = 1,00,000

Current Assets = 13,00,000

Trading and Profit and Loss Account for the year ended

	₹		₹
To Opening Stock	20,000	By Sales	8,00,000
To Purchases	6,80,000	By Closing Stock	1,00,000
To Gross Profit	2,00,000		
	9,00,000		9,00,000
To Expenses	40,000	By Gross Profit	2,00,000
To Net Profit	1,60,000		
	2,00,000		2,00,000

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital (8,00,000 – 1,60,000)	6,40,000	Fixed Assets	10,00,000
Net Profit	1,60,000	Stock	1,00,000
Current Liabilities	16,00,000	Other Current Assets	13,00,000
	24,00,000		24,00,000

Illustration 16. *You are given the following information pertaining to the Financial Statements of Reliance Ltd as on 31.12.2004. On the basis of the information supplied, you are required to prepare Trading, Profit and Loss Account for the year ended and a Balance Sheet as on the date.*

Net Current Assets : 2,00,000

Issued Share Capital : 6,00,000

Current Ratio : 1.8

Quick Ratio [Ratio of Debtors and Bank
Balance to Current Liabilities] : 1.35

Notes

Fixed Assets to Shareholder's Equity	:	*80%*
Ratio of Gross Profit on Turnover	:	*25%*
Net Profit to Issued Share Capital	:	*20%*
Stock Turnover Ratio	:	*5 times*
Average of Outstanding for the year	:	*36 ½ days*

On 31.12.2004, the Current Assets consisted only of Stock Debtors and Bank Balance. Liabilities consisted of Share Capital, Current Liabilities and Assets consisted of Fixed Assets and Current Assets.

Solution.

1.

Current Assets	–	Current Liabilities	=	Working Capital
1.8		1.00		.8
4,50,000	–	2,50,000	=	2,00,000

2. Quick Ratio

Quick Assets	:	Current Liabilities
1.35		1.00
3,37,500		2,50,000

3. Stock

Current Assets – Quick Assets = Stock

4,50,000 – 3,37,500 = 1,12,500

4. Stock Turnover

$$\frac{\text{Cost of Goods Sold}\,(X)}{\text{Closing Stock}\,(1,12,500)} = 5$$

$$X = 1,12,500 \times 5 = 5,62,500$$

5. Ratio of Gross Profit on Turnover 25%

Cost of Goods Sold	+	GP	=	Sales
75%	+	25%		100%
5,62,500	+	1,87,500		7,50,000

6. Debtor's Turnover Ratio (Here, there are no Bills Receivable)

$$\frac{\text{Drs}}{\text{Sales}} \times 365 = \text{i.e., } \frac{X}{7,50,000} \times 365 = 36.5$$

$$X = 7,50,000 \times \frac{36.5}{365}$$

Debtors = ₹ 75,000

7. Quick Assets (Debtors + Bank) = 3,37,500

Less : Debtors = 75,000

Cash in hand = 2,62,500

8. Net Profit to Issued Share Capital : 20%

20%	:	100
↓		↓
1,20,000	:	6,00,000

$$\left[\frac{6,00,000}{100}\times 20\right] = 1,20,000$$

9. Fixed Assets

   Fixed Assets to Shareholder's Equity, change into

Shareholder's equity	–	Fixed Assets	=	Net Current Assets
↓		↓		↓
100%	–	80%	=	20
↓		↓		↓
10,00,000	–	8,00,000	=	2,00,000

$$\left[\frac{2,00,000}{20}\times 80\right] = 8,00,000$$

Trading and Profit and Loss Account for the year ended

	₹		₹
To Cost of Goods Sold	5,62,500	By Sales	7,50,000
To Gross Profit	1,87,500		
	7,50,000		7,50,000
To Expenses	67,500	By Gross Profit	1,87,500
To Net Profit	1,20,000		
	1,87,500		1,87,5000

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	6,00,000	Fixed Assets	8,00,000
Reserves and Surplus (B/F)	2,80,000	Current Assets :	
		Stock	1,12,500
		Debtors	75,000
		Bank	2,62,500
Profit for the year	1,20,000		
Current Liabilities	2,50,000		
	12,50,000		12,50,000

Illustration 17. The following are the Ratios and other details of Rubix Ltd. :

Debtor's velocity	:	*3 months*
Creditor's velocity	:	*2 months*
Stock turnover	:	*8 times*

Capital - turnover Ratio : 2.5 times

Fixed Assets - Turnover Ratio : 8 times

Gross profit Turnover Ratio : 25%

Gross Profit in a year amounts to ₹ 80,000. There is no Long-term Loan or Overdraft. Reserves and Surplus amount to ₹ 28,000. Liquid Assets are ₹ 97,333. Closing Stock of the year is ₹ 2,000 more than the Opening Stock. Bills Receivable amount to ₹ 5,000 and Bills Payable to ₹ 2,000.

Find out :

(i) Sales	*(ii) Sundry Debtors*
(iii) Sundry Creditors	*(iv) Closing Stock*
(v) Fixed Assets	*(vi) Proprietor's Fund*

Construct the Balance Sheet with as many details as possible.

Solution.

(*i*) Sales

Cost of Goods Sold	+	GP	–	Sales
75%		25%		100%
2,40,000		80,000		3,20,000

(*ii*) Debtor's Turnover Ratio (Here, there are no Bills Receivable)

$$\text{Debtor's Velocity} = \frac{\text{Debtors} + \text{Bill Receivable}\,(\text{X})}{\text{Sales}\,(3,20,000)} \times 12$$

$$\text{X} = 3,20,000 \times \frac{3}{12} = 80,000$$

Debtors + Bills Receivable = 80,000

Less : Bills Receivable = 5,000

Debtors = 75,000

(*iii*) Sundry Creditors

$$\frac{\text{Creditors} + \text{Bills Payable}}{\text{Purchase (Credit)}} \times 12 = 2$$

$$\text{X} = 2,42,000 \times \frac{2}{12} = 40,333$$

Less : Bills Payable = 2,000

Creditors = 38,333

Find out the purchase

Opening Stock	+	Purchase – Closing Stock	=	Cost of Goods Sold
29,000	+	X – 31,000	=	2,40,000
X = 2,40,000	+	31,000 – 29,000		
X = 2,42,000	*i.e.,*	Purchase = ₹ 2,42,000		

(*iv*) Closing Stock

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock (X)}} = 8$$

$$X = \frac{2,40,000}{8}$$

Average Stock	=	30,000
Total Stock Value 30,000 × 2	=	60,000
Less : Excess	=	2,000
		58,000
Opening Stock	=	29,000
Closing Stock 29,000 + 2,000	=	31,000

(*v*) Fixed Assets

$$X = \frac{3,20,000}{8} = 40,000$$

Fixed Assets Turnover Ratio = 8

(*vi*) Proprietor's Fund

Proprietor's Fund = Fixed Assets + Stock + Liquid Assets – Current Liability

= 40,000 + 31,000 + 97,333 – 40,333 = ₹ 1,28,000

Cash and Bank Balance

Quick Assets		97,333
Less : Bills Receivable	5,000	
Debtors	75,000	80,000
Cash at Bank		17,333

Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	1,00,000	Fixed Assets	40,000
Reserves and Surplus	28,000	Stock	31,000
Bills Payable	2,000	Debtors	75,000
Sundry Creditors	38,333	Bills Receivable	5,000
		Cash and Bank	17,333
	1,68,333		1,68,333

Illustration 18. *From the following information of a Textile Company complete the Proforma balance Sheet if Sales are worth ₹ 28,00,000.*

Sales to Net worth	=	*2.3 times*
Current Debt to Net worth	=	*42%*
Total Debt to Net worth	=	*75%*
Current Ratio	=	*2.9 times*
Net Sales to Inventory	=	*4.7 times*

Average Collection Period = *64 days*
Fixed Assets to Net worth = *53.2%*

Preforms Balance Sheet

Notes

Net worth	*?*	*Fixed Assets*	*?*
Long-term Debt	*?*	*Cash*	*?*
Current Debt	*?*	*Stock*	*?*
		Sundry Debtors	*?*

Solution.

1. Sales to Net worth : 2.3 times

$$\frac{\text{Sales}\,(23,00,000)}{\text{Net worth}\,(X)} = 2.3 \text{ times}$$

$$X = \frac{23,00,000}{2.3} = 10,00,000$$

Net worth = ₹ 10,00,000

2. Current Debt

Current Debt	:	Net worth
↓		↓
42%	:	100%
↓		↓
4,20,000		10,00,000

$$\frac{10,00,000}{100} \times 42 = 4,20,000$$

3. Total Debt

Total Debt to Net worth = 75%
Total Debt : Net worth
75% : 100
7,50,000 : 10,00,000

[*i.e.,* Total debt is 75% of net worth $10,00,000 \times \frac{75}{100}$ = 7,50,000]

4. Long-term Debt

Long-term Debt = Total Debt – Current Debt
= 7,50,000 – 4,20,000
= 3,30,000

5. Current Assets

Current Ratio	:	2.9
Current Assets	:	Current Liabilities
2.9		1.0

12,18,000 4,20,000

$$\frac{4,28,000}{10} \times 2.9 = 12,18,000$$

6. Inventory

Net Sales to Inventory

$$\frac{\text{Sales}\,(23,00,000)}{\text{Inventory}\,(X)} = 4.6 \text{ times}$$

$$X = \frac{23,00,000}{4.6}$$

$$\text{Inventory} = 5,00,000$$

7. Debtor

Average Collection Period

Here, there is no bill receivable. Hence, the formula

$$\frac{\text{Debtors}\,(X)}{\text{Sales}\,(23,00,000)} \times 360 = 90$$

$$X = 23,00,000 \times \frac{90}{360}$$

$$\text{Debtors} = 5,75,000$$

8. Fixed Assets

Fixed Assets to Net worth

$$\frac{\text{Fixed Assets}}{\text{Net worth}} = 53.2\%$$

Fixed Assets	Net worth
↓	↓
53.2%	100%
5,32,000	10,00,000

$$\frac{10,00,000}{100} \times 53.2$$

9. Find out the Cash

Total Current Assets		12,18,000
Less Stock	5,00,000	
Debtors	5,75,000	10,75,000
Cash		1,43,000

Balance Sheet

Liabilities	₹	*Assets*	₹
Net worth	10,00,000	Fixed Assets	5,32,000
Long-term Debt	3,30,000	Debtors	5,75,000
Current Debt	4,20,000	Stock	5,00,000
		Cash	1,43,000
	17,50,000		17,50,000

Notes

Illustration 19. Srinivasan Cotton Company's Stock Turnover is 5 times stock at the end is ₹ 20,000 which is more than at the beginning. Sales (all Credit) are ₹ 8,00,000. Rate of Gross Profit on Cost is 1/4. Current Liabilities ₹ 1,20,000. Quick Ratio is 0.75. Calculate Current Assets.

Notes

Solution.

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}\,(6{,}00{,}000)}{\text{Average Stock}\,(X)} = 5$$

$$X = \frac{6{,}00{,}000}{5} = 1{,}20{,}000$$

Average Stock = 1,20,000

NOTE :

Cost of Goods Sold	=	Sales	–	Gross Profit
	=	8,00,000	–	2,00,000 = 6,00,000
Total Stock Value	:	1,20,000 × 2		2,40,000
Less : Excess Value				20,000
				2,20,000

Opening Stock = ₹ 1,10,000

Closing Stock = ₹ 20,000 + 1,10,000 = 1,30,000

Quick Ratio :

Quick Ratio	:	Current Liabilities
↓		↓
.75		1.00
↓		↓
90,000		1,20,000

Current Assets

Quick Assets = ₹ 90,000

Closing Stock = ₹ 1,30,000

Current Assets = ₹ 2,20,000

Illustration 20. *Calculate Stock Turnover Ratio from the following details :*

(i) Opening Stock ₹ 29,000

(ii) Closing Stock ₹ 31,000

(iii) Sales ₹ 3,20,000

(iv) Gross Profit − Ratio 25% on Sales

Solution.

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$= \frac{2{,}40{,}000}{30{,}000} = 8 \text{ times}$$

$$\text{Average Stock} = \frac{29,000 + 31,000}{2} = 30,000$$

Cost of Goods Sold	+	GP	–	Sales
75%	+	25%		100%
2,40,000		80,000		3,20,000

4.6. Financial Analysis

Financial Analysis is the systematic numerical calculation of the relationship of one financial fact with the other to measure the profitability, operational efficiency, solvency and the growth potential of the business. The analysis serves the interest of shareholders, debenture-holders, potential investors, account payable, bankers, journalists, legislators, politicians, researchers, stock exchanges, taxation authorities politicians, researchers, stock exchanges, taxation authorities and economists. The analysis of financial statements makes it simple, intelligible and meaningful for all the concerned parties. Financial statements are split into simple statements by the process of rearranging, regrouping and the calculations of various ratios. The analysis simplifies, summarizes and systematises the monotonous figures.

Financial analysis in this way is the purposeful and systematic presentation of financial statements. Various items of income and position statements are compared and their inter-relationship is established . Financial analysis, as such presents meaningful, expression of the relationship between different items, such as relationship between gross profit and net sales.

Suppose the Gross profit of the company is ₹ 25,000 and Net sales are worth ₹ 1,00,000. At the same time the Gross profit of the second company is ₹ 30,000, and the net sales amounts to ₹ 2,00,000. According to these figures, the company which has earned ₹ 30,000, as profit may be said to be superior as regards its performance. If we analysis the figures, we come to know that the Gross profit margin of the first company amount to 25% *i.e.,* $\frac{25,000}{1,00,000} \times 100$ and the second company amounts to 15% *i.e.,* $\frac{30,000}{2,00,000} \times 100$. As such analysis show that the operational efficiency of the first company is better than the second company.

The use of financial analysis is made to measure the profitability, efficiency and financial soundness of the business, to make comparative studies and effective future plans.

Parties interested in the Financial Analysis

Every person concerned with the affairs of the business has an interest in the financial statements of the business. The information available from the analysis, serves the interest of different sections. The following parties have an interest in the analysis of financial statements:

1. **Management.** The management needs information regarding the profitability, operational efficiency and financial soundness of the business,

so that weaknesses of the business may be identified and effective business plans may be formulated.

2. **Shareholders.** The shareholders, the virtual owners of business corporate units have an interest in the welfare and progress of the business. They want to know about the profitability and future prospects of the enterprise. The requisite information is available from the analysis of financial statements.
3. **Workers.** Employees of the business are interested in the profit of the business. In case of sufficient profits, labour unions have moral justification to demand for higher wages. Workers in the business are paid bonus on the basis of productivity and profitability, so they have an interest in the financial analysis of the business.
4. **Account Payable.** Creditors of the enterprise are interested in the short-term and long-term financial soundness of the business. They want to ensure themselves, whether their funds are safe and secured and the business is capable of making payment of interest regularly and also refund as per agreements.
5. **Government.** Financial statements help government in determining tax liability. The government is also capable of ascertaining the economic development of the country through the financial analysis. The government requires the information for formulating effective economic plans and balanced growth of different sectors and regions of the economy.
6. **Potential investors.** The potential investors of the business have an interest in the operational efficiency and profit earning capacity of the business unit. They would like to know, how far their previous investment has been safe and how much the new investment will be safer and secured.
7. **Economist and researchers.** These parties are interested in the financial activities of the business, so that they amy study the financial health of the economic structure of the business, study the rate of economic growth, compare it with other economics and suggest effective measures to accelerate the pace of growth.
8. **Stock exchange.** It is an institution which deals in securities (*i.e.,* Shares, Debentures, Debentures Inventory, Bonds etc.). In other words, it facilitates purchase and sale of shares and debentures of companies. Stock exchanges are interested in the financial statements, because they have to collect, analyse and report the financial status of the companies.

Type of Financial Analysis/Analysis of Financial Statements

Analysis of financial statements is an art. In this way, It can be presented as under:

- **Horizontal analysis.** According to this method, the relationship between different items of financial statements is established, comparisons are made and results obtained. The basis of this comparison may be:
  - (*i*) Comparison of the financial statements of different years of the same business unit.

(*ii*) Comparison of financial statements of a particular year of different business units.

- **Vertical analysis.** According to this analysis financial statements of the same period of different items of the same financial statements are compared. For example, presenting the value of individual asset as a part of the value of total assets.

Income statement and position statement used as the basis for analysis are known as common size statements (common size Profit and Loss Account and Common size Balance Sheet).

The analysis can be made in the following ways:

(*i*) By preparation of the common size statements of the two similar units.

(*ii*) By preparing common size statements of different years of the same business unit.

Analysis of financial statements is also made on the basis of available information, such analysis is known as External and Internal analysis.

- **External analysis.** This analysis is made on the basis of published statements, reports and informations. These informations of the business are available even to the outsiders.
- **Internal analysis.** This analysis is based upon the information available to the business only. These informations are not published for outside parties. Such pieces of information are used by the management to evaluate managerial and operational efficiency of their performance. It detects the plus points of the business operations and reinforces it. It also discovers weaknesses of the business and tries its best to correct it by applying remedial measures.

Significance/Importance, Purpose and Advantages of Financial Analysis

Financial statements are prepared at a certain point of time according to established conventions. These statements are prepared to suit the requirements of the proprietor. It is therefore, necessary to analyse financial statements to measure the efficiency, profitability, financial soundness and future prospects of the company. Financial analysis serves the following purpose.

1. **Judging the operational efficiency of the business.** It is very significant that the company must know the operational efficiency of its management. We analyse the financial statements, match the amount of manufacturing, selling, distribution and financial expenses of the current year with the corresponding expenses of the previous year and assess the managerial efficiency of the business. We can judge the operational efficiency of the business by calculating profitability ratios.
2. **Measuring short and long-term financial position.** The business must know its financial soundness. It should satisfy itself that its current resources are sufficient to meet its current liabilities. We can calculate current and liquid ratios for comparing current assets and current liabilities to ascertain short-term financial soundness. Long-term financial position can be measured by calculating debt equity, proprietary and fixed assets ratios. The results of the financial analysis may be studied and corrective steps can be taken, if necessary.

Notes

3. Indicating the trend of achievements. Financial statements of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profit and net profit can be ascertained, cost of goods sold, values of assets and liabilities can be compared and the future prospects of the business can be indicated.
4. **Assessing the growth potential of the business.** The trend and dynamic analysis of the business provides us sufficient information indicating the growth potential of the business. If the trend predicts gloomy picture, effective measures can be applied as remedial (corrective) measures. If cost of production is rising without corresponding increase in sales price, efforts should be made to reduce cost of production.
5. **Measuring the profitability.** Financial statements show the gross profit, net profit and other expenses. The relationship of these items can be established with sales. Gross profit, net profit, expenses and operating ratios may be calculated and the profitability of the business ascertained. In case of improving profitability ratios, the causes responsible for this performance should be reinforced.
6. **Intra-firm and inter-firm comparison of the performance.** Analysis of financial statements can be made with the previous year's performance of the same firm and also with the performance of other firms. Intra-firm analysis provides an opportunity to self-appraisal, whereas inter-firm analysis presents the operational efficiency of the firm as compared to other firms. Comparison helps us in detecting our weaknesses and applying corrective measures.
7. **Forecasting, budgeting and deciding future line of action.** Analysis of financial statements predicts the growth potential of the business. Comparison of actual performance with the desired performance shows our shortcomings. The analysis provides sufficient information regarding the profitability, performance and financial soundness of the business on the basis of these informations, we can make effective forecasting, budgeting and planning.
8. **Simplified, systematic and intelligible presentation of facts.** Analysis of financial statement is an effective tool for simplifying, systematising and summarising the monotonous figures. An average person can draw conclusion from these ratios. The facts can be made more attractive by graphs and diagrams, which can be easily understood.

Limitations of Financial Analysis

In spite of all significance of analysis of financial statements as discussed above, it has the following limitations:

1. **Suffering from the limitations of financial statements.** Financial statements suffer from variety of weaknesses. Balance Sheet is prepared on historical record of the value of assets. It is just possible that assets may not have the same value. Financial statements are prepared according to certain conventions at a point of time, whereas the investor is concerned

with the present and future of the company. Certain assets and liabilities are not disclosed. Personal judgment plays an important role in determining the figure of the balance sheet. In other words, we can say that balance sheet cannot be said to have a complete accuracy. Financial statements suffer from these weaknesses, so analysis based upon these statements cannot be said to be always reliable.

2. **Absence of standard universally accepted terminology.** Accounting is not an exact science. It does not have standard, universally accepted terminology. Different meanings are given to a particular term. There are different methods of providing depreciation. Interest may be charged on different rates. In this way, there is sufficient possibility of manipulation and the financial statements have to suffer. As a consequence financial analysis also proves to be defective.
3. **Ignoring price level changes.** The results shown by financial statements may be misleading, if price level changes have not been accounted for. The ratio may improve with the increase in price, whereas the actual efficiency may not improve. Ratios of the two years will not be meaningful for comparison, if the prices of commodities are different. Change in price affects cost of production, sales and values of assets and as a consequence comparability of ratios also suffers.
4. **Ignoring qualitative aspect.** Financial analysis does not measure the qualitative aspects of the business. It does not show the skill, technical know how and the efficiency of its employees and managers. It is the quantitative measurement of the performance. It means that analysis of financial statements measures only the one sided performance of the business. It completely ignores human resources.
5. **Financial statements are affected by window dressing.** The management displays rosy picture of the enterprise through financial statements. Sometimes material informations is concealed. Financial statements sometimes contain false information. In order to show excellent profit, sales may be exaggerated, stock may be over valued and certain purchases may not be shown. In such cases analysis of financial statements will also be incorrect.
6. **Financial statements are affected by the personal ability and bias of analyst.** The figures of financial statements do not speak themselves. These informations are analysed and interpreted by shrewd analysts, who may have their own views, reflected in the analysis. In many situations the accountant has to choose between alternative available *i.e.,* choice between straight line and diminishing balance method of depreciation and choice between LIFO and FIFO method of the valuation of stock. In other words, it is the personal ability of the analyst which manipulates the information of the financial statements in its own favour and satisfy their own whims. As subjectivity is inherent in the personal judgement, so financial statements can never be free from bias. In such cases, financial analysis fails to disclose the true picture.
7. Misleading results in the absence of absence of absolute data. Result

shown by financial analysis may be misleading in the absence of absolute data. We cannot have the idea of the size of the business. Increase in sales form ₹ 40,000 to 80,000 shows that sales has doubled. In case of other firms increases of sale from ₹ 20,00,000 to 40,00,000 also shows that the sales has doubled but the size of the firm is quite different. Profitability ratio of two firms may be the same, but magnitude of their businesses may be quite different.

Tools of Financial Analysis

The following tools are used to measure the operational efficiency and financial soundness of the enterprise:

Comparative Statements	4 : Ratios Analysis*
Common Size Statements	5 : Funds Flow Statements*
Trend Analysis	6 : Cash Flow Statement**

* Funds Flow Statement and Trend Analysis is out of CBSE syllabus.

** These have been discussed in detail in the next chapters.

4.7. Comparative Statements

Business is a continuing activity with profit motive. An efficient management should not be satisfied with the present performance but should try to discover the possible profit earning possibilities of the business. In order to achieve this objective, the management should compare its current performance with the performance of previous year and identify the plus and minus points of the business. Weaknesses and shortcomings identified by the comparison should be removed as early as possible. In this way, remedial measures may be applied. The plus points may be strengthened. For example, if cost of production is increasing as compared to the previous years, it should be ascertained whether sales is also increasing proportionately. The management should also ensure itself with the causes responsible for the increasing cost of production, whether it is due to the economic policies of the business, unavoidable adverse circumstances of the business or due to the operational inefficiency. In this way we can also compare with the financial statements of other competitive enterprises.

Comparative study of financial statement as such is the comparison of the financial statements of the business with the previous year's financial statements and with the performance of other competitive enterprise, so that weaknesses may be identified and remedial measures applied.

Format of Comparative Statement of Profit & Loss

For the years ended 31st March .... and 31st March.......

	Particulars (A)	*Note No. (B)*	*Figure at the end of current reporting period (C) (₹)*	*Figures at the end of Previous reporting period (D) (₹)*	*Absolute Change (Increase or Decrease) (E) = (C – D) (₹)*	*Percentage change (Increase) (F) =* $\left(E \times \frac{100}{c}\right)$ *(%)*
I.	**Revenue from Operations**		---	---	---	---
II.	**Other Income**		---	---	---	---
III	**Total Revenue (I + II)**		---	---	---	---
IV.	**Expenses**					
	Cost of Materials Consumed		---	---	---	---
	Purchase of Stock-In-Trade		---	---	---	---
	Changes in Inventories of Finished Goods		---	---	---	---
	Work-in-Progress and Stock-in-Trade		---	---	---	---
	Employees Benefits Expenses		---	---	---	---
	Finance Costs		---	---	---	---
	Depreciation and Amortization Expenses		---	---	---	---
	Other Expenses		---	---	---	---
	Total Expenses		---	---	---	---
V.	**Profit before Tax (III - IV)**		---	---	---	---
VI.	**Tax**		---	---	---	---
VII.	**Profit after Tax (V - VI)**					

Comparison of financial statements can be made, if information of all the statements are uniform. This is why, common size income statements and position statements are prepared. Unless the information are uniform, the purpose of making comparative statement cannot be achieved.

In the words of FAULKE, *"Comparative analysis is the study of trend of the same items and computed from two or more financial statements of the same business enterprise on different dates."*

Inter-Firm Versus Intra-Firm Comparison

Financial statements can be compared both inter-firm and intra-firm. In case of inter-firm comparison financial statements of two or more firms are compared, whereas in case of intra-firm comparison financial statements of the same enterprise for two or more years are compared. *Intra-firm comparison is also termed as trend analyses. It indicates the trend of the profitability, operational efficiency and financial soundness of the business enterprise. Trend analysis may also be named as horizontal analysis, because each accounting variable is placed and analysed horizontally.*

(A) Comparative Income Statement

It is a statement which shows in percentage term the total of income earned and expenses incurred during the two or more accounting periods. It is useful for the purpose of comparing the income statement over the past few years or quarters etc. It helps the horizontal analysis of each accounting variable for future decision-making purpose.

Notes

Explanation of items

The above format is designed as per the new schedule VI format introduced with effect from 31st March 2012. The items under this format are discussed as below:

Revenue from operations: It indicates the revenue generated from the sale of goods or by providing services to the customers. It includes net sales which is gross sales less returns inward (sales return) and sales tax (if not deducted). If sales return is separately given, it should be deducted from sales to ascertain Net sales. If sales return is not given, sales should be supposed to be Net sales. Also, in the case of service organizations, it will include separate revenue stream of the business like in the case of telecom company (say Airtel) it will be landline revenue, GSM mobile connection revenue, messaging revenue etc.

Profit before tax: If we deduct operating expenses (selling, distribution and administrative expenses) we shall get operating net income. We can get Profit before tax and interest, if we add other income. We can get Profit before tax and interest, if we add other income to operating Net income. After deducting interest from Profit before interest and tax we get profit before tax. If PBT is not specifically given it should be separately ascertained and change in its absolute figures and percentage should be shown in the comparative statement.

Profit after tax: It can be ascertained by deducting tax from before tax. If it is not given it should be determined and change in its absolute figures and percentage be shown in the comparative statement.

How to Prepare Comparative Income Statement?

Step 1: Write the items related with incomes and expenses in Column A one by one.

Step 2: Write the previous year's income statement data in Column B one by one.

Step 3: Write the current year's income statement data in Column C one by one.

Step 4: Find out the absolute change (difference between figure of current year and previous year i.e., Column C – Column B) and write them in Column D one by one.

Step 5: Find out the proportionate change (expressing absolute as percentage of figures of previous year) and write them in Column E one by one.

Illustration 1. *From the following Statement of Profit and Loss of Moon Ltd., for the years ended 31st March 2011 and 2012, prepare a comparative statement of Profit and Loss.*

Particulars	Note No.	2010-11	2011-12
Revenue from operations		*6,00,000*	*10,00,000*
Employee benefits expenses		*2,00,000*	*3,00,000*
Other expenses		*50,000*	*25,000*
Tax Rate 40%			

Solution.

Comparative Statement of Profit and Loss

For the years ended 31st March 2011 and 31st March 2012

	Particulars	2010-11 (₹)	2011-12 (₹)	Absolute Increase/decrease (₹)	Percentage Increase/decrease (%)
I.	**Revenue from Operations**	6,00,000	10,00,000	4,00,000	67
	Less: Expenses:				
II.	**Employee Benefits Expenses**	2,00,000	3,00,000	1,00,000	50
	Other Expenses	50,000	25,000	(25,000)	(50)
III.	**Profit before Tax**	**3,50,000**	**6,75,000**	**3,25,000**	**93**
	Less: Tax 40%	1,40,000	2,70,000	1,30,000	
IV.	**Profit after Tax**	**2,10,000**	**4,05,00**	**1,95,000**	**93**

(B) Comparative Balance Sheet

Comparative Balance Sheet is a statement showing assets and liabilities of the business for two or more accounting periods. It also shows the percentage change in the monetary value of the assets and liabilities. It helps in analysing the financial position of the company in terms of change in the value of assets and liabilities. It is useful for the purpose of showing the comparative value of assets and liabilities.

Format of Comparative Balance Sheet as per schedule III

Format of Comparative Balance Sheet

For the years ended March..... and March ....

	Particulars (A)	*Note No.*	*(B) Previous Year (₹)*	*(C) Current Year (₹)*	*(D) = B – C Absolute Increase/ decrease (₹)*	*(E) = D × 100/B Percentage increase/ decrease (%)*
I.	EQUITY AND LIABILITIES					
1.	**Shareholder's Funds**					
	(*a*) Share capital		–	–	–	–
	(*b*) Reserves and surplus		–	–	–	–
	(*c*) Money received against share warrants		–	–	–	–
2.	**Share Application Money Pending Allotment**					
3.	Non-current Liabilities					
	(*a*) Long-term borrowings		–	–	–	–
	(*b*) Deferred tax liabilities (net)		–	–	–	–

	(*c*) Other long-term liabilities		–	–	–	–
	(*d*) Long-term provisions		–	–	–	–
4.	**Current Liabilities**					
	(*a*) Short-term borrowings		–	–	–	–
	(*b*) Trade payables		–	–	–	–
	(*c*) Other current liabilities		–	–	–	–
	(*d*) Short-term provisions		–	–	–	–
	Total		–	–	–	–
II.	**ASSETS**					
1.	**Non-current Assets**		–	–	–	–
	(*a*) Fixed assets		–	–	–	–
	(*i*) Tangible assets		–	–	–	–
	(*ii*) Intangible assets		–	–	–	–
	(*iii*) Capital work in progress		–	–	–	–
	(*iv*) Intangible assets under development		–	–	–	–
	(*b*) Non-current investments		–	–	–	–
	(*c*) Deferred tax assets (net)		–	–	–	–
	(*d*) Long-term loans and advances		–	–	–	–
	(*e*) Other non-current assets		–	–	–	–
2.	**Current Assets**					
	(*a*) Current investments		–	–	–	–
	(*b*) Inventories		–	–	–	–
	(*c*) Trade receivables		–	–	–	–
	(*d*) Cash and cash equivalents		–	–	–	–
	(*e*) Short-term loans and advances		–	–	–	–
	(*f*) Other current assets		–	–	–	–
	Total		–	–	–	–

Explanation

The above format is designed as per the new schedule III format introduced by the companies Act, 2013.

How to Prepare Comparative Income Statement?

Step 1: Write the items related with assets, capital and liabilities in Column A one by one

Step 2: Write the previous year's Balance Sheet data in Column A one by one.

Step 3: Write the current year's Balance Sheet data in Column C one by one.

Step 4: Find out the absolute changes (difference between the figure of current year and previous year *i.e.,* Column C – Column B) one by one.

Step 5: Find out the proportionate changes (expressing absolute changes as percentage of figures of previous year) and write them in Column E one by one.

Illustration 2. *Convert the following statement of profit and loss into the comparative statement of profit and loss of BCR Co., Ltd.:*

Particulars	*Note No.*	*31 March 13*	*31 March 14*
(i) Revenue from Operations		*60,00,000*	*75,00,000*
(ii) Other Incomes		*1,20,000*	*1,50,000*
(iii) Expenses		*50,60,000*	*44,00,000*
(iv) Income Tax		*40%*	*35%*

Solution.

Comparative Statement of Profit and Loss

For the years ended March 31, 2013 and 2014

	Particulars	2014	2013	Absolute Increase (+) or decrease (–)	(%) Percentage Increase (+) or decrease (–)
		(₹)	(₹)	(₹)	(₹)
I.	**Revenue from Operations**	75,00,000	60,00,000	15,00,000	25.00
II.	*Add:* Other Incomes	1,20,000	1,50,000	(30,000)	(20.00)
III.	**Total Revenue (I + II)**	**76,20,00**	**61,50,000**	**14,70,000**	**23.90**
IV.	***Less:*** Expenses	50,60,000	44,00,000	6,60,000	15.00
	Profit before Tax	**25,60,000**	**17,50,000**	**8,10,000**	**46.29**
V.	*Less:* Tax	10,24,000	6,12,500	4,11,500	67.18
	Profit after Tax	**15,36,000**	**11,37,500**	**3,98,500**	**35.03**

Illustration 3. *From the following statement of profit and loss of Madhu Co. Ltd., prepare comparative statement of profit and loss for the year ended March 31, 2013 and 2014:*

Particulars	**Note No.**	**31 March 2013 (₹)**	**31 March 2014 (₹)**
Revenue from operations		*16,00,000*	*20,00,000*
Employee benefits expenses		*8,00,000*	*10,00,000*
Other expenses		*2,00,000*	*1,00,000*
Tax Rate 40%			

Solution. Comparative statement of profit and loss of Madhu Co. Ltd., for the year ended March 31, 2013 and 2014:

	Particulars	2014	2013	Absolute Increase (+) or decrease (–)	(%) Percentage Increase (+) or decrease (–)
		(₹)	(₹)	(₹)	(₹)
I.	**Revenue from Operations**	20,00,000	16,00,000	4,00,000	25
II.	*Less:* **Expenses**				
	(*a*) Employee benefit expenses	10,00,000	8,00,000	2,00,000	25
	(*b*) Other expenses	1,00,000	2,00,000	(1,00,000)	(50)
III	**Profit before Tax (I – II)**	**9,00,000**	**6,00,000**	**3,00,000**	**50**
IV.	***Less:* Tax @ 40%**	3,60,000	2,40,000	1,20,000	50
	Profit after Tax	**5,40,000**	**3,60,000**	**1,80,000**	**50**

Illustration 4. *From the following 'Statement of Profit and Loss' for the year*

ended 31st March, 2013, prepare a 'Comparative Statement of Profit and Loss' of Vidya Ltd.:

Particulars	Note No.	2012-2013 (₹)	2011 – 2012 (₹)
Revenue from operations		*14,00,000*	*11,00,000*
Other Income		*4,00,000*	*3,00,000*
Expenses		*11,00,000*	*12,00,000*

Notes

Solution.

Comparative Statement of Profit and Loss of Vidya Ltd.

For the years ended 31st, 2012 and 2013

	Particulars	Note No.	2010-11 (₹)	2011-12 (₹)	Absolute Increase/ decrease	Percentage Increase/ decrease (%)
I.	**Revenue from Operations**		11,00,000	14,00,000	3,00,000	27.27%
	(*a*) *Add :* Other Income		3,00,000	4,00,000	1,00,000	33.33%
II.	**Total Revenue (I + II)**		14,00,000	18,00,000	4,00,000	28.57%
	(*a*) *Less :* Expenses		12,00,000	11,00,000	(1,00,000)	(8.33%)
III.	**Profit before Tax (III – IV)**		2,00,000	7,00,000	5,00,000	250%
	(*a*) Less : Tax @ 50%		1,00,000	3,50,000	2,50,000	250%
IV.	**Profit after Tax (V – VI)**		1,00,000	3,50,000	2,50,000	250%

Illustration 5. *From the following Statement of Profit and Loss of Suntrack Ltd., for the years ended 31st March, 2011 and 2012, prepare a 'Comparative Statement of Profit and Loss'.*

Particulars	Note No.	2011-2012 (₹)	2010 – 2011 (₹)
Revenue from operations		*20,00,000*	*12,00,000*
Other Income		*12,00,000*	*9,00,000*
Expenses		*13,00,000*	*10,00,000*

Solution.

Suntract Ltd.

Comparative Statement of Profit and Loss of Suntrack Ltd.

For the years ended 31st March, 2011 and 2012

	Particulars	2010-11 (₹)	2011-12 (₹)	Absolute Increase/ decrease	Percentage Increase/ decrease (%)
I.	**Revenue from Operations**	12,00,000	20,00,000	8,00,000	66.67
II.	**Other Income**	9,00,000	12,00,000	3,00,000	33.33
III.	**Total Revenue (I + II)**	21,00,000	32,00,000	11,00,000	52.38
IV.	*Less :* Expenses	10,00,000	13,00,000	3,00,000	30.00
V.	**Profit before Tax (III – IV)**	11,00,000	19,00,000	8,00,000	72.72

Illustration 6. *From the following 'Statement of Profit and Loss' for the year ended 31st March, 2013 prepare a 'Comparative Statement of Profit and Loss' of Goods Services Ltd.:*

Particulars	Note No.	2011-2012 (₹)	2010 – 2011 (₹)
Revenue from operations		*20,00,000*	*15,00,000*
Other Income		*10,00,000*	*4,00,000*
Expenses		*21,00,000*	*15,00,000*

Rate of Income tax was 50%

Notes

Solution.

Comparative Statement of Profit and Loss

For the years ended 31st March, 2012 and 2013

	Note No.	*2014*	*2013*	*Absolute Increase/ decrease*	*Percentage Increase / decrease*
		(₹)	*(₹)*	*(₹)*	*(₹)*
Revenue from Operations		15,00,000	20,00,000	5,00,000	33.33%
Add: Other Incomes		4,00,000	10,00,000	6,00,000	150%
Total Revenue		19,00,000	30,00,000	11,00,000	57.89%
Less: Expenses		15,00,000	21,00,000	6,00,000	40%
Profit before Tax		4,00,000	9,00,000	5,00,000	125%
Less: Tax @ 50%		2,00,000	4,50,000	2,50,000	125%
Profit after Tax		2,00,000	4,50,000	2,50,000	125%

Illustration 7. *From the following Statement of Profit and Loss of Moontrack Ltd., for the years ended 31st March 2011 and 2012, prepare a 'Comparative Statement of Profit and Loss'.*

Particulars	*Note No.*	*2011-2012 (₹)*	*2010 – 2011 (₹)*
Revenue from operations		*40,00,000*	*24,00,000*
Other Income		*24,00,000*	*18,00,000*
Expenses		*16,00,000*	*14,00,000*

Solution.

Comparative Statement of Profit and Loss

For the years ended 31st March, 2011 and 2012

	2014	*2013*	*Absolute Increase/decrease*	*Percentage Increase /decrease*
	(₹)	*(₹)*	*(₹)*	*(₹)*
Revenue from Operations	24,00,000	40,00,000	16,00,000	66.67
Other Incomes	18,00,000	24,00,000	6,00,000	33.33
Total Revenue	42,00,000	64,00,000	22,00,000	52.38
Less: Expenses	14,00,000	16,00,000	2,00,000	14.28
Profit before Tax	28,00,000	48,00,000	20,00,000	71.42

Illustration 8. *Following information is extracted from the statement of Profit and Loss for the years ended 31st March, 2012 and 2013. Prepare a Comparative Statement of Profit and Loss:*

Notes

Particulars	Note No.	31 March 2013 (₹)	31 March 2013 (₹)
Revenue from operations		40,00,000	32,00,000
Employee benefits expenses		20,00,000	16,00,000
Other expenses		2,00,000	4,00,000
Tax Rate		40%	40%

Solution.

Comparative Statement of Profit and Loss

For the years ended 31st March, 2012 and 2013

	Particulars	2012 (₹)	2013 (₹)	Absolute Increase/decrease	Percentage Increase/decrease (%)
I.	**Revenue from Operations**	32,00,000	40,00,000	8,00,000	25%
II.	**Total Revenue**	32,00,000	40,00,000	8,00,000	25%
III.	**Expenses**				
	Employee's Benefit Expenses	16,00,000	20,00,000	4,00,000	25%
	Other Expenses	4,00,000	2,00,000	(2,00,000)	(50%)
	Total Expenses	20,00,000	22,00,000	2,00,000	10%
IV.	**Profit before Tax**	12,00,000	18,00,000	6,00,000	50%
V.	**Less: Tax**	41,80,000	7,20,000	2,40,000	50%
VI.	**Profit after Tax**	7,20,000	10,80,000	3,60,000	50%

Illustration 9. *Prepare a Comparative Statement of Profit and Loss from the following details:*

Particulars	Note No.	31-03-2013 (₹)	31-03-2012 (₹)
Revenue from operations		₹ 30,00,000	₹ 20,00,000
Other Income (% of Revenue from operations)		15%	20%
Expenses (% of Revenue from operations)		60%	50%

Solution. (*a*)

Comparative Statement of Profit and Loss

For the years ended 31st March, 2011 and 2012

	Particulars	Note No.	31-03-2012 (₹)	31-03-2013 (₹)	Absolute Increase/ decrease (₹)	Percentage Increase/ decrease (%)
	1		2	3	4	5
			A	B	(B – A) = C	$\frac{C}{A} \times 100 = D$
I.	**Revenue from Operations**		20,00,000	30,00,000	10,00,000	50
II.	**Other Income**		4,00,000	4,50,000	50,000	12.5
III.	**Total Revenue (I + II)**		24,00,000	34,50,000	10,50,000	43.75
IV.	**Expenses**		10,00,000	18,00,000	8,00,000	80
V.	**Profit before Tax (III-IV)**		14,00,000	16,50,000	2,50,000	17.85

From the following statement of Profit and Loss of Star Ltd. for the years ended 31st March 2011 and 2012 prepare a comparative statement of Profit and Loss

Particulars	Note No.	31-03-2012 (₹)	31-03-2011 (₹)
Revenue from operations		20,00,000	16,00,000
Employee benefits expenses		10,00,000	8,00,000
Other expenses		1,00,000	2,00,000
Tax		50%	50%

(***b***)

Comparative Statement of Profit and Loss

For the years ended 31st March, 2011 and 2012

	Particulars	Note No.	31-03-2012 (₹)	31-03-2013 (₹)	Absolute Increase/ decrease (₹)	Percentage Increase/ decrease (%)
1			2	3	4	5
			A	B	(B – A) = C	$\frac{C}{A} \times 100$ = D
I.	**Revenue from Operations**		16,00,000	20,00,000	4,00,000	25
II.	**Less: Expenses**					
	Employee benefit expenses		8,00,000	10,00,000	2,00,000	25
	Other Expenses		2,00,000	1,00,000	(1,00,000)	(50)
III.	**Total Expenses**		10,00,000	11,00,000	1,00,000	10
IV.	**Profit before tax (I – III)**		6,00,000	9,00,000	3,00,000	50
V.	**Tax**		3,00,000	4,50,000	1,50,000	50
VI.	**Profit after tax**		3,00,000	4,50,000	1,50,000	50

Illustration 10. *From the following Balance Sheet of Shahnaz Shahab Limited as on 31st March 2011 and 2012, prepare a Comparative Balance Sheet:*

Particulars	Note No.	2010–11	2011–12
EQUITY AND LIABILITIES			
1. ***Shareholders Funds***			
(a) Share Capital		*21,00,000*	*29,00,000*
(b) Reserves and surplus		*10,00,000*	*12,00,000*
2. ***Non-current Liabilities***			
Long-term borrowings		*12,00,000*	*18,00,000*
3. ***Current Liabilities***			
Trade payables		*8,00,000*	*12,00,000*
Total		***51,00,000***	***71,00,000***
ASSETS			
1. ***Non-current Assets***			
Fixed Assets			
(i) Tangible assets		*21,00,000*	*29,00,000*
(ii) Intangible assets		*12,00,000*	*18,00,000*

2. ***Current Assets***			
(a) Inventories		*10,00,000*	*12,00,000*
(b) Cash and cash equivalents		*8,00,000*	*12,00,000*
		51,00,000	***71,00,000***

Notes

Solution.

Shahnaz Shahab Ltd.

Comparative Balance Sheet

For the years ended on 31st March 2011 and 31st March 2012

Particulars	*Note No.*	*2010–11*	*2011–12*	*Absolute increase/decrease (₹)*	*Percentage increase/decrease (%)*
EQUITY AND LIABILITIES					
1. **Shareholders Funds**					
(*a*) Share Capital		21,00,000	29,00,000	8,00,000	38
(*b*) Reserves and surplus		10,00,000	12,00,000	2,00,000	20
2. **Non-current Liabilities**					
Long-term borrowings		12,00,000	18,00,000	6,00,000	50
3. **Current Liabilities**					
Trade payables		8,00,000	12,00,000	4,00,000	50
Total		**51,00,000**	**71,00,000**	**20,00,000**	**39**
ASSETS					
1. **Non-current Assets**					
Fixed Assets					
(*i*) Tangible assets		21,00,000	29,00,000	8,00,000	38
(*ii*) Intangible assets		12,00,000	18,00,000	6,00,000	50
2. **Current Assets**					
(*a*) Inventories		10,00,000	12,00,000	2,00,000	20
(*b*) Cash and cash equivalents		8,00,000	12,00,000	4,00,000	50
		51,00,000	**71,00,000**	**20,00,000**	**39**

Note. *Figure in bracket are negative*

Assets have been classified as Non-current and Current Assets.

In the same way, liabilities have been classified as shareholder's fund, current and non-current liabilities.

Illustration 11. *From the following Balance Sheet of Balaji Traders as 31st March 2011 and 2012, prepare a Comparative Balance Sheet:*

Particulars	*Note No.*	*2010–11*	*2011–12*
EQUITY AND LIABILITIES			
1. ***Shareholders Funds***			
(a) Share Capital		*10,00,000*	*12,00,000*
(b) Reserves and surplus		*1,00,000*	*1,10,000*
2. ***Non-current Liabilities***			

Notes

	Long-term borrowings		*6,00,000*	*7,00,000*
	Other long-term borrowings		*1,50,000*	*1,30,000*
	Long-term provisions		*25,000*	*20,000*
3.	***Current Liabilities***			
	Trade payables		*80,000*	*1,00,000*
	Short-term provisions		*15,000*	*18,000*
	Total		***19,70,000***	***22,78,000***
	ASSETS			
1.	***Non-current Assets***			
	Fixed Assets			
	(i) Tangible assets		*14,95,000*	*17,21,000*
	(ii) Intangible assets		*1,20,000*	*1,50,000*
	Capital work in progress		*80,000*	*90,000*
2.	***Current Assets***			
	(a) Inventories		*50,000*	*45,000*
	(b) Cash and cash equivalents		*35,000*	*42,000*
	(c) Current investments		*1,00,000*	*1,20,000*
	(d) Trade receivables		*90,000*	*1,10,000*
	Total		***19,70,000***	***22,78,000***

Solution.

Balaji Traders

Comparative Balance Sheet

For the years ended on 31st March 2012 and 31st March 2013

Particulars	Note No.	2010–12 (₹)	2011–13 (₹)	Absolute increase/decrease (₹)	Percentage increase/ decrease (%)
EQUITY AND LIABILITIES					
1. **Shareholders Funds**					
(*a*) Share Capital		10,00,000	12,00,000	2,00,000	20
(*b*) Reserves and surplus		1,00,000	1,10,000	10,000	10
2. **Non-current Liabilities**					
(*a*) Long-term borrowings		6,00,000	7,00,000	1,00,000	17
(*b*) Other long-term borrowings		1,50,000	1,30,000	(20,000)	(13)
(*c*) Long-term provisions		25,000	20,000	(5,000)	(20)
3. **Current Liabilities**					
(*a*) Trade payables		80,000	1,00,000	20,000	25
(*b*) Short-term provisions		15,000	18,000	3,000	20
Total		**19,70,000**	**22,78,000**	**3,08,000**	**16**
ASSETS					
1. **Non-current Assets**					

Notes

(*a*) Fixed Assets					
(*i*) Tangible assets		14,95,000	17,21,000	2,26,000	15
(*ii*) Intangible assets		1,20,000	1,50,000	30,000	25
(*b*) Capital work in progress		80,000	90,000	10,000	13
2. **Current Assets**					
(*a*) Inventories		50,000	45,000	(5,000)	(10)
(*b*) Cash and cash equivalents		35,000	42,000	7,000	20
(*c*) Current investments		1,00,000	1,20,000	20,000	20
(*d*) Trade receivables		90,000	1,10,000	20,000	22
Total		**19,70,000**	**22,78,000**	**3,08,000**	**16**

Note. *Figures in the brackets are negative.*

Illustration 12. *The followings are the excerpts of balance sheets of J. Ltd., for the year ended March 31, 2013 and 2014. Prepare a Comparative balance sheet and comment on the financial position of the business firm.*

Particulars	*Note No.*	*2014 (₹)*	*2013 (₹)*
I. ***EQUITY AND LIABILITIES***			
1. ***Shareholders Funds***			
(a) Share Capital		*20,00,000*	*15,00,000*
(b) Reserves and surplus		*3,00,000*	*4,00,000*
2. ***Non-current Liabilities***			
(a) Long-term borrowings		*9,00,000*	*6,00,000*
3. ***Current Liabilities***			
(a) Trade payables		*3,00,000*	*2,00,000*
Total		***35,00,000***	***27,00,000***
II. ***ASSETS***			
1. ***Non-current Assets***			
(a) Fixed Assets			
– Tangible assets		*20,00,000*	*15,00,000*
– Intangible assets		*9,00,000*	*6,00,000*
2. ***Current Assets***			
(a) Current assets		*3,00,000*	*4,00,000*
– Inventories		*3,00,000*	*2,00,000*
– Cash and cash equivalents			
Total		***35,00,000***	***27,00,000***

Solution

Comparative Balance Sheet

as a March 2013 and March 2014 *(Figure in Lakhs)*

Particulars	2014	2013	Absolute Change	Percentage Change (%)
I. **EQUITY AND LIABILITIES**				
1. **Shareholders Funds**				
(*a*) Share Capital	20	15	05	33.33
(*b*) Reserves and surplus	03	04	01	(25)
2. **Non-current Liabilities**				
(*a*) Long-term borrowings	09	06	3	50
3. **Current Liabilities**				
(*a*) Trade payables	03	02	01	50
Total	**35**	**27**	**08**	**29.63**
II. **ASSETS**				
1. **Non-current Assets**				
(*a*) Fixed Assets				
(*i*) Tangible assets	20	15	05	33.33
(*ii*) Intangible assets	09	06	03	50
2. **Current Assets**				
(*a*) Inventories	03	04	(01)	(25)
(*b*) Cash and cash equivalents	03	02	01	50
Total	**35**	**27**	**08**	**29.63**

Notes

4.8. Common Size Statements

Convenient comparison of the financial statements requires that the financial statement should be converted into common size statements. Every item of the statement is presented in the form of percentage of its important heading. Every item of income statement is expressed in terms of the percentage of the total sales. In the same way every asset is expressed in terms of the percentage of total assets and every liability is expressed in terms of the percentage of total liability.

Common Size Balance Sheet

Common Size Balance Sheet refers to the statement which shows the assets and liabilities of the business in percentage terms to enable better comparison of the value of assets and liabilities over two or more accounting periods. It is useful to analyse the increasing or decreasing trend of the assets and liabilities as compared with the previous period from current period.

How to Prepare Common Size Balance Sheet?

Step 1: Pick up the items of assets, liabilities and capital and write them in Column A.

Step 2: Pick up the absolute amounts of assets, liabilities and capital of **current years's Balance Sheet** and write them in Column C.

Notes

Step 3: Pick up the absolute amounts of assets, liabilities and capital of **previous year's Balance Sheet** and write them in Column C.

Step 4: Calculate the percentage of different items of **previous year's Balance Sheet to total liabilities of previous year** and write them in Column D.

Step 5: Calculate the percentage of different items of current year's Balance Sheet to total liabilities of the current year and write them in Column E.

Illustration 13. From the following Balance Sheet of Rashmi Mills Ltd., prepare the common size balance sheet for the year ended March 31st 2011 and March 31st 2012

Particulars	*Note No.*	*2010–11 (₹)*	*2011–12 (₹)*
EQUITY AND LIABILITIES			
1. ***Shareholders Funds***			
(a) Share Capital		*24,00,000*	*30,50,000*
(b) Reserves and surplus		*13,00,000*	*13,50,000*
2. ***Non-current Liabilities***			
Long-term borrowings		*15,00,000*	*19,50,000*
3. ***Current Liabilities***			
Trade payables		*11,00,000*	*12,00,000*
Total		***63,00,000***	***75,50,000***
ASSETS			
1. ***Non-current Assets***			
Fixed Assets			
(i) Tangible assets		*24,00,000*	*30,50,000*
(ii) Intangible assets		*15,00,000*	*19,50,000*
2. ***Current Assets***			
(a) Inventories		*13,00,000*	*13,50,000*
(b) Cash and cash equivalents		*11,00,000*	*12,00,000*
Total		***63,00,000***	***75,50,000***

Solution.

Common Size Balance Sheet

For the years ended on 31st March 2011 and March 2012

Particulars	*Note No.*	*2010–11 (₹)*	*2011–12 (₹)*	*Percentage of total 2010-11*	*Percentage of total 2011-12*
EQUITY AND LIABILITIES					
1. **Shareholders Funds**					
(*a*) Share Capital		24,00,000	30,50,000	38	40
(*b*) Reserves and surplus		13,00,000	13,50,000	21	18

2.	**Non-current Liabilities**					
	Long-term borrowings		15,00,000	19,50,000	24	26
3.	**Current Liabilities**					
	Trade payables		11,00,000	12,00,000	17	16
	Total		**63,00,000**	**75,50,000**	**100**	**100**
	ASSETS					
1.	**Non-current Assets**					
	Fixed Assets					
	(*i*) Tangible assets		24,00,000	30,50,000	38	40
	(*ii*) Intangible assets		15,00,000	19,50,000	24	26
2.	**Current Assets**					
	(*a*) Inventories		13,00,000	13,50,000	21	18
	(*b*) Cash and cash equivalents		11,00,000	12,00,000	17	16
	Total		**63,00,000**	**75,50,000**	**100**	**100**

Working Notes

Calculation of Percentage

Assets	**2010-11**	**2011-12**
Share capital	$\frac{24,00,000}{63,00,000} \times 100 = 38\%$	$\frac{30,50,000}{75,50,000} \times 100 = 40\%$
Reserve and surplus	$\frac{13,00,000}{63,00,000} \times 100 = 21\%$	$\frac{13,50,000}{75,50,000} \times 100 = 18\%$
Long-term borrowings	$\frac{15,00,000}{63,00,000} \times 100 = 24\%$	$\frac{19,50,000}{75,50,000} \times 100 = 26\%$
Trade payables	$\frac{11,00,000}{63,00,000} \times 100 = 17\%$	$\frac{12,00,000}{75,50,000} \times 100 = 16\%$
Tangible assets	$\frac{24,00,000}{63,00,000} \times 100 = 38\%$	$\frac{30,50,000}{75,50,000} \times 100 = 40\%$
Inventories	$\frac{13,00,000}{63,00,000} \times 100 = 21\%$	$\frac{13,50,000}{75,50,000} \times 100 = 18\%$
Cash and cash equivalents	$\frac{11,00,000}{63,00,000} \times 100 = 17\%$	$\frac{12,00,000}{75,50,000} \times 100 = 16\%$

Common Size Income Statement

Common Size Income Statement is known as common size because it is converted to a common variable indicated by percentage. "Common size income statement refers to the income statement for two or more accounting period on the basis of which income and expenses are shown in percentage terms." It helps in comparing the relative value of income and expenses over two or more accounting periods. Financial managers prepare these common size statements for business reporting and decision making purposes.

Notes

Format of Common-size Statement of Profit and Loss

For the years ended March..... and March ....

Particulars (A)		Note No. (B)	Absolute Amount		Percentage of Revenue from Operations	
			Figure at the end of Current reporting Period (C) (₹)	Figure at the end of Previous reporting Period (D) (₹)	Current reporting period (%) (E)	Previous reporting period (%) (F)
I.	**Revenue from Operations**		---	---	100	100
II.	**Other Income**		---	---	---	---
III.	**Total Revenue (I + II)**		---	---	---	---
IV.	**Expenses**		---	---	---	---
	Cost of Materials Consumed		---	---	---	---
	Purchases of Stock-in-Trade		---	---	---	---
	Changes in inventories of Finished Goods		---	---	---	---
	Work-in-Progress and Stock-in-Trade		---	---	---	---
	Employees Benefits Expenses		---	---	---	---
	Finance Costs		---	---	---	---
	Depreciation and Amortization Expenses		---	---	---	---
	Other Expenses		---	---	---	---
			---	---	---	---
	Total Expenses		---	---	---	---
V.	**Profit before Tax (III – IV)**		---	---	---	---
VI.	**Tax**		---	---	---	---
VII.	**Profit after Tax (V – VI)**		---	---	---	---
	(*d*) Cash and cash equivalents		–	–	–	–
	(*e*) Short-term loans and advances		–	–	–	–
	(*f*) Other current assets		–	–	–	–
	Total		–	–	–	–

How to Prepare Common Size Income Statement?

Step 1: Pick up the items of income statement and write them in Column A.

Step 2: Write the current year's income statement data in Column C.

Step 3: Write the previous year's income statement data in Column D.

Step 4: Calculate the percentage relation of current year's income statement data to net sales of current year and write it in Column E.

Step 5: Calculate the percentage relation of previous year's income statement data to net sales of the previous year and write it in Column F.

In order to make such common size income statement sales is supposed to be

100 and every item of the income statement is expressed in terms of percentage of total sales.

Illustration 14. *Prepare common-size balance sheet of XRI Ltd., from the following information:*

Notes

Particulars	*Note No.*	*March 31, 2014 (₹)*	*March 31, 2013 (₹)*
I. ***EQUITY AND LIABILITIES***			
1. ***Shareholders Funds***			
(a) Share Capital		*20,00,000*	*12,00,000*
(b) Reserves and surplus		*5,00,000*	*5,00,000*
2. ***Non-current Liabilities***			
(a) Long-term borrowings		*6,00,000*	*5,00,000*
3. ***Current Liabilities***			
(a) Trade payables		*15,50,000*	*10,50,000*
Total		***41,50,000***	***32,50,000***
II. ***ASSETS***			
1. ***Non-current Assets***			
(a) Fixed Assets			
– Tangible assets			
Plant and machinery		*15,00,000*	*10,00,000*
– Intangible assets			
Goodwill		*15,00,000*	*10,00,000*
(b) Non-current investments		*10,00,000*	*10,00,000*
2. ***Current Assets***			
(a) Inventories		*1,50,000*	*2,50,000*
Total		***35,00,000***	***27,00,000***

Solution

Common-size Balance Sheet of XRI Lt

For the year ended March 31, 2013 and March 31, 2014

Particulars	*Absolute Amounts*		*Percentage of Net Sales*	
	31-3-2014	*31-03-2013*	*31-03-2014 (%)*	*31-03-2013 (%)*
I. **EQUITY AND LIABILITIES**				
1. **Shareholders Funds**				
(*a*) Share Capital	15,00,000	12,00,000	36,14	36.93
(*b*) Reserves and surplus	5,00,000	5,00,000	12.05	15.38
2. **Non-current Liabilities**				
(*a*) Long-term borrowings	6,00,000	5,00,000	14.46	15.38

Notes

3.	**Current Liabilities**				
	(*a*) Trade payables	15,50,000	10,50,000	37.35	32.31
	Total	**41,50,000**	**32,50,000**	**100**	**1000**
II.	**ASSETS**				
1.	**Non-current Assets**				
	(*a*) Fixed Assets				
	– Tangible assets				
	Plant & machinery	14,00,000	8,00,000	33.73	24.61
	– Intangible assets				
	Goodwill	16,00,000	12,00,000	38.55	36.92
2.	**Non-current Investments**				
	(*a*) Current assets	10,00,000	10,00,000	24.10	30.77
	– Inventories	1,50,000	2,50,000	3.62	7.69
	Total	**41,50,000**	**32,50,000**	**100**	**100**

Illustration 15. *From the following Income Statement of ABC Ltd., prepare the common size income statement for the year ended March 31st 2013 and March 31st 2014.*

	Particulars	*2012-13 (₹)*	*2013-14 (₹)*
I.	***Revenue from Operations***	*15,00,000*	*18,00,000*
II.	***Expenses***		
	Purchases of Stock-in-Trade	*7,05,000*	*7,92,000*
	Changes in inventories of Finished Goods	*1,05,000*	*72,000*
	Employees Benefits Expenses	*4,05,000*	*5,04,000*
	Finance Costs	*75,000*	*54,000*
	Depreciation and Amortization Expenses	*15,000*	*18,000*
	Other Expenses	*45,000*	*36,000*
	Total Expenses	*13,50,000*	*14,76,000*
III.	***Profit before Tax (I – II)***	*1,50,000*	*3,24,000*
IV.	***Tax @ 35%***	*52,500*	*1,13,400*
V.	***Profit after Tax (III – IV)***	*97,500*	*2,10,600*

Solution.

	Particulars	*2012-13 (₹)*	*2013-14 (₹)*	*Percentage of Total 2012-13 (₹)*	*Percentage of Total 2013-14 (₹)*
I.	**Revenue from Operations**	15,00,000	18,00,000	100	100
II.	**Expenses**				
	Purchases of Stock-in-Trade	7,05,000	7,92,000	47	44
	Changes in inventories of Finished Goods	1,05,000	72,000	7	4
	Employees Benefits Expenses	4,05,000	5,04,000	27	28
	Finance Costs	75,000	54,000	5	3

	Depreciation and Amortization Expenses	15,000	18,000	1	1
	Other Expenses	45,000	36,000	3	2
	Total Expenses	13,50,000	14,76,000	90	82
III.	**Profit before Tax (I – II)**	1,50,000	3,24,000	10	18
IV.	**Tax @ 35%**	52,500	1,13,400	3.5	6.3
V.	**Profit after Tax (III – IV)**	97,500	2,10,600	6.5	11.7

Illustration 16. *From the following Income Statements of Kejriwal Ltd., prepare the common size income statement for the year ended March 31st 2014 and March 31st 2015.*

	Particulars	*2013–14 (₹)*	*2014–15 (₹)*
I.	***Revenue from Operations***	*15,00,000*	*18,00,000*
II.	***Other Income***	*3,00,000*	*2,70,000*
III.	***Total Revenue (I + II)***	*18,00,000*	*20,70,000*
IV.	***Expenses***		
	Cost of Materials Consumed	*3,00,000*	*4,50,000*
	Purchases of Stock-in-Trade	*2,70,000*	*1,80,000*
	Changes in inventories of Finished Goods		
	Work-in-Progress and Stock-in-Trade	*75,000*	*36,000*
	Employees Benefits Expenses	*2,25,000*	*3,24,000*
	Finance Costs	*2,40,000*	*2,52,000*
	Depreciation and Amortization Expenses	*30,000*	*1,80,000*
	Other Expenses	*75,000*	*90,000*
	Total Expenses	*12,15,000*	*15,12,000*
V.	***Profit before Tax (III – IV)***	*5,85,000*	*5,58,000*
VI.	***Tax @ 35%***	*2,04,750*	*1,95,300*
VII.	***Profit after Tax (V – VI)***	*3,80,250*	*3,62,700*

Solution.

	Particulars	2013–14 (₹)	2014–15 (₹)	Percentage of Total 2013-14 (₹)	Percentage of Total 2014-15 (₹)
I.	**Revenue from Operations**	15,00,000	18,00,000	100	100
II.	**Other Income**	3,00,000	2,70,000	20	15
III.	**Total Revenue (I + II)**	18,00,000	20,70,000	120	115
IV.	**Expenses**				
	Cost of Materials Consumed	3,00,000	4,50,000	20	25
	Purchases of Stock-in-Trade	2,70,000	1,80,000	18	10
	Changes in inventories of Finished Goods				
	Work-in-Progress and Stock-in-Trade	75,000	36,000	5	2
	Employees Benefits Expenses	2,25,000	3,24,000	15	18

Notes

	Finance Costs	2,40,000	2,52,000	16	14
	Depreciation and Amortization Expenses	30,000	1,80,000	2	10
	Other Expenses	75,000	90,000	5	5
	Total Expenses	12,15,000	15,12,000	81	84
V.	**Profit before Tax (III – IV)**	5,85,000	5,58,000	39	31
VI.	**Tax @ 35%**	2,04,750	1,95,300	13.65	10.85
VII.	**Profit after Tax (V – VI)**	3,80,250	3,62,700	25.36	2015

Illustration 17. *From the following statement of Profit and Loss of Star Ltd., fro the year ended 31st March 2012, Prepare a common Size Statement of Profit and Loss.*

Particulars	Note No.	31-03-2012 (₹)
Revenue from Operations		*20,00,000*
Employee benefit expenses		*10,00,000*
Other Expenses		*1,00,000*

Solution.

Common Size Statement of Profit and Loss

For the year ended 31, March , 2012

	Particulars	*Note No.*	*Absolute Amount (₹)*	*Percentage of Revenu from Operations*
			2011-12	*2011-12*
I.	**Revenue from Operations**		20,00,000	100
II.	**Employee benefit expenses**		10,00,000	50
	Other Expenses		1,00,000	5
III.	**Total Expenses**		11,00,000	55
IV.	**Profit before Tax (I – III)**		9,00,000	45

4.9. Test Problems

1. The following information is extracted from the book of Confident Co. Ltd. You are required to rearrange the information for Financial Analysis and calculate (1) Return on investment (ROI) (2) Return on capital employed (3) Return on shareholder's funds (4) Return on equity shareholder's (5) Return on total assets.

Particulars	₹	*Particulars*	₹
Net Sales	10,00,000	Profit & Loss Account	2,00,000
Cost of goods sold	6,00,000	Debentures	2,50,000
Interest on debentures	25,000	Sundry creditors	50,000
Loss on sale of furniture	5,000	Equity share capital	3,00,000
Interest on govt. securities	5,000	10% pref. share capital	2,00,000
Fixed assets less depreciation	10,75,000	Operating expenses	1,50,000

Investment in govt. securities	50,000	Provision for tax	75,000
Current assets	5,00,000		
Reserves	4,00,000		

[**Ans.** (1) 17.24%, (2) 12%, (3) 12.62%, (4) 10.77%]

2. Calculate the earnings per share from the following information:

Net Profit before tax	₹ 10,00,000
Tax on profit	₹ 50%
15% preference share capital (₹ 10 each)	₹ 2,00,000
Equity share capital 4,700 shares of ₹ 10 each	₹ 4,70,000

[Ans. ₹ 100 per share]

3. Profit and Loss Account of X Ltd., is given below

Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Opening stock	2,00,000	By sales	16,00,000
To Purchases	12,00,000	By Closing stock	3,20,000
To Administration expenses	1,20,000	By Dividend	4,000
To Selling expenses	80,000		
To Financial expenses	40,000		
To Loss on sale of assets	5,000		
To Net profit	2,79,000		
	19,24,000		**19,24,000**

Calculate the Profitability Ratios

[**Ans.** (1) G.P: 32.5%, (2) N.P: 17.44%, (3) OP: 20%, (4) OP Ratio: 80%]

4. (*a*) From the following details of a trader you are required to calculate stock turnover ratio.

	₹
Sales	39,984
Sales returns	380
Opening stock at cost	1,378
Closing stock at cost	1,814
Total Gross profit for the year	8.068

(*b*) Calculate stock turnover ratio and Stock turnover period from the following sales ₹ 10,000,000; Gross profit ratio 20%; Stock at the beginning of the year ₹ 1,75,000; Stock at the end of the year ₹ 1,45,000

[**Ans.** (1) 19.76 Times (2) 2.4 months]

Notes

5. Ganesh Bros. sells goods on cash and credit terms and also purchased goods on cash and credit terms. The following particulars are obtained from their books.

	₹
Total sales	5,00,000
Cash sales	40,000
Sales returns	20,000
Debtors at the end	80,000
Bills receivable at the end	20,000
Reserve for doubtful debts	1,000
Total purchases	3,00,000
Cash purchases	50,000
Purchase returns	10,000
Creditors at the end	60,000
Bills payable at the end	20,000
Reserve for discount on creditors	2,000
Opening stock	50,000
Closing stock	40,000
Gross profit	1,00,000
Fixed assets	10,00,000

Calculate activity ratio (turnover ratio)

[**Ans.** (1) 8.44 Stock Turnover Ratio; (2) 0.48 Times Fixed Asset Turnover Ratio; (3) 4.4 Debtors Turnover Ratio; (4) 83 Debtors Collection Period; (5) 2 Times A/c Payable; (6) 122 A/c Payable Period]

6. You are given the following information

	₹
Cash	18,000
Debtors	1,42,000
Closing Stock	1,80,000
Bills Payable	27,000
Creditors	50,000
Outstanding expenses	15,000
Tax payable	75,000

Calculate: (*a*) Current ratio (*b*) Liquidity ratio (*c*) Absolute liquidity ratio.

[**Ans.** (1) 2.036 Times, (2) 0.96, (3) 0.11]

7. From the following Balance Sheet of Balaji Industries Ltd., you are required to calculate debt equity ratio.

Balance Sheet

As at 31.12.1999

Liabilities	₹	*Assets*	₹
Share capital		Fixed assets	1,20,000
10,000 shares of ₹ 10 each	1,00,000	Current assets	80,000
General reserve	12,000		
P & L A/c	8,000		
Debentures	30,000		
Current liabilities	50,000		
	2,00,000		**2,00,000**

[**Ans.** 0.67]

8. Balance Sheet of Rama Ltd. as at 31.12.1993 is as follows:

Liabilities	₹	*Assets*	₹
Equity capital	2,00,000	Fixed assets	3,60,000
9% Preference share capital	1,00,000	Stock	50,000
8% Debentures	1,00,000	Debtors	1,10,000
Profit and Loss A/c	40,000	Bills Receivable	6,000
Creditors	90,000	Bank balance	4,000
	5,30,000		**5,30,000**

Find out: (1) Fixed assets ratio and (2) Capital gearing ratio.

[**Ans.** (1) 0.81 (2) 0.833]

9. Given below is the summarized Balance Sheet and Profit and Loss of Ragunath Sugar Mills Ltd. as on 31.12.2007. You are required to calculate.
   1. Current ratio
   2. Quick ratio
   3. Fixed assets ratio
   4. Debt equity ratio
   5. Proprietary ratio
   6. Stock turnover ratio
   7. Fixed assets turnover ratio
   8. Return on capital employed
   9. Debtors turnover ratio
   10. Creditors turnover ratio
   11. Net profit ratio
   12. Operating ratio

Balance Sheet

As at 31.12.1999

Liabilities	₹	*Assets*	₹
Share capital		Land and building	30,00,000
40,000 shares of ₹ 10 each	40,00,000	Plant & Machinery	16,00,000
Reserves	18,00,000	Stock	29,60,000
Creditors	26,00,000	Debtors	14,20,000
Profit & Loss Account	6,00,000	Cash at bank	6,20,000

Notes

6% Debentures	6,00,000		
	96,00,000		**96,00,000**

Profit and Loss Account for the year ended on 31.12.2007

Particulars	₹	*Particulars*	₹
To Opening stock	19,90,000	By sales	1,70,00,000
To Purchases	1,09,05,000	By Closing stock	29,80,000
To Direct expenses	2,85,000		
To Gross profit	68,00,000		
	1,99,80,000		**1,99,80,000**
To Administration expenses	30,00,000	By Gross profit b/d	68,00,000
To Selling & Distribution exp.	6,00,000	By Non-operating income	1,80,000
To Financial expenses	3,00,000		
To Other non-operating exp.	80,000		
To Net profit	30,00,000		
	69,80,000		**69,80,000**

[**Ans.** (1) 1.92, (2) 0.78, (3) 0.66, (4) 0.67, (6) 4.10 times, (7) 3.69 times, (8) 45.71%, (9) 11.97 times, (10) 4.19 times (11) 17.64%, (12) 81.17%]

10. Find out fixed assets and gross profit from the following information:

    Sales ₹ 10,00,000

    Gross profit ratio 25%

    Fixed assets turnover (on cost of sales) 5 times

    [**Ans.** ₹ 1,50,000]

11. Given:

    Current assets = 2.8

    Acid-test ratio = 1.5

    Working capital = ₹ 1,62,000

    Calculate:

    1. Current
    2. Current liabilities
    3. Liquid assets
    4. Stock

    [**Ans.** (1) ₹ 2,52,000, (2) ₹ 90,000, (3) ₹ 1,35,000 (4) ₹ 1,17,000]

12. Following are the ratios relating to the trading activities of Nagul Trader Ltd., Madras

    Receivable turnover = 90 days

    Inventory turnover = 3 times

    Payable turnover = 3 months

    Gross profit ratio = 25%

    Gross profit for the amounted to ₹ 18,000, closing inventory of the year is ₹ 2,000 above the opening inventory. Bill Receivable amount to ₹ 2,500 and Bills Payable ₹ 1,00. Ascertain the following:

1. Sales
2. Debtors
3. Closing inventory and
4. Sundry creditors.

[**Ans.** (1) ₹ 72,000, (2) ₹ 1550 Debtors, (3) 19,000, (4) 13,000]

13. The following figures are extracted from the Balance Sheet of X Ltd. As on 31st December:

Particulars	*1992 ₹*	*1993 ₹*
Stock	25,000	40,000
Debtors	10,000	16,000
Cash at Bank	5,000	4,000
Creditors	8,000	15,000
Bills Payable	2,000	3,000
Provision for Taxes	5,000	7,000
Bank Overdraft	5,000	15,000

Calculate the Current ratio and Quick ratio for two years.

[**Ans.** (1) Current ratio, (2) Quick ratio 1992 - 2 times, 1992 - 0.75, 1993 - 1.5 times, 1993 - 0.50]

14. From the following particulars, pertaining to assets and liabilities of a company calculate (*a*) liquid ratio, (*b*) proprietary ratio, (*c*) debt equity ratio, and (*d*) capital gearing ratio.

Liabilities	₹	*Assets*	₹
5,000 equity shares of ₹ 50 each	2,50,000	Building	3,00,000
1,000 8% preference shares of ₹ 100 each	1,00,000	Machinery	2,50,000
2,000 9% Debentures of ₹ 100 each	2,00,000	Stock	1,20,000
Reserves	1,50,000	Debtors	1,00,000
Creditors	75,000	Cash at Bank	27,500
Bank Overdraft	25,000	Prepaid expenses	2,500
	8,00,000		**8,00,000**

[**Ans.** (1) Current ratio, (2) Quick ratio 1992 - 2 times, 1992 - 0.75, 1993 - 1.5 times, 1993 - 0.50]

15. Following is the Balance Sheet of Kovalan & Co. Ltd.

Liabilities	₹	*Assets*	₹
Equity shares capital	1,00,000	Cash	2,000
6% Preference share capital	1,00,000	Bank	10,000
7% Debentures	40,000	Bills Receivable	30,000

Notes

8% Public debt	20,000	Investments	20,000
Bank overdraft	40,000	Debtors	70,000
Creditors	60,000	Stock	40,000
Outstanding creditors	7,000	Furniture	30,000
Proposed dividend	10,000	Machinery	1,00,000
Reserves	1,50,000	Land & Building	2,20,000
Reserves for taxation	20,000	Goodwill	35,000
P & L Account	20,000	Preliminary exp.	10,000
	5,67,000		**5,67,000**

During the year provision for taxation was ₹ 20,000. Dividend was proposed at ₹ 10,000. Profit carried from the last year was 15,000. You are required to calculate.

(*i*) Current ratio
(*ii*) Liquidity ratio
(*iii*) Debt-equity ratio
(*iv*) Fixed assets ratio and
(*v*) Fixed charges cover ratio

[**Ans.** (1) 1.26, (2) 0.96, (3) 0.17, (4) 0.83, (5) 8.95
(Profit before interest and tax ₹ 39400,
Fixed charges 2,800 + 1,600 = 44000)]

16. From the following given ratios and figures, prepare a summarized Balance Sheet of XYZ Co. Ltd., for the year ended 31.12.2005.

(*a*) Working capital = ₹ 60,000
(*b*) Reserves and surplus = ₹ 40,000
(*c*) Bank overdraft = ₹ 10,000
(*d*) Assets (fixed) proprietorship ratio = 0.75
(*e*) Current ratio = 2.50
(*f*) Liquid ratio = 1.50

[**Ans.** Assets – Total: ₹ 2,80,000: Fixed assets: ₹ 1,80,000: Stock: ₹ 40,000; Other current assets: ₹ 60,000; Liabilities – Total : ₹ 2,80,000; Capital: ₹ 2,00,000; Reserves and surplus: ₹ 40,000; Bank overdraft: ₹ 10,000; Other current liabilities: ₹ 30,000]

17. From the following details prepare statement of Proprietary funds with as many details as possible.

(*i*) Stock velocity = 6
(*ii*) Capital turnover ratio = 2
(*iii*) Fixed assets turnover ratio = 4
(*iv*) Gross profit turnover ratio = 20 percent
(*v*) Debtors velocity = 2 months
(*vi*) Creditors velocity = 73 days

The Gross profit was ₹ 60,000. Reserves and surplus amount to ₹ 20,000. Closing stock was ₹ 5,000 in excess of opening stock

[**Ans.** Proprietary funds: ₹ 1,20,000; Capital : ₹ 1,00,000; Reserves : ₹ 20,000; Current liabilities : ₹ 49,000; Debtors ₹ 50,000; Closing stock : ₹ 42,500; Other current assets: ₹ 16,500; (Bal. fig. in Balance Sheet) fixed assets ₹ 60,000]

18. From the following comparative Balance Sheet of Shahnaz Shahab Limited for the years 2010 and 2011, find out the change (Increase/Decrease) in the absolute figures and also the changes in percentage.

Particulars	*2010 (₹)*	*2011 (₹)*
I. **EQUITY AND LIABILITIES**		
1. **Shareholders Funds:**		
(*a*) Share Capital	16,20,000	18,00,000
2. **Non-current Liabilities**		
(*a*) Long-term borrowings	3,60,000	4,95,000
3. **Current Liabilities**	1,35,000	1,35,000
	21,15,000	24,30,000
II. **ASSETS**		
1. **Non-current Assets**		
(*a*) *Fixed Assets*		
(*i*) *Tangible assets*	10,80,000	13,50,000
(*ii*) *Intangible assets*	4,50,000	6,30,000
(*iii*) Capital work-in-progress	3,60,000	2,70,000
2. **Current Assets**	2,25,000	1,80,000
	1,50,00,000	1,54,50,000

19. From the following information prepare a Comparative Income Statement:

Particulars	*2012 (₹)*	*2013 (₹)*
Revenue from operations	6,40,000	8,00,000
Cost of goods sold	3,20,000	4,80,000
Administrative, selling & distribution expenses	64,000	1,60,000
Other income	32,000	48,000
Income tax	96,000	1,12,000

20. Prepare the comparative Balance Sheet of M/s Balaji Traders from the following:

Particulars	*2010 (₹)*	*2011 (₹)*
I. **EQUITY AND LIABILITIES**		
1. **Shareholders Funds:**		
(*a*) Share Capital	32,000	56,000

Notes

(*b*) Reserves and Surplus	9,600	8,000
2. **Non-current Liabilities:**		
(*a*) Long-term borrowings	40,000	40,000
	81,600	1,04,000
II. **ASSETS**		
1. **Non-current Assets**		
(*a*) *Fixed Assets*		
(*i*) *Tangible assets*	64,000	81,600
2. **Current Assets**		
(*a*) Trade receivables	8,000	16,000
(*b*) Cash and cash equivalents	9,600	6,400
	81,600	1,04,000

21. Following are the Balance Sheet of Radha Ltd., as on 31.12.2008 and 31.12.2009.

Particulars	*2008 (₹)*	*2009 (₹)*
I. **EQUITY AND LIABILITIES**		
1. **Shareholders Funds:**		
(*a*) Share Capital	13,00,000	19,50,000
(*b*) Reserves and Surplus	13,00,000	13,00,000
2. **Non-current Liabilities:**		
Long-term borrowings	2,60,000	10,40,000
3. **Current Liabilities:**	3,90,000	6,50,000
	32,50,000	49,40,000
II. **ASSETS**		
1. **Non-current Assets**		
(*a*) *Fixed Assets*		
(*i*) *Tangible assets*	26,00,000	39,00,000
2. **Current Assets**	6,50,000	10,40,000
	32,50,000	49,40,000

You are required to prepare a comparative Balance Sheet on the basis of the information given in the above Balance Sheet.

22. Prepare a Comparative Balance Sheet of M/s Gupta Traders from the following information:

Particulars	*2011 (₹)*	*2012 (₹)*	*Particulars*	*2011 ₹*	*2012 ₹*
Share Capital	35,000	50,000	Tangible assets	55,000	66,000
Reserve and surplus	6,000	5,000	Trade receivable	5,000	10,000

Long-term borrowings	25,000	25,000	Cash and cash equivalent	6,000	4,000
	66,000	80,000		66,000	80,000

23. Prepare a Common Size Balance Sheet from the following information:

Particulars	*2012 (₹)*	*2013 (₹)*
Equity share capital	7,20,000	9,00,000
Preference share capital	4,80,000	5,40,000
Reserves and Surplus	1,50,000	1,20,000
Long-term borrowing	2,40,000	1,80,000
Short-term borrowing	1,20,000	1,20,000
Trade Payable	48,000	60,000
Short term provision	18,000	24,000
Tangible assets	9,60,000	14,40,000
Intangible assets	6,00,000	3,60,000
Current assets	2,16,000	1,44,000

Notes

24. From the following information prepare common size income statement.

Particulars	*March 31, 2012*	*March 31, 2011*
Revenue from operations	10,00,000	12,50,000
Cost of materials consumed	7,70,000	11,00,000
Other income	1,00,000	1,25,000
Finance cost	1,65,000	1,50,000
Other expenses	1,10,000	75,000
Profit	55,000	50,000

25. From the following information relating to B C Ltd., prepare a comparative Income Statement, showing the percentage increase/decrease in 2011 over 2010:

Particulars	*2010 (₹)*	*2011 (₹)*
Revenue from operations	2,00,000	4,00,000
Cost of materials consumed	80,000	1,44,000
Other expenses	60,000	1,32,000
Income tax	10,000	19,000
Profit	50,000	1,05,000

26. From the following Balance Sheet of Usha Chemical Ltd., on 31st December, 2011 and 2012, prepare comparative balance sheets.

Particulars	*2011 (₹)*	*2012 (₹)*
I. **EQUITY AND LIABILITIES**		
1. **Shareholders Funds:**		

Notes

(a) Share Capital	5,00,000	10,00,000
(b) Reserves and Surplus	3,00,000	2,00,000
2. **Non-current Liabilities:**		
(a) Long-term borrowings	5,00,000	8,00,000
3. **Current Liabilities:**		
(a) Trade Payables	2,00,000	4,00,000
	15,00,000	24,00,000
II. **ASSETS**		
1. **Non-current Assets**		
(a) *Fixed Assets*		
(i) *Tangible assets*	10,00,000	15,00,000
2. **Current Assets**		
(a) Cash and cash equivalents	5,00,000	9,00,000
	15,00,000	24,00,000

27. From the following information, prepare a comparative income statement.

Particulars	*2012* ₹	*2013* ₹
Revenue from operations	10,00,000	15,00,000
Cost of materials consumed	8,00,000	11,00,000
Purchase of stock-in-trade	1,00,000	1,50,000
Other expenses	1,00,000	2,50,000
Other Income	20,000	24,000
Income tax	40,000	80,000

28. From the following summarised Balance Sheet as 31st December, prepare a Comparative Balance Sheet of X Ltd. as at that date.

Particulars	*2011 (₹)*	*2012 (₹)*
I. **EQUITY AND LIABILITIES**		
1. **Shareholders Funds:**		
(a) Share Capital		
(i) Equity Share Capital	60,00,000	60,00,000
(ii) Preference Share Capital	15,00,000	15,00,000
(b) Reserve and Surplus	15,00,000	18,00,000
2. **Non-current Liabilities:**		
(a) Long-term borrowings	30,00,000	27,00,000
3. **Current Liabilities:**		
(a) Short-term borrowings	15,00,000	18,00,000
(b) Other current liabilities	12,00,000	13,20,000

(*c*) Short-term provisions	3,00,000	3,30,000
	1,50,00,000	1,54,50,000
II. **ASSETS**		
1. **Non-current Assets**		
(*a*) *Fixed Assets*		
(*i*) *Tangible assets*	90,00,000	1,08,00,000
(*ii*) Intangible assets	15,00,000	15,00,000
2. **Current Assets**		
(*a*) Cash and cash equivalents	45,00,000	31,50,000
	1,50,00,000	1,54,50,000

29. What is meant by Ratio Analysis?
30. List out the Liquidity Ratios.
31. What are Turnover Ratios?
32. What do you understand by Operating Ratios and Stock Turnover Ratio?
33. Briefly explain the objectives of Ratio Analysis.
34. What are the Limitations Ratio Analysis.
35. Discuss some of the important ratios usually worked from the financial statement showing how they would be useful to top level management.
36. "Ratio analysis is a tool to examine the health of a business with a view to make the financial results more intelligible".
37. Discuss the significance of various accounting ratios in the analysis of financial statements.

Unit–5

Fund Flow Statement

Structure

5.1. Definition of Working Capital
5.2. Nature and Scope of Working Capital
5.3. Learning Objectives
5.4. Introduction to Working Capital
5.5. Types of Working Capital
5.6. Needs of Working Capital
5.7. Computation (OR Estimation) of Working Capital: Working Capital Cycle
5.8. Introduction
5.9. Meaning of Fund Flow Statement
5.10. Different Names of Fund Flow Statement
5.11. Managerial Uses of Fund Flow Statement
5.12. Limitations of Fund Flow Statement
5.13. Steps in Preparation of Fund Flow Statement
5.14. Review Exercise

5.1. Definition of Working Capital

Capital of the concern may be divided into two major heading

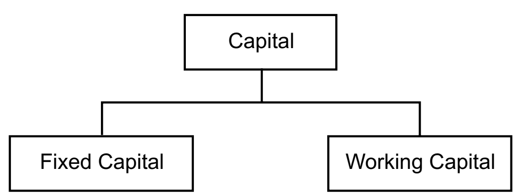


Fig. 5.1. Capital of the Business

Fixed capital means that capital, which is used for long-term investment of the business concern. For example, purchase of permanent assets. Normally it consists of non-recurring in nature.

Working Capital is another part of the capital which is needed for meeting day to day requirement of the business concern. For example, payment to creditors, salary paid to workers, purchase of raw materials etc., normally it consists of recurring in nature. It can be easily converted into cash. Hence, it is also known as short-term capital.

There are some definitions given by experts, such as:

Notes

According to the definition of **Mead, Baker and Malott,** *"Working Capital means Current Assets"*. According to the definition of **J.S. Mill,** *"The sum of the current asset is the working capital of a business"*. —

According to the definition of **Weston and Brigham,** *"Working Capital refers to a firm's investment in short-term assets, cash, short-term securities, accounts receivables and inventories"*.

According to the definition of **Bonneville,** *"Any acquisition of funds which increases the current assets, increase working capital also for they are one and the same"*. According to the definition of Shubin, *"Working Capital is the amount of funds necessary to cover the cost of operating the enterprises"*.

According to the definition of **Genestenberg,** *"Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, for example, from cash to inventories, inventories to receivables, receivables to cash"*.

5.2. Nature and Scope of Working Capital

Working capital can be classified or understood with the help of the following two important concepts.

5.3. Learning Objectives

After going through this unit you should be able to:

- explain nature, scope and definition of working capital.
- illustrate working capital cycle.
- assess and compute the working capital management.
- describe profitability through liquidity trade-off and working capital policy.
- state overview of working capital management.

5.4. Introduction to Working Capital

Working capital management is also one of the important parts of the financial management. It is concerned with short-term finance of the business concern which is closely related trade between profitability and liquidity. Efficient working capital management leads to improve the operating performance of the business concern and it helps to meet the short term liquidity. Hence, study of working capital management is not only an important part of financial management but also are overall management of the business concern.

Working capital is described as the capital which is not fixed but the more common uses of the working capital is to consider it as the difference between the book value of current assets an current liabilities. This unit deals with the following important aspects of the working capital management:

- Meaning of Working Capital
- Concept of Working Capital
- Types of Working Capital
- Needs of Working Capital

- Factors determining Working Capital
- Computation of Working Capital
- Sources of Working Capital
- Working Capital Management Policy
- Working Capital and Banking Committee

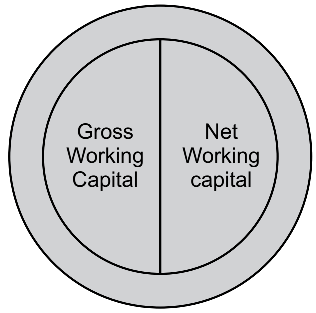


Fig. 5.2. Working Capital Concept

Gross Working Capital

Gross Working Capital is the general concept which determines the working capital concept. Thus, the gross working capital is the capital invested in total current assets of the business concern.

$$\boxed{GWC = CA}$$

Net Working Capital

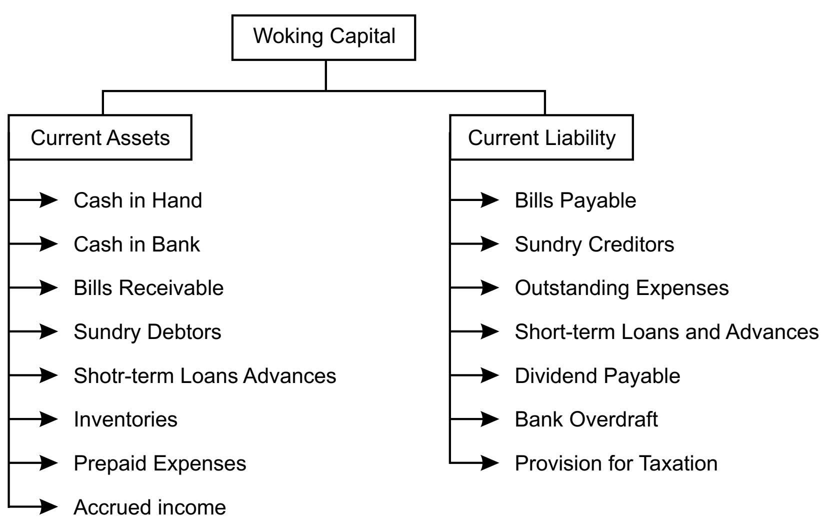
Net Working Capital is the specific concept, which, considers both current assets and current liability of the concern. Net Working Capital is the excess of current assets over the current liability of the concern during a particular period.

If the current assets exceed the current liabilities it is said to be positive working capital; it is reverse, it is said to be Negative working capital.

$$\boxed{NWC = CA - CL}$$

Component of Working Capital

Working capital constitutes various current assets and current liabilities. This can be illustrated by the following chart.



5.5. Types of Working Capital

Working Capital may be classified into three important types on the basis of time.

Permanent Working Capital

It is also known as Fixed Working Capital. It is the capital; the business concern must maintain certain amount of capital at minimum level at all times. The level of Permanent Capital depends upon the nature of the business. Permanent or Fixed Working Capital will not change irrespective of time or volume of sales.

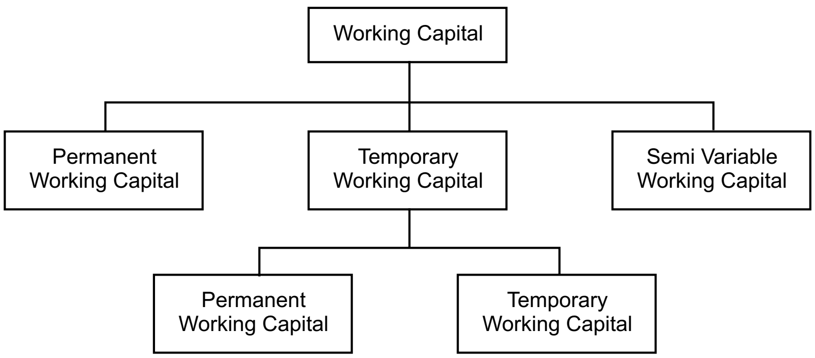


Fig. 5.3. Types of Working Capital

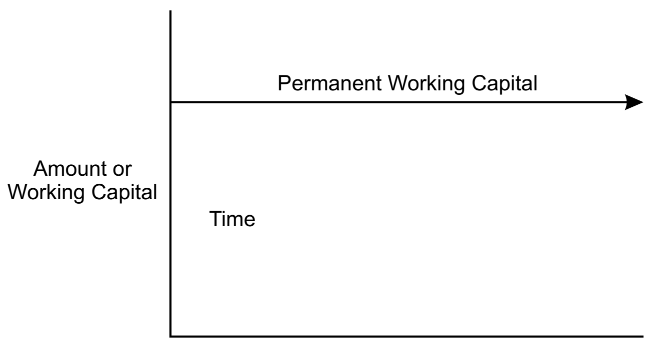


Fig. 5.4. Permanent Working Capital.

Temporary Working Capital

It is also known as variable working capital. It is the amount of capital which is required to meet the Seasonal demands and some special purposes. It can be further classified into Seasonal Working Capital and Special Working Capital.

The capital required to meet the seasonal needs of the business concern is called as Seasonal Working Capital. The capital required to meet the special exigencies such as launching of extensive marketing campaigns for conducting research, etc.

Semi Variable Working Capital

Certain amount of Working Capital is in the field level up to a certain stage and after that it will increase depending upon the change of sales or time.

Notes

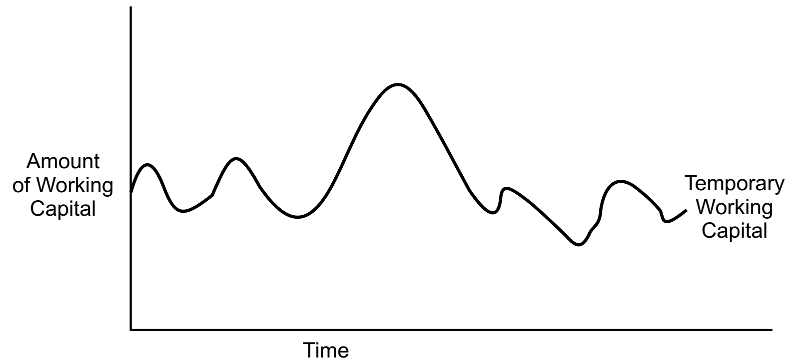


Fig. 5.5. Temporary Working Capital

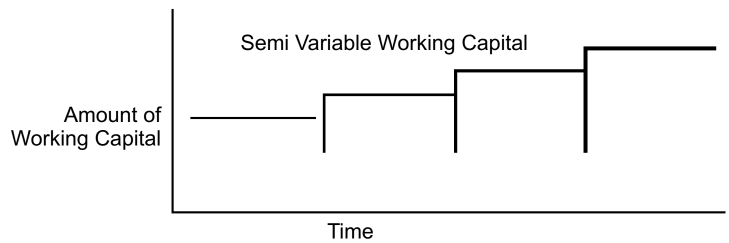


Fig. 5.6. Semi Variable Working Capital

5.6. Needs of Working Capital

Working Capital is an essential part of the business concern. Every business concern must maintain certain amount of Working Capital for their day-to-day requirements and meet the short-term obligations. Working Capital is needed for the following purposes.

1. **Purchase of raw materials and spares:** The basic part of manufacturing process is, raw materials. It should purchase frequently according to the needs of the business concern. Hence, every business concern maintains certain amount as Working Capital to purchase raw materials, components, spares, etc.
2. **Payment of wages and salary:** The next part of Working Capital is payment of wages and salaries to labour and employees. Periodical payment facilities make employees perfect in their work. So a business concern maintains adequate the amount of working capital to make the payment of wages and salaries.
3. **Day-to-day expenses:** A business concern has to meet various expenditures regarding the operations at daily basis like fuel, power, office expenses, etc.
4. **Provide credit obligations:** A business concern responsible to provide credit facilities to the customer and meet the short-term obligation. So the concern must provide adequate Working Capital.

Working Capital Position/Balanced Working Capital Position

A business concern must maintain a sound Working Capital position to improve the efficiency of business operation and efficient management of finance. Both excessive and inadequate Working Capital lead to some problems in the business concern.

Notes

A.Causes and effects of excessive working capital

- Excessive Working Capital leads to unnecessary accumulation of raw materials, components and spares.
- Excessive Working Capital results in locking up of excess Working Capital.
- It creates bad debts, reduces collection periods, etc.
- It leads to reduce the profits.

B. Causes and effects of inadequate working capital

- Inadequate working capital cannot buy its requirements in bulk order.
- It becomes difficult to implement operating plans and activate the firm's profit target.
- It becomes impossible to utilize efficiently the fixed assets.
- The rate of return on investment also falls with the shortage of Working Capital.
- It reduces the overall operation of the business.

5.7. Computation (OR Estimation) of Working Capital: Working Capital Cycle

Working Capital requirement depends upon number of factors. Now the discussion is on how to calculate the Working Capital needs of the business concern. It may also depend upon various factors but some of the common methods are used to estimate the Working Capital.

A. Estimation of Components of Working Capital Method

Working capital consists of various current assets and current liabilities. Hence, we have to estimate how much current assets as inventories required and how much cash required to meet the short term obligations. Finance Manager first estimates the assets and required Working Capital for a particular period.

B. Percent of Sales Method

Based on the past experience between Sales and Working Capital requirements, a ratio can be determined for estimating the Working Capital requirement in future. It is the simple and tradition method to estimate the Working Capital requirements. Under this method, first we have to find out the sales to Working Capital ratio and based on that we have to estimate Working Capital requirements. This method also expresses the relationship between the Sales and Working Capital.

C. Operating Cycle

Working Capital requirements depend upon the operating cycle of the business. The operating cycle begins with the acquisition of raw material and ends with the collection of receivables. Operating cycle consists of the following important stages:

1. Raw Material and Storage Stage, (R)
2. Work in Process Stage, (W)
3. Finished Goods Stage, (F)

4. Debtors Collection Stage, (D)
5. Creditors Payment Period Stage, (C)

Notes

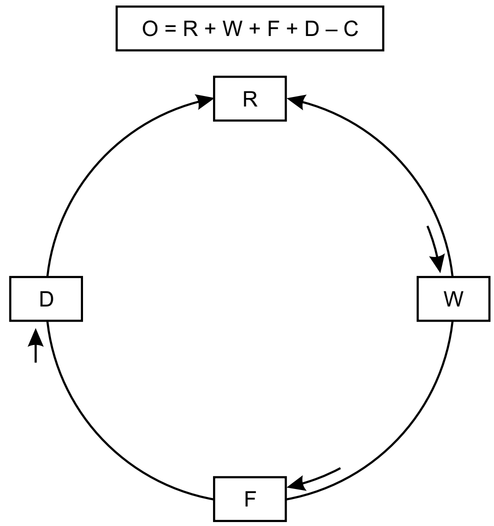


Fig. 5.7. Working Capital Cycle

Each component of the operating cycle can be calculated by the following formula:

$$R = \frac{\text{Average Stock of Raw Material}}{\text{Average Raw Material Consumption Per Day}}$$

$$W = \frac{\text{Average Work in Process Inventory}}{\text{Average Cost of Production Per Day}}$$

$$F = \frac{\text{Average Finished Stock Inventory}}{\text{Average cost of Goods Sold Per Day}}$$

$$D = \frac{\text{Average Book Debts}}{\text{Average Credit Sales Per Day}}$$

$$C = \frac{\text{Average Trade Creditors}}{\text{Average Credit Purchase Per Day}}$$

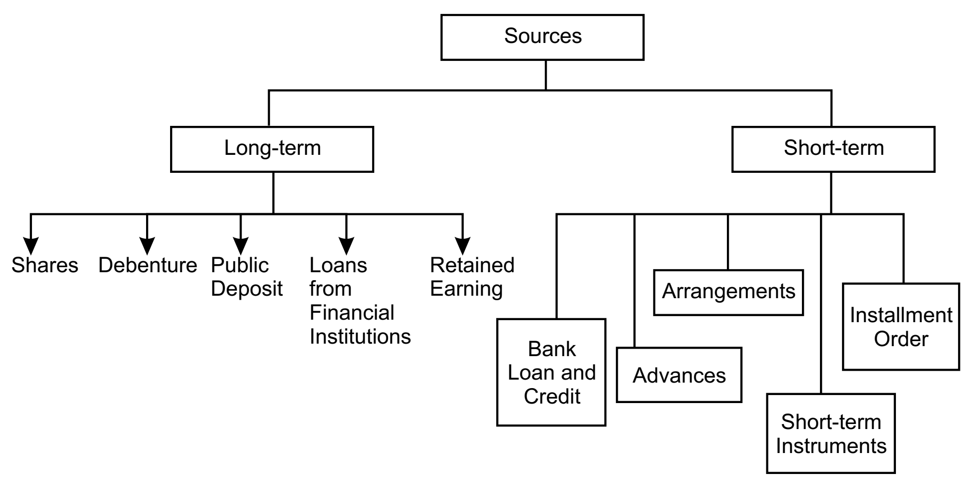


Fig. 5.8. ?????

The above sources are also classified into internal sources and external sources of working capital. Internal sources such as:

- Retained Earnings
- Depreciation Funds etc.

External sources such as:

- Debentures and Public Deposits
- Loans from Banks and Financial Institutions
- Advances and Credit
- Financial arrangements like Factoring, etc.

5.8. Introduction

The traditional concept of profit and loss account and balance sheet has a limited role to play in financial analysis. The profit and loss account reflects the results of the business operations for a specified period of time. It takes into account only the expenses incurred and income received during the accounting period. The balance sheet gives a summary of the assets and liabilities at a particular period of time. And at the same time, balance sheet does not explain the details about the movement of funds. In actual practice, a business concern receives funds from various sources and invested in various ways of investment. It is a continuous process. The ultimate aim of the financial management is to study and control these funds in order to maintain the solvency and financial soundness of the firm. For the purpose of complete study of sources and applications of funds over the accounting period, a separate statement is essential to find the periodical increase or decrease of such funds of an enterprise. This statement is called fund flow statement.

5.9. Meaning of Fund Flow Statement

The fund flow statement is a statement which reveals the methods by which the business has been financed and how it has used its funds between two balance sheet dates.

In the words of Foulke : "A statement of sources and application of funds is a technical device, designed to analyse the changes in the financial conditions of a business enterprise between two balance sheet dates."

5.10. Different Names of Fund Flow Statement

A statement of sources and application of funds

A statement of sources and uses of funds

Where Got and where Gone statement

Inflow-outflow of fund statement

Statement of funds supplied and applied; funds received and disbursed statement

5.11. Managerial Uses of Fund Flow Statement

Fund flow statement is an invaluable analytical tool for a financial manager for the purpose of evaluating the employment of funds by a firm and also to assess sources of such funds. Following are the important managerial uses of fund flow statement.

Notes

1. The foremost use of the fund flow statement is to explain the reasons for changes in the assets and liabilities between two balance sheet dates.
2. Fund flow statement gives details about the funds obtained and used in past. Based upon this detail, manager can take correct actions at appropriate times.
3. Fund flow statement acts as a control device when compared with budgeted figures. It also gives guidance to the finance manager for taking remedial action if there is any deviation.
4. It helps the management to formulate various financial policies—viz dividend, bonus etc.
5. It gives guidance to the management with regard to working capital. Through fund flow statement, management can take proper steps for effective utilisation of surplus working capital or in case of inadequacy, suitable arrangement can be made for improving the working capital position.
6. It identifies the strong and weak financial areas of the firm.
7. It gives the answers for various financial intricate questions :

   – How much funds were generated ?

   – How were the funds used ?
8. Effective utilisation of available resources and scarce resources should be allocated according to the preferential needs.
9. With the help of the fund flow statement, financial and lending institutions can easily evaluate the credit worthiness and repaying capacity of the borrowing company.
10. It enables the management to reformulate the firm's financial activity on the basis of the statement.

5.12. Limitations of Fund Flow Statement

1. In the real sense, the fund flow statement lacks originality, because it is only a rearrangement of data given in financial statements.
2. It indicates only the past year's performance and is not for the future. Even to prepare projected fund flow statement, it cannot show much accuracy.
3. It cannot reveal continuous changes. Because, only any particular two years are taken into account for analysis purpose.
4. Fund flow statement is not a substitute for a financial statement. It gives only some informations about changes in working capital alone.

5.13. Steps in Preparation of Fund Flow Statement

(*i*) Preparation of fund flow statement.

(*ii*) Preparation of statement of changes in working capital.

(*iii*) Preparation of adjusted profits and loss account (to find out fund from operation or fund lost in operation).

(*iv*) Adjustment and their treatments.

(*v*) Preparation of separate ledger.

(*vi*) Treatment about the provision for taxation and proposed divider.

Notes

NOTE: Fund flow statement alone is a major part of the solution; remaining other things *i.e.,* working capital statement, P.L. A /c, preparation of ledger, treatment of provision for taxation and proposed dividend, adjustment etc were supported to work the fund flow statement.

I. Preparation Fund Flow Statement

Here we have to prepare the fund flow statement in the T Shape

I. Fund Flow Statement : (Specimen form)

Source of Funds	Amount ₹	Applications of Funds	Amount ₹
Issue of shares	XX	Redemption of redeemable	XX
Issue of debentures	XX	Preference shares	XX
Loan borrowed	XX	Redemption of debentures	XX
(Long term, medium term)		Repayment of loans	XX
Acceptance of deposits	XX	Repayment of deposits	XX
Sale of fixed assets	XX	Purchase of fixed assets	XX
Sale of investments (Long term)	XX	Purchase of long term investments	XX
Decrease in working capital	XX	Payment of dividend	XX
(Transfer from working capital statements)		Income tax paid	XX
Fund from operation	XX	Increase in working capital	XX
(Transfer from P&L A/c		Fund loss in operation	XX
Working capital statement)		(Transfer from P&L A/c)	

II. Working Capital Statement

For the purpose of finding out increase or decrease in working capital, we have to prepare statement of changes in working capital. [TCA − TCL = WC]

Particulars	**Year I**	**Year II**
Current Assets		
Cash in hand	XX	XX
Cash at bank	XX	XX
Sundry debtors	XX	XX
Bills receivable	XX	XX
Marketable securities	XX	XX
Inventory	XX	XX
Prepaid expenses	XX	XX

Notes

Short term investment	XX	XX
Accrued incomes	XX	XX
Total Current Assets (TCA) (A)	XX	XX
Current Liabilities		
Sundry Creditors	XX	XX
Bills payable	XX	XX
Outstanding expenses	XX	XX
Bank overdraft	XX	XX
Income received in advance	XX	XX
Short term loans	XX	XX
Cash credit from bank	XX	XX
Provision for taxation	XX	XX
Proposed dividend	XX	XX
Provision against current assets	XX	XX
Provision for doubtful debts	XX	XX
Total Current Liabilities (TCL) (B)	XX	XX
Working Capital (A-B)	XX	XX
Increase of Decrease	XX	

[TAC – TCL = WC]

After the computation of working capital, we have to find out the increase or decrease in working.

III. Fund from Operation : Fund from operation is found out by two methods

(*i*) Statement method.

(*ii*) Accounting method.

Normally, accounting method is easy and convenient. So, we have to adopt accounting method *i.e.,* profit and loss account is used to find out the fund from operation. Here, profit and loss account is prepared in a usual procedure.

Particulars	Amount ₹	Particulars	Amount ₹
To Goodwill written off	XX	By Balance b/d	XX
To Preliminary expenses written off	XX	By Profit on sale of fixed assets	XX
To Patents written off	XX		
To Depreciation	XX	By Interest sale of investment	XX
To Dividend paid	XX	By Any other non-operating incomes	XX
To Provision for taxation	XX		XX
To Loss on sale of fixed assets	XX	By Fund from operation	XX
To Discount on issue of shares	XX		

To Interim dividend paid	XX		
To Balance c/d	XX		
To Fund operation	XX		
To Fund operation	XX		XX

IV. Important adjustments and their treatments

All the adjustments appear in two places :

Adjustment		Treatment
1. Depreciation	–	P.L. A/c debit side
		Respective asset A/c credit side
2. Dividend paid	–	P.L. A/c debit side
		Fund flow statement Application side
3. Income tax paid	–	Income tax A/c debit side
		Fund flow statement—Application side
4. Income tax provision	–	P.L. A/c debit side
		Income tax A/c credit side
5. Loss on sale of fixed	–	P.L. A/c debit side
		Assets Respective asset A/c credit side
6. Interim dividend paid	–	P.L . A/c debit side
		Fund flow statement—Application side

V. Preparation of separate ledger A/c, if necessary *i.e.,* about the non-current (either Assets or Liability) items related information given in the adjustment means we have to prepare separate ledger. Balances from this ledger can be transferred to fund flow statement means we have to prepare a separate ledger. Balances from this ledger can be transferred to fund flow statement.

VI. Treatment about the provision for taxation and proposed dividend

Provision for taxation and proposed dividend taken as current liability means it should appear under working capital statement.

Some times, regarding the provision for taxation, information is given in the adjustment. So, it should be treated as non current liability. Provision for taxation taken as non-current liability means proposed dividend is also taken as a non-current liability.

(*a*) Treatment of provision for taxation

(*i*) Income Tax provided given in the adjustment, we have to find the tax paid-P.L. A/c debit side

Income Tax A/c credit

(Balancing figure of taxation A/c is called tax paid and then it is transferred to Applications side)

(*ii*) Income tax paid given in the adjustment, we have to find the income tax provision.

Fund flow statement − application side

Income tax A/c − debit side

(Balancing figure of taxation A/c is called tax provided and then it is transferred to P.L. A/c debit side)

(*b*) **Treatment of proposed dividend**

Whenever provision for taxation is treated as non-current liability, proposed dividend is also taken as non-current liability. At that time, the following rules will be applicable.

Last year amount − application side

Current year amount : profit & loss A/c debit side.

Illustrations and Solutions

Illustration 1. *The following are the summarised balance sheets of M/s. Krishna Ltd. as on 31.12.2019 and 2020*

Liabilities	2019 Rs.	2020 Rs.
10% preference shares	1,00,000	1,10,000
Equity Shares	2,20,000	2,50,000
Share premium	20,000	26,000
Profit & Loss A/c	1,04,000	1,34,000
12% debentures	70,00	64,000
Creditors	38,000	46,000
Bills Payable	5,000	4,000
Provision for tax	10,000	12,000
Dividend Payable	7,000	8,000
	5,74,000	6,54,000

Assets	2019 Rs.	2020 Rs.
Machinery	2,00,000	2,30,000
Buildings	1,50,000	1,76,000
Land	18,000	18,000
Cash	42,000	32,000
Debtors	38,000	38,000
Bills receivable	42,000	62,000
Stock	84,000	98,000
	5,74,000	6,54,000

You are required to prepare a statement of sources and application of funds

Solution : **Fund Flow Statement**

Particulars	Amount ₹	Particulars	Amount ₹
Issue of preference shares	10,000	Purchase of machinery	30,000
Issue of Equity shares	30,000	Purchase of Building	26,000
Share premium received	6,000	Increase in working capital	14,000
Fund from operation	30,000	Redemption of debenture	6,000
	76,000		76,000

Working : **(*i*) Statement of changes in working capital**

	2019 ₹	2020 ₹
Current Assets:		
Cash	42,000	32,000
Debtors	38,000	38,000
Bills receivables	42,000	62,000
Stock	84,000	98,000
Total current assets	2,06,000	2,30,000
Current Liabilities :		
Creditors	38,000	46,000
Bills payable	5,000	4,000
Provision for Tax	10,000	12,000
Dividend payable	7,000	8,000
Total current liabilities	60,000	70,000
Working capital	1,46,000	1,60,000

Increase in working capital : ₹ 14000 (1,46,000 – 1,60,000)

[Transfer to Fund Flow Statement]

(*ii*) Profit and Loss Account

To Balance b/d (Closing)	1,34,000	By Balance c/d (Opening)	1,04,000
		By Fund from operation	30,000
	1,34,000		1,34,000

Illustration 2. *From the following balance sheets, prepare schedule of changes in working capital.*

Liabilities	Dec. 1980 ₹	Dec. 1981 ₹	Assets	Dec. 1980 ₹	Dec. 1981 ₹
Share capital	2,00,000	2,50,000	Cash	30,000	47,000
Creditors	70,000	45,000	Debtors	1,20,000	1,15,000
Retained			Land	50,000	66,000

Earnings	10,000	23,000	Stock	80,000	90,000
	2,80,000	3,18,000		2,80,000	3,18,000

Solution : Fund Flow Statement

Notes

Particulars	Amount ₹	Particulars	Amount ₹
Issue of shares	50,000	Purchase of Land	16,000
Fund from operation	13,000	Increase in working capital	47,000
	63,000		63,000

Working : (*i*) Statement of changes in working capital

	1980 ₹	1981 ₹
Current Assets:		
Cash	30,000	47,000
Debtors	1,20,000	1,15,000
Stock	80,000	90,000
Total current assets	2,30,000	2,52,000
Current Liabilities :		
Creditors	70,000	45,000
Total current Liabilities	70,000	45,000
Working capital	1,60,000	2,07,000

Increase in working capital : (1,60,000 – 2,07,000)

(*ii*) Profit and Loss Account

To Balance b/d	23,000	By Balance c/d	10,000
		By Fund from operation (B/f)	13,000
	23,000		23,000

Illustration 3. *The following are the summarised balance sheets of X Ltd., as on 31 December 2018 and 2019.*

Liabilities	*31st Dec. 2018* ₹	*31st Dec. 2019* ₹	*Assets*	*31st Dec. 2018* ₹	*31st Dec. 2019* ₹
Redeemable Preference Shares		*10,000*	*Fixed Assets*	*41,000*	*40,000*
Equity shares	*40,000*	*40,000*	*Less : Depreciation*	*11,000*	*15,000*
General Reserve	*2,000*	*2,000*			
Profit & loss A/c	*1,000*	*1,200*		*30,000*	*25,000*
Debentures	*6,000*	*7,000*	*Debtors*	*20,000*	*24,000*

Creditors	*12,000*	*11,000*	*Stock*	*30,000*	*35,000*
Provision for Tax	*3,000*	*4,200*	*Prepaid exp.*	*300*	*500*
Proposed dividend	*5,000*	*5,800*	*Cash*	*1,200*	*3,500*
Bank overdraft	*12,500*	*6,800*			
	81,500	*88,000*		*81,500*	*88,000*

Notes

You are required to prepare :

1. *A statement showing changes in the working capital*
2. *A statement of sources and application of funds.*

Solution : **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of preference shares	10,000	Increase in working capital	16,200
Issue of Debentures	1,000		
Sale of fixed assets	1,000		
Fund from operation	4,200		
	16,200		16,200

Working : **(*i*) Statement of changes in working capital**

	2018	2019
	₹	₹
Current Assets:		
Debtors	20,000	24,000
Stock	30,000	35,000
Prepaid Expenses	300	500
Cash	1,200	3,500
Total Current Assets	51,500	63,000
Current Liabilities :		
Creditors	12,000	11,000
Provision for tax	3,000	4,200
Proposed Dividend	5,000	5,800
Bank Overdraft	12,500	6,800
Total current liabilities	32,500	27,800
Working capital	19,000	35,200
Increase in working capital	16,200	(19,000 – 35,200)

Hint : Provision for taxation and proposed dividend taken as current liabilities.

(*ii*) Profit and Loss Account

To Balance b/d	1,200	By Balance c/d	1,000
To Depreciation	4,000	By Fund from operation	4,200
	5,200		5,200

Notes

Illustration 4. *From the following balance sheets, prepare a statement showing changes in working capital during 1995.*

Balance sheet of Pioneer Ltd. as on 31st December.

Liabilities	***1994 (₹)***	***1995 (₹)***
Share capital	*5,00,000*	*6,00,000*
Reserves	*1,50,000*	*1,80,000*
P.L. A/c	*40,000*	*65,000*
Debentures	*3,00,000*	*2,50,000*
Creditors for goods	*1,70,000*	*1,60,000*
Provision for income tax	*60,000*	*80,000*
	12,20,000	*13,35,000*
Assets	***2018 (₹)***	***2019 (₹)***
Fixed assets	*10,00,000*	*11,20,000*
Less : Depreciation	*3,70,000*	*4,60,000*
	6,30,000	*6,60,000*
Stock	*2,40,000*	*3,70,000*
Book debts	*2,50,000*	*2,30,000*
Cash in hand and at Bank Balance	*80,000*	*60,000*
Preliminary Expenses	*20,000*	*15,000*
	12,20,000	*13,35,000*

Solution : **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of shares	1,00,000	Redemption of debentures	50,000
Fund from operation	1,50,000	Purchase of fixed assets	1,20,000
		Increase in working capital	80,000
	2,50,000		2,50,000

Working : **(*i*) Statement of changes in working capital**

	1994	**1995**
	₹	₹
Current Assets:		
Stock	2,40,000	3,70,000
Book Debts	2,40,000	3,70,000
Cash in hand & Bank Balance	80,000	60,000
Total Current Assets	5,70,000	60,000
Current Liabilities :		

Creditors for goods	1,70,000	1,60,000
Provision for income tax	60,000	80,000
Total current liabilities	2,30,000	2,40,000
Working capital	3,40,000	4,20,000
Increase in working capital	80,000	3,40,000 – 4,20,000

Hint : Provision for taxation and proposed dividend taken as current liabilities.

(*ii*) Profit and Loss Account

	₹		₹
To Balance b/d	65,000	By Balance c/d	40,000
To Reserves	30,000	By Fund from operation	1,50,000
To Preliminary expenses written off	5,000		
To Depreciation	90,000		
	1,90,000		1,90,000

Illustration 5. *Calculate fund from operation from the information given below as on 31.3.2000.*

1. Net profit for the year ended 31.3.2000 ₹ 6,50,000.
2. Gain on sale of buildings ₹ 35,500.
3. Goodwill appears in the books at ₹ 1,80,000 out of that 10% has been written off during the year.
4. Old machinery worth ₹ 8,000 has been sold for ₹ 6,500 during the year.
5. ₹ 1,25,000 have been transferred to reserve fund.
6. Depreciation has been provided during the year on machinery and furniture at 20% whose value is ₹ 6,50,000.

Solution: **Calculation of Fund from Operation**

	₹	₹
Net profit for the year ended 31.3.2019		6,50,000
Add : Non fund items : [P.L. A/c Debit side items]		
Goodwill written off	18,000	
(1,80,000 × 10/100)		
Loss on sale of machinery		
(8000 – 6500)	1,500	
Transferred to Reserve fund	1,25,000	
Depreciation		
(6,50,000 × 20/100)	1,30,000	
		2,74,500
		9,24,500

Less : Non fund items [P.L A/c credit side items]

Gain on sale of Buildings	35,500
Fund from operation	8,89,000

Notes

Illustration 6. *From the following balance sheets of a sole trader, prepare a fund flow statement.*

Liabilities	*1999* ₹	*2000* ₹	*Assets*	*1999* ₹	*2000* ₹
Capital	*63,000*	*1,00,000*	*Cash*	*15,000*	*20,000*
Long term loans	*50,000*	*60,000*	*Debtors*	*30,000*	*28,000*
Trade creditors	*42,000*	*39,000*	*Stock*	*55,000*	*72,000*
Bank overdraft	*35,000*	*25,000*	*Land & Building*	*80,000*	*1,00,000*
Outstanding expenses	*5,000*	*6,000*	*Furniture*	*15,000*	*10,000*
	1,95,000	*2,30,000*		*1,95,000*	*2,30,000*

Solution : **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Loan borrowed	10,000	Purchase of Land & Buildings	20,000
Sales of Furniture	5,000	Increase in working capital	32,000
Fund from operation	37,000		
	52,000		52,000

Working : **(*i*) Statement of changes in working capital**

	1999 ₹	**2000** ₹
Current Assets:		
Cash	15,000	20,000
Debtors	30,000	28,000
Stock	55,000	72,000
Total Current Assets	1,00,000	1,20,000
Current Liabilities :		
Trade creditors	42,000	39,000
Bank overdraft	35,000	25,000
Outstanding expenses	5,000	6,000
Total current liabilities	82,000	70,000
Working capital	18,000	50,000
Increase in working capital	32,000	(18,000 – 50,000)

(*ii*) Capital Account

To Balance c/d	1,00,000	By Balance b/d	63,000
		By P.L.A/c	37,000
	1,00,000		1,00,000

Notes

(*iii*) Profit and Loss Account

To Capital Account	37,000	By Fund from operation	37,000
	37,000		37,000

Illustration 7. *Following are the comparative balance sheets of a HAL company for the year 1989 and 1990.*

Balance Sheet

Liabilities	*1989* ₹	*1990* ₹	*Assets*	*1989* ₹	*1990* ₹
Share capital	*70,000*	*74,000*	*Cash*	*9,000*	*7,800*
Debentures	*12,000*	*6,000*	*Debtors*	*14,900*	*17,700*
Creditors	*10,360*	*11,840*	*Stock*	*49,200*	*42,700*
Profit & loss A/c	*10,740*	*11,360*	*Goodwill*	*10,000*	*5,000*
			Land	*20,000*	*30,000*
	1,03,100	*1,03,200*		*1,03,100*	*1,03,200*

The following additional information is also available :

(i) Dividends were paid totalling ₹ 4,000.

(ii) Land was purchased for ₹ 10,000. You are required to prepare fund flow statement.

Solution : **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of shares	4,000	Redemption of Debenture	6,000
Fund from operation	9,620	Dividend paid	4,000
Decrease in working capital	6,380	Purchase of Land	10,000
	20,000		20,000

Working : **(*i*) Statement of changes in working capital**

	1989 ₹	1990 ₹
Current Assets:		
Cash	9,000	7,800
Debtors	14,900	17,700
Stock	49,200	42,700
Total Current Assets	73,100	68,200

Notes

Current Liabilities :		
Creditors	10,360	11,840
Total current liabilities	10,360	11,840
Working capital	62,740	56,360
Increase in working capital	(62,740 – 56,360)	6,380

(*ii*) Profit and Loss Account

To Balance c/d	11,360	By Balance b/d	10,740
To Goodwill written of	5,000	By Fund from operation	9,620
To Dividend Paid	4,000		
	20,360		20,360

(*iii*) Land Account

To Balance b/d	20,000	By Balance b/d	30,000
To Cash	10,000		
	30,000		30,000

Illustration 8. *From the following balance sheets of AMB Ltd. as on 31.12.2018 and 2019, prepare a schedule of changes in working capital and fund flow statement.*

Balance Sheet

Liabilities	*2018*	*2019*
	₹	₹
Share capital	*1,00,000*	*1,00,000*
General reserve	*14,000*	*18,000*
P.L. A/c	*16,000*	*13,000*
Sundry creditors	*8,000*	*5,400*
Bills payable	*1,200*	*800*
Provision for Tax	*16,000*	*18,000*
Provision for doubtful debts	*400*	*600*
	1,55,600	*1,55,800*

Assets	*2018*	*2019*
	₹	₹
Goodwill	*12,000*	*12,000*
Buildings	*40,000*	*36,000*
Plant	*37,000*	*36,000*
Investments	*10,000*	*11,000*
Stock	*30,000*	*23,400*

Bills receivable	*2,000*	*3,200*
Debtors	*18,000*	*19,000*
Cash at bank	*6,600*	*15,200*
	1,55,600	*1,55,800*

Notes

The following additional information is also available :

1. *Depreciation charges on Plant & Buildings at ₹4,000 each.*
2. *Provision for taxation of ₹19,000 was made during the year 2019.*
3. *Interim dividend of ₹ 8,000 was paid during the year 2019.*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Fund from operation	36,000	Increase in working capital	7,000
		Interim dividend paid	8,000
		Tax paid	17,000
		Purchase of Plant	3,000
		Investments	1,000
	36,000		36,000

Workings: **(*i*) Statement of changes in working capital**

Current Assets :	2018	2019
Stock	30,000	23,400
Bills receivable	2,000	3,200
Debtors	18,000	19,000
Cash at Bank	6,600	15,200
Total current assets	56,600	60,800
Current Liabilities :		
Sundry creditors	8,000	5,400
Bills payable	1,200	800
Provision for Doubtful debts	400	600
Total current liabilities	9,600	6,800
Working capital	47,000	54,000
Increase in working capital	(47,000 – 54,000)	7,000

(*ii*) Profit and Loss Account

To Balance c/d	13,000	By Balance b/d	16,000
To Depreciation on Buildings	4,000	By Fund from operation	36,000
To Depreciation on Plant	4,000		
To Income tax provided	19,000		

Notes

To Interim dividend paid	8,000		
To General reserve	4,000		
	52,000		52,000

(*iii*) Provision for Taxation Account

To Balance b/d	18,000	By Balance b/d	16,000
To Cash (Tax Paid)	17,000	By PL A/c	19,000
		(Income Tax Provided)	
	35,000		35,000

(*iv*) Building Account

To Balance b/d	40,000	By Balance b/d	36,000
		By Depreciation	4,000
	40,000		40,000

(*v*) Plant Account

To Balance b/d	37,000	By Balance b/d	36,000
To Cash (Purchase)	3,000	By Depreciation	4,000
	40,000		40,000

Illustration 9. From the following balance sheets of Exe Ltd. prepare

(*a*) *A statement of changes in working capital*

(*b*) *A fund flow statement*

Liabilities	***1999*** ₹	***2000*** ₹	***Assets***	***1999*** ₹	***2000*** ₹
Equity share capital	*3,00,000*	*4,00,000*	*Good will*	*1,15,000*	*90,000*
Redeemable preference			*Land & Building*	*2,00,000*	*1,70,000*
share capital	*1,50,000*	*1,00,000*	*Plant*	*80,000*	*2,00,000*
General reserve	*40,000*	*70,000*	*Debtors*	*1,60,000*	*2,00,000*
Profit & Loss A/c	*30,000*	*48,000*	*Stock*	*77,000*	*1,09,000*
Proposed dividend	*42,000*	*50,000*	*Bills receivable*	*20,000*	*30,000*
Creditors	*55,000*	*83,000*	*Cash in hand*	*15,000*	*10,000*
Bills payable	*20,000*	*16,000*	*Cash at bank*	*10,000*	*8,000*
Provision for taxation	*40,000*	*50,000*			
	6,77,000	*8,17,000*		*6,77,000*	*8,17,000*

The following additional information is also available :

(a) Depreciation of ₹ 10,000 and ₹ 20,000 have been charged on plant and land buildings respectively in 2000.

(b) A dividend of ₹ 20,000 has been paid in 2000.

(c) Income tax of ₹ 35,000 has been paid during 2000

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Equity shares	1,00,000	Redemption of Redeemable	50,000
Sales of Land & Building	10,000	Dividend paid	20,000
Fund from operation	2,18,000	Income tax paid	35,000
		Purchase of Plant	1,30,000
		Proposed dividend paid	42,000
		Increase in working capital	51,000
	3,28,000		3,28,000

Notes

Workings: **(*i*) Statement of changes in working capital**

	1999 ₹	2000 ₹
Current Assets :		
Debtors	1,60,000	2,00,000
Stock	77,000	1,09,000
Bills receivable	20,000	30,000
Cash in hand	15,000	10,000
Cash at Bank	10,000	8,000
Total current assets	2,82,000	3,57,000
Current Liabilities :		
Creditors	55,000	83,000
Bills payable	20,000	16,000
Total current liabilities	75,000	99,000
Working capital	2,07,000	2,58,000
Increase in working capital	51,000	(2,58,000 – 2,07,000)

(*ii*) Profit and Loss Account

To General Reserve	30,000	By Balance c/d	30,000
To Goodwill written off	25,000	By Fund from operation	2,18,000
To Depreciation on Plant	10,000		
To Depreciation of Building	20,000		
To Dividend paid	20,000		
To Balance c/d	48,000		
To Income Tax provided	45,000		
To Proposed dividend	50,000		
	2,48,000		2,48,000

(*iii*) Provision for Taxation Account

To Cash (Tax Paid)	35,000	By Balance b/d	40,000
To Balance c/d	50,000	By P.L. A/c	45,000
	85,000		85,000

(*iv*) Land & Building Account

To Balance b/d	2,00,000	By Depreciation	20,000
		By Balance c/d	1,70,000
		By Cash (Sale)	10,000
	2,00,000		2,00,000

(*v*) Plant Account

To Balance b/d	80,000	By Depreciation	10,000
To Cash	1,30,000	By Balance c/d	2,00,000
	2,10,000		2,10,000

Illustration 10. *The following are the summarised Balance Sheets of Lucky Ltd. as on 31.12.96 and 1997.*

Liabilities	**1996** ₹	**1997** ₹	**Assets**	**1996** ₹	**1997** ₹
Share capital	2,00,000	2,50,000	Land & Buildings	2,00,000	1,90,000
General reserve	50,000	60,000	Machinery	1,50,000	1,69,000
P.L. A/c	30,500	30,600	Stock	1,00,000	74,000
Bank loan (Long term)	70,000	—	Sundry debtors	80,000	64,200
Sundry creditors	1,50,000	1,35,200	Cash	500	600
Provision for taxation	30,000	35,000	Bank	—	8,000
			Goodwill	—	5,000
	5,30,500	5,10,800		5,30,500	5,10,800

Additional information supplied during the year ended 31.12.2019:

(*a*) *Dividend of ₹ 23,000 was paid.*

(*b*) *Assets of another company were purchased for a consideration of ₹ 50,000 payable in shares.*

The following assets were purchased :

Machinery ₹ 25,000 : stock ₹ 20,000.

(*c*) *Machinery was further purchased for ₹ 8,000.*

(*d*) *Depreciation written off against machinery ₹ 12,000.*

(*e*) *Income tax paid during the year ₹ 33,000.*

(*f*) *Loss on sale of machinery ₹ 200 was written off to general reserve.*

(*g*) *Depreciation charged against land & buildings was ₹ 10,000. You are required to prepare fund flow statement.*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Sales of Machinery	1,800	Repayment of Bank loan	70,000
Fund from operation	93,300	Dividend paid	23,000
Decrease in working capital	18,900	Purchase of Machinery	8,000
Issue of shares (For stock)	20,000	Income Tax Paid	33,000
	1,34,000		1,34,000

Notes

Workings: **(*i*) Statement of changes in working capital**

Current Assets :	1996 ₹	1997 ₹
Stock	1,00,000	74,000
Sundry Debtors	80,000	64,200
Cash	500	600
Bank	—	8,000
Total current assets	1,80,500	1,46,800
Current Liabilities :		
Sundry Creditors	1,50,000	1, 35,200
Total current liabilities	1,50,000	1,35,200
Working capital	30,500	11,600
Increase in working capital	18,900	(30,500 – 11,600)

(*ii*) Profit and Loss Account

To Dividend paid	23,000	By Balance b/d	30,500
To Depreciation on Machinery	12,000	By Fund from operation	93,300
To Depreciation on Land & Building	10,000		
To General Reserve	10,200		
To Income Tax (provided)	38,000		
To Balance c/d	30,600		
	1,23,800		1,23,800

(*iii*) Provision for Taxation Account

	₹		₹
To Cash	33,000	By Balance b/d	33,000
To Balance c/d	35,000	By Income (Tax provided) BF	38,000
	68,000		68,000

Notes

(*iv*) Machinery Account

	₹		₹
To Balance b/d	1,50,000	By Depreciation	12,000
To Shares	25,000	By General Reserve	200
To Cash (Purchase)	8,000	By Balance c/d	1,69,000
		By Cash	1,800
	1,83,000		1,83,000

(*v*) Goodwill Account

	₹		₹
To Balance b/d	Nil	By Balance c/d	5,000
To Share	5,000		
	5,000		5,000

(*vi*) General Reserve Account

	₹		₹
To Balance b/d	60,000	By Balance b/d	50,000
To Loss on sale of Machinery	200	By Profit & Loss A/c	10,200
	60,200		60,200

(*vii*) Land & Buildings Account

	₹		₹
To Balance b/d	2,00,000	By Depreciation	10,000
		By Balance c/d	1,90,000
	2,00,000		2,00,000

(*iv*) Share Capital Account

	₹		₹
To Balance c/d	2,50,000	By Balance b/d	2,00,000
		By Machinery	25,000
		By Stock	20,000
		By Goodwill	5,000
	2,50,000		2,50,000

NOTE: Total shares issued to ₹ 50,000. Among this ₹ 25,000 as against machinery and ₹ 5,000 as against goodwill. Both are non current items. It should not affect the working capital. So, only ₹ 20,000 issued as against the stock. It should be treated as a source of funds. Because, it is a current asset.

Notes

Illustration 11. *From the following summarised financial statement of Anxious Ltd as on 30.04.2018, prepare*

(*a*) *Statement of changes in working capital for the year ended 30.04.2018 and*

(*b*) *A statement showing sources and applications of funds during the same period.*

Liabilities	*2017*	*2018*	*Assets*	*2017*	*2018*
	₹	₹		₹	₹
Share capital	*10,00,000*	*13,50,000*	*Fixed assets (Net)*	*18,00,000*	*20,50,000*
General reserve	*5,00,000*	*6,00,000*	*Investments*	*2,00,000*	*2,50,000*
Profit & loss A/c	*1,00,000*	*1,50,000*	*Inventories*	*5,00,000*	*7,00,000*
Debentures	*6,00,000*	*5,00,000*	*Debtors*	*5,85,000*	*6,40,000*
Sundry creditors	*9,00,000*	*10,50,000*	*Cash*	*15,000*	*10,000*
	31,00,000	*36,50,000*		*31,00,000*	*36,50,000*

During the year ended on 30.04.2018 depreciation charged on fixed assets amounted to ₹2,50,000. The final dividend for the year ended 30.04.2017 amounted to ₹1,00,000 was paid on 08.01.2018.

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Shares	3,50,000	Purchase of fixed assets	5,00,000
Fund from operation	5,00,000	Purchase of Investments	50,000
		Dividend paid	1,00,000
		Increase in working capital	1,00,000
		Redemption of debenture	1,00,000
	8,50,000		8,50,000

Workings: **(*i*) Statement of changes in working capital**

	2018 (₹)	2019 (₹)
Current Assets :		
Inventors	5,00,000	7,00,000
Debtors	5,85,000	6,40,000
Cash	15,000	10,000
Total current assets	11,00,000	13,50,000
Current Liabilities :		
Sundry creditors	9,00,000	10,50,000
Total current liabilities	9,00,000	10,50,000
Working capital	2,00,000	3,00,000
Increase in working capital	1,00,000	(2,00,000 – 3,00,000)

Notes

(*ii*) Profit and Loss Account

	₹		₹
To General Reserve	1,00,000	By Balance b/d	1,00,000
To Dividend paid	1,00,000	By Fund from operation	5,00,000
To Depreciation	1,50,000		
To Balance c/d	2,50,000		
	6,00,000		6,00,000

(*iii*) Fixed Assets Account

To Balance b/d	18,00,000	By Depreciation	2,50,000
To Cash	5,00,000	By Balance c/d	20,50,000
	23,00,000		23,00,000

Illustration 12. *From the following balance sheet you are required to prepare schedule of changes in working capital and fund flow statement.*

Balance Sheet

Liabilities	*31.3.98*	*31.3.99*	*Assets*	*31.3.98*	*31.3.99*
	₹	₹		₹	₹
Share capital	*50,000*	*50,000*	*Cash*	*20,000*	*10,000*
P.L. A/c	*80,000*	*1,10,000*	*Marketable securities*	*10,000*	-
12% debentures	-	*30,000*	*Investment*	*60,000*	*1,00,000*
Sundry creditors	*20,000*	*25,000*	*Debtors*	*30,000*	*40,000*
Bills payable	*20,000*	*5,000*	*Gross block*	*1,00,000*	*1,40,000*
Other current liabilities	*10,000*	*15,000*	*(–) accumulated depreciation*	*(40,000)*	*(55,000)*
	1,80,000	*2,35,000*		*1,80,000*	*2,35,000*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Debentures	30,000	Purchase of Gross block	40,000
Fund from operation	45,000	Increase in working capital	35,000
	75,000		75,000

Workings: **(*i*) Statement of changes in working capital**

Current Assets :	31.3.98 (₹)	31.3.99 (₹)
Cash	20,000	10,000
Marketable securities	10,000	-
Inventories	60,000	1,00,000
Debtors	30,000	40,000

Total current assets	1,20,000	1,50,000
Current Liabilities :		
Sundry creditors	20,000	25,000
Bills payable	20,000	5,000
Other Current Liabilities	10,000	15,000
Total current liabilities	50,000	45,000
Working capital	70,000	1,05,000
Increase in working capital	35,000	(70,000 – 1,05,000)

(*ii*) Profit and Loss Account

To Depreciation	15,000	By Balance b/d	80,000
To Balance c/d	1,10,000	By Fund from operation	45,000
	1,25,000		1,25,000

NOTE: Gross Block means total fixed assets.

Illustration 13. *The following are the summarized balance sheets of KNP Ltd. on 31st December 2002 and 2003.*

Liabilities	*2002*	*2003*	*Assets*	*2002*	*2003*
	₹	₹		₹	₹
Share capital	*12,00,000*	*16,00,000*	*Plant & Machinery*	*8,00,000*	*12,90,000*
Debentures	*4,00,000*	*6,00,000*	*Land & building*	*6,00,000*	*8,00,000*
Profit & loss A/c	*2,50,000*	*5,00,000*	*Stock*	*6,00,000*	*7,00,000*
Creditors	*2,30,000*	*1,80,000*	*Bank*	*40,000*	*80,000*
Provision for			*Preliminary*		
Bad & doubtful debts	*12,000*	*6,000*	*Expenses*	*14,000*	*12,000*
Depreciation on land & building	*40,000*	*48,000*			
Depreciation on plant & machinery	*60,000*	*70,000*			
	21,92,000	*30,04,000*		*21,92,000*	*30,04,000*

The following adjustments are to be made:

1. *During the year a part of machinery costing ₹ 1,40,000 (accumulated depreciation there on ₹ 4,000) was sold for ₹ 12,000.*
2. *Dividend of ₹ 1,00,000 was paid during the year.*

   Prepare : (a) statement of changes in working capital, (b) Fund flow statement

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Shares	4,00,000	Dividend paid	1,00,000
Issue of Debentures	2,00,000	Purchase of Plant & Machinery	6,30,000
Sales of Machinery	12,000	Purchase of Land & Building	2,00,000
Fund from operation	4,98,000		
		Increase in working capital	1,80,000
	11,10,000		11,10,000

Notes

Workings: **(*i*) Statement of changes in working capital**

	2002 (₹)	2003 (₹)
Current Assets :		
Stock	6,00,000	7,00,000
Bank	40,000	80,000
Debtors	1,38,000	1,22,000
Total current assets	7,78,000	9,02,000
Current Liabilities :		
Creditors	2,30,000	1,80,000
Provision for doubtful debts	12,000	6,000
Total current liabilities	2,42,000	1,86,000
Working capital	5,36,000	7,16,000
Increase in working capital	1,80,000	(5,36,000 – 7,16,000)

(*ii*) Profit and Loss Account

To Depreciation :		By Balance b/d	2,50,000
Plant & Machinery	14,000	By Fund from operation	4,98,000
Land & Building	8,000		
To Preliminary Expenses			
Written off	2,000		
To Dividend paid	1,00,000		
To Loss on sale of Machinery	1,24,000		
To Balance c/d	5,00,000		
	7,48,000		7,48,000

(*iii*) Plant and Machinery Account

To Balance b/d	8,00,000	By Cash	12,000
To Cash (Purchase)	6,30,000	By Accumulated Depreciation	4,000
		By Profit & Loss A/c	1,24,000
		By Balance c/d	12,90,000
	14,30,000		14,30,000

(*iv*) Accumulated Depreciation Account on Plant & Machinery

To Balance c/d	70,000	By Balance b/d	60,000
To Machinery A/c	4,000	By Profit & Loss A/c	
		(Current year Depreciation)	14,000
	74,000		74,000

Notes

(*v*) Land & Buildings A/c

To Balance b/d	6,00,000	By Balance c/d	8,00,000
To Cash	2,00,000		
	8,00,000		8,00,000

(*vi*) Accumulated Depreciation Account on Land & Building

To Balance c/d	48,000	By Balance c/d	40,000
		By Profit & Loss A/c	8,000
	48,000		48,000

NOTE :

Journal Entry for Ist Adjustment

Cash A/c	Dr.	12,000		[Sale of machinery]
Accumulated depreciation A/c	Dr.	4,000		[Depreciation]
Profit and Loss A/c	Dr.	1,24,000		[Loss on sale of machinery]
To machinery A/c			1,40,00	[Cost of machinery]

Illustration 14. *From the following balance sheets of a Indian Company Ltd. you are required to prepare fund flow statement.*

Liabilities	*Jan. 2002* ₹	*Dec. 2002* ₹	*Assets*	*Jan. 2002* ₹	*Dec. 2002* ₹
Current Liabilities	*30,000*	*32,000*	*Cash*	*40,000*	*44,400*
Bonds payable	*22,000*	*22,000*	*Accounts receivable*	*10,000*	*20,700*
Bonds Payable discount	*(2000)*	*(1,800)*	*Inventories*	*15,000*	*15,000*
Capital stock	*35,000*	*43,500*	*Land*	*4,000*	*4,000*
Retained earnings	*15,000*	*19,500*	*Buildings*	*20,000*	*16,000*
			Equipment	*15,000*	*17,000*
			Accumulated Depreciation	*(5,000)*	*(2,800)*
			Patents	*1,000*	*900*
	1,00,000	*1,15,200*		*1,00,000*	*1,15,200*

The following additional information is also available:

(*a*) *Income for the period ₹ 10,000.*

(*b*) *A building that costs ₹ 4,000 and which had a book value of ₹ 1,000 was sold for ₹ 1,400.*

(*c*) *The depreciation charged for the period was ₹ 800.*

(*d*) *There was an issue of common stock ₹ 5,000.*

(*e*) *Cash dividend of ₹ 2,000 and ₹ 3,500 stock dividend were declared.*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Sale of Building	1,400	Purchase of equipment	2,000
Issue of Common stock	5,000	Cash dividend paid	2,000
Fund from operation	10,700	Increase in working capital	13,100
	17,100		17,100

Workings: **(*i*) Statement of changes in working capital**

Current Assets :	Jan. 2002 (₹)	Dec. 2002 (₹)
Cash	40,000	44,400
Account receivable	10,000	20,700
Inventories	15,000	15,000
Total current assets	65,000	80,100
Current Liabilities :		
Current Liabilities	30,000	32,000
Total current liabilities	30,000	32,000
Working capital	35,000	48,100
Increase in working capital [48,100 – 35,000]	—	13,100

(*ii*) Profit and Loss Account

To Loss on Bond Payable discount	200	By Balance b/d	15,000
To Patent written off	100	By Profit on sale of Building	400
To Cash dividend paid	2,000	By Fund from operation	10,700
To Depreciation	800		
To Stock dividend	3,500		
To Balance c/d	19,500		
	26,100		26,100

(*iii*) Capital Stock Account

To Balance c/d	43,500	By Balance c/d	35,000
		By Cash	5,000
		By Stock Dividend	3,500
	43,500		43,500

(*iv*) Accumulated Depreciation Account

To Balance c/d	2,800	By Balance b/d	5,000
To Buildings A/c	3,000	By Profit & Loss A/c	800
	5,800		5,800

(*v*) Buildings A/c

To Balance b/d	20,000	By Cash	1,400
To Profit & Loss A/c (Profit on sale)	400	By Accumulated Depreciation	3,000
		By Balance c/d	16,000
	20,400		20,400

NOTE :

Journal Entry for IInd Adjustment

Cash A/c	Dr.	1,400		[Sale of Building]
Accumulated depreciation A/c	Dr.	3,000		[Depreciation]
To Building A/c			4,000	[Book value]
Profit and Loss A/c			400	[Profit]

illutration 15. *From the following balance sheets of Kavin Ltd., prepare a statement of changes in working capital and fund flow statement for the year ended 31.3.2002.*

Liabilities	*2001* ₹	*2002* ₹	*Assets*	*2001* ₹	*2002* ₹
Share capital	*3,00,000*	*3,50,000*	*Goodwill*	*1,00,000*	*80,000*
Debentures	*1,50,000*	*2,50,000*	*Machinery*	*4,10,000*	*5,40,000*
General reserve	*1,00,000*	*1,50,000*	*Investment*	*30,000*	*80,000*
Profit & loss A/c	*60,000*	*70,000*	*Discount on issue of Debentures*	*5,000*	—
Provision for depreciation on machinery	*90,000*	*1,30,000*	*Cash at bank*	*1,20,000*	*1,30,000*
Sundry creditors	*75,000*	*1,10,000*	*Sundry debtors*	*80,000*	*1,90,000*
Bills payable	*10,000*	*15,000*	*Stock*	*40,000*	*55,000*
	7,85,000	*10,75,000*		*7,85,000*	*10,75,000*

During the year investments costing ₹ 30,000 were sold for ₹ 28,000 and a new machine was purchased for ₹ 45,000. The payment was made in fully paid shares.

Solution: **Fund Flow Statement**

Notes

Source of funds	₹	Application of funds	₹
Issue of shares	5,000	Purchase of Machinery (4)	85,000
Issue of Debentures	1,00,000	Increase in Working Capital (1)	95,000
Sale of investments	28,000	Purchase of Investment (6)	80,000
Fund from operation	1,27,000		
	2,60,000		2,60,000

Workings: **(*i*) Statement of changes in working capital**

	1999 (₹)	2000 (₹)
Current Assets :		
Cash at bank	1,20,000	1,30,000
Sundry Debtors	80,000	1,90,000
Stock	40,000	55,000
Total current assets	2,40,000	3,75,000
Current Liabilities :		
Sundry creditors	75,000	1,10,000
Bills payable	10,000	15,000
Total current liabilities	85,000	1,25,000
Working capital	1,55,000	2,50,000
Increase in working capital	95,000	(1,55,000 – 2,50,000)

(*ii*) Profit and Loss Account

To Goodwill written off	20,000	By Balance b/d	60,000
To General Reserve	50,000	By Fund from operation	1,27,000
To Discount issue of Debentures	5,000		
To Depreciation	40,000		
To Loss on Sale of Investments	2,000		
To Balance c/d	70,000		
	1,87,000		1,87,000

(*iii*) Share Capital Account

To Balance c/d	3,50,000	By Balance b/d	3,00,000
		By Machinery	45,000
		By Cash	5,000
	3,50,000		3,50,000

(*iv*) Machinery Account

To Balance b/d	4,10,000	By Balance c/d	5,40,000
To Shares	45,000		
To Cash (b/f)	85,000		
	5,40,000		5,40,000

(*v*) Provision for Depreciation on Machinery Account

To Balance b/d	30,000	By Bank	28,000
To Purchase of Investment (b/f)	80,000	By Loss Sale of Investment	2,000
		By Balance c/d	80,000
	1,10,000		1,10,000

NOTE : Sale of Investment

Cash A/c	Dr.	28,000		[Actual sale]
Profit & Loss A/c	Dr.	2,000		[Loss on sale]
To Investments			30,000	[Value of investment]

Illustration 16. *From the following summarised balance sheets of Balaji & Co. as on 31.12.2003 and other information furnished, prepare fund flow statement.*

Balance sheet

Liabilities	*2003* ₹	*2002* ₹	*Assets*	*2003* ₹	*2002* ₹
Share capital	*2,00,000*	*50,000*	*Fixed assets*	*4,20,000*	*2,40,000*
Redeemable per shares	—	*1,00,000*	*Investments*	*15,000*	*18,000*
Profit & loss A/c	*3,50,000*	*1,20,000*	*Stock*	*1,60,000*	*58,500*
Debentures	—	*1,25,000*	*Bills receivable*	*92,000*	*1,37,000*
Sundry creditors	*1,90,000*	*2,25,000*	*Cash at bank*	*1,20,000*	*1,85,000*
Provision for Tax	*75,000*	*25,000*	*Prepaid expenses*	*8,000*	*6,500*
	8,15,000	*6,45,000*		*8,15,000*	*6,45,000*

The following additional information is also available :

(*a*) *On 31.12.2003 accumulated depreciation on fixed assets amounted to ₹ 1,20,000 and on 31st December 2002 ₹ 1,10,000*

(*b*) *Machinery costing ₹ 10,000 (accumulated depreciation thereon being ₹ 5,000) was discarded and written off during 2003.*

(*c*) *Depreciation written off during 2003 amounted to ₹ 15,000.*

(*d*) *During the year 2003 investments costing ₹ 6,000 were sold for ₹ 7,000.*

(*e*) *Dividend paid during the year was ₹ 45,000*

(*f*) *Redeemable preference shares were redeemed out of profits during the year at a premium of 5%.*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of shares	1,50,000	Repayment of Secured Loan	1,25,000
Sales of investments	7,000	Dividend paid	95,000
Decrease in working capital	22,000	Redemption of preference	
Fund from operation	2,99,000	Share	1,05,000
		Purchase of Investments	3,000
		Purchase of Fixed assets	2,00,000
	4,78,000		4,78,000

Workings: **(*i*) Statement of changes in working capital**

	2002 (₹)	2003 (₹)
Current Assets :		
Stock	58,500	1,60,000
Sundry Debtors	1,37,000	92,000
Cash at Bank	1,85,000	1,20,000
Prepaid expenses	6,500	8,000
Total current assets	3,87,000	3,80,000
Current Liabilities :		
Sundry creditors	2,25,000	1,90,000
Provision for tax	25,000	75,000
Total current liabilities	2,50,000	2,65,000
Working capital	1,37,000	1,15,000
Increase in working capital	22,000	(1,37,000 – 1,15,000)

(*ii*) Profit and Loss Account

	₹		₹
To Loss on sale of Machinery	5,000	By Balance b/d	1,20,000
To Dividend paid	45,000	By profit on sale of Investment	1,000
To Premium on Redemption of Preference share	5,000	By Fund from operation	2,99,000
To Depreciation	15,000		
To Balance c/d	3,50,000		
	4,20,000		4,20,000

(*iii*) Redeemable Preference Share Capital Account

To Cash	1,05,000	By Balance b/d	1,00,000
		By P & L A/c (premium)	5,000
	1,05,000		1,05,000

Notes

(*iv*) Fixed Assets Account

To Balance b/d (2,40,000 + 1,10,000)	3,50,000	By P & L A/c	5,000
To Cash	2,00,000	By Accumulated Depreciation	5,000
		By Balance c/d (4,20,000 + 1,20,000)	
	5,50,000		5,50,000

(*v*) Accumulated Depreciation Account

To Fixed Assets	5,000	By Balance b/d	1,10,000
		By P& L A/c (Current year Depreciation)	15,000
To Balance c/d	1,20,000		
	1,25,000		1,25,000

(*vi*) Investment Account

To Balance b/d	18,000	By Cash	6,000
To Cash	3,000	By Balance c/d	15,000
	21,000		21,000

NOTE :

(*i*) Journal Entry for IInd Adjustment

Profit & Loss A/c	Dr.	5,000		[Loss]
Accumulated depreciation A/c	Dr.	5,000		[Depreciation]
To machinery A/c			10,000	[Value of machinery]

(*ii*) Journal Entry for IV Transaction

Cash A/c	Dr.	7,000	
To Profit & Loss A/c			1,000
To Investment A/c			6,000

(*iii*) Here, provisional for Taxation assumed to current liability

Illustration 17. *From the following data of National Auto Ltd. for the year 2000 and 2001. Particulars*

Liabilities	*2000*	*2001*
	₹	₹
Cash	*2,000*	*2,500*
Account receivable	*2,400*	*2,700*
Inventories	*3,100*	*3,200*
Other current assets	*800*	*700*
Fixed assets	*5,000*	*5,800*
Accumulated depreciation	*2,100*	*2,500*
Accounts payable	*2,000*	*2,100*
Long term debt	*1,400*	*1,300*

Equity capital	*5,000*	*5,300*
Retained earnings	*2,800*	*3,700*

The following additional information is also available :

Notes

(*a*) *Fixed assets costing ₹1,200 were purchased for cash.*

(*b*) *Fixed assets [Original cost of ₹400 accumulated depreciation ₹150] were sold for ₹ 200.*

(*c*) *Depreciation for the year 2001 amounted to ₹ 550 and duly debited to profit & loss account.*

(*d*) *Dividend paid amounted to ₹dd 300 in 2001.*

(*e*) *Reported income for 2001 was ₹ 2,400.*

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Equity Shares	300	Dividend paid	300
Sale of Fixed Assets	200	Purchase of Fixed Assets	1,200
Fund from operation	1,800	Repayment of Long term Debt	100
		Increase in working capital	700
	2,300		2,300

Workings: **(*i*) Statement of changes in working capital**

	2000 (₹)	2001 (₹)
Current Assets :		
Cash	2,000	2,500
Accounts receivable	2,400	2,700
Inventories	3,100	3,200
Other current assets	800	700
Total current assets	8,300	9,100
Current Liabilities :		
Account payable	2,000	2,100
Total current liabilities	2,000	2,100
Working capital	6,300	7,000
Increase in working capital	700	(6300 – 7000)

(*ii*) Fixed Assets Account

To Balance b/d	5,000	By Cash	200
To Cash	1,200	By Accumulated Depreciation	150
		By Profit & Loss A/c	50
		By Balance c/d	5,800
	6,200		6,200

Notes

(*iii*) Profit and Loss Account

To Fixed Assets	50	By Balance c/d	2,800
To Depreciation	550	By Fund from operation	1,800
To Dividend paid	300		
To Balance c/d	3,700		
	4,600		4,600

(*iv*) Accumulated Depreciation Account

To Fixed Assets	150	By Balance b/d	2,100
To Balance c/d		By Profit & Loss A/c	550
	2,500		2,650

NOTE :

(*i*) Journal Entry for IInd Adjustment

Cash A/c	Dr.	200		[Sale of fixed assets]
Accumulated depreciation A/c	Dr.	150		[Depreciation]
Profit and Loss A/c	Dr.	50		[Loss on sale]
To Fixed assets			400	

(*ii*) Reported income

It is included in the Retained Earnings. So, there is no need to give the effect of this Adjustment.

Illustration 18. From the following information, calculate funds from operations.

Profit and Loss Account

To expenses	₹		₹
To Operating expenses	*1,00,000*	*By Gross profit*	*2,00,000*
To Depreciation	*40,000*	*By Gain on sale of building*	*20,000*
To loss on sale of machinery	*10,000*		
To advertisement expenses A/c	*5,000*		
To discount of debtors	*500*		
To discount on issue a shares	*500*		
To goodwill written off	*12,000*		
To preliminary expenses written off	*2,000*		
To Net profit	*50,000*		
	2,20,000		*2,20,000*

Solution:

Notes

Computation of fund from operation Profit & Loss Account

To expenses	**₹**	**Incomes**	**₹**
To Depreciation	40,000	By Balance b/d	Nil
To Loss on sale of Machinery	10,000	By Gain on sale of Buildings	20,000
To Goodwill written off	12,000	By Fund from operation	99,500
To Advertisement Expenses	5,000		
To Discount allowed	500		
To Preliminary Expenses Written off	2,000		
To Balance c/d	50,000		
	1,19,500		1,19,500

Illustration 19. *Balance sheets of M/s Black and White as on 1st Jan. 2000 and 31st Dec 2000 were as follows:*

Liabilities	*Jan. 2000 ₹*	*Dec. 2000 ₹*	*Assets*	*Jan. 2000 ₹*	*Dec. 2000 ₹*
Creditors	*40,000*	*44,000*	*Cash*	*10,000*	*7,000*
White's loan	*25,000*	*—*	*Debtors*	*30,000*	*50,000*
Loan from bank	*40,000*	*50,000*	*Stock*	*35,000*	*25,000*
Capital	*1,25,000*	*1,53,000*	*Land*	*40,000*	*50,000*
			Buildings	*35,000*	*60,000*
			Machinery	*80,000*	*55,000*
	2,30,000	*2,47,000*		*2,30,000*	*2,47,000*

During the year machine costing ₹ 10,000 [accumulated depreciation ₹ 3,000] was sold for ₹ 5,000. The provision for depreciation against machinery as on Ist Jan 2000 was ₹ 25,000 and on 31st Dec 2000 ₹ 40,000. Net profit for the year 2000 amounted to ₹ 45,000. Prepare fund flow statement.

Solution: **Fund Flow Statement**

Source of funds	**₹**	**Application of funds**	**₹**
Loan from PN Bank	10,000	Repayment of Mr. White's Loan	25,000
Sales of Machinery	5,000	Purchase of Land	10,000
Fund from operation	65,000	Purchase of Building	25,000
		Increase in working capital	3,000
		Drawings (Capital A/c)	17,000
	80,000		80,000

Workings: **(*i*) Statement of changes in working capital**

Current Assets :	1.1.2002 (₹)	31.12.2002 (₹)
Cash	10,000	7,000

Debtors	30,000	50,000
Stock	35,000	25,000
Total current assets	75,000	82,000
Current Liabilities :		
Creditors	40,000	40,000
Total current liabilities	40,000	44,000
Working capital	35,000	38,000
Increase in working capital	3,000	(35,000 – 38,000)

Notes

(*ii*) Profit and Loss Account

To Loss on sale of Machinery	2,000	By Fund from operation	65,000
To Depreciation	18,000		
To Balance c/d	45,000		
	65,000		65,000

(*iii*) Capital Account

To Balance c/d	1,53,000	By Cash	5,000
To Cash (b/f)	17,000	By Profit & Loss A/c	45,000
	1,70,000		1,70,000

(i*v*) Machinery A/c

To Balance c/d (80,000 + 25,000)	1,05,000	By Cash	5,000
		By P & L A.c	2,000
		By Accumulated Depreciation	3,000
		By Balance c/d	95,000
	1,05,000		1,05,000

(*iv*) Accumulated Depreciation Account

To Machinery A/c	3,000	By Balance b/d	25,000
To Balance c/d	40,000	By P & L A/c (b/f)	18,000
	43,000		43,000

NOTE :

Journal Entry for Ist Adjustment

Cash A/c	Dr.	5,000	
Accumulated depreciation A/c	Dr.	3,000	
Profit and Loss A/c	Dr.	2,000	
To Machinery A/c			10,000

Illustration 20. *The Balance sheets of Dharan Ltd. as on 31.12.1999 and 31.12.2000 are as follows.*

Liabilities	1999 ₹	2000 ₹	Assets	1999 ₹	2000 ₹
Share capital	2,00,000	2,50,000	Fixed assets	3,50,000	4,75,000
Retained earnings	1,60,000	3,00,000	Inventory	1,00,000	95,000
Premium on share	—	5,000	Accounts receivable	43,000	50,000
Accumulated depreciation	80,000	60,000	Prepaid expenses	4,000	5,000
Debentures	60,000	—	Cash	15,800	10,200
Bank overdraft	37,800	40,200	Commission on shares	25,000	20,000
	5,37,800	6,55,200		5,37,800	6,55,200

The following additional information is also available :

(*i*) Net profit for the year ₹ 1,40,000

(*ii*) Income tax was paid ₹ 40,000

(*iii*) Interim dividend paid during the year was ₹ 20,000.

(*iv*) An addition to the fixed asset was made during the year at a cost of ₹ 1,65,000 and fully depreciated machinery costing ₹ 40,000 was discarded, no salvage being realised.

(*v*) Depreciation for the year ₹ 20,000

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Issue of Shares	50,000	Redemption of debentures	60,000
Premium on shares received	5,000	Purchase of Fixed Assets	1,65,000
Fund from operation	2,25,000	Income Tax paid	40,000
Decreasing in working capital	5,000	Interim dividend paid	20,000
	2,85,000		2,85,000

Workings: **(*i*) Statement of changes in working capital**

	1999 (₹)	2000 (₹)
Current Assets :		
Inventories	1,00,000	95,000
Accounts receivable	43,000	50,000
Prepaid expenses	4,000	5,000
Cash	15,800	10,200
	1,62,800	1,60,200
Current Liabilities :		
Bank overdraft	37,800	40,200
Total current liabilities	37,800	40,200
Working capital	1,25,000	1,20,000
Decrease in working capital	5,000	[1,25,000 – 1,20,000]

(*ii*) Profit and Loss Account

	₹		₹
To Commission on shares written off	5,000	By Balance b/d	1,60,000
To Depreciation	20,000	By Fund from operation (b/f)	2,25,000
To Income Tax paid	40,000		
To Interim dividend paid	20,000		
To Balance c/d	3,00,000		
	3,85,000		3,85,000

(*iii*) Fixed Assets Account

To Balance b/d	3,50,000	By accumulated depreciation	40,000
To Cash (b/f)	1,65,000	By Balance c/d	4,75,000
	5,15,000		5,15,000

(*iv*) Accumulated Depreciation Account

To Machinery A/c (Fully Depreciated Machinery)	40,000	By Balance b/d	80,000
To Balance c/d	60,000	By Profit & Loss A/c (b/f)	20,000
	1,00,000		1,00,000

Illustration 21. *Following are the summarized Balance Sheet of XYZ Ltd. As on 31st Dec. 2002 and 2003.*

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Share Capital	*1,00,000*	*1,25,000*	*Land and Building*	*1,00,000*	*95,000*
General Reserve	*25,000*	*30,000*	*Machinery*	*75,000*	*84,500*
Profit and Loss A/c	*15,250*	*15,300*	*Stock*	*50,000*	*37,000*
Bank loan (long-term)	*35,000*	----	*Debtors*	*40,000*	*32,100*
Sundry Creditors	*75,000*	*67,600*	*Cash*	*250*	*300*
Provision for Taxation	*15,000*	*17,500*	*Bank*	----	*4,000*
			Goodwill	----	*2,500*
	2,65,250	*2,55,400*		*2,65,250*	*2,55,400*

Additional Information :

(*i*) *Dividend of ₹ 16,500/- was paid.*

(*ii*) *Assets of another company were purchased for a consideration of ₹ 25,000/- payable in shares.*

The following assets purchased

Stock *10,000*

Machinery *12,500*

(*iii*) *Machinery was further purchased for ₹ 4,000*

(*iv*) *Depreciation written off on machinery ₹ 6,000*

(*v*) *Income tax provided during the year ₹ 16,500/-*

(*vi*) *Loss on sale of machinery ₹ 100/- was written off to General Reserve. Prepare a statement of Funds Flow of XYZ Ltd.*

Notes

Solution: **Fund Flow Statement**

Source of funds	₹	Application of funds	₹
Sale of land and buildings	5,000	Repayment of bank loan	35,000
Funds from operation	44,150	Dividend paid	16,500
Sale of machinery	900	Purchase of machinery	4,000
Decrease in working capital	9,450	Income tax paid	14,000
Issue of shares for stock	10,000		
	69,500		69,500

Workings :

1. Statement of changes in working capital :

	2002 (₹)		2003 (₹)
Current Assets :			
Stock	50,000		37,000
Debtors	40,000		32,100
Cash	250		300
Bank	---		4,000
Total current assets	90,250		73,400
Current Liabilities :			
Sundry creditors	75,000		67,600
Total current liabilities	75,000		67,600
Working capital	15,250		5,800
Decrease in working capital		9,450	

2. Share Capital A/c

	₹		₹
To Balance c/d	1,25,000	By Balance b/d	1,00,000
		By Stock	10,000
		By Machinery	12,500
		By Goodwill	2,500
	1,25,000		1,25,000

3. Profit and Loss A/c

	₹		₹
To Balance c/d	15,300	By Balance b/d	15,250
To Dividend paid	16,500	By FFO	44,150
To Depreciation (mach)	6,000		
To Income tax provision	16,500		
To General Reserves	5,100		
	59,400		59,400

4. Provision for Taxation A/c

	₹		₹
To Balance c/d	17,500	By Balance b/d	15,000
To Cash (Tax paid)	14,000	By P.L. A/c	16,500
	31,500		31,500

5. Machinery A/c

	₹		₹
To Balance b/d	75,000	By Balance c/d	84,500
To Shares	12,500	By Profit and loss A/c	6,000
To Cash	4,000	By General Reserve A/c	100
		By Cash	900
	91,500		91,500

6. Goodwill A/c

	₹		₹
To Balance b/d	Nil	By Balance c/d	2,500
To Shares	2,500		
	2,500		2,500

7. General Reserve A/c

	₹		₹
To Balance c/d	30,000	By Balance b/d	25,000
To Machinery	100	By Profit and Loss A/c	5,100
	30,100		30,100

Notes

5.14. Review Exercise

1. Babu & Co. presents the following Financial Statement for 1988 and 1989. Prepare a sources and application for funds statement.

Notes

Liabilities	1988 ₹	1989 ₹	Assets	1988 ₹	1989 ₹
Bills payable	4,52,000	6,28,000	Cash	1,06,000	62,000
Creditors	8,26,000	12,54,00	Investment	1,74,000	–
Loan from bank	2,00,000	4,70,000	Debtors	6,92,000	10,56,000
Receives & Surplus	13,84,000	17,28,000	Stock	8,64,000	13,66,000
Share capital	12,00,000	12,00,000	Net fixed assets	22,26,000	27,96,000
	40,62,000	**52,80,000**		**40,62,000**	**52,80,000**

Depreciation of ₹ 3,78,000 was written off for the year 1989 on fixed assets.

[**Ans.** Increase in working capital ₹ 2,18,000]

2. Balance Sheets of M/s. Raman and Krishna as on 1st January, 1989 and 31 st December 1998 were as follows:

Balance Sheet

Liabilities	1.1.98 ₹	31.12.98 ₹	Assets	1.1.98 ₹	31.12.98 ₹
Bill Payable	80,000	88,000	Cash	25,000	22,000
Mrs. Krishnan's laon	50,000	–	Debtors	30,000	80,000
Loan, secured on Building	80,000	80,000	Stock	75,000	40,000
Creditors	30,000	60,000	Bills Receivable	25,000	30,000
Capitals:			Building	1,00,000	90,000
Raman	40,000	50,000	Furniture	1,05,000	86,000
Krishnan	80,000	70,000			
	3,60,000	**3,48,000**		**3,60,000**	**3,48,000**

During 1998, furniture costing 10,000 (accumulated depreciation ₹ 6,000) was sold for ₹ 3,000.

Net profit for the year was ₹ 80,000, divided equally to the partners.

Prepare a statement of sources and uses of funds for the year 1998.

[**Ans.** Decrease in working capital ₹ 21,000]

3. Balance Sheet of Ganesh Mills Ltd.

Liabilities	1992 ₹	1993 ₹	Assets	1992 ₹	1993 ₹
Equity share capital	3,00,000	4,00,000	Building	2,50,000	3,00,000
10% Redeemable per share capital	2,00,000	–	Machinery	3,00,000	3,20,000
Capital Redemption			Furniture	20,000	18,000
Reserve	–	1,00,000	Investments	1,00,000	1,50,000

Reserve Fund	2,00,000	1,20,000	Debtors	1,40,000	2,00,000
Share Premium	30,000	30,000	Cash at Bank	20,000	32,000
Profit & Loss A/c	1,20,000	1,80,000			
12% Debentures	2,00,000	3,00,000			
Creditors	80,000	1,40,000			
	11,30,000	**12,70,000**		**11,30,000**	**12,70,000**

Notes

The following transaction took place during the year 1993:

(*a*) Preference shares were redeemed at 10% premium.

(*b*) ₹ 20,000 was transferred to Reserve Fund from P & L A/c.

(*c*) Investments (book value ₹ 40,000) were sold for ₹ 70,000.

(*d*) Depreciation provided on Building, Machinery and Furniture ₹ 20,000, ₹ 30,000 and ₹ 2,000 respectively.

(*e*) Dividends paid ₹ 50,000 and income tax paid ₹ 45,000. Prepare a funds flow statement showing change in working capital.

[**Ans.** Decrease in working capital ₹ 38,000]

4. From the following prepare a statement showing changes in working capital during 2002

Balance Sheet

as on 31st December

Liabilities	2001	2002	Assets	2001	2002
	₹	₹		₹	₹
Share capital	5,00,000	6,00,000	Fixed Assets	10,00,000	11,20,000
Reserves	15,00,00	1,80,000	Less: Depreciation	3,70,000	4,60,000
P&L Amount	40,000	65,000		6,30,000	6,60,000
Debentures	3,00,000	2,50,000	Stock	2,40,000	3,70,000
			Book debts	2,50,000	2,30,000
Creditors for good	1,70,000	1,60,000	Cash in hand and at bank	80,000	60,000
Provision for			Preliminary exp.	20,000	15,000
Income tax	60,000	1,80,000			
	12,20,000	**13,35,000**		**12,20,000**	**13,35,000**

[**Ans.** Increase in working capital ₹ 1,00,000]

5. Prepare a statement of changes in working capital from the following details of 'R' Ltd.

Liabilities	31.12.99	31.12.2000	Assets	31.12.99	31.12.99
	₹	₹		₹	₹
Equity capital	5,00,000	5,00,000	Fixed Assets	6,00,000	7,00,000
Debentures	3,70,000	4,50,000	Long-term		

Notes

Tax payable	77,000	43,000	Investments	2,00,000	1,00,000
Creditors	96,000	1,92,000	Work-in-progress	80,000	90,000
Dividend payable	87,000	80,000	Stock	1,50,000	2,25,000
			Debtors	70,000	1,40,000
			Cash	30,000	10,000
	11,30,000	**12,65,000**		**11,30,000**	**12,65,000**

[**Ans.** Increase in working capital ₹ 80,000]

6. Finds fund from operations from the following data:

   Opening balance of P&L A/c ₹ 60,000
   Closing balance of P&L ₹ 30,000

   The following items appeared in P&L A/c:

   Interim divided paid ₹ 20,000, proposed divided ₹ 30,000, depreciation ₹ 50,000, Preliminary expenses ₹ 1,000, loss on sale of machinery ₹ 3,000, General Reserve ₹, 5,000, sinking fund ₹ 10,000, salaries paid ₹ , 3,000, profit on sale of car ₹ 4,000, and tax paid ₹ 5,000.

   [Ans. Funds from operation ₹ 90,000]

7. From the following, compute the funds from operation

Profit and Loss Account

	₹		₹
To cash Purchase	50,000	By sales	60,000
To Gross Profit c/d	10,000		
	60,000		60,000
To Salaries	8,000	By Gross Profit b/d	10,000
To Rent	7,000	By Dividends received	3,000
To Depreciation	2,000	By Interest Investments	3,000
To Goodwill written off	1,000	By Net Loss	4,000
To Preliminary expenses written off	500		
To Discount on issue of Debentures	1,500		
	20,000		**20,000**

[**Ans.** Funds outflow account of operation ₹ 5,000]

8. From the following details, calculate funds from operations

Particulars	₹
Salaries	5,000
Rent	3,000
Depreciation on Plant	5,000
Provision for tax	4,000
Loss on sale of Plant	2,000
Opening balance of P & L A/c	25,000

Transfer of General Reserve	1,000
Goodwill written off	2,000
Dividend Received	5,000
Refund of tax	3,000
Profit on sale of building	5,000
Closing balance of P & L A/c	60,000
Discount on issue of debentures	2,000
Provision for bad debts	1,000
Preliminary expenses written off	3,000
Proposed divided	6,000

[**Ans.** Funds from operation ₹ 47,000]

9. The followings is the comparative Balance Sheet of A Ltd. Prepare a Funds Flow Statement:

Balance Sheet

Liabilities	31.12.05	31.12.05	Assets	31.12.05	31.12.05
	₹	₹		₹	₹
Share capital	8,000	8,500	Land	5,000	5,000
P&L Appn. A/c	1,450	2,450	Plant	2,400	3,400
Creditors	900	500	Debtors	1,650	1,950
Mortgage loan	–	500	Stock	900	700
			Cash at Bank	400	900
	10,350	**11,950**		**10,350**	**11,950**

[**Ans.** Increase in working capital: ₹ 1,000;
Total sources: ₹ 2,000; Applications:
₹ 1,000; Funds from operations: ₹ 1000]

10. From the following Balance Sheets of Arun Ltd. Prepare a sources and uses of funds statement for 2005.

	31.12.05	31.12.04
	₹	₹
Assets		
Cash	75,000	35,000
Debtors	90,000	98,000
Stock & work-in-progress	1,20,000	87,000
Long term investments	10,000	15,000
Land	30,000	20,000
	3,25,000	**2,55,000**
Liabilities :		

Notes

Account payable	45,000	50,000
Notes payable (short-term)	35,000	20,000
Notes payable (due Dec. 206)	20,000	–
Capital Stock	1,50,000	1,25,000
Retained earnings	75,000	60,000
	3,25,000	**2,55,000**

[**Ans.** Increase in working capital: ₹ 35,000;
Total sources: ₹ 45,000; Applications: ₹ 10,000;
Funds from operations: ₹ 15,000]

11. The Balance Sheet of Swatantra Bharat Co. Ltd. As at 31st December 1991 and 1992 are given below:

	1991	1992
	₹	₹
Assets		
Freehold land	1,00,000	1,00,000
Plant at cost	1,04,000	1,00,000
Furniture at cost	7,000	9,000
Investment at cost	60,000	80,000
Debtors	30,000	70,000
Stock	60,000	65,000
Cash	30,000	45,000
	3,91,000	**4,69,000**
Liabilities :		
Share capital	1,00,000	1,50,000
Share premium	–	5,000
General reserve	50,000	60,000
Profit & Loss A/c	10,000	17,000
6% Debentures	70,000	50,000
Provision for depreciation on plant	50,000	56,000
Provision for depreciation on furniture	5,000	6,000
Provision for taxation	20,000	30,000
Sundry creditors	86,000	95,000
	3,91,000	**4,69,000**

A plant purchase for ₹ 4,000 (depreciation ₹ 2,000) was sold for cash ₹ 800 on 30th Sep. 1992. On 30th June 1992, an item of furniture was purchased for ₹ 2,000. These were the only transitions fixed assets during 1992. Depreciation on plant was provided at 8% on cost (the sold item is not taken into consideration) and on furniture at 12½ % on average cost. A dividend of 22½% on original shares was paid.

Prepare a schedule of changing in working capital and statement of sources and application of funds during 1992.

[**Ans.** Increase in working capital: ₹ 51,000; Total sources of funds: ₹ 1,35,500; Applications of funds: ₹ 84,500; Funds from operation: ₹ 79,700; Loss on sale of plant: ₹ 1,200; Depreciation of plant for 1992; ₹ 8,000; Opening Balance of provision for tax is to be assumed as paid i.e., ₹ 20,000; Closing balance of ₹ 30,000 is the provision for 1992; Dividend ₹ 22,5000]

Unit–6

Cash Flow Statement

Notes

Structure

5.1. How to Adjust for Non-Cash Transactions
5.2. Introduction
5.3. Meaning
5.4. Uses of Cash Flow Statement
5.5. Limitations of Cash Flow Analysis
5.6. Difference Between Cash Flow Analysis and Fund Flow Analysis
5.7. Steps in Preparation of Cash Flow Statement
5.8. Review Exercise

5.1. How to Adjust for Non-Cash Transactions

In business accounting, non-cash transactions include any items that do not directly involve the transfer of money. When preparing a cash-flow statement, the only way to adjust fro non-cash transactions is through the indirect method, which subtracts rule items from the company's net income. For longer businesses that often deal with non-cash transactions, preparing a cash-flow statement using the indirect method is important as it gives a more accurate description of the company's current finances.

Cash-Flow Statements

A cash-flow statement is a document prepared by a company that details how much money is flowing in and out of the business. Specifically, it shows the change in cash and cash equivalents in a given period of time. Along with a income statement, most small businesses prepare a cash-flow statement, most small businesses prepare a cash-flow statement at least every quarter. Some may even prepare one every month. While a cash-flow statement is a requirement for publicly listed companies, non-listed companies still use them for keeping track of payments. Many hire an accountant familiar with GAAP accounting rules and standard to prepare a cash-flow statement.

Non-Cash Transactions

On a cash-flow statement, a non-cash transaction encompasses any aspect that undergoes depreciation or amortization. This included transactions such as the conversion of bonds to other types of assets or vice versa, lease arrangements that lead to a purchase, such as commercial real estate rentals, and the exchange of any asset for another asset that is not cash. Items such as interest rate payments are non-cash transactions. Although non-cash transactions do not normally appear on a cash-flow statement, an accountant can adjust a cash-flow statement to factor in such transactions. To do this, an accountant uses the indirect method of creating a cash-flow statement.

Notes

The Indirect Method of Cash-Flow Statement Preparation

There are two main methods for constructing a cash-flow statement: the direct and indirect method. The former simply sums up all cash transactions, from both customers and investment activities and adds and subtracts any interest or dividends the company is liable for. The accountant, using this information, then computes the cash flow for the company for the end of the year. The indirect method, on the other hand, computes the end of year cash flow by adding up net income and rule items. The accountant obtains net income from the company's income statement. Rule items include all non-cash transactions.

Example

Consider a company with a net income of $ 100,000 a year. The accountant adjusts net income upward for the following non-cash transactions: $ 2,000 for depreciation, $₹ 1,000 for the amortization of bond discount, $ 1,000 for the loss on sale of equipment, $ 1,000 for the decreases in account receivable and ₹ 1000 to ₹ 1,06,000. The accountant then adjust net income downward premium. ₹ 200 for gain on the sale of –

5.2. Introduction

Cash contributes significant role in the entire economic activities of the business world. And at the same time, cash is not only essential for business, but is also essential for each and every activity of human life. What blood is to human body, cash is to a business firm. The firm receives cash from various sources like issue of shares, sale of assets etc. It needs cash to make payments for various purposes like payment to suppliers and to meet out the day to day expenses. The foremost responsibility of the financial manager is to determine cash planning activities and to maintain adequate cash balances. At this juncture cash flow statement is an important tool of cash planning and control. The term cash is used to refer to cash in hand and bank balance.

5.3. Meaning

Cash flow statement is a statement which is prepared from the historical data showing the inflow and outflow of cash. It shows the sources and uses of cash between the two balance sheet dates. It clearly explains the causes for changes in cash position between two periods. Simply, it is a receipts and payments account in a summary form.

5.4. Uses of Cash Flow Statement

Cash flow statement is an important tool of financial analysis. It is vital to financial management. Its main uses are as follows :

Notes

(*i*) It gives guidance to the management in taking and implementing short-term financial policies.

(*ii*) It helps to strengthen the borrowing capacities of the firms. The financial institutions can easily assess the repaying capacities of the firms through the cash flow analysis.

(*iii*) It contributes significant role for the capital budgeting decisions.

(*iv*) It helps in short term financial decisions relating to liquidity.

(*v*) In order to find out the variation and take necessary remedial measures with the help of the comparison of actual cash flow statements with the projected cash flow statements.

(*vi*) To overcome the problem of meeting deficit cash or investment of surplus cash with the help of the projected cash flow statement. Thus, projected cash flow statement is usually prepared on the basis of past year's experience.

(*vii*) It explains the causes for poor cash position in spite of huge profits or surplus cash balance in spite of low profits.

(*viii*) It explains the major sources and uses of cash for the business concern during a particular period of time.

5.5. Limitations of Cash Flow Analysis

Cash flow statement is a systematic tool of financial analysis. However, it suffers from some limitations which are as follows :

1. A cash flow statement cannot be equated with the income statement. An income statement considers both cash and non-cash items. So, cash does not mean net income of business.
2. The cash flow statement may not represent the real liquid position of the concern. Due to this aspect, postponing of purchases and payments could be developed.
3. Cash flow statement cannot replace the income statement or fund flow statement. Each and every statement has a separate function to perform.
4. Due to inflation, economic depression and other external factors, projected cash flow statement may not achieve its results.

5.6. Difference Between Cash Flow Analysis and Fund Flow Analysis

1. Cash flow statement starts with the opening cash balance and ends with the closing cash balance by processing through various sources and uses. But, there are no opening and closing balances in fund flow statement.
2. Cash from operation can be found out under the cash flow statement. But, fund from operation can be found out under the fund flow statement.
3. Separate statements are prepared for the purpose of finding out increase or decrease in working capital under the fund flow statement. But, no separate

statements for increase or decrease in working capital are prepared in cash flow analysis.

4. A cash flow statement explains the causes for the changes in cash and bank balances i.e., cash receipts and cash payments alone. But, fund flow statement indicates the causes for the changes in net working capital.
5. Cash flow statement is suitable for short term financial planning and decision, while fund flow statement is appropriate for long term financial planning and decisions.
6. Cash flow analysis deals with the movement of actual or notional cash. But, fund flow statement deals with not only cash but also the items constituting working capital. Cash is one of the components of working capital.
7. Whenever, wherever there is inflow of cash there will definitely be inflow of funds. But, sound fund position need not be a sound cash position.

Notes

5.7. Steps in Preparation of Cash Flow Statement

Cash flow statement can be prepared on the same pattern on which fund flow statement is prepared. But, here statement of changes in working capital does not need to be prepared. Remaining all other procedures were same in fund flow statement.

Cash flow statement is prepared on any one of the following assumptions :

— When all transactions are taken as cash transactions.

— When all transactions are not cash transactions.

Here, we have to proceed with all the problems by treating all the transactions as cash transactions.

Steps

1. No need to prepare working capital statement
2. Preparation of cash flow statement
3. Preparation of profit & loss account-computation of cash from operation
4. Preparation of separate ledger if necessary
5. Treatment of adjustments

1. No need to prepare the working capital statement

Changes in current assets and current liabilities are adjusted in the cash flow statement itself. So, separate statement is not necessary for the changes in working capital.

2. Cash Flow Statement (Proforma)

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening Cash Balance	xx	Redemption of preference shares	xx
(including bank balance)	xx	Repayment debenture holders	xx
Issue of Shares	xx	Repayment of Loans	xx

Notes

Issue of Debentures	xx	Purchase of fixed assets	xx
Raising of loans	xx	Dividend paid	xx
Sale of fixed assets	xx	Income Tax paid	xx
Dividends received	xx	Cash from Operation (Lost in operation) Transfer from P&L A/c	xx
Share premium received	xx	Closing balance (including bank balance)	
Cash from operation (Transfer from P&L A/c)	xx		
	xx		xx

3. **Preparation of Profit & Loss Account - Computation of cash from operation**

   Cash from operations can be found out in two methods. One is statement form another one is preparation of profit and loss account. Normally, cash from operation can be found out with the help of the preparation of profit and loss account because it is an easy and convenient method. Here, profit and loss account is prepared in usual procedure.

Profit and Loss A/c

Dr. **Cr.**

	Amount ₹		Amount ₹
To Goodwill written off	xx	By Opening Balance b/d	xx
To General reserve	xx	By Dividends received	xx
To Preliminary expenses written off	xx	By Interest on investments	xx
To Depreciation	xx	By Profit on sale of assets	xx
To Loss on sale of fixed assets	xx	By Cash from operation (Balancing figure)	xx
To Loss on sale of Investments	xx		
To Patents & Trade mark written off	xx		
To Income tax provided	xx		
To Interim dividend paid	xx		
To Closing balance c/d	xx		
To Cash from operation (Balancing figure)	xx		
	xx		xx

4. **Preparation of Separate Ledger**

   If information of any particular assets or liabilities are given in the adjustment, we have to prepare separate asset or liabilities account. Balances from this ledger can be transferred to cash flow statement.

5. **Treatment of adjustments**

   The additional information which are given apart from the balance sheet are, simply called as adjustment. All the adjustments will appear in two places. The following are the important adjustments and their treatment.

(*a*) Dividend paid	–	Cash flow statement - outflow side
	–	Profit & loss A/c - Debit side
(*b*) Depreciation	–	P.L.A/c - Debit side
		Respective asset A/c - credit side
(*c*) Loss on sale of assets	–	P.L.A/c - Debit side
		Respective asset A/c - credit side
(*d*) Income Tax provision	–	P.L.A/c - Debit side
	–	Income Tax - Credit side.

Note:	The adjustments applicable for fund flow statements will also be applicable for cash flow statements.

Notes

Illustration and Solutions

Illustration 1. *From the following profit and loss account, compute the case from operations.*

Profit and Loss account for the year ended 31.3.2001

	Amount ₹		**Amount ₹**
To Salaries	25,000	By Gross Profit	1,25,000
To Rent	3,000	By Profit on sale of land	15,000
To Depreciation	10,000	By Income tax refund	13,000
To Loss on Sale of plant	4,000		
To Goodwill written off	10,000		
To Proposed dividend	15,000		
To Provision for Tax	12,000		
To Net Profit	74,000		
	1,53,000		1,53,000

Solution :

Computation of cash from operation

Net profit earned during the year		74,000
Add : Non-cash and Non-operating expenses		
Depreciation	10,000	
Loss on sale of plant	4,000	

Notes

Goodwill written off	10,000	
Proposed dividend	15,000	
Provision for tax	12,000	
		51,000
		1,25,000
Less : Non-cash and Non-operating income		
Profit on sale of land	15,000	
Income tax refund	13,000	
		28,000
Cash from operation		97,000

Illustration 2. *Statement of financial position of Mr.Arun is given below.*

Liabilities	*1.1.2000* ₹	*31.12.200* ₹	*Assets*	*1.1.2000* ₹	*31.12.200* ₹
Account Payable	*29,000*	*25,000*	*Cash*	*40,000*	*30,000*
Capital	*7,39,000*	*6,15,000*	*Debtors*	*20,000*	*17,000*
			Stock	*8,000*	*13,000*
			Building	*1,00,000*	*80,000*
			Other fixed Assets	*6,00,000*	*5,00,000*
	7,68,000	*6,40,000*		*7,68,000*	*6,40,000*

The following additional information is also available:

(a) There were no drawings.

(b) There were no purchases or sale of either building or other fixed assets. Prepare a statement of case flow.

Solution : Cash Flow Statement

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	40,000	Decrease in accounts payable	4,000
Decrease in Debtors	3,000	Increase in Stock	5,000
		Cash from operation (1)	4,000
		Closing cash balance	30,000
	43,000		43,000

Workings : 1. Profit and Loss Account

	Amount ₹		Amount ₹
To Depreciation on Building	20,000	By Capital Account (Loss)	1,24,000
To Depreciation on Plant	1,00,000		
To Cash from operation (Loss on operation)			
	1,24,000		1,24,000

2. Capital Account of Mr. Arun

To Profit & Loss A/c (Loss)	1,24,000	By Balance b/d	7,39,000
To Balance c/d	6,15,000		
	7,39,000		7,39,000

3. Building Account

To Balance b/d	6,00,000	By Depreciation (P&L A/c)	1,00,000
		By Balance c/d	80,000
	1,00,000		1,00,000

4. Other Fixed Assets Account

To Balance c/d	6,00,000	By Depreciation (P&L A/c)	1,00,000
		By Balance c/d	5,00,000
	6,00,000		6,00,000

Illustration 3. *From the following particulars of Mrs.Ragu, prepare cash flow statements.*

Liabilities:	**1.1.99**	**31.12.99**
	₹	₹
Creditors	36,000	41,000
Mrs.A's Loan	—	20,000
Capital	1,48,000	1,49,000
Bank Loan	30,000	25,000
	2,14,000	2,35,000
Assets:		
Cash	4,000	3,600
Debtors	35,000	38,400
Stock	25,000	22,000
Land	20,000	30,000
Buildings	50,000	55,000
Machinery	80,000	86,000
	2,14,000	2,35,000

During the year Mrs.Ragu had drawn ₹ 26,000 for personal use. The provision for depreciation against machinery as on 1.1.99 was ₹ 27,000 and as on 31.12.99 ₹ 36,000.

Notes

Solution : Cash Flow Statement

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	4,000	Repayment of Bank loan	5,000
Loan borrowed from Mrs. A	20,000	Increase in Debtors	3,400
Decrease in stock	3,000	Purchase of Land	10,000
Cash from operation (1)	36,000	Purchase of Buildings	5,000
Increase in creditors	5,000	Capital Account (Drawings)	26,000
		Purchase of machinery (3)	15,000
		Closing Cash Balance	3,600
	68,000		68,000

Workings : 1. Profit and Loss Account

	Amount ₹		Amount ₹
To Depreciation (4)	9,000	By Cash from operation	36,000
To Capital Account	27,000		
	36,000		36,000

2. Capital Account

To Cash (Drawings)	26,000	By Balance b/d	1,48,000
To Balance c/d	1,49,000	By Profit & Loss A/c	27,000
		(Transfer to P&L A/c)	
	1,75,000		1,75,000

3. Machinery Account

To Balance b/d (80,000+27,000)	1,07,000	By Balance c/d (86,000+36,000)	1,22,000
To Cash (b/f)	15,000		
	1,22,000		1,22,000

4. Accumulated Depreciation Account

To Balance c/d	36,000	By Balance b/d	27,000
		By P&L A/c (b/f)	9,000
	36,000		36,000

Illustration 4. *The Balance sheet of Super Computers Ltd. as on 31.12.1992 and 31.12.1993 respectively are given below.*

Liabilities	*1992* ₹	*1993* ₹	*Assets*	*1992* ₹	*1993* ₹
Share capital	*1,00,000*	*1,60,000*	*Fixed assets at*		
Retained earnings	*70,250*	*85,300*	*cost*	*1,52,000*	*2,00,000*

Accumulated			*Inventory*	*93,400*	*89,200*
Depreciation	*60,000*	*40,000*	*Sundry Debtors*	*30,800*	*21,100*
6% Debentures	*50,000*	*—*	*Prepaid expenses*	*3,950*	*3,000*
Sundry creditors	*28,000*	*48,000*	*Bank*	*28,100*	*20,000*
	3,08,250	*3,33,300*		*3,08,250*	*3,33,300*

Notes

The following additional information for the year 1993 is also available.

(i) Net profit ₹ 27,050.

(ii) Depreciation charged ₹ 10,000.

(iii) Cash dividend declared during the period ₹ 12,000.

(iv) An addition to the building was made during the year at a cost of ₹ 78,000 and fully depreciated equipment costing ₹ 30,000 was discorded, no salvage value being realised. Prepare cash flow statement.

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	28,100	Redemption of debentures	50,000
Decrease in inventory	4,200	Cash dividend paid	12,000
Decrease in debtors	9,700	Purchase of building	78,000
Decrease in prepaid expenses	950	Closing cash balance	20,000
Issue of shares	60,000		
Cash from operation	37,050		
Increase in creditors	20,000		
	1,60,000		1,60,000

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Cash dividend paid	12,000	By balance b/d	70,250
To Depreciation (Current year)	10,000	By Cash from operation (b/f)	37,050
To Balance c/d	85,300		
	1,07,300		1,07,300

2. Accumulated Depreciation Account

To Fixed Assets (Discarded Equipment)	30,000	By Balance b/d	60,000
		By P&L A/c	10,000
To Balance c/d	40,000		
	70,000		70,000

Notes

3. Accumulated Depreciation Account

To Balance b/d	1,52,000	By Depreciation	30,000
To Cash (Purchase)	78,000	By Balance c/d	2,00,000
	2,30,000		2,30,000

Illustration 5. *The following are the summarised balance sheets of South Computers Ltd. as on 31.12.2000 and 31.12.2001.*

Liabilities	*2000* ₹	*2001* ₹	*Assets*	*2000* ₹	*2001* ₹
Share Capital	*2,00,000*	*2,50,000*	*Land & Buildings*	*2,00,000*	*1,90,000*
General Reserve	*50,000*	*60,000*	*Machinery*	*1,50,000*	*1,69,000*
P&L A/c	*30,500*	*30,600*	*Stock*	*1,00,000*	*74,000*
Bank loan	*70,000*	—	*Sundry Debtors*	*80,000*	*64,200*
Sundry Creditors	*1,50,000*	*1,35,200*	*Cash*	*500*	*600*
Provision for			*Bank*	—	*8,000*
Taxation	*30,000*	*35,000*	*Goodwill*	—	*5,000*
	5,30,500	*5,10,800*		*5,30,500*	*5,10,800*

The following additional information for the the year 2001 is also available :

(*i*) *Dividend of ₹ 23,000 was paid.*

(*ii*) *The following assets of another company were purchased for a consideration of ₹ 50,000 paid in shares.*

(a) Stock ₹ 20,000 and (b) Machinery ₹ 25,000

(*iii*) *Machinery was further purchased for ₹ 8,000.*

(*iv*) *Depreciation written off machinery ₹ 12,000.*

(*v*) *Income Tax provided during the year ₹ 33,000.*

(*vi*) *Loss on sale of machinery ₹ 200 was written off to general reserve.*

(*vii*) *Prepare cash flow statement.*

Solution : **Cash Flow Statement**

Inflow of cash	**Amount** ₹	**Outflow of cash**	**Amount** ₹
Opening cash balance	500	Repayment of Bank Loan	70,000
Sale of Land & Building	10,000	Decrease in Sundry Creditors	14,800
Decrease in Sundry Debtors	15,800	Dividend paid	23,000
Sale of Machinery	1,800	Purchase of Machinery	8,000
Sale of Stock	46,000	Income Tax paid	28,000
Cash from operation	78,300	Closing cash balance	8,600
		(8,000 + 600)	
	1,52,400		1,52,400

Notes

Workings :

1. Share Capital Account

	Amount ₹		Amount ₹
To Balance c/d	2,50,000	By Balance b/d	2,00,000
		By Stock	20,000
		By Machinery	25,000
		By Goodwill	5,000
	2,50,000		2,50,000

2. General Reserve Account

To Loss on sale of Machinery	200	By Balance b/d	50,000
To Balance c/d	60,000	By Profit & Loss A/c	10,200
	60,200		60,200

3. Provision for Taxation Account

To Cash (Tax paid)	28,000	By Balance b/d	30,000
To Balance c/d	35,000	By P & L A/c	33,000
	63,000		63,000

4. Profit and Loss Account

To Dividend Paid	23,000	By Balance b/d	30,500
To Depreciation on Machinery	12,000	By Cash from operation	78,300
To Income tax provided	33,000		
To Transfer to General Reserve	10,200		
To Balance c/d	30,600		
	1,08,800		1,08,800

5. Machinery Account

To Balance b/d	1,50,000	By Depreciation	12,000
To Shares	25,000	By Loss on sale of Machinery	200
To Cash	8,000	By Cash (b/f)	1,800
		By Balance c/d	1,69,000
	1,83,000		1,83,000

6. Stock Account

To Balance b/d	1,00,000	By Cash (b/f)	46,000
To Shares	20,000	By Balance c/d	74,000
	1,20,000		1,20,000

Notes

7. Goodwill Account

To Balance b/d	Nil	By Balance c/d	5,000
To Shares	5,000		
	5,000		5,000

Note: In the absence of direction, the differences in the Land & Building value (i.e., 2,00,000 − 1,90,000 = 10,000) are treated as sale of Land & Building and not as depreciation. If any specific direction is given in the problem, we proceed with the problem according to the direction.

Illustration 6. *Balance Sheets of M/s.Black and White as on 1st Jan.2000 and 31st Dec. 2000 were as follows.*

Liabilities	***Jan.2000*** ₹	***Dec.2000*** ₹	***Assets***	***Jan.2000*** ₹	***Dec.2000*** ₹
Creditors	*40,000*	*44,000*	*Cash*	*10,000*	*7,000*
White loan	*25,000*	—	*Debtors*	*30,000*	*50,000*
Loan from bank	*40,000*	*50,000*	*Stock*	*35,000*	*25,000*
Capital	*1,25,000*	*1,53,000*	*Land*	*40,000*	*50,000*
			Building	*35,000*	*60,000*
			Machinery	*80,000*	*55,000*
	2,30,000	*2,47,000*		*2,30,000*	*2,47,000*

During the year machine costing ₹ 10,000 (accumulated depreciation ₹ 3,000) was sold for ₹ 5,000. The provision for depreciation against machinery as on 1st Jan. 2000 was ₹ 25,000 and on 31st Dec. 2000 ₹ 40,000. Net profit for the year 2000 amounted to ₹ 45,000. Prepare cash flow statement.

Solution : **Cash Flow Statement**

Inflow of cash	**Amount** ₹	**Outflow of cash**	**Amount** ₹
Opening cash balance	10,000	Increase in Debtors	20,000
Decrease in stock	10,000	Purchase of Land	10,000
Increase in Creditors	4,000	Purchase of Buildings	25,000
Loan from Bank	10,000	Repayment of Mr. White's Loan	25,000
Cash from Operation (1)	65,000	Capital Account (3) (Drawings)	17,000
		Closing Cash Balance	7,000
	1,04,000		1,04,000

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Loss on sale of Machinery	2,000	By Balance b/d	Nil
To Depreciation (4)	18,000	By Cash from operation	65,000
To Balance c/d	45,000		
	65,000		65,000

2. Machinery Account

To Balance b/d (80,000 + 25,000)	1,05,000	By Cash	5,000
		By P&L A/c	2,000
		By Accumulated Depreciation	3,000
		By Balance c/d (55,000 + 40,000)	95,000
	1,05,000		1,05,000

3. Capital Account

To Cash	17,000	By Balance b/d	1,25,000
To Balance c/d	1,53,000	By P&L A/c	45,000
	1,70,000		1,70,000

4. Accumulated Depreciation Account

To Machinery A/c	3,000	By Balance b/d	25,000
To Balance c/d	40,000	By P&L A/c	18,000
	43,000		43,000

Illustration 7. *From the following balance sheet of Exe Ltd., prepare cash flow statement.*

Liabilities	***1.1.99*** ₹	***31.12.99*** ₹
Equity share capital	*3,00,000*	*4,00,000*
Redeemable preference		
Share capital	*1,50,000*	*1,00,000*
General Reserve	*40,000*	*70,000*
Profit & Loss A/c	*30,000*	*48,000*
Proposed dividend	*42,000*	*50,000*
Creditors	*55,000*	*83,000*
Bills Payable	*20,000*	*16,000*
Provision for taxation	*40,000*	*50,000*
	6,77,000	*8,17,000*

Notes

Assets		
Goodwill	*1,15,000*	*90,000*
Land & Buildings	*2,00,000*	*1,70,000*
Plant	*80,000*	*2,00,000*
Debtors	*1,60,000*	*2,00,000*
Stock	*77,000*	*1,09,000*
Bills Receivable	*20,000*	*30,000*
Cash in hand	*15,000*	*10,000*
Cash at bank	*10,000*	*8,000*
	6,77,000	*8,17,000*

The following additional information is also available :

(*a*) Depreciation of ₹ 10,000 and ₹ 20,000 have been charged on Plant and Land and Buildings in 2000.

(*b*) A dividend of ₹ 20,000 has been paid in 2000.

(*c*) Income tax of ₹ 35,000 has been paid during 2000.

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening Cash Balance	25,000	Redemption of preference Shares	50,000
Issue of Shares	1,00,000	Dividend paid	42,000
Increase in Sundry Creditors	28,000	Decrease in Bills Payable	4,000
Sale of Land & building	10,000	Increase in Debtors	40,000
Cash from operation	2,18,000	Increase in Stock	32,000
		Increase in bills receivable	10,000
		Purchase of Plant	1,30,000
		Interim dividend paid	20,000
		Income Tax paid	35,000
		Closing Cash balance (10,000 + 8,000)	18,000
	3,81,000		3,81,000

Workings: **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To General Reserve	30,000	By Balance c/d	30,000
To Proposed dividend	50,000	By Cash from operation	2,18,000
To Goodwill written off	25,000		

Notes

To Depreciation of Plant	10,000		
To Depreciation of			
Land & Buildings	20,000		
To Interim dividend paid	20,000		
To Income Tax provided (2)	45,000		
To Balance c/d	48,000		
	2,48,000		2,48,000

2. Provision for Taxation Account

To Cash (Tax paid)	35,000	By Balance b/d	40,000
To Balance c/d	50,000	By P&L A/c	45,000
	85,000	(Tax Provisions)	85,000

3. Land & Buildings Account

To Balance b/d	2,00,000	By Depreciation A/c	20,000
		By Balance c/d	1,70,000
		By Cash (b/f)	10,000
	2,00,000		2,00,000

4. Plant Account

To Balance b/d	80,000	By Depreciation	10,000
To Cash (b/f)	1,30,000	By Balance c/d	2,00,000
	2,10,000		2,10,000

Illustration 8. *From the following comparative Balance Sheet of ABC Ltd. as on 31.12.2002 and 2002.*

Liabilities	2001 ₹	2002 ₹	Assets	2001 ₹	2002 ₹
Share Capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Trade Debtors	14,900	17,700
Creditors	10,360	11,840	Marketable		
Provision for			Securities	49,200	42,700
Doubtful debts	700	800	Land	20,000	30,000
Profit & Loss A/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	1,03,200		1,03,100	1,03,200

The following additional information is also available :

(i) Dividend of ₹ 3,500 was paid during the year 2002.

(ii) Land was purchased for ₹ 10,000 and amount provided for the amortization of goodwill of ₹ 5,000.

(iii) Debentures was repaid ₹ 6,000.

Prepare cash flow statement.

Notes

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	9,000	Increase in Debtors	2,800
Issue of Shares	4,000	Dividend paid	3,500
Increase in Creditors	1,480	Purchase of land	10,000
Decrease in Marketable Securities	6,500	Redemption of debentures	6,000
Cash from Operation	9,120	Closing cash balance	7,800
	30,100		30,100

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Provision for Doubtful debts	100	By Balance b/d	10,040
To Dividend Paid	3,500	By Cash from operation	9,120
To Goodwill written off	5,000		
To Balance c/d	10,560		
	19,160		19,160

2. Debentures Account

To Cash (b/f)	6,000	By Balance b/d	12,000
To Balance c/d	6,000		
	12,000		12,000

3. Land Account

To Balance b/d	20,000	By Balance c/d	30,000
To Cash	10,000	By Balance c/d	5,000
	30,000		30,000

4. Goodwill Account

To Balance b/d	10,000	By P&L A/c	5,000
		By Balance c/d	5,000
	10,000		10,000

Illustration 9. *From the following Balance Sheet of Gristol Ltd., make out the statement of sources and uses of case.*

Liabilities	*1998* ₹	*1999* ₹	*Assets*	*1998* ₹	*1999* ₹
Capital	*1,15,000*	*1,15,000*	*Cash & Bank*		
Sundry Creditors	*51,500*	*48,000*	*Balance*	*45,000*	*45,000*
Outstanding Expn.	*6,500*	*6,000*	*Sundry Debtors*	*33,500*	*21,500*

Notes

8% Debentures	*45,000*	*35,000*	*Temporary*		
Depreciation Fund	*20,000*	*22,000*	*Investment*	*55,000*	*37,000*
Reserve for			*Prepaid Expenses*	*500*	*1,000*
Contingencies	*30,000*	*30,000*	*Stock in Trade*	*41,000*	*53,000*
Profit & Loss A/c	*8,000*	*11,500*	*Land & Buildings*	*75,000*	*75,000*
			Machinery	*26,000*	*35,000*
	2,76,000	*2,67,500*		*2,76,000*	*2,67,500*

The following additional information is also available :

(*i*) 10% dividend was paid in cash.

(*ii*) New machinery for ₹ 15,000 was purchased but old machinery costing ₹ 6,000 was sold for ₹ 2,000; accumulated depreciation was ₹ 3,000.

(*iii*) ₹ 10,000 8% debentures were redeemed by purchase from open market @ ₹ 96 for a debenture of ₹ 100.

(*iv*) ₹ 18,000 investments were sold at book value.

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening Cash balance	45,000	Decrease in Sundry Creditors	3,500
Decrease in Sundry debtors	12,000	Decrease in Outstanding	
Sale of Machinery	2,000	Expenses	500
Sale of Investments	18,000	Increase in prepaid expenses	500
Cash from operation	20,600	Redemption of debentures	9,600
		Increase in Stock in Trade	12,000
		Payment of dividend	11,500
		Purchase of Machinery	15,000
		Closing Stock balance	45,000
	97,600		97,600

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Payment of dividend	11,500	By Balance b/d	8,000
To Loss on sale of Machinery	1,000	By Profit on Redemption of	
To Depreciation	5,000	Debentures	
To Balance c/d	11,500	(10,000-9,600)	400
		By Cash from operation	20,600
	29,000		29,000

2. Accumulated Depreciation Account

To Machinery	22,000	By Balance b/d	20,000
To Balance c/d	3,000	By P&L A/c (b/f)	5,000
	25,000		25,000

3. Machinery Account

To Balance b/d	26,000	By Cash	2,000
To Cash (b/f)	15,000	By P&L A/c	1,000
		By Accumulated Depreciation	3,000
		By Balance c/d	35,000
	41,000		41,000

4. Debenture Account

To Cash	9,600	By Balance b/d	45,000
To Profit on Redemption	400		
To Balance c/d	35,000		
	45,000		45,000

5. Investment Account

To Balance b/d	55,000	By Cash	18,000
		By Balance c/d	37,000
	55,000		55,000

Note: Redemption of debenture $\frac{96}{100} \times 10,000 = 9,600$

Actual value of debenture	=	10,000
Amount paid	=	9,600
Profit on Redemption of debenture	=	400

Illustration 10. *The Comparative Balance Sheets of Mr. Hitler for the two years are as follows.*

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Loan from wife	—	*20,000*	*Cash*	*11,000*	*15,000*
Bills Payable	*12,000*	*8,000*	*Debtors*	*40,000*	*35,000*
Creditors	*25,000*	*52,000*	*Stock*	*25,000*	*30,000*
Loan from Bank	*43,000*	*60,000*	*Machinery*	*20,000*	*14,000*
Capital	*66,000*	*34,000*	*Land & Buildings*	*50,000*	*80,000*
	1,46,000	*1,74,000*		*1,46,000*	*1,74,000*

The following additional information is also available :

(i) Net Loss for the year 2003 amounted to ₹ 13,000.

(ii) During the year machine costing ₹ 5,000 (accumulated depreciation ₹ 2,000) was sold for ₹ 2,500. The provision for depreciation against machinery as on 31.12.2002 was ₹ 6,000 and on 31.12.2003 was ₹ 7,000.

Notes

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	11,000	Decrease in bills payable	4,000
Loan borrowed from wife	20,000	Increase in Stock	5,000
Increase in Creditors	27,000	Purchase of Land & Buildings	30,000
Loan borrowed from bank	17,000	Drawings (2) (Capital A/c)	19,000
Decrease in Debtors	5,000	Cash from operation	9,500
Sale of Machinery	2,500	Closing cash balance	15,000
	82,500		82,500

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Loss on sale of Machinery	500	By Balance b/d	13,000
To Depreciation A/c	3,000		
To Cash from operation	9,500		
	13,000		13,000

2. Capital Account

To Profit & Loss A/c (Net Loss)	13,000	By Balance b/d	66,000
To Balance c/d	34,000	By Profit & Loss A/c	500
To Cash (b/f)	19,000		
	66,000		66,000

3. Machinery Account

To Balance b/d (20,000 + 6,000)	26,000	By Cash	2,500
		By Profit & Loss A/c	500
		By Accumulated Deprecation	2,000
		By Balance c/d (14,000 + 7,000)	21,000
	26,000		26,000

4. Accumulated Depreciation Account

To Machinery A/c	2,000	By Balance b/d	6,000
To Balance c/d	7,000	By P&L A/c	3,000
	9,000		9,000

Notes

Note:	**Journal Entry for IInd Adjustment**			
	Cash A/c	Dr.	2,500	(Sale price)
	Accumulated Depreciation A/c	Dr.	2,500	(Depreciation)
	Profit & Loss A/c	Dr.	500	(Loss)
	To Machinery		5,000	(Value of machinery)

Illustration 11. *From the comparative balance sheets of Serial Engineering Ltd. As at 31.12.1998 and other information furnished, prepare a cash flow statement for the year ended on 31.12.1998.*

Liabilities	*1997* ₹	*1998* ₹	*Assets*	*1997* ₹	*1998* ₹
Equity Share Capital	*50,000*	*2,00,000*	*Fixed Assets*	*2,40,000*	*4,20,000*
			Investments	*18,000*	*15,000*
Redeemable Pref. Share Capital	*1,00,000*	—	*Stock*	*58,500*	*1,60,000*
			Sundry Debtors	*1,37,000*	*92,000*
Retained Earning	*1,20,000*	*3,50,000*	*Cash at Bank*	*1,85,000*	*1,20,000*
Unsecured Loan	*1,25,000*	—	*Prepaid expenses*	*6,500*	*8,000*
Bills payable	*2,25,000*	*1,90,000*			
Provision for Tax	*25,000*	*75,000*			
	6,45,000	*8,15,000*		*6,45,000*	*8,15,000*

The following additional information is also available :

(*i*) *On 31.12.1998 accumulated depreciation on fixed assets amounted to ₹ 1,20,000 and on 31st December 1997 to ₹ 1,10,000.*

(*ii*) *Machinery costing ₹ 10,000 (Accumulated depreciation thereon being ₹ 5,000) was discarded and written off during 1998.*

(*iii*) *Depreciation written off during 1998 amounted to ₹ 15,000.*

(*iv*) *During the year 1998 investments costing ₹ 6,000 were sold for ₹ 7,000.*

(*v*) *Dividend paid during the year was ₹ 45,000.*

(*vi*) *Redeemable preference shares were redeemed out of profile during the year at a premium of 5%.*

Solution : **Cash Flow Statement**

Inflow of cash	**Amount** ₹	**Outflow of cash**	**Amount** ₹
Opening Cash Balance	1,85,000	Repayment unsecured loan	1,25,000
Issue of Shares	1,50,000	Decrease in bills payable	35,000
Increase in provision for taxation	50,000	Increase in stock	1,01,500
Decrease in Sundry Debtors	45,000	Increase in prepaid expenses	1,500
		Dividend paid	45,000
Sale of Investments	7,000	Purchase of fixed assets (3)	2,00,000
Cash from operation	2,99,000	Redemption of preference	

		Shares	1,05,000
		Purchase of investment (4)	3,000
		Closing Cash balance	1,20,000
	7,36,000		7,36,000

Notes

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Loss on Machinery (Discarded)	5,000	By Balance b/d	1,20,000
		By Profit on sale of Investment	1,000
To Dividend paid	45,000	By Cash from Operation	2,99,000
To Premium on Redemption of Preference shares	5,000		
To Depreciation	15,000		
To Balance c/d	3,50,000		
	4,20,000		4,20,000

2. Redeemable Preference Share Capital Account

To Cash	1,05,000	By Balance b/d	1,00,000
		By Premium	5,000
	1,05,000		1,05,000

3. Fixed Assets Account (Machinery)

To Balance b/d	3,50,000	By Profit & Loss A/c	5,000
To Cash	2,00,000	By Accumulated Depreciation	5,000
		By Balance c/d (4,20,000 + 1,20,000)	5,40,000
	5,50,000		5,50,000

4. Investment Account

To Balance b/d	18,000	By Cash	6,000
To Cash	3,000	By Balance c/d	15,000
	21,000		21,000

5. Accumulated Depreciation Account

To Balance c/d	1,20,000	By Balance b/d	1,10,000
To Machinery	5,000	By P&L A/c	15,000
	1,25,000		1,25,000

Notes

Note:	Journal Entry for Adjustment (*ii* & *iv*)			
(*ii*)	Profit & Loss A/c	Dr.	5,000	
	Accumulated Depreciation A/c	Dr.	5,000	
	To Machinery A/c			10,000
(*iv*)	Cash A/c	Dr.	7,000	
	To Profit & Loss A/c			1,000
	To Investment A/c			6,000

Illustration 12. *Prepare a cash flow statement from the balance sheets of TTD & Co. as on 31.3.2000 and 31.3.2001. (₹ in thousand)*

Liabilities	*2000* ₹	*2001* ₹	*Assets*	*2000* ₹	*2001* ₹
Capital	*140*	*140*	*Fixed Assets (Net)*	*90*	*87*
Reserve	*74*	*105*	*Cash*	*75*	*97*
Creditors	*32*	*35*	*Debtors*	*43*	*40*
Outstanding			*Inventory*	*49*	*58*
Wages	*3*	*4*	*Prepaid Expenses*	*3*	*5*
Expenses					
Outstanding	*11*	*3*			
	260	*287*		*260*	*287*

Accumulated depreciation was ₹ 16,000 and ₹ 19,000 respectively at the beginning and end of the year 2001.

Other information Sales ₹ 3,00,000, Wages ₹ 23,000, Operating Expenses ₹ 47,000, Cost of goods ₹ 1,90,000, Rent ₹ 6,000 and Depreciation ₹ 3,000.

Solution : **Cash Flow Statement**

Inflow of cash	Amount ₹	Outflow of cash	Amount ₹
Opening cash balance	75,000	Increase in inventory	9,000
Increase in creditors	3,000	Decrease in Miscellaneous	
Increase in wages outstanding	1,000	Expenses outstanding	8,000
Decrease on debtors	3,000	Increase in prepaid expenses	2,000
Cash from operation (1)	34,000	Closing cash balance	97,000
	1,16,000		1,16,000

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Depreciation	3,000	By Balance b/d	74,000
To Balance c/d	1,05,000	By Cash operation	34,000
	1,08,000		1,08,000

2. Fixed Assets Account

To Balance b/d (90,000 + 16,000)	1,06,000	By Balance c/d (87,000 + 19,000)	1,06,000
	1,06,000		1,06,000

Notes

4. Accumulated Depreciation Account

To Balance b/d	19,000	By Balance b/d	16,000
		By P&L A/c (Current year Depreciation)	3,000
	19,000		19,000

Illustration 13. *Kapin Ltd. furnishes you the following balance sheet for the year ending on 31.12.2002 and 2003. You are required to prepare cash flow statement of the year ended on 31.12.2003.*

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Equity Share Capital	*10,000*	*10,000*	*Goodwill*	*1,200*	*1,200*
General Reserve	*1,400*	*1,800*	*Land*	*4,000*	*3,600*
Profit & Loss A/c	*1,600*	*1,300*	*Building*	*3,700*	*3,600*
Sundry Creditors	*800*	*540*	*Equipment*	*1,000*	*1,100*
Bills payable	*120*	*80*	*Stock*	*3,000*	*2,340*
Provision for Taxation	*1,600*	*1,800*	*Accounts Receivable*	*2,000*	*2,220*
Provision for Bad Debts	*40*	*60*	*Bank Balance*	*660*	*1,520*
	15,560	*15,580*		*15,560*	*15,580*

The following additional information is also available :

(*i*) *A piece of land has also been sold for ₹ 800.*

(*ii*) *Depreciation amounting to ₹ 600 has been charged on building.*

(*iii*) *Provision for taxation has been made for ₹ 1,700 during the year.*

Solution : **Cash Flow Statement**

Inflow of cash	**Amount** ₹	**Outflow of cash**	**Amount** ₹
Opening Cash balance	660	Decrease in Sundry Creditors	260
Decrease in stock	660	Decrease in Bills payable	40
Sale of land	800	Purchase of equipment	100
Cash from operation	2,420	Increase in account receivables	220
		Tax paid	1,500
		Purchase of building	500
		Land purchased	400
		Closing Cash balance	1,520
	4,540		4,540

Notes

Workings : 1. Profit and Loss Account

	Amount ₹		Amount ₹
To General Reserve	400	By Balance b/d	1,600
To Provision for Doubtful debts	20	By Cash from Operation	2,420
To Depreciation on Building	600		
To Income Tax Provision	1,700		
To Balance c/d	1,300		
	4,020		4,020

2. Provision for Taxation Account

To Cash (Tax paid)	1,500	By Balance b/d	1,600
To Balance c/d	1,800	By Profit & Loss A/c	1,700
		(Income Tax provision)	
	3,300		3,300

3. Land Account

To Balance b/d	4,000	By Cash	800
To Cash	400	By Balance c/d	3,600
	4,400		4,400

4. Building Account

To Balance b/d	3,700	By Depreciation (P&L A/c)	600
To Cash	500	By Balance c/d	3,600
	4,200		4,200

Cash Flow (AS 3) Revised Format

Under the revised format, cash flow statement should be prepared in such a way as to report the cash flows during the periods separately for operating, investing and financing activities.

I Cash Flows from Operating Activities

Net profit earned during the year	xx
Add : Depreciation	xx
Loss on sale of machinery	xx
Preliminary expenses written off	xx
Goodwill written off	xx
Patents and copy right written off	xx
Operating profit before working capital changes	xx
Adjustment of working capital	
(Add cash flow, less cash outflows)	
Decrease in current assets	xx

Decrease in current liabilities	xx	
Increase in current assets	xx	
Increase in current liabilities	xx	
Cash flows from operating activities	xx	xx

Notes

II Cash Flows from Investing Activities

Purchase of machinery	xx	
Purchase of land & building	xx	
Purchase of goodwill	xx	
Purchase of furniture	xx	
Sale of machinery	xx	
Sale of land & building	xx	
Sale of furniture	xx	
Interest on investment received	xx	
Cash flows from investing activities		xx

III Cash Flows from Financing Activities

Issue shares	xx	
Issue debentures	xx	
Loan borrowed	xx	
Redemption of shares	xx	
Redemption of debentures	xx	
Loan repaid	xx	
Dividend paid	xx	
Interim dividend paid	xx	
Drawings	xx	
Net cash flows from financing activities		xx
Net increase or decrease in cash and cash equivalent		xx
Add : Opening cash balance (Adjust BOD if any given the problem)		xx
Closing cash Balance (Adjust BOD if any given the problem)		xx

Note: In the question will specifically mention for the applying revised methods only, we follow the revised format otherwise better to follow Existing format.

Illustration 14. *Prepare cash flow statement under Revised format from the following balance sheets of Tiruchengodu Traders Ltd.*

Liabilities	*2000* ₹	*2001* ₹	*Assets*	*2000* ₹	*2001* ₹
Share Capital	*17,00,000*	*18,35,000*	*Buildings*	*8,00,000*	*10,00,000*
Reserves	*40,000*	*83,700*	*Plant and Machinery*	*2,50,000*	*3,70,000*
P & LAPP. A/c	*1,00,000*	*1,30,000*	*Furniture*	*5,000*	*6,000*

Notes

Provision for dividends	*70,000*	*50,000*	*Cash*	*2,000*	*2,200*
Creditors	*1,00,000*	*95,000*	*Debtors*	*1,00,000*	*45,000*
Bank overdraft	*8,000*	*18,000*	*Bills receivable*	*8,000*	*9,000*
Bills payable	*14,000*	*13,000*	*Stock*	*4,00,000*	*3,43,700*
Mortgage Loan	*10,000*	*70,000*	*Prepaid expenses*	*3,000*	*3,100*
			Investments	*1,64,000*	*1,70,000*
			Goodwill	*3,00,000*	*3,43,700*
			Preliminary Expenses	*10,000*	*2,000*
	20,42,000	*22,94,700*		*20,42,000*	*22,94,700*

The following additional information is also available:

(a) Depreciation is charged on buildings at 3% of cost of ₹ 9,00,000 on plant and machinery at 8% of cost of ₹ 4,00,000; Furniture at 5% of cost ₹ 8,000.

(b) Investments were purchased and interest was received ₹ 3,000 which was used in writing down the book value of investment.

(c) The declared dividends for 70,000 were paid and interim dividend for ₹ 20,000 was paid out of P & L App. A/c.

Solution : Cash Flow Statement (Revised Method)

	₹	₹
I Cash Flows from Operating Activities		
Net profit before tax and extraordinary item	1,43,700	
Adjustment for depreciation for furniture	400	
Adjustment for depreciation for plant and machinery	32,000	
Adjustment for depreciation on building	27,000	
Preliminary expenses written off	8,000	
Operating profit before working capital changes	2,11,000	
Decrease in debtors	55,000	
Decrease in stock	56,300	
Decrease in creditors	(5,000)	
Increase in bills receivable	(1,000)	
Decrease in bills payable	(1,000)	
Increase in prepaid expenses	(100)	
Net cash flow from invsting activities		3,15,300
II Cash Flows from Investing Activities		
Interest on investments	3,000	
Purchase of investment	(9,000)	
Purchase of building	(2,27,000)	
Purchase of machinery	(1,52,000)	
Purchase of furniture	(1,400)	
Purchase of goodwill	(43,700)	
Net cash flow from investing activities		4,30,100

III Cash Flows from Financing Activities

Issue of shares	1,35,000	
Mortgage loan	60,000	
Dividend paid for 2000	(70,000)	
Interim dividend paid	(20,000)	
Net cash flows from financing activities		1,05,000
Net increase (decrease) in cash and cash equivalents		(9,800)
Cash and cash equivalents opening balance (Bank O/D-cash)		(6,000)
Cash and cash equivalents closing balance (Bank O/D-cash)		(15,800)

Notes

Workings : **1. Profit and Loss Account**

	Amount ₹		Amount ₹
To Balance c/d	1,30,000	By Balance b/d	1,00,000
To Transfer reserves	43,700		
To Provision for dividend	50,000	By	1,43,700
To Interim dividend paid	20,000		
	2,43,700		2,43,700

2. Building Account

To Balance b/d	8,00,000	By Balance c/d	10,00,000
To Purchase (Bf)	2,27,000	By Depreciation	
		(9,00,000 × 3/100)	
	10,27,000		10,27,000

3. Plant & Machinery A/c

To Balance b/d	2,50,000	By Balance c/d	3,70,000
To Purchase (Bf)	1,52,000	By Depreciation	
		(9,00,000 × 8/100)	32,000
	4,02,000		4,02,000

4. Furniture Account

To Balance b/d	5,000	By Balance c/d	6,000
To Purchase (Bf)	1,400	By Depreciation	
		(8,000 × 5/100)	400
	6,400		6,400

4. Investment Account

To Balance b/d	1,64,000	By Balance c/d	1,70,000
To Purchase Investment (Bf)	9,000	By Bank (Interest)	3,000
	1,73,000		1,73,000

5.8. Review Exercise

Notes

1. What is meant by cash flow statement ?
2. How will you prepare the cash flow statement ?
3. What is the purpose of preparing cash flow statement ?
4. What are the differences between cash flow and fund flow statement ?
5. Explain the advantages of cash flow statement.
6. What are the limitations of cash flow statement ?
7. From the following Balance Sheet of Arvind Ltd., you are required to prepare a cash flow statement:

Liabilities	1989 ₹	1990 ₹	Assets	1989 ₹	1990 ₹
Share Capital	4,00,000	5,00,000	Cash	60,000	94,000
Trade Creditors	1,40,000	90,000	Debtors	2,40,000	2,30,000
Profit & Loss A/c	20,000	46,000	Stock	1,60,000	1,80,000
			Land	1,00,000	1,32,000
	5,60,000	**6,36,000**		**5,60,000**	**6,36,000**

2. From the following Balance Sheet as on 31.12.93 and 31.12.92, prepare a Cash Flow Statement:

Liabilities	1993 ₹	1992 ₹	Assets	1993 ₹	1992 ₹
Share Capital	1,50,000	1,00,000	Fixed assets	1,50,000	1,00,000
Profit & Loss A/c	80,000	50,000	Goodwill	40,000	50,000
General Reserve	40,000	30,000	Stock	80,000	30,000
6% Debentures	60,000	50,000	Debtors	80,000	50,000
Creditors	40,000	30,000	Bills Receivable	20,000	30,000
Outstanding exp.	15,000	10,000	Bank	15,000	10,000
	3,85,000	**2,70,000**		**3,85,000**	**2,70,000**

3. The summarized Balance Sheet of Kandan Ltd., as on 31.12.91 and 31.12.92 are as following:

Liabilities	1991 ₹	1992 ₹	Assets	1991 ₹	1992 ₹
Share Capital	4,50,000	4,50,000	Fixed assets	4,00,000	3,20,000
General reserve	3,00,000	3,10,000	Investment	50,000	60,000
P&L A/c	56,000	68,000	Stock	2,40,000	2,10,000
Creditors	1,68,000	1,34,000	Debtors	2,10,000	4,55,000
Tax provision	75,000	10,000	Bank	1,49,000	1,97,000
Mortgage loan	-	2,70,000			
	10,49,000	**12,42,000**		**10,49,000**	**12,42,000**

Additional Details

1. Investment costing ₹ 8,000 were sold for ₹ 8,500.
2. Tax provision made the year was ₹ 9,000.
3. During the year part of the fixed assets costing ₹ 10,000 was sold for ₹ 12,000 and the profit was included in P&L Account. You are required to prepare cash flow statement for 1992.

4. The following shows the balance in condensed from of Pavitra Ltd. At the beginning as well as at the end of the year 1987:

Liabilities	1.1.87 ₹	31.12.87 ₹	Assets	1.1.87 ₹	31.12.87 ₹
Creditors	52,000	47,500	Cash & Bank balance	45,000	45,000
Outstanding exp.	6,000	6,500	Debtors	38,500	26,500
8% Debentures	45,000	35,000	Investments	50,000	32,000
Depreciation fund	20,000	22,00	Prepaid exp.	500	1,000
Reserve for contingencies	30,000	30,000	Stock-in-trade	41,000	53,0000
P&L A/c	8,000	11,5000	Land & Building	77,000	77,000
Share capital	1,15,000	1,15,000	Machinery	24,000	33,000
	2,76,000	**2,67,5000**		**2,76,000**	**2,67,5000**

The following information is also available

(*a*) 10% dividend was paid in cash.

(*b*) New Machinery for ₹ 15,000 was purchased but old machinery costing ₹ 6,000 was sold for ₹ 2,000 on which accumulated depreciation was ₹ 3,000.

(*c*) ₹ 10,000 Debentures were redeemed by purchase from open market at ₹ 96 for a debenture of ₹ 100.

(*d*) Investments were sold at book value.

Prepare a Cash Flow statement

5. From the following balance you are required to calculate cash from operations:

Liabilities	31.12.89 ₹	31.12.90 ₹
P & L A/c balance	50,000	3,10,000
Debtors	90,000	84,000
Creditors	40,000	52,000
Bills Receivable	24,000	30,000
Prepaid expenses	3,200	2,800
Bills Payable	30,000	32,000
Outstanding expenses	2,400	3,200
Outstanding Income	1,600	1,800
Income received in advance	500	600

Notes

6. From the following Balance Sheets as on 31st December, prepare a Cash Flow statement and Adjusted P & L A/c.

Liabilities	31.12.200 ₹	31.12.2001 ₹	Assets	31.12.2000 ₹	31.12.2001 ₹
Share Capital	1,00,000	1,50,000	Fixed assets	1,00,000	1,50,000
P & L A/c	50,000	80,000	Goodwill	50,000	40,000
General Reserve	30,000	40,000	Inventories	50,000	80,000
16% Bonds	50,000	60,000	Debtors	50,000	80,000
Sundry creditors	30,000	40,000	Bill Receivable	10,000	15,000
Expenses outstanding	10,000	15,000	Bank	10,000	15,000
	2,70,000	**3,85,000**		**2,70,000**	**3,85,000**

7. The Comparative Balance Sheet of Mr. Wheldon for the two years were as follows:

Liabilities	1988 ₹	1989 ₹	Assets	1988 ₹	1989 ₹
Capital	1,50,000	1,75,000	Land & Buildings	1,10,000	1,50,000
Loan from Bank	1,60,000	1,00,000	Machinery	2,00,000	1,40,000
Creditors	90,000	1,00,000	Stock	50,000	45,000
Bills Payable	50,000	40,000	Debtors	70,000	80,000
Loan from IFC	-	25,000	Cash	20,000	25,000
	4,50,000	**4,40,000**		**4,50,000**	**4,40,000**

Additional Information:

Net profit of the year 1989 amounted to ₹ 60,000. During the year a machine costing ₹ 25,000 (accumulated depreciation ₹ 10,000) was sold for ₹ 13,000. The provision for depreciation against machinery as on 31-12-88 was ₹ 50,000 and on 31-12-89 ₹ 85,000. You are required to prepare a Cash Flow Statement.

8. The Balance Sheet of Thiruganananam Ltd., for the year 1989 and 1990 were as follows:

Liabilities	1989 ₹	1990 ₹	Assets	1989 ₹	1990 ₹
Share capital	1,50,000	1,75,000	Buildings	1,10,000	1,50,000
P & L A/c	1,20,000	80,000	Plant	2,00,000	1,40,000
Lon from bank	1,40,000	20,000	Stock	50,000	45,000
Creditors	85,000	93,000	Debtors	70,000	80,000
Outstanding exp.	5,000	7,000	Cash	15,000	22,000
Bills payable	50,000	40,000	Prepaid exp.	5,000	3,000
Loan from IFC	-	25,000			
	4,50,000	**4,40,000**		**4,50,000**	**4,40,000**

Additional Information :

(*a*) Net profit for the year 1990 ₹ 60,000.

(*b*) During the year a plant costing ₹ 25,000 (accumulated depreciation ₹ 10,000) was sold for ₹ 13,000.

(*c*) The provision for depreciation against plant as on 31-12-89 was ₹ 50,000 and on 31-12-90 was ₹ 85,000.

You are required to prepare a Cash Flow Statement.

9. The following are the Balance Sheet of Velavan Brothers Ltd., as on 31st, March 1986 and 1987.

Balance Sheet

Liabilities	31.3.87 ₹	31.3.86 ₹	Assets	31.3.87 ₹	31.3.86 ₹
Share capital	5,000	4,000	Fixed assets	4,000	4,1000
P & L A/c	320	300	*Less:* Depreciation	4,000	4,000
Debentures	700	600		1,500	1,100
				2,500	3,000
Creditors	1,400	1,700	Debtors	2,400	2,000
Provision of tax	420	300	Prepaid expenses	50	30
Proposed dividend	580	500	Preliminary exp.	300	500
Bank Overdraft	680	1,250	Cash	350	120
			Stock	3,500	3,000
	9,100	**8,650**		**9,100**	**8,650**

Additional Information :

1. Tax paid during the year ending 31.3.87 ₹ 350.
2. Dividend proposed during the year ending 31.3.87 ₹ 400.
3. Fixed assets coasting ₹ 700, accumulated depreciation thereon ₹ 300 were sold at book value

You are required to prepare a cash flow statement.