

**LECTURE NOTES**  
**ON**  
**ACCOUNTING FOR MANAGEMENT**

**MBA I Semester**

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**MASTER OF BUSINESS ADMINISTRATION**  
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**ACCOUNTING FOR MANAGEMENT SYLLABUS**

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## **UNIT – I**

### **INTRODUCTION TO FINANCIAL ACCOUNTING:**

Importance, objectives and principles, accounting concepts and conventions, and the generally accepted accounting principles (GAAP), their implications on accounting system; double entry system, recording business transactions, classification of accounts, accounting cycle.

## **UNIT – II**

### **THE PROCESS OF ACCOUNTING:**

Books of original record: journal and subsidiary books, ledger, trial balance, classification of capital and revenue expenses, final accounts with adjustments; valuation of fixed assets, tangible vs. intangible assets and methods of depreciation: depreciation concept, depreciation of fixed assets, methods of depreciation, their impact on measurement of business accounting.

## **UNIT – III**

### **INVENTORY VALUATION:**

Methods of inventory valuation and valuation of goodwill, methods of valuation of goodwill.

Issue of shares and debentures: entries for issue of shares, forfeiture issue of shares at discount and premium; alteration of share capital and reduction of share capital, issue and redemption of debentures.

## **UNIT – IV**

### **FINANCIAL ANALYSIS:**

Statement of changes in working capital, funds from operations, paid cost and unpaid costs; distinction between cash profits and book profits; preparation and analysis of cash flow statement and funds flow statement.

## **UNIT – V**

### **FINANCIAL STATEMENTS AND RATIO ANALYSIS:**

Analysis and interpretation of financial statements from investor and company point of view, horizontal analysis and vertical analysis of company financial statements; liquidity, leverage, solvency and profitability ratios, du Pont chart, accounting standards issued by the institute of chartered accounts of India (ICAI.).

## **UNIT-I**

# INTRODUCTION TO FINANCIAL ACCOUNTING

## MEANING OF BOOK-KEEPING

Book-keeping is the art and science of recording, classifying and summarizing business transactions in money or money's worth accurately and systematically so that the businessman may be able to know his profit/loss during a specified period and also financial position on a particular date. Book-keeping is thus the recording of business transactions in a systematic manner.

## DEFINITIONS OF BOOK-KEEPING

According to Carter, "Book-keeping is the science and art of correctly recording in the books of accounts all those transactions that result in the transfer of money or money's worth".

According to Vickery, "Book-keeping is an art of recording day-to-day business transactions in a set of books in the most scientific manner".

## BOOK-KEEPING TERMS

### 1. BUSINESS:

It is an establishment for the conduct of trade or commerce. It denotes activities of a person or a group of persons undertaken to exchange goods and /or services with a view to earn profit. From the accounting point of view, a business is different from its proprietor. Therefore, it owns assets and also accepts claims against it.

### 2. PROPRIETOR:

He is the owner of the business. He invests capital in the business with the object of earning profits. He enjoys all the incomes and profits and bears all expenses and losses, if any.

### 3. TRANSACTION:

Transaction refers transfer of money or money's worth from one person to another person. Transactions are the result of transfer of money or money's worth. Every transaction affects two accounts in the opposite direction.

### 4. BUSINESS TRANSACTION:

Every business operation deals with exchange of cash, goods and services. This results in change in the financial position of the business concern. Hence, a business transaction may be defined as an activity that brings a change in the aspects of the business. Suppose, the trader purchases a building for Rs. 50,000. He acquire a new assets (i.e., Building) worth Rs.50,000 and parts with cash Rs.50,000. This transaction affects two accounts (viz., Cash A/c and Buildings A/c) in the opposite direction. The value of the asset Building increases and cash balance decreases.

**Transaction may be classified into three categories.**

**a) Cash Transaction:**

Cash transaction is one where cash receipt or cash payment is involved in the exchange. Cash transactions are those in which cash is involved in the exchange. Cash receipts and cash payments are called as cash transactions.

Eg. **Cash Receipts:** Capital, Cash Sales, Cash received from individual, cash withdrawn from Bank, Sale of Fixed Assets for cash, Loan taken from Bank/Individual, Incomes received, Profits received.

Eg. **Cash Payments:** Drawings, Cash Purchases, Cash paid to an Individual, Cash deposited into Bank, Purchase of Fixed Assets, Loan given to Individual, Expenditure paid, Losses incurred.

**b) Credit Transaction:**

Credit transactions will not have cash, either received or paid, for some thing given or received, respectively. Credit transactions give rise to debtor and creditor relationship. Credit transactions are those in which cash is not paid immediately. The settlement is postponed to later date.

Eg. Goods sold to an Individual, Goods purchased from an Individual, Asset sold to an Individual, Asset purchased from an individual.

**c) Non-Cash Transactions:**

It is a transaction where the question of cash receipt or payment does not arise at all.

Eg. Depreciation, Return of goods etc.,

**5. ASSETS:**

Assets are the properties or possessions, which belong to a trader. They help the trade in carrying on his business. Assets are those which are essential and beneficial for running the business operations. Asset mean conglomeration of benefits. There are four types of Assets.

**a) Fixed Assets:**

Fixed Assets are those assets which are acquired/purchased only for use and not for sale. Fixed assets are those which provide long-term benefits for running the business. Change in the value of these assets is minimum.

For instance, Plant and Machinery, Land and Buildings, Furniture and Fixtures, Long term Investments etc.

**b) Current Assets:**

Current Assets are those which can be converted into cash as soon as possible. Current assets are also known as Floating Assets. Floating assets are those which dedicate their benefits for running the business and which change in value within a short span of time.

Eg. Cash in hand, Cash at Bank, Stock/ Inventory, Debtors, Short term investments etc.

**c) Intangible Assets:** Intangible Assets are those having no physical existence.

Eg. Goodwill, Copyrights, Trademarks, Patents.

d) Tangible Assets: Tangible assets are those having physical existence. Fixed Assets and Current assets are also called as Tangible Assets.

## **6. LIABILITIES:**

The debts owed by a trader to outsiders and also to the investors i.e., Owners on different Accounts in the course of business are called Liabilities.

Eg. Creditors, Bills Payable, Bank Overdraft, Loan taken etc.,

Liabilities = Assets - Capital

## **7. EQUITY:**

Any right or claim to assess or any interest in property or in a business is known as equity.

An equity holder may be a creditor, part owner or proprietor. Therefore liabilities are creditor's equity and capital is owner's equity.

## **8. CAPITAL:**

This is the amount of money or property with which a trader starts business. This is known as the net worth or net assets. The amount invested by the owner for running the business is called Capital. This can be in the form of Goods or cash. In other words, the excess of assets over liabilities is known as capital.

Capital = Assets - Liabilities

## **9. ACCOUNTING EQUATION:**

It is a mathematical form of saying that always the total assets equal owner's equity and creditor's equity.

Assets = Owner's Equity + Creditors equity

Assets = Capital + Liabilities

## **10. DEBTOR:**

Debtor is a person who owes money to the trader. The person who receives benefit from the trader is called Debtor. 'Dr' is an abbreviation of Debtor.

## **11. CREDITOR:**

A creditor is a person to whom something owns by the business. He is a person to whom some amount is payable for loan taken, services obtained or goods bought. 'Cr' is an abbreviation of Creditor. The person who gives benefit to others is also known as creditor.

## **12. DRAWINGS:**

It is the value of cash or goods withdrawn from the business by the owner or proprietor for his personal or domestic use. It is treated as loan taken by the proprietor from the business.

### **13. BALANCE SHEET:**

It is a statement of financial position of a business at any given time. It discloses the position of Assets, Liabilities and Capital. In this statement all assets are shown on the right hand side and Liabilities and Capital on the left hand side. It is a statement form of the accounting equation. This is a statement showing the assets and liabilities of a trader. This shows financial position of the business on a particular date.

### **14. OPENING AND CLOSING STOCKS:**

Stock of goods at the commencement of a trading period is called opening stock. Stock of goods at the end of the trading period represents closing stock.

### **15. GOODS:**

It is a general term used for the articles in which the business deals. This is, commodities bought bought for the purpose of resale are termed as goods. Goods are those with which the business concern does business. If a commodity is produced or purchased for the purpose of sale, it is called 'goods'. The furniture purchased for the office use to run the business is not goods. The furniture will be goods, if it is purchased by the business concern for the sake of sale.

### **16. ENTRY:**

Entry is a record of the transaction either in the journal or in the ledger.

### **17. JOURNAL:**

This is a book of first entry or original entry. Business transactions are first entered in this book before they are taken to the appropriate accounts in the ledger. The word Journal is derived from the Latin word 'Journ' which means a day. Hence, Journal is also termed as a day book where in the day to day transactions are recorded in chronological order

### **18. LEDGER:**

This is the main book of account. This is a book in which all accounts are kept. The entries recorded in the journal are posted into the accounts opened in the ledger and their balances are found. It is a set of accounts.

### **19. ACCOUNT:**

Account is a classified record of business transactions relating to a particular person or item or thing. It is a statement of a particular matter or series of dealings expressed in words and figures. The matter and figures are set forth in an Account in such a manner that the result of them may be readily seen.

Account is a summarized statement of debit and credit. It is vertically divided into two parts in T shape. The left hand side of the part is called Debit side and right hand side of the part is known as Credit side. The benefits received by that account are recorded on the

debit side and the benefits given by that account are recorded on the credit side of this account.

## **20. INCOME:**

Income is an earning of the business. It increases the profit. Eg. Rent received, commission received, interest received etc. The amount earned by a firm out of its business transaction during a period is called income. Income may be classified into two types. They are Capital Gain and Revenue Income.

### **CAPITAL GAIN:**

Capital Gain is the excess amount received over the book value of the asset owned by the firm. For example, profit received on sale of Machinery.

### **REVENUE INCOME:**

Revenue Income is the income received during business transactions or sale and purchase of goods or on services rendered to outsiders. For example, Interest and commission received.

## **21. EXPENDITURE:**

It is money spent in conducting the business activities. It is the expenditure in return for which some benefit is received. Eg. Salaries paid, Rent paid, Wages paid, Insurance paid, Transport paid, Taxes paid, Advertisements paid, selling expenses paid etc.

Amount spent for acquiring goods and services for running the business is known as expenditure. It may be Capital expenditure and Revenue expenditure.

### **CAPITAL EXPENDITURE:**

The amount spent for the acquisition of fixed assets which have long life and which are useful for the long term benefit of the business is known as Capital Expenditure. For example Machinery, Furniture, Land, Building etc.,

### **REVENUE EXPENDITURE:**

All expenses incurred for running the business for the current year is known as Revenue Expenditure. For example Salaries, Rent, Interest etc.,

## **22. LOSS:**

It is decrease in value of any asset without resulting in any revenue or benefit. Eg. Depreciation on Fixed Asset, Loss on sale of Asset etc.,

## **23. PROFIT:**

The difference between the selling price and the cost price is called Gross profit. It does not include any allowance for the traders office and other trading expenses are deducted from the gross profit the amount of profit then remaining is called the Net profit. In other words, excess of income over expenditure during a given period is called profit.

**24. DEBIT AND CREDIT:**

A transaction affects two accounts in the opposite direction. The account which receives the benefit is debited and the account which gives the benefit is the credited. Debit represents the receiving aspect of the transaction and Credit represents the giving aspect of a transaction. Debit is the left hand side of the account and is indicated as 'Dr'. Credit is the right hand side of the account and is indicated as 'Cr'.

**25. SOLVENT:**

If a trader's assets are equal or exceed his liabilities he is able to pay all his debts. Then he is said to be solvent. Therefore, a person is said to be solvent, when his assets exceed or equal to his liabilities.

**26. INSOLVENT:**

If a trader's liabilities exceed his assets then he cannot pay all his debts. Then is said to be insolvent. Therefore, a person is said to be insolvent when his liabilities exceed his assets.\

**27. CASTING:**

This means totaling and balancing of accounts.

**28. POSTING:**

Entering of transactions from Journal to the Ledger is called Posting.

**29. ACCOUNTING PERIOD:**

It is a period of twelve months for which the accounts are usually department.

**30. JOURNAL ENTRY:**

The process of recording the business transaction in the journal is known as journalizing. To divide business transactions into two aspects and recording in the journal is called Journal Entry. The first one is debit aspect and the second one is credit aspect.

**31. CHEQUE:**

A cheque is an instrument, by means of which a depositor can order the bank to pay a certain sum of money only to the order of a person or to the bearer of the instrument.

**32. INVOICE:**

Invoice is a statement sent by the seller to the purchaser which contains the details of the quantity of goods sold and price of the goods/product, terms and conditions of payment particulars.



### **33. TRIAL BALANCE:**

This is the list of the balances of the accounts appearing in a trader's ledger. The trial balance is a statement containing the balances of all ledger accounts, as at any given date, arranged in the form of debit and credit columns side by side and prepared with the object of checking the arithmetical accuracy of the ledger postings. In other words, the Trial Balance is a connecting link between the ledger accounts and final accounts.

### **34. VOUCHER:**

It is documentary evidence in support of a transaction recorded in the books of account.

### **35. BAD DEBTS:**

These are the debts due to a trader which will never be paid.

The amount of debt which is unrealizable from a debtor is called Bad Debts.

### **36. TRADE DISCOUNT:**

Trade discount is an allowance given by the seller to the buyer on the list price at the time of sale. Trade discount is not recorded in the books but it must be deducted from the list price.

## **DEFINITIONS OF FINANCIAL ACCOUNTING**

### **1. According to Smith and Ashburne,**

“Accounting is the science of recording and classifying business transactions and events, primarily of financial character and art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements”.

### **2. According to committee on terminology of American Institute of Certified Public Accountants (AICPA),**

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

### **3. Another definition given by the same professional body, namely, AICPA stated that** “Accounting is the collection, measurement, recording, classification and communication of economic data relating to an enterprise for the purpose of reporting, decision making and control.

### **4. in 1966, the American Accounting Association defined accounting as follows:**

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information.”

## **CHARACTERISTICS / NATURE OF FINANCIAL ACCOUNTING**

### **1. It is a Science and an Art:**

Accounting is a science because it has some objects. In other words Accounting is a science because every business transaction is recorded in a systematic manner. This is done first in the Journal which is the primary book of Accounting/ Business. Accounting is an art because it prescribes the process through which the objects can be achieved.

### **2. It is the art of recording business transactions:**

First, all transactions should be recorded in the journal or the books of original entry known as subsidiary books as and when they take place so that a complete record of financial transactions is available.

### **3. It is the art of classifying business transactions**

All entries in the journal or subsidiary books should be classified by posting them to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.

For example, all transactions relating to shyam Sundar’s Account in the journal or various subsidiary books will be posted to shyam Sundar’s Account. It may be noted that business transactions are recorded and classified in such a way that it may be possible to determine profit or loss made by the business and its financial position on a specified date.

### **4. Recording of Transactions of Financial Nature:**

Transactions or events which are of financial or economic nature are only recorded in accounting. Transactions or Events which cannot be measured in terms of money are not at all recorded in financial accounting. For example, a quarrel between production manager and financial manager may be affecting the business but it cannot be measured in terms of money and thus will not be recorded in the books of accounts. Another example is efficiency or honesty of the employees cannot be recorded because it cannot be measured in terms of money though it affects the total profits of business.

### **5. It is the art of summarizing financial transactions:**

After recording and classifying financial transactions next stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and financial position of the business on a particular date.

### **6. It is an art of analysis and interpretation of these financial transactions:**

The accounting information must be analyzed and interpreted by calculating various ratios and percentages or other relationship in order to evaluate the past performance of the business and to make sound plans for the future. As we know that the purpose of accounting is not only recording of transactions but also of analyzing and interpreting data for taking certain important future decisions. This is also known as future forecasting. Thus we see the definition of accounting is changing rapidly because of increase in its functions. i.e., recording of transactions to interpreting of economic events.

7. The results of such analysis must be communicated to the persons who are to make decisions or form judgments. All information must be provided in time and presented to the different categories of the persons so that appropriate decisions may be taken at the right time.

## **OBJECTIVES OF FINANCIAL ACCOUNTING**

### **1. Maintaining proper/systematic record of Business Transactions:**

Accounting replaces the limitations of human memory. The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Accounting helps to keep record of all financial transactions and events systematically in proper books of accounts.

### **2. To ascertain the financial results of the enterprise:**

One of the main objects of accounting is to ascertain or calculate the profit or loss of the business enterprise. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of the accounting period, we prepare trading account and ascertain gross profit or gross loss. Afterwards profit and loss account is prepared to ascertain net profit or net loss.

### **3. To ascertain financial position or financial health of the business:**

At the end of the accounting period, we prepare position statement. Balance sheet is a statement of assets and liabilities of the business on a particular date and serves as a parameter to measure the financial health of the business.

### **4. To help in decision making:**

Accounting serves as an information system for helping to arrive at rational decisions. American Accounting Association also stresses upon this point while defining the term Accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information. Accounting keeps systematic record of all transactions and events which are used to assist the management in its function of decision making and control.

### **5. Providing Effective Control over the Business:**

Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost of production and the book value of the sundry assets. The actual performance can be compared with the planned and or desired performance of the business. It can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points.

### **6. Making Information to various groups:**

Accounting makes information available to all these interested parties. Proprietors have interest in profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. The object of the accounting is to provide meaningful information to all these interested parties.

# ACCOUNT

## Meaning of an Account:

An account is a classified summary of business transactions relating to a particular person or property or an income or an expense.

It is vertically divided into two halves/parts. It is prepared in the form of alphabet T. The left side of this account is known as Debit side and right side of the account is known as Credit side. The word Dr should be written at the top left hand corner side of the account. The word Cr should be written at the top right hand corner side of the account. The title or name of the account should be written at the top in the middle of the account. The word 'To' should be written on the debit side of an account in the particulars column. The word 'By' should be written on the credit side in the particulars column of an account. All the receiving aspects are entered on the debit side and all the giving aspects are entered on the credit side of the account in the particulars column. All accounts are maintained in Ledger. So they are called "Ledger accounts".

## PROFORMA OF ACCOUNT

Dr.		Name of Account			Cr		
Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To Particulars of Benefits Received				By Particulars of Benefits given		

An account contains 1) Date column 2) Particulars column 3) Journal Folio column 4) Amount column on the both sides. The format or ruling of an account is given as above.

## Classification of Accounts:

Broadly speaking accounts are classified into two types. They are I. Personal Accounts II. Impersonal Accounts. Impersonal accounts are again divided into Real Accounts and Nominal Accounts. Thus accounts are of Three types.

1. Personal Accounts
2. Real Accounts
3. Nominal Accounts

Real and Nominal Accounts are collectively called “Impersonal Accounts”.

## **1. Personal Account:**

These are accounts of persons and institutions with whom the business deals. A separate account is kept for each person. Personal accounts can be classified into three categories:

They are i) Natural personal accounts ii) Artificial Personal accounts iii) Representative Personal accounts.

I) Natural Personal Accounts: The term Natural Persons means who are creations of Gods. For example Ravi Account, Rani Account, Raghu account Nagarjuna Account etc., are called as Natural Personal Accounts.

II) Artificial Personal Accounts: These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. The account of a Limited Company, the accounts of co-operative society, the accounts of clubs, the account of Government, the account of insurance company, the account of Colleges, Schools, Universities and Hotels etc., are examples of Artificial Personal Accounts.

Personal Accounts:

III) Representative Personal Accounts: These are accounts which represent a certain person or group of persons. For example, Outstanding expenses A/c, Prepaid expenses A/c, Income Receivable A/c and Income received in advance A/c, Drawings A/c and Capital A/c are termed as Representative Accounts.

### **Principle/ Rule of Personal Account:**

Debit the receiver and Credit the giver.

For example, if cash has been paid to Raja, the account of Raja will have to be debited. Similarly, if cash received from Meena, the account of Meena will have to be credited.

## **2. Real Account:**

Accounts relating to properties or assets or possessions of the firm are called Real Accounts. Every business firm needs Fixed Assets such as Land and Buildings, Plant and Machinery, Furniture and Fixtures etc for running its business. A separate account is maintained for each asset. There are Four types of Assets. They are

Fixed Assets: Those assets which are acquired for long term use by the business concern are known as Fixed assets. For example Land and Buildings, Plant and Machinery, Furniture and Fixtures etc are called as Fixed Assets.

Current Assets: Those assets which are possible to convert into cash are known as known as Current assets. For example cash in hand, cash at Bank, Stock in trade, Debtors, Bills Receivable etc., are called as current assets.

Tangible Assets: Tangible assets are those which relate to such things which can be touched, felt, measured etc., Tangible assets have physical existence. Hence these

assets may be transferred from one place to another place. Fixed asset and Current assets are the examples of Tangible assets.

**Intangible Assets:** These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. Intangible assets haven't any physical existence. Goodwill, copy rights, patents and trademarks are the examples of Intangible assets.

### **Principle of Real Account:**

- i) Debit what comes into the business and
- ii) Credit what goes out of the business.

For example, if machinery has been purchased for cash, machinery account should be debited since it is coming into the business, while cash account should be credited since cash is going out of the business.

If furniture is sold for cash, cash account should be debited since cash is coming into the business, while Furniture account should be credited since furniture is going out of the business.

### **3. Nominal Account:**

Nominal accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are salaries, wages, rent, taxes, lighting charges, transport charges, travelling charges, coolie charges, warehouse rent, insurance, advertisement paid, Bad debts, commission paid, Discount allowed, interest paid, interest paid on capital, rent received, interest received, commission received, discount received, dividend received, interest on investment received, bad debts recovered etc.,

These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business when salary is paid to the manager, commission is paid to the salesmen, rent is paid to landlord, cash goes out of the business and it is something real, while salary, commission, or rent as such does not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the cashier to explain how the cash at his disposal was utilized. Nominal accounts are also called Fictitious Accounts.

### **Principle or Rule of Nominal Account:**

- 1. Debit all expenses and losses and
- 2. Credit all incomes and gains.

For example when salaries paid in cash, salaries account should be debited since it is an expense to the business, while cash account should be credited since cash is going out of the business. If Rent received in cash, Cash account should be debited since cash is coming into the business, while rent account should be credited since it is an income to the business.

The principle of Nominal account is quite opposite to the principles of personal account and real account. As per the principle of Nominal account receiving aspects (Incomes and profits) are credited and giving aspects (expenses and losses) are debited. But as per the principles of personal account and real account, receiving aspect is debited and giving aspect is credited. Hence the rule of Nominal account is different from the principles of Real account and Nominal account.

## **Functions / Scope of Financial Accounting:**

### **1. Systematic record of business transactions / Recording:**

Recording is the basic function of accounting. Accounting records business transactions in terms of money. It is essentially concerned with ensuring that all business transactions of financial nature are properly recorded. Recording is done in Journal or subsidiary books in chronological order. To keep systematic record of transactions, post them into ledger and ultimately to prepare the final accounts is the first function of accounting.

### **2. Classifying:**

Accounting also facilitates classification of all business transactions recorded in the journal. Items of similar nature are classified under appropriated heads. It deals with classification of recorded transactions so as to group similar transactions at one place. The work of classification is done in a book called the Ledger, where similar transactions are recorded at one place under individual account heads. Eg. In sales account all sale of goods are recorded. In purchases account all purchase of goods are recorded.

### **3. Summarizing:**

It involves presenting classified transactions in a manner useful to both its internal and external users. It involves preparation of financial statements i.e profit & loss account and Balance sheet etc., Accounting summarizes the classified information. This process leads to the preparation of Trial balance, Income statement and balance sheet.

### **4. Analyzing:**

The recorded data in financial statement is analyzed to make useful interpretation. The figures given in financial statements need to be put in a simplified manner. Eg. All items relating to fixed assets are placed at one place while long term liabilities are placed at one place.

### **5. Interpretation:**

It deals with explaining the meaning and significance of the data simplified. The accountants should interpret the statements in a manner useful to the users. Interpretation of data helps management, outsiders and shareholders in decision making. It aims at drawing meaningful conclusions from the information. Different parties can make meaningful judgments about the financial condition and profitability of business operations.

### **6. Communicating Results to Interested Parties:**

Accounting also serves as an information system. It is the language of the business. It supplies the meaningful information about the financial activities of the business to various parties i.e., owners, creditors, investors, employees, government, public, research scholars

and managers at the right time. It is a service function. It is not an end itself but a means to an end. It involves preparation and distribution of reports to the users to make decisions.

**7. Compliance with legal requirements:**

The accounting system must aim at fulfilling the requirements of law. Under the provisions of law, the business man has to file various statements such as income-tax returns, sales tax returns etc.

**8. Protecting the property of the business:**

For performing this function the accountant is required to devise such a system of recording information so that assets of the business are not put to wrong use and a complete record of the assets of the concern is available without any difficulty.

### **ADVANTAGES/ IMPORTANCE OF FINANCIAL ACCOUNTING**

**1. Provides for systematic records:**

Since all the financial transactions are recorded in the books, one need not rely on memory. Any information required is really available from these records.

**2. Facilitates the preparation of financial statements:**

Profit and Loss Account and Balance Sheet can be easily prepared with the help of the information in the records. This enables the trader to know the net result of the business operations. During the accounting period and financial position of the business at the end of the accounting period.

**3. Provides control over assets:**

Book-keeping provides information regarding cash in hand, cash at bank, stock of goods, Accounts receivables, from various parties and the amounts invested in various other assets. As the trader knows the values of the assets he will have control over them.

**4. Assistance to various parties:**

It provides information to various parties i.e., owners, money lenders, creditors, investors, government, managers, research scholars, public and employees and financial position of a business concern from their own view point.

**5. Assistance to the insolvent person:**

If a person is maintaining proper accounts and unfortunately he becomes insolvent (i.e., when he is unable to pay to his creditors), he can explain many things about the past with help of accounts and can start a fresh life.

**6. Comparative study:**

One can compare the present performance of the organization with that of its past. This enables the managers to draw useful conclusions and make proper decisions.

**7. Less scope for fraud or theft:**



It is difficult to conceal fraud or theft etc., because of the balancing of the books of accounts periodically. As the work is divided among many persons, there will be check and counter check.

**8. Settlement of Taxation Liability:**

If accounts are properly maintained, it will be of great help to the businessman in settling the income tax and sales tax liability otherwise tax authorities may impose any amount of tax which the businessman will have to pay.

**9. Documentary evidence:**

Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. As such, courts accept these records as evidence.

**10. Helpful to management:**

Accounting is useful to the management in various ways. It enables the management to assess the achievement of its performance. The weaknesses of the business can be identified and corrective measures can be applied to remove them with of the accounting.

**11. Replacement of memory:**

In a large business it is very difficult for a business man to remember all the transactions. Accounting provides records which will furnish information as and when desired and thus it replaces human memory.

## **LIMITATIONS / DISADVANTAGES OF FINANCIAL ACCOUNTING**

**1. Records only monetary transactions:**

Accounting records only those transactions which can be measured in monetary terms. Those transactions which can not be measured in monetary terms as conflict between production manager and marketing manager , office management etc., may be very important for concern but not recorded in the business books.

**2. Effect of price level changes not considered:**

Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of various years becomes difficult. For example, the sales to total assets in 2007 would be much higher than in 2003 due to rising prices, fixed assets being shown at cost and not at market price.

**3. No realistic information:**

Accounting information may not be realistic as accounting statements are properly prepared by following basic concepts and conventions. For example, going concern concept gives us an idea that the business will continue and assets are to be recorded at cost but the book value which the asset is showing may not be actually realizable. Similarly, by following the principles of conservation the financial statements will not reflect the true position of the business.

**4. No real test of managerial performance:**

Profit earned during an accounting period is the test of managerial performance. Profit may be shown in excess by manipulation of accounts by suppressing such costs as depreciation, advertisement and research and development or taking excess value of closing stock. Consequently real idea of managerial performance may not be available by manipulated profit.

**5. Historical in nature:**

Usually accounting supplies information in the form of Profit and Loss Account and Balance Sheet at the end of the year. So, the information provided is of historical interest and only gives post-mortem analysis of the past accounting information. For control and planning purposes management is interested in quick and timely information which is not provided by financial accounting.

**6. Personal bias / judgement of Accountant affects the accounting Statements:** Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortization of fixed assets and treatment of deferred revenue expenditure. Such judgment based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

**7. Permits alternative treatments:**

Accounting permits alternative treatments within generally accepted accounting concepts and conventions. For example, method of charging depreciation may be straight line method or diminishing balance method or some other method. Similarly, closing stock may be valued by FIFO(First-in-First Out) or LIFO(Last in First Out) or Average Price Method. Application of different methods may give different results and results may not be comparable.

## **MEANING OF DOUBLE ENTRY SYSTEM**

Double entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under double entry system. The taxation authorities also compel the businessmen to prepare the accounts under Double Entry System.

Under dual aspect the Account deals with the two aspects of business transaction i.e., (1) receiving aspect and (2) giving aspect. Receiving aspect is known as Debit aspect and giving aspect is known as Credit aspect. Under which system these two aspects of transactions are recorded in chronological manner in the books of the business concern is known as Double Entry System. In Double Entry System these two aspects are recorded facilitating the preparation of Trial Balance and the Final Accounts.

## **PRINCIPLE OF DOUBLE ENTRY SYSTEM**

Every business transaction has got two accounts, where one account is debited and the other account is credited. If one account receives a benefit, there should be another account to impart the benefit. The principle of Double Entry is based on the fact that there can be no giving without receiving nor can there be receiving without something giving. The receiving

account is debited (i.e., entered on the debit side of the account) and the giving account is credited (i.e., entered on the credit side of the account).

The principle under which both debit and credit aspects are recorded is known as the principle of double entry. According to this principle every debit must necessarily have a corresponding credit and vice versa.

## **ADVANTAGES OF DOUBLE ENTRY SYSTEM**

### **1. Scientific system:**

Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision makers. It is more scientific as compared to single entry of book-keeping.

### **2. Full Information:**

Full and authentic information can be had about all transactions as the trader maintains the ledger with all types of accounts.

### **3. Assessment of Profit and Loss:**

The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trader to take such steps so as to increase the efficiency of the firm.

### **4. Knowledge of Debtors:**

The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

### **5. Knowledge of Creditors:**

The trader is also knows the exact amounts owed by the firm to others and he will be able to arrange prompt payment to obtain cash discount.

### **6. Arithmetical Accuracy:**

The arithmetical accuracy of the books can be proved by the trial balance.

### **7. Assessment of Financial Position:**

The trader will be able to prepare the Balance Sheet which will help the interested parties to know fully about the financial position of the firm.

### **8. Comparison of Results:**

It facilitates the comparison of current year results with those of previous years.

### **9. Maintenance according to Income Tax Rules:**

Proper maintenance of books will satisfy the tax authorities and facilitates accurate assessment. In India Joint stock companies should maintain accounts under double entry system.

#### **10. Detection of Frauds:**

The systematic and scientific recording of business transactions on the basis of this system minimizes the chances of embezzlement and frauds or errors. The frauds or errors can be easily detected by vouching, verification and auditing of accounts.

### **DISADVANTAGES/ LIMITATIONS OF DOUBLE ENTRY SYSTEM**

#### **1. Not Practical to All Concerns:**

This system requires the maintenance of a number of books of accounts which is not practical in small concerns.

#### **2. Costly system:**

This system is costly because of a number of records are to be maintained.

#### **3. No guarantee of Absolute Accuracy of the Books of Account:**

There is no guarantee of absolute accuracy of the books of account inspite of agreement of the trial balance because of there are some errors like errors of principles, errors of omission, compensating errors etc., which remain understand inspite of agreement of trial balance.

#### **4. Errors of Omission:**

In case the entire transaction is not recorded in the books of accounts, the mistake cannot be detected by accounting. The Trial Balance will tally inspite of the mistakes.

#### **5. Errors of Principle:**

Double entry is based upon the fact that every debit has its corresponding credit and vice versa. It will not be able to detect the mistake such as debiting Ram's account instead of Rao's account or Building account in place of Repairs account.

#### **6. Compensating Errors:**

If Rahim's account is by mistake debited with Rs. 15 lesser and Mohan's account is also by mistake credited with Rs.15 lesser, the Trial Balance will tally but mistake will remain in accounts.

### **ACCOUNTING CONCEPTS**

Account is a system evolves to achieve a set of objectives. In order to achieve the goals, we need a set of rules or guide lines. These guide lines are termed as "Basic accounting concepts". The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying theory and practice of financial accounting.

These concepts are termed as "generally accepted accounting principles". These are broad working rules of accounting activity. They are evolved over a period in response to changing business environment. They are developed and accepted by accounting profession. The concepts guide the identification of events and transactions to be accounted for.

The concepts help in bringing about uniformity in the practice in accounting. In accountancy following concepts are quite popular.

**1. Business Entity Concept:**

Business is treated separate from the proprietor. All the transactions are recorded in the books of the proprietor. The proprietor is also treated as a creditor for the business. When he contributes capital, he is treated as a person who has invested his amount in the business. Therefore, capital appears in the liabilities of balance sheet of the proprietor.

Effects of this Concept:

Financial position of the business can be easily found out.

Earning position of the business can be easily ascertained.

**2. Going Concern Concept:**

This concept relates with the long life of the business. The assumption is that business will continue to exist unlimited period unless it is dissolved due to some reason or the other. When final accounts are prepared, record is made for outstanding expenses and prepaid expenses because of the assumption that business will continue. Going concern concept helps other business undertaking to make contracts with specific business unit for business dealing in future.

Effects of this concept:

- i) Working life of asset is taken into consideration for writing of depreciation because of this concept.
- ii) Accountant always remains hopeful about continuity of the business. Therefore, he does not stop writing transactions even though the condition of business is deteriorating.

**3. Money Measurement Concept:**

Only those transactions are recorded in accounting which cannot be expressed in terms of money. The transactions which cannot be expressed in money fall beyond the scope of accounting. One serious short coming of this concept is that the money value of that date is recorded on which transaction has taken place. It does not recognize the changes in the purchasing power of monetary unit.

Effects of this concept:

- i. In the absence of this concept, it would have not been possible to add various possessions. For example : A proprietor has 40 chairs, 50 tables, 15 machines and 20 acres of land. He cannot add them. But total amount of all these possessions can be easily found out by finding out their value in money.
  - ii. It fails to keep any record of such matters which cannot be expressed in terms of money. For example: ability of the board of directors, quality of the articles produced and efficiency of workers cannot be recorded.
- 4. Cost Concept:**

According to this concept, an asset is recorded at its cost in the books of account, i.e., the price, which is paid at the time of acquiring it. In balance sheet, these assets appear not at cost price every year, but depreciation is deducted and they appear at the amount, which is cost less depreciation. Under this concept, all such events are ignored which affect the

business but have no cost. For example, if an important and influential director dies, then the earning capacity and position of the business will be affected. But this event has no cost. Hence it will not be recorded in account books.

Effects of the cost concept:

- i. Under this concept market price is ignored. Balance sheet indicates financial position on cost and expired cost less.
- ii. This concept is mainly for fixed assets. Current assets are not affected by it. Current assets appear in balance sheet at cost or market price whichever is lower. But both these assets are acquired at cost price.

#### **5. Account Period Concept:**

Every businessman wants to know the result of his investment and efforts after a certain period. Usually one-year period is regarded as an ideal for this purpose. The life of the business is considered to be indefinite, but the measurement of income cannot be postponed for a very long period of time. Therefore, it is necessary to have a period for which the operational results are assessed for external reporting. Hence a period of one year i.e., twelve months is considered as accounting period. It may be a calendar year (January to December or any period of one year.) In India, the accounting period begins on 1<sup>st</sup> April every year and ends on 31<sup>st</sup> March every year. This concept implies that at the end of each accounting period, financial statements i.e., profit & loss account and balance sheet are to be prepared. It is mandatory under Income Tax Act to assess profit of the business every year and determine tax liability.

Effects of Accounting Period concept:

- i. Financial position and earning capacity of one year maybe compared with another year.
- ii. These comparisons help the management in planning and increasing the efficiency of business.

#### **6. Dual Aspect Concept:**

Under this concept, every transaction has got a twofold aspects i.e.,

- i. receiving aspect/ receiving benefit and
- ii. giving aspect/ giving of benefit. For instance, when a firm acquires an asset (receiving of the benefit), it must have to pay cash (giving of benefit).

Therefore, two accounts are to be passed in the books of accounts. One for the receiving benefit and the other for the giving of benefit. Thus, there will be a double entry for every transaction – debit for receiving the benefit and credit for giving the benefit.

Effects of Dual aspect concept:

- i. This concept is of great help in indicating the true position of the business.
- ii. This concept helps in detecting the errors of employees and in having strict control over them.
- iii. The accounting equation, i.e.,  $\text{Assets} = \text{Equities (or liabilities + capital)}$  is based on this concept.

#### **7. Matching Concept:**

Every businessman is eager to make maximum profit at minimum cost. Hence, he tries to find out revenue and cost during the accounting period. An accountant records all

expenses of a year (whether they are paid in cash or are outstanding) and all revenues of a year (whether they are received in cash or accrued).

Expenses, which are incurred during a particular accounting period for earning the revenue of. All expenses incurred during the accounting period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement. the related period, are to be considered to revenue is called “Matching process”. While ascertaining profit, other appropriate cost which are not directly related to cost of goods sold are to be taken into consideration. Example, rent paid, interest paid, depreciation etc., Thus appropriate costs have to be matched against the appropriate revenues for the accounting period.

Effects of this Concept:

- i. Proprietor can easily know about his profit or loss.
- ii. On the basis of this concept, he can make efforts to create economy, increasing efficiently and increasing his income.

#### **8. Realisation Concept:**

This concept is also known as “revenue recognition concept”. Revenue results out of sale of goods and services. According to this concept revenue is realized when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. No profit or income will arise without the realization of sales. Likely sales and anticipated revenues are not to be recorded in account books. The realization concept is important in ascertaining the exact profit earned during a period in a business concern. According to this concept, the revenue should be considered only when it is realized. Any business transaction should be recorded only after it actually taken place. Production of goods does not mean that the total production is sold, it should be recorded only when they are sold and cash realized or obligation created.

#### **9. Objectivity Concept:**

This concept implies that all accounting records should be supported by proper documents. Cash memos, invoices, correspondence, agreements, vouchers, etc., are examples of business documents. These documents supply the information. They form the basis for record of entries in the books of account. Accounting record based on documentary evidence is readily and objectively verifiable.

#### **10. Accrual Concept:**

This concept implies that revenue is recognized in the period in which it is earned irrespective of the fact whether it is received or not during the period. For example, commission Rs.2,000 earned in the year 2008, but received in cash in the year 2009, then the commission is to be taken as income for the year 2008 only, not as income of the year 2009.

## **ACCOUNTING CONVENTIONS**

In accounting, convention means a custom or tradition, used as a guide for the preparation of accounting statement. The following are the accounting conventions:

### **1. Convention of Full Disclosure:**

Accounting to this convention, accounts should be prepared honestly and they should disclose all materials and significant information. Every company shall keep proper books of accounts. Auditor records expenses, incomes, profits, losses, assets and liabilities. The essential items to be disclosed in the Profit and Loss Account are given. There is legal form for the balance sheet.

### **2. Convention of Consistency:**

In every business, the management draws important conclusion from the financial statements, regarding working of the concern, for this purpose in preparing the final accounts. The same principle and practices should be followed from year to year.

### **3. Convention of Conservation:**

This is very important in preparing final accounts. This term suggests caution. All prospective profits should be ignored. All outstanding expenses should be taken into account. Adequate reserves or provisions should be provided for. This means that there should be no window dressing and secret reserves.

### **4. Convention of Materiality:**

This is also called the convention of reasonable degree of accuracy. According to this, the information given in the accounts should be reasonable accurate. All the entries should be exact. Fraction of a rupee is avoided.

### **5. Convention of Relevance:**

As per this convention, the firm should give relevant accounting information whenever required with documentary evidence like, purchases or sales invoices, vouchers etc., as documentary proof of a transaction.

## **Definitions, of Generally Accepted Accounting Principles (GAAP)**

1. Accounting principles may be defined as those rules of conduct or procedure which are adopted by the accountants universally while recording the accounting transactions. Accounting principles are not rigid or inflexible.
2. Accounting principles may be defined as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. This is also known as Generally Accepted Accounting Principles (GAAP).
3. According to the American Institute of Certified Public Accountants (AICPA) in their Accounting Terminology Bulletin defines the principles as “A general law or rule adopted or proposed as guide to action, a settled ground or basis of conduct or Practice.”



## Features of Accounting Principles (GAAP)

### 1. Accounting Principles are Based on General Rules:

The accounting principles are based on general rules, conventions and assumptions which are widely accepted by accountants, auditors, managers and government agencies. It is not worthy here that the accounting principles are neither cent percent fool-proof nor can their accuracy be tested in any laboratory.

### 2. Accounting Principles are Launched on the Basis of Logic and Experience:

It is not proper to think that the accounting principles are the creation of any law. In fact, these are put forward on the basis of logic and experience in the preparation of financial statements. The practical requirements of business, law, government agencies, creditors, shareholders and other users do affect the formulation of accounting principles.

### 3. Accounting Principles are Widely Accepted:

It is an important characteristic that the accounting principles are widely accepted. The accountants also take it for granted that certain alternatives in accounting can be used by concerns according to their choice. For example, we can use “Asset Accrued Method” or “Total Cash Price Method” for accounting the hire-purchase transactions.

### 4. Accounting principles are fast evolving and keep on changing according to the requirements on the basis of the business.

### 5. Accounting Principles have been developed on the basis of reasoning and observation, but as they are made by man, so they are not universally applicable as the principles of pure sciences. These are influenced by business practices and customs, rules of government in ever changing society.

### 6. In order to be generally acceptable accounting principles must meet the three criterions: Relevance, objectivity and feasibility. Relevance means suitable for the circumstances under consideration. Objectivity means accounting principles should not be influenced by subjective choices and personal bias of the accountant. Feasibility means it should be possible to use the principles without undue cost and hassles.

## Limitations of Accounting Principles (GAAP)

### 1. Lack of complete set of Principles:

Though the American Institute of Certified Public Accountants has explained some accounting principles, yet they are not complete in themselves. That is why; the accountants use different methods in accounting and try to solve their problems as per their own convenience.

### 2. Lack of General Acceptance of Principles:

Accounting principles are not only incomplete but also deprived of from the general acceptance. Because of difference in opinion, some accountants recommend a particular view while others are opposed to it. There are a number of methods for valuation of stock and goodwill, accounting for hire purchase system etc.

### **3. Difference in the Application of Principles:**

One limitation of accounting principles is that all accountants do not use a principle in a similar manner.

For instance, all the accountants agree on the principle that depreciation must be charged on fixed assets, but some of them charge it on “Straight Line Method”, some on “Diminishing Balance Method” while others use some other methods. Similarly, there are a number of systems for valuation of assets. The accountants of different business houses are implementing the accounting principles according to their need, convenience and nature of business.

### **Process of Accounting**

Accounting Process consists of the following stages:

- Recording of entries for all business transactions in Journal.
- Posting of entries into Ledger.
- Balancing of accounts.
- Preparing of Trial Balance with the help of different accounts to know the arithmetical accuracy.
- Preparing final accounts with the help of Trial Balance.
- Trading and Profit and Loss Account is prepared to know the Profit or Loss.
- Balance Sheet is prepared to know the financial position of the Business concern. Accounting Process is also known as accounting cycle.

### **ACCOUNTING CYCLE**

#### **STEPS IN ACCOUNTING CYCLE:**

Step 1: Journalizing: Record the transactions and events in the Journal.

Step 2: Posting: Transfer the transactions in the respective accounts opened in the Ledger.

Step 3: Balancing: Ascertain the difference between the total of debit amount column and the total of credit amount column of a ledger account.

Step 4: Trial Balance: Prepare a list showing the balance of each and every account to verify whether the sum of the debit balances is equal to the sum of the credit balances.

Step 5: Income Statement: Prepare Trading and Profit and Loss account to ascertain the profit or loss for accounting period.

Step 6: Position Statement/Balance Sheet: Prepare the Balance Sheet to ascertain the financial position as at the end of accounting period.

## UNIT-II

### PROCESS OF ACCOUNTING

#### 1. THE JOURNAL

The word Journal is derived from the French word 'Jour' which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry/prime entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. The journal is a complete and chronological record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called Journalising. The entries made in the book are called Journal Entries.

Proforma of Journal

Journal Entries in the books of-----

Date	Particulars	L.F	Debit Amount (Rs.)	Credit Amount (Rs.)

#### ADVANTAGES OF JOURNAL

##### 1. Availability of Full information/Complete Record:

All business transactions date-wise will be recorded in the Journal As such the total information for every transaction can be obtained very easily without late. So Journal serves as a complete record. It provides a chronological record of all transactions and hence provides permanent record.

##### 2. Posting becomes easy:

When once the transactions are entered in the Journal, recording the same in the relevant accounts in the ledger can be made easily. The businessman can have an understanding on debit and credit principles in the beginning itself. It provides information of debit and credit in an entry and an explanation to make it understandable properly.

##### 3. Explanation of the transaction:

Every Journal entry will be briefly explained with a narration. Narration helps in the proper understanding of the entry.

**4. Location of the errors easy:**

Journal helps to locate the errors easily. Both debit and credit aspects of a transaction are recorded in the journal. Since the amount recorded in debit amount column and credit amount column must be equal. Therefore, the possibility of committing errors is reduced and the detection of errors, if any, committed becomes easy.

**5. Chronological order:**

Transactions are recorded in a chronological order in the Journal. Hence, when any information is required, the information can be traced out quickly and easily.

**6. Eliminates the need for reliance on memory:**

It eliminates the need for a reliance on memory of the accounts keeper. Some transactions are of a complicated nature and without the journal, the entries may be difficult, if not impossible.

**7. Journal provides information relating to the following aspects:**

- a. Credit sale and purchase of fixed assets, investment or any thing else not dealt in by the firm.
- b. Special allowances received from suppliers or given to the customers.
- c. Writing off extra-ordinary losses viz. losses due to fire, earth quakes, theft etc., and bad debts.
- d. Recording in the reduction of the assets i.e., depreciation.
- e. Receipt and issue of bills of exchange, promissory notes, hundies and their dishonour, renewal etc.,
- f. Transactions with Bank(unless bank column added to the cash book)
- g. Income earned but not received in cash.
- h. Expenses incurred but not yet paid for in cash and other similar adjusting entries.
- i. Transfer entries viz. posting total of subsidiary books to the respective impersonal accounts in the ledger at the end of every month, transfer of gross profit or loss to the Profit & Loss A/c and net profit or net loss and also drawings A/c to the Capital A/c at the end of the trading period.
- j. Closing entries-entries to close the books at the time of preparing trading and profit & loss account.

**LIMITATIONS OF JOURNAL**

The following are the main limitations of the journal.

1. The Journal will be too long and becomes unwieldy if all transactions are recorded in the journal.
2. The Journal is unable to ascertain daily cash balance. That is why cash transactions are directly recorded in a separate cash book so that daily cash balances may be available.
3. It becomes difficult in practice to post each and every transaction from the Journal to the ledger. Hence in order to make the accounting easier and systematic, transactions are recorded in total in different books.

**2. THE LEDGER**

- The second stage in the accounting cycle is ledger posting it means posting transactions entered in the journal into their respective accounts in the ledger. It is the book of final entry. The Ledger is designed to accommodate the various accounts maintained by a trader. It contains the final and permanent record of all transactions in duly classified form. A ledger is

a book which contains various accounts. The process of transferring the entries from the journal into the ledger is called posting.

- A Ledger may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect. The up to date state of any account can be easily known by referring to the ledger.

### **FEATURES OF LEDGER**

- i. Ledger contains all the accounts-personal, real and nominal accounts.
- ii. It is a permanent record of business transactions.
- iii. It provides a means of easy reference.
- iv. It provides final balance of the accounts.

Ledger is the principal book of accounts because it helps us in achieving the objectives of accounting. It gives answers to the following pertinent questions.

1. How much amount is due from others to the business?
2. How much amount is owed to others?
3. What are the total sales to an individual customer and what are the total purchases from an individual supplier?
4. What is the amount of profit or loss made during a particular period?
5. What is the financial position of the firm on a particular date?

### **ADVANTAGES OF LEDGER**

The following are the main utilities of Ledger

1. It provides complete information about all accounts in one book.
2. It is easy to ascertain how much money is due to suppliers (trade creditors from creditors' ledger) and how much money is due from customers (trade debtors from debtors' ledger).
3. It enables to ascertain, what are the main items of revenues/incomes (Nominal accounts).
4. It enables to ascertain, What are the main items of expenses(Nominal accounts)
5. It enables to know the kind of assets the enterprise holds and their respective values(Real Accounts)
6. It facilitates preparation of trial balance and thereafter preparation of financial statements i.e., profit and loss account and balance sheet.

### 3. TRIAL BALANCE

Trial Balance is a statement in which debit and credit balances of all ledger accounts are shown to test the Arithmetical accuracy of the books of account. Trial Balance is not conclusive proof of accuracy of books of accounts.

#### DEFINITIONS OF TRIAL BALANCE:

1. According to J.R.Batliboi, “ A Trial Balance is a statement of Debit and Credit balances extracted from the various accounts in the ledger with a view to test the arithmetical accuracy of the books.”
2. According to Spicer and Peglar, “ A Trial Balance is a list of all the balances standing on the ledger accounts and cash book of a concern at any given date.”

#### FEATURES OF TRIAL BALANCE

1. It is not an account., it is only a statement which is prepared to verify the arithmetical accuracy of ledger accounts.
2. It contains debit and credit balances of ledger account.
3. It is prepared on a particular date generally at the end o f business year.
4. Trial Balance helps in preparing final accounts.
5. As it is prepared by taking up the ledger account balances, both debit and credit side of a Trial Balance are always equal.
6. The preparation of Trial Balance is not compulsory. There is no hard fast rule in this regard.

#### IMPORTANCE OF TRIAL BALANCE:

- 1. Proof of Arithmetical accuracy:**  
It helps in checking the arithmetical accuracy of books of accounts.
- 2. Preparation of financial statements:**  
It helps in the preparation of final accounts i.e., Trading Account, Profit & Loss Account and Balance Sheet.
- 3. Detection of Errors:**  
It will help in detection of errors in the books of accounts and in their rectification.
- 4. Rectification of Errors:**  
It serves as instrument for carrying out the job of rectification of errors.
- 5. Easy Checking:**  
It is possible to find out the balances of various accounts at one place.

#### LIMITATIONS OF TRIAL BALANCE

1. Trial balance can be prepared only in those concerns where double entry system of accounting is adopted. This system is very costly and time consuming. It cannot be adopted by the small business concerns.

2. Though Trial Balance gives arithmetical accuracy of the books of accounts but there are certain errors which are not disclosed by Trial Balance. That is why it is said that Trial balance is not a conclusive proof of the accuracy of the books of accounts.
3. If Trial Balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of the affairs/financial position of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.
5. Trial Balance tallies even though errors are existing in the books of accounts.
6. Even some transactions are omitted the Trial Balance tallies.

### **OBJECTIVES OF TRIAL BALANCE:**

The following are the main objectives of preparing the Trial Balance.

1. To have balances of all the accounts of the ledger in order to avoid the necessity of going through the pages of the ledger to find it out.
2. To have a proof that the double entry of each transaction has been recorded because of its agreement.
3. To have arithmetical accuracy of the books of accounts because of the agreement of the Trial Balance.
4. To have material for preparing the profit or loss account and balance sheet of the business.

### **METHODS FOR PREPARING TRIAL BALANCE:**

#### **1. Totals Method:**

Under this method the total of debits and credits of all ledger accounts are shown in the debit and credit side of the Trial Balance. The Trial Balance prepared under this method is known as gross Trial Balance.

#### **2. Balances Method:**

Under this method all the balances of each and every account will be shown against the debit or credit side of the Trial Balance. If an account has no balance then it will not be shown in the Trial Balance. This method is more convenient and commonly used.

#### **3. Totals and Balances Method / Compound Method:**

Under this method, the above two methods are combined. Under this method statement of trial balance contains seven columns instead of two columns.

#### **4. Elimination of Equal Totals Method:**

Under this method equal totals of accounts will be eliminated from the trial balance.

## **• TRADING ACCOUNT**

This account is prepared to know the trading results or gross margin on trading of business, i.e., how much gross profit of the business has earned from buying and selling during a particular period. The difference between the sales and cost of goods sold is gross profit.

This is a nominal account in its nature hence all the trading expenses should be debited where as all the trading incomes should be credited to Trading Account. The balance of trading account will be considered as Gross Profit (credit balance) or Gross Loss (debit balance) and will be transferred to profit and loss A/c. While preparing the trading A/c the following equations also can be used.

- Sales less returns – Cost of goods sold = Gross Profit or Gross Loss
- Sales = Total cash sales + credit sales.
- Cost of goods sold = Opening stock + purchases less purchase returns + Direct expenses– Closing stock of goods.

## • **IMPORTANCE OF TRADING ACCOUNT**

### **1. Information of Gross profit or Gross Loss:**

Trading Account provides information regarding gross profit and sets the upper limit within which indirect expenses are to be incurred. Indirect expenses should be much less than the gross profit so that a good amount of profit may be earned. If trading account discloses gross loss , it is better to close the business rather than running at a gross loss because gross loss will further increase when indirect expenses are added to it.

Gross Profit Ratio: This ratio is calculated as follows:

$$\text{Gross profit Ratio} = \text{Gross Profit} / \text{Sales} \times 100$$

Higher the ratio, it is better condition. Gross profit ratio can be calculated with the help the Trading account year after year and comparison of performance of year after year can be made. A low ratio indicates unfavorable trend in the form of reduction in selling prices not accompanied by the proportionate decrease in cost of goods purchased or increase in cost of production.

### **2. Comparison of Closing Stock with Opening Stock:**

Comparison of stock figures of one period with another period will be helpful in avoiding overstocking. Investment in stock should be reasonable so that production and sales go on smoothly.

### **3. Fixation of selling price:**

In case of a new product, the selling price can be easily fixed by adding in the cost of purchases or cost of goods manufactured the desired percentage of gross profit.

4. It enables the comparison of sales, purchases and direct expenses of one period with another period. The comparative study helps the management to control the affairs of the business and take sound decisions.

5. It helps to check the direct expenses. 6. It gives us the information about the proportion of gross profit or gross loss to the direct expenses. This study helps the management in arresting the unnecessary expenditure on any time.



## **PROFIT AND LOSS ACCOUNT**

This account is prepared to calculate the net profit or net loss of the business concern.

There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit or net loss of the business concern.

These are of indirect nature i.e., the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the customers.

Indirect expenses may be administrative expenses or management expenses, selling and distribution expenses, financial expenses and extra-ordinary losses and expenses to maintain the assets into working order.

This account is prepared from nominal accounts and its balance is transferred to capital account as the whole the profit or loss will be that of the owner and it will increase or decrease the capital.

### **IMPORTANCE OF PROFIT AND LOSS ACCOUNT**

**1. Information of Net profit or Net loss:**

One of the important objectives of maintains the accounts are to see whether the business has earned profit or suffered loss during the accounting period. Profit and Loss A/c provides information regarding this important objective because it gives information about the profitability or otherwise of the business.

**2. Comparison of current profit with the last year profit:**

Profit and Loss A/c affords comparison of the current year's net profit with those of the past years. With this comparison it can be ascertained whether net profit of the business is showing a rising trend or down ward trend.

**3. Comparison of expenses:**

Comparison of various expenses included in the profit and loss account with expenses of the previous period helps in taking effective steps for control of unnecessary expenses.

**4. Helpful in preparation of Balance Sheet:**

Net profit or Net loss disclosed by the profit and loss A/c is transferred to capital Account and Capital Account appears on the liabilities side of the Balance Sheet. Without taking net profit or net loss, the balance sheet cannot be completed. Thus, the profit and loss account helps in the preparation of the balance sheet.

**5. Helpful in future Growth of business:**

On the basis of their profit figures of the current and previous period, estimates about the profits in the years to come can be made and projections about the expansion of the business can be made.

### **BALANCE SHEET**

A Balance Sheet a statement prepared with a view to measure the financial position of a business on a certain fixed date. The financial position of a concern is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance sheet is also described as a “statement showing the sources and application of the capital”. It is a statement and not an account and prepared from real and personal accounts. Sources or liabilities are shown on the left hand side of the Balance Sheet. Application of funds (Assets) is shown on the right hand side of the Balance Sheet.

### **CHARACTERISTICS OF BALANCE SHEET**

Characteristics of Balance Sheet:

1. It is prepared on a particular date and not for a particular period.
2. It is prepared after preparation of the Trading and Profit & Loss A/c.
3. As assets must be equal to the total liabilities. The two sides of the Balance must have the same total.
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets and liabilities and not an account.

### **IMPORTANCE OF BALANCE SHEET**

Information that Balance Sheet convey to Outsiders (Importance):

1. The nature and the value of assets.
2. It shows the nature and extent of liabilities.
3. It shows the owner’s equity (i.e., assets-liabilities = capital)
4. It tells about the creditworthiness and solvency of the firm.
5. It reflects the liquidity of a firm.
6. It reveals other information required to changes in economic reserves and obligations.

### **FINANCIAL STATEMENTS**

Though financial statements are relevant and useful for the concern, still they do not present a final picture of the concern. The utility of these statements is dependent upon a number of factors. The analysis and interpretation of these statements should be done very carefully otherwise misleading conclusions may be drawn.

### **LIMITATIONS OF FINANCIAL STATEMENTS**

#### **1. Only Interim Reports:**

These statements do not give a final picture of the concern. The data given in the statements is only approximate. The actual position can only be determined when the business is sold or liquidated. However, the statements have to be prepared for different accounting periods, generally one year, during the life time of the concern. The costs and incomes be apportioned to different periods with a view to determine profits etc. the allocation of expenses and

incomes will depend upon the personal judgment of the accountant. The existence of contingent assets and liabilities also makes the statements imprecise. So financial statements do not give the final picture and they are at the most interim reports.

- **2. Do not give Exact Position:**

The financial statements are expressed in monetary values. So, they appear to give final and accurate position. The value of fixed assets in the balance sheet neither represents the value for which fixed assets can be sold nor the amount which will be required to replace these assets.

The balance sheet is prepared on the presumption of a going concern. The concern is expected to continue in the future. So fixed assets are shown at cost less accumulated depreciation. There are certain assets in the balance sheet such as preliminary expenses, goodwill and discount on issue of shares which will realize nothing at the time of liquidation though they are shown in the balance sheet.

- **3. Historical Costs:**

The financial statements are prepared on the basis of historical costs or original costs. The value of assets decreases with the passage of time current price changes are not taken into account. The statements are not prepared keeping in view the present economic conditions.

The balance sheet loses the significance of being an index of current economic realities. Similarly, the profitability shown by the income statement may not represent the earning capacity of the concern. The increase in profits may be due to an increase in prices or due to some abnormal causes and not due to increase in efficiency. The conclusion drawn from financial statements may not give a fair picture of the concern.

- **4. Impact of Non-Monetary Factors Ignored:**

There are certain factors which have a bearing on the financial position and operating results of the business but they do not become a part of these statements because they cannot be measured in monetary terms.

Such factors may include the reputation of the management, credit worthiness of the concern, sources and commitments for purchases and sales, co-operation of the employees, etc. The financial statements only show the position of the financial accounting for business and not the financial position.

- **5. No Precision:**

The precision of financial statement data is not possible because the statements deal with matters which cannot be precisely stated.

The data are recorded by conventional procedures followed over the year. Various

Conventions, postulates, personal judgements etc., are used for developing the data.

# UNIT-II

## DEPRECIATION ACCOUNTS

Meaning of Depreciation:

The word Depreciation is derived from the Latin word 'Depretium.' De means decline and pretium means price. It means decline in the value of an asset.

Depreciation is a permanent, continuing and gradual shrinkage in the book value of a fixed asset. Depreciation is charged on the fixed assets only.

Definitions of Depreciation:

1) According to Carter

“Depreciation is the gradual decrease in the value of asset from any cause.”

2) According to Spicer and Pegler

Depreciation may be defined as “a measure of the exhaustion of the effective life of an asset from any cause during a given period.”

3) According to Pickles

“Depreciation may be defined as the permanent and continuous diminution in the quality, quantity or value of an asset.”

4) According to 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”.

Causes of Depreciation:

1. Physical Deterioration:

Depreciation is caused mainly from wear and tear when the asset is in the use and from erosion, rust, rot and decay from being exposed to wind, rain, sun and other elements of nature.

2. Economic Factors:

These may be said to be those that cause the asset to be put out of use even though it is in good physical condition.

These arise due to obsolescence and inadequacy. Obsolescence means the process of becoming obsolete or out of date.

Old machinery though in good physical condition may be rendered obsolete by the introduction of a new model which produces more than the old machinery.

Inadequacy refers to the termination of the use of an asset because of growth and changes in the size of the firm. But obsolescence and inadequacy do not necessarily mean that the asset is scrapped. It is merely put out of use by the firm. Another firm will often buy it.

3. Time Factors:

There are certain assets with a fixed period of legal life such as lease, patents and copyrights. For example, a lease can be entered into for any period while a patent's legal life is for some years but on certain grounds this can be extended.

Provision for the consumption of these assets is called amortisation rather than depreciation.

4. Depletion:

Some assets are of a wasting character perhaps due to the extraction of raw materials from them.

These materials are then either used by the firm to make something else or are sold in their raw state to other firms.

Natural resources such as mines, quarries and other oil wells come under this head.

To provide for the consumption of an asset of a wasting character is called provision for depletion.

5. Accident:

An asset may reduce in value because of meeting of an accident.

**NEED FOR PROVIDING DEPRECIATION:**

1. To know the true profits:

We have seen that depreciation is an expense and becomes an important element of the cost of production.

Though it is not visible like other expenses and never paid to the outside party yet it is desirable to charge depreciation on fixed assets as these are used for earning purposes.

So their depreciation must be deducted out of the income earned from their use in order to calculate true net profit or net loss.

2. To show true financial position:

Financial position can be studied from the balance sheet and for the preparation of the balance sheet fixed assets are required to be shown at their true value.

If assets are shown in the balance sheet without any charge made for their use or depreciation, then their value must have been overstated in the balance sheet and will not reflect the true financial position of the business.

So, for the purpose of reflecting true financial position, it is necessary that depreciation must be deducted from the asset and then at such reduced value these may be shown in the balance sheet.

3. To make provision for replacement of assets:

If depreciation is not provided, the profits of the concern will be overstated and can be distributed to the shareholders as dividend.

After the end of the working life of the asset, there will be no provision or funds at the disposal of the concern and has to borrow for purchasing new assets.

Provision for depreciation is a charge to profit and loss account though depreciation is not paid.

The amount of depreciation accumulated during the working life of the asset provides additional working capital besides providing sum at the end of working life of the asset for its replacement.

4. To ascertain the true cost of production.
5. To comply with the legal requirements.
6. To conserve the cash resources of the concern.
7. To save tax payable on profits.

## **METHODS OF PROVIDING DEPRECIATION:**

### **1. Fixed Instalment Method:**

Under this method a fixed percentage of the original value of the asset is written off every year so as to reduce the asset account to nil or to its scrap value at the end of its estimated life of an asset. To ascertain the annual charge under this method all that is necessary is to divide the original value of the asset (minus its scrap value, if any) by the number of years of its estimated life i.e.,

$$\text{Annual Depreciation} = \frac{\text{Cost of asset} - \text{Scrap value}}{\text{Estimated Life of Asset}}$$

The amount of depreciation charged during each period of the asset's life is constant. If the charge of depreciation is plotted annually on a graph paper and the points joined together, then the gap will reveal a straight line that is why it is also called as straight line method. It is also called as fixed percentage on original cost method.

Merits of Fixed Instalment Method:

1. This method is simple to understand and easy to apply.
2. It can write down an asset to zero at the end of its working life, if so desired.
3. This method is very suitable for those assets which have a fixed life e.g., furniture, fixtures, short leases and other assets of a small intrinsic value.

Demerits of Fixed Instalment Method:

1. The charge for depreciation remains constant year after year. The expenses of repairs and maintenance are increasing as the asset grows older. The profit and loss account thus in the later years bears more than its share of valuation.
2. It becomes difficult to calculate the depreciation on additions made during the year.
3. Under this method the depreciation charge remains the same from year to year irrespective of the use of the asset. Thus it does not take into consideration the effective utilisation of the asset.
4. It does not take into consideration the interest on capital on vested in fixed assets.
5. It does not provide funds for replacement of assets.
6. This method tends to report an increasing rate of return on investment in the asset amount due to the fact that the net balance of the asset amount is taken. In spite of these drawbacks, this method is mostly used by firms in U.S.A, Canada, U.K and some firms in India.

## **2. Diminishing Balance Method:**

Under this method depreciation is calculated at a certain percentage each year on the balance of the asset which is brought forward from the previous year.

The amount of depreciation is charged in each period is not fixed but it goes on decreasing gradually as the beginning balance of the asset in each year will reduce.

This method is also known as Reducing Balance method or Written Down Value Method.

Merits of Diminishing Balance Method

1. It tends to give even charge of depreciation against revenue each year. Depreciation is generally heavy during the first few years and is counter balanced by the repairs being light and in the later years when repairs are heavy this is counter-balanced by the decreasing charge for depreciation.
2. Fresh calculations of depreciation are not necessary as and when additions are made.
3. This method is recognized by the income tax authorities in India.
4. It will provide funds for the replacement of asset on the expiry of its useful life.
5. This method is suitable for Plant and Machinery, Buildings etc. Where the amount of repairs and renewals increases as the asset grows older and the possibilities of assets are more.

Demerits of Diminishing Balance Method:

1. The original cost of the asset is altogether lost sight of subsequent years and the asset can never be reduced to zero.
2. This method does not take into consideration the asset as an investment and interest is not taken into consideration.
3. As compared to the first method, it is difficult to determine the suitable rate of depreciation.

## **3. Annuity Method:**

Under this method amount spent on the purchase of an asset is regarded as an investment which is assumed to earn interest at a certain rate.

Every year the asset account is debited with the amount of interest and credited with the amount of depreciation.

This interest is calculated on the debit balance of the asset account at the beginning of the year.

This method is a great extent scientific as it treats the purchase of an asset as an investment in the business itself and charge interest on the same.

## **4. Depreciation Fund Method:**

Ready cash may not be available when the time of replacement comes because the amount of depreciation is retained in the business itself in the form of assets not separate from other assets which cannot be readily sold.

This method implies that the amount written off as depreciation should be kept aside and invested in readily saleable securities.

The securities accumulate and when the life of the asset expires, the securities are sold and with the sale proceeds a new asset is purchased.

Since the securities always earn interest, it is not necessary to provide for the full amount of depreciation, something less will do.

How much amount is to be invested every year so that a given sum is available at the end of a given period depends on the rate of interest which is easily calculated from sinking fund tables.

### **DIFFERENCES BETWEEN STRAIGHT LINE METHOD AND DIMINISHING BALANCE METHOD:**

Differences between Fixed Instalment Method and Diminishing Balance Method

Point of Difference	Straight Line Method	Diminishing Balance Method
1. Change in Depreciation amount	Throughout the life of the asset, the amount of depreciation remains to be equal.	Amount of depreciation is more during earlier years of the life of asset than later years and therefore amount is never equal.
2. Balance in Asset's A/c	Asset account at the expiry of the expected life becomes nil.	The amount never becomes nil
3. Overall Charge	The overall charge i.e., depreciation and repairs taken together go on increasing from year to year. In other words the amount of depreciation and repairs is relatively less during the earlier years of the life of the asset than later years because repairs go on increasing with use of asset.	Overall charge remains more or less same for every year throughout the life of the asset. Since depreciation goes on decreasing and amount of repairs goes on increasing.
4. Profits	Profits under this method are more during the earlier years of the life of the asset.	Profits are less during earlier years than the later years.

### **DIFFERENCES BETWEEN CAPITAL AND REVENUE EXPENDITURE**

Differences between Capital and Revenue Expenditure

Capital Expenditure	Revenue Expenditure
1. It results in acquisition of fixed assets which are meant for use and not for sale. The assets acquired are used for earning profit as long as they can serve the purpose of the business and sold only when they become unfit or obsolete for the business.	1. It does not result in acquisition of any fixed asset. This expenditure is incurred for meeting the day-to-day expenses of carrying on operations of business.
2. It results in improving the earning capacity of the fixed assets e.g., over-	2. It results in maintenance of business assets such as repairs and maintenance of



hauling the machinery for improving the business by increasing the earning capacity of the machinery.	machinery. It is helpful in maintaining the existing capacity of the asset.
3. It represents unexpired cost i.e., cost of benefit to be taken in future.	3. It represents expired cost i.e., benefit of cost has been taken.
4. It is a non-recurring expenditure.	4. It is recurring expenditure.
5. The benefit of such expenditure will be for more than one year. Only a portion of such expenditure known as depreciation is charged to profit and Loss Account and balance amount of such expenditure unless it is written off is shown in the Balance Sheet as an asset.	5. The benefit of such expenditure expires during the year and the amount is charged to Revenue Account (i.e., Trading and Profit and Loss Account) of the same year.
6. All items of capital expenditure which are not written off are shown in the Balance Sheet as assets and are carried forward to the next year.	6. All items of revenue expenditure the benefit of which has exhausted during the year are transferred to Trading and Profit & Loss Account and accounts representing such items are closed by transferring them to Trading and Profit & Loss Account. Such items are not carried forward to the next year because their benefit has been taken during the year. Only the portion of the deferred revenue expenditure (i.e., Heavy Advertisement) the benefit of which has not expired during the year is carried forward to the next year.

**PROBLEM ON DIMINISHING BALANCE METHOD AND FIXED INSTALMENT METHOD:**

Mr.Rao purchased a machine for Rs.44,000 on 1-7-97 and spent Rs.6,000 on its erection. On 31-12-199, the machine became absolute and was sold for Rs.40,000. Depreciation was charged @10%p.a.at the end of every year. Show machinery A/c upto the date of sale under the following methods

I. Fixed Instalment Method

II. Diminishing Balance Method

**Under Fixed Instalment Method:**

Dr				Machinery A/c		Cr	
Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
1-7-97	To Bank		50,000	31-12-97	By Depreciation (6 months)		2,500
					By Balance c/d		47,500
			50,000				50,000
1-1-98	To Bal b/d		47,500	31-12-98	By Depreciation		5,000
					By Bal c/d		42,500
			47,500				47,500
1-1-99	To Bal b/d		42,500	31-12-99	By Bank (sale)		40,000
31-12-99	To P&L A/c (Profit)		2,500		By Depreciation		5,000
			45,000				45,000

Working Notes :

## Under Diminishing Balance Method

Calculation of Profit or loss on sale of machinery:                    Rs.

The original cost of Machinery    = 50,000

Less: Total Depreciation upto date of sale

1997	Depreciation	2,500	
1998	Depreciation	5,000	
1999	Depreciation	<u>5,000</u>	<u>12,500</u>
	Net Value		37,500
	Less Amount realised on sale		<u>40,000</u>
	Profit on sale		<u>2,500</u>

**Under Diminishing Balance Method:**

Dr				Machinery A/c		Cr	
Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
1-7-97	To Bank		50,000	31-12-97	By Depreciation (6 months)		2,500
					By Balance c/d		47,500
			50,000				50,000
1-1-98	To Bal b/d		47,500	31-12-98	By Depreciation		4,750
					By Bal c/d		42,750
			47,500				47,500
1-1-99	To Bal b/d		42,750	31-12-99	By Bank (sale)		47,500
31-12-99	To P&L A/c (Profit)		1,525	31-12-99	By Depreciation		40,000
							4,275
			44,275				44,275

Working Notes

Calculation of Profit or loss on sale of machinery under Diminishing Balance Method

The original cost of Machinery = Rs. 50,000

Less: Total Depreciation upto date of sale

1997 Depreciation	2,500	
1998 Depreciation	4,750	
1999 Depreciation	<u>4,275</u>	<u>11, 525</u>
	Net Value	38,475
	Less Amount realised on sale	<u>40,000</u>
	Profit on sale	<u>1,525</u>

**PROBLEM No.2**

A Company purchased a lease for 3 years on 1-1-1999 for Rs.25,000. It was decided to provide for the replacement of the lease at the end of 3 years by setting up a depreciation fund. It is expected that investment will fetch interest at 5% p.a. Sinking fund table show that to provide the requisite sum at 5% p.a.at the end of 3years , an investment of Rs.7,932.22 is required to be made. Investments are made to the nearest rupee.

On 31-12-2001 the investments are sold for Rs.15,250. On 1-1-2001 the same lease was renewed for a further period of 3 years by payment of Rs.30,000.

Prepare Lease Account, Depreciation Fund Account and Depreciation Fund Investments Account.

SOLUTION:

**Dr** **Depreciation Fund A/c** **Cr**

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
31-12-99	To Bal.c/d		7,932.22	31-12-99	By P&L A/c		7,932.22
31-12-2000			7,932.22	1-1-2000			7,932.22
	To Bal c/d		16,261.04	31-12-2000	By Bal b/d		7,932.22
					By Bank		396.60
					By P&L A/c		7,932.22
31-12-2001			16,261.04	1-1-2001			16,261.04
	To Dep.Fund			31-12-01	By Bal b/d		
	Inv. A/c		1,011.00	31-12-01	By Bank		16,261.04
	To Lease			31-12-01	By P&L A/c		813.05
					By P&L A/c		7,932.22
			25,000.00				1,004.69
			26,011.00				
							26,011.00

**Dr****Depreciation Fund Investments A/c****Cr**

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
31-12-99	To Bank		7,932	31-12-99	By Bal c/d		7,932
1-1-2000	To Bal b/d		7,932.22	1-1-2000			7,932.22
31-12-2000	To Bank		7,932	31-12-2000	By Bal c/d		16,261
1-1-01			8,329				
	To Bal.b/d		16,261.04	31-12-01	By Bank		16,261.04
			16,261	31-12-01	By Dep.Fund		15,250.00
							1,011.00
			16,261.00				16,261.00

**Dr****Lease A/c****Cr**

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
1-1-99	To Bank		25,000	31-12-99	By Bal c/d		25,000
1-1-00	To Bal b/d		7,932.22	31-12-00	By Bal c/d		7,932.22
			25,000				25,000
			16,261.04	31-12-01	By Dep.Fund		16,261.04

1-1-01	To Bal b/d		25,000		A/c		25,000
			25,000				25,000

## **UNIT-III**

### **INVENTORY VALUATION**

**According to Kohler's Dictionary for Accountants**, inventory is defined as "raw materials and supplies, goods finished and in process of manufacture and merchandise on hand, in transit and owned, in storage or consigned to other at the end of an accounting period."

**According to Accounting Standards-A(AS-2) 'INVENTORIES'** mean tangible property held

- 1) For sale.
- 2) In the process of production for sale.
- 3) For computation in the production of goods or services for sale, inventories are normally classified in the financial statements as current assets as under:
  - i) Raw materials and components,
  - ii) Work-in-progress.
  - iii) Finished goods.
  - iv) Stores and spares.

#### **Objectives of Inventory Control:**

- i) To determine the cashment income.
- ii) To present true and correct view of financial affairs.
- iii) To compute the ratios.

#### **Methods of Valuation of Inventory:**

##### **1. First in First Out Method (FIFO):**

Under this method materials are first issued from the earliest consignment on hand and priced at the cost at which that consignment was placed in stores.

In other words, materials received first are issued first.

The units in the opening stock of materials are treated as if they are issued first.

The units from the first purchase issued next and so on until the units left in the closing stock of materials are valued at the latest cost of purchases.

It follows that unit costs are apportioned to cost of production according to their chronological order of receipts in the store.

This method is the most suitable in times of falling prices because the issue price of materials to jobs or works orders will be high while the cost of replacement of materials will be low.

But in case of rising prices this method is not suitable because the issue price of materials to production will be low while the cost of replacement of materials will be high.

Two points should be noted (i) materials are charged at the actual cost price and at the oldest price of materials in stock. (ii) Stock of materials in hand is valued at the latest purchase prices.

### **Advantages of FIFO Method:**

1. The main advantage of FIFO method is that it is simple to understand and easy to operate.
2. Closing stock valuation is at cost as well as at the latest market prices.
3. Materials are issued at actual cost. Thus, no unrealised profit / loss results from the use of this method.
4. This method is based on a realistic assumption that materials which are received first are issued first.
5. It is a logical method because it takes into consideration the normal procedure of utilising first those materials which are received first. Materials are issued in order of purchases, so materials received first are utilised first.
6. Under this method, materials are issued at the purchase price; so the cost of jobs or work orders is correctly ascertained so far as cost of materials is concerned. Thus, this method recovers the cost price of materials.
7. This method is suitable when prices are falling.
8. Closing stock of raw materials will be valued at the market price as the closing stock under this method would consist of recent purchase of materials.
9. This method is also useful when transactions are not too many and prices of materials are fairly steady.

### **Disadvantages of FIFO Method:**

1. Materials are not charged at the current market prices. Therefore, in times of rising prices, charge to production is unduly low.
2. This method sometimes produces unfair results as between one job and another job.
3. When transactions are large in number and the price fluctuates very frequently, the method involves more calculations and increases the possibility of errors.
4. This method increases the possibility of clerical errors, if consignments are received frequently at fluctuating prices as every time an issue of materials is made, the store ledger clerk will have to go through this record to ascertain the price to be charged.
5. In case of fluctuations in price of materials, comparison between one job and the other becomes difficult because one job started a few minutes later than another of the same nature may be issued materials at different prices, merely because the earlier job exhausted the supply of the lower priced materials in stock.
6. For pricing one requisition more than one price has often to be taken.
7. When prices rise, the issue price does not reflect the market price as materials are issued from the earliest consignments. Therefore, the charge to production is low because the cost of replacing the material consumed will be higher than the price of issue.

## **2. Last in First Out Method (LIFO):**

As against the First in First Out method the issues under this method are priced in the reverse order of purchase i.e., the price of the latest available consignment is taken.

This method is sometimes known as the replacement cost method because materials are issued at the current cost to jobs or work orders except when purchases were made long



ago. This method is suitable in times of rising prices because material will be issued from the latest consignment at a price which is closely related to the current price levels.

Valuing materials issues at the price of the latest available consignment will help the management in fixing the competitive selling prices of the products.

This method was first introduced in the U.S.A. during the Second World War to get the advantage of rising prices.

Two important points in this method are (i) issues are priced at actual cost and at the latest prices paid. (ii) Closing stock is valued at the older prices and is completely out of line with current prices.

### **Advantages of LIFO Method:**

1. The value of materials issued is closely related to current market prices.
2. As materials are issued at actual cost, it does not result in any unrealised profit or loss.
3. When prices are rising, the higher prices of the most recent purchases are charged to production. This reduces profit figure and results in Income tax saving.
4. Like FIFO method, this is simple to operate and is useful when transactions are not too many and the prices are fairly steady.
5. Like FIFO method, this method recovers cost from production because actual cost of material is charged to production.
6. Production is charged at the recent prices because materials are issued from the latest consignment. Thus, effect of current market prices of materials is reflected in the cost of sales provided the materials are recently purchased.
7. In times of rising prices, LIFO method of pricing issues is suitable because materials are issued at the current market prices which are high. This method thus helps in showing a lower profit because of increased charge to production during periods of rising prices and lower profit produces burden of income tax.

### **Disadvantages of LIFO Method:**

1. Although stock is valued at cost, the price is that of the earliest materials purchased, so that stock value does not represent its current value.
2. This method is not realistic as it does not conform to the physical flow of materials.
3. Like FIFO, in this method also, the material cost of similar jobs may differ simply because the prior job exhausted the supply of lower priced stock. This renders comparisons between jobs different.
4. When prices fluctuate very often, the calculations complicate the stores account and increase the possibility of clerical errors.
5. Like FIFO method, this may lead to clerical errors as every time an issue is made, the stores ledger clerk will have to go through the record to ascertain the price to be charged.

6. Like FIFO method, comparison between one job and the other job will become difficult because one job started a few minutes after another of the same type may bear a different charge for materials consumed, merely because the earlier job exhausted the supply of the lower priced or higher priced materials in stock.

7. For pricing a single requisition, more than one price has often to be adopted.

8. the stock in hand is valued at price which does not reflect current market price. Consequently, closing stock will be understated or overstated in the Balance Sheet.

**Differences Between FIFO and LIFO Methods:**

<b>Point of Difference</b>	<b>FIFO method</b>	<b>LIFO method</b>
1. Assumption	It assumes that materials which are received first are issued first.	It assumes that materials which are received last are issued first.
2. Cost of materials	Cost of materials issued at the older prices.	Cost of materials issued is at the latest prices paid.
3. Value of closing stock	Closing stock is valued at the latest prices paid.	Closing stock is valued at the price of oldest materials in stock.
4. When prices are rising	When prices show a rising trend, FIFO reports higher profit and resultantly highest tax liability.	When prices are rising, LIFO shows lower profits because higher costs are matched against current revenues. Tax liability is thus reduced.
5. When prices are falling	When prices of materials are declining, FIFO shows lower profits and thus lower tax liability.	When prices are declining, LIFO shows higher profits and thus higher tax liability.

**3. Average Price Method:**

These methods are based on the assumption that when materials purchased in different lots is stored together, their identity is lost, and therefore, these should be charged at an average price. Basically average prices of two types. They are (i) Simple Average Price method (ii) Weighted Average Price Method.

**i) Simple Average Price Method**

Simple average price is calculated by adding all the different prices and dividing by the number of such prices. It does not take into account quantities of materials while computing average price.

For instance, when 100 units are purchased @Rs.9 per unit and 900 units are purchased @Rs.7 per unit, the simple average price will be =  $9+7 / 2 = Rs.8$

Advantages:

The only advantage of this method is that it is simple to understand and easy to operate.

Disadvantages:

1. Materials are not charged out at actual cost. Thus, unrealised profit or loss will usually arise out of pricing.
2. This method is unscientific and usually produces unsatisfactory results. The value of closing stock may be a negative figure which is quite absurd.

## ii) Weighted Average Price Method

This method gives due weight to the quantities held at each price when calculating the average price.

The weighted average price is calculated by dividing the total cost of materials in stock from which the materials to be priced could have been drawn, by that total quantity of materials in that stock.

The simple formula is that weighted average price at any time is the balance value figure divided by the balance units figure. Thus

$$\text{Weighted Average Price} = \frac{\text{Total cost of Materials in stock}}{\text{Total quantity of materials in stock}}$$

### Advantages:

1. This method is rational, systematic and not subject to manipulation. It is representative of the prices that prevailed during the entire period rather than of the price at the beginning, end or at one point of issue during the period because it is based on the average of the material costs of the various lots available in the store.
2. This method evens out the effect of widely varying prices of different purchases.
3. The new issue price is calculated only at the time of each new purchase and not at the time of each issue. This reduces the work of making calculations.
4. No unrealised profit or loss arises.
5. This method recovers the cost of materials from production.
6. Issue prices are not to be calculated each time issues are made, issue prices are changed only when new lot of materials is received.
7. Average price method is considered to be the best method when prices fluctuate considerably because this method tends to smooth out fluctuations in prices.
8. This method maintains the issue prices as near to the market price possible.
9. This method eliminates the necessity for adjustments in stock valuation.

### Disadvantages:

1. Where receipts are numerous, this method requires a good deal of calculations.
2. Issue prices generally run to a number of decimal points.
3. Materials are not issued at the current market prices.
4. Closing stock is not valued at current cost.
5. Issue price of materials does not represent actual cost price of materials issued but it represents average cost of materials in stores. At the time of rising prices, it overstates profit but not as much as FIFO because average price is lower than the most recent price.
6. A fresh rate calculation will have to be made as soon as a new lot of materials is purchased which may involve tedious calculations. Thus, there are chances of clerical errors.

## 4. Inflated Price Method

There are some materials which are subjected to natural wastage. Examples are

- i) Materials lost due to loading and unloading and
- ii) Timber lost due to seasoning. In such cases, the materials are issued at an inflated price (a price higher than the actual cost) so as to recover the cost of natural wastage of

materials from the production. In this way, the total cost of the material is recovered from the production.

### **5. Specific Price/ Identification Method**

Under this method, materials issued to production are priced at their purchase prices. The basic assumption in following this method is that materials in the stores are capable of being identified as belonging to specific lots. Identification can be made by placing some distinguishing mark usually price tag on every lot. When materials are issued, price tags are removed and forwarded to the costing department for ascertaining the material cost of production. This method is simple in its mechanism and operation.

### **6. Base Stock Method**

Each concern always maintains a minimum quantity of material in stock. This minimum quantity is known as safety or base stock and this should be used only when an emergency arises. The base stock is created out of the first lot of the material purchased and, therefore, it is always valued at the cost price of the first lot and is carried forward as a fixed asset. This method works with some other method and is generally used with FIFO or LIFO method. Therefore, the advantages or disadvantages of the method (with which the base stock is used) will arise. Any quantity over and above the base stock is issued in accordance with the other method which is used in conjunction with this method. The objective of this method is to issue the material according to the current prices. This objective will be achieved only when the LIFO method is used together with Base stock method.

### **7. Highest in First Out Method (HIFO)**

This method is based on the assumption that the closing stock of materials should always remain at the minimum value; so the issues are priced at highest value of the available consignments in the store. This method is not popular as it always undervalues the stock which amounts to creating a secret reserve. This method is mainly used in case of cost plus contracts or monopoly products as it is helpful in increasing the price of the contract or products.

### **8. Market Price Method**

Market price can either be the replacement price or the realisable price. The replacement price is used in case of the items which are held in stock for use in production while realisable price is used in respect of the items which are kept in stock for sale. Under this method, materials are issued at a price at which they can be replaced. Therefore, cost of the materials issued is not considered but materials are issued at the market price prevailing on the date of issue.

This method is considered to be the best method where quotations have to be sent because quotations sent would reflect the latest competitive conditions so far as materials are concerned.

This method discloses whether the buying is efficient or inefficient.

There will be efficiency in buying if the market price is higher than the cost price and inefficiency if reverse is the case.

### **Stock Levels**

There are five levels of stocks should be calculated under valuation of inventory.

They are 1. Re-Order Level

2. Maximum Stock Level

3. Minimum Stock Level

4. Average Stock Level

5. Danger Level

#### **1. Re-Order Level:**

This is that level of material to be reordered should be calculated as follows:

Re-ordering Level =

Maximum Consumption X Maximum Re-order Period

#### **2. Minimum Stock Level =**

Minimum Stock Level =

Re-ordering Level – (Normal Consumption X Normal Re-order Period)

#### **3. Maximum Stock Level =**

**Maximum Stock Level =**

Re-ordering Level + Re-ordering Quantity- (Minimum Consumption X Minimum Re-ordering Period)

#### **4. Average Stock Level**

**Average Stock Level =**

$\frac{1}{2}$  (Minimum Stock Level + Maximum Stock Level)

OR

Minimum Stock Level +  $\frac{1}{2}$  of Re-order Quantity.

#### **5. Danger Level =**

Average consumption X Maximum re-orders period for emergency purchases.

**6. Economic Ordering Quantity (EOQ) =  
Economic Ordering Quantity (EOQ)**

$$Q = \sqrt{(2CO) / I}$$

Where Q = Quantity to be Ordered.

C = Consumption of the material consumed in units during a year.

O = Cost of placing one order including the cost of receiving the goods.

I = Interest payment including variable cost of storing per unit per year i.e., holding costs of inventory.

1. Prepare Stores Ledger under FIFO, LIFO, SIMPLE AVERAGE AND WEIGHTED AVERAGE methods from the following

2008 July 1<sup>st</sup> Opening Stock of 1,000 units @Rs 5 each

July 2<sup>nd</sup> Received 2,000 units @ Rs.7 each

July 3<sup>rd</sup> Issued 2,500 units

July 4<sup>th</sup> Received 1,000 Units @ Rs.8 each

July 5<sup>th</sup> Issued 800 units

July 31<sup>st</sup> Stock verification report revealed that shortage of material was 100 units.

SOLUTION:

**STORES LEDGER UNDER FIFO METHOD**

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)
2008 July 1 <sup>st</sup>	Opening stock	-	-	-	-	-	-	1000	5	5,000
July 2 <sup>nd</sup>	Received	2,000	7	14,000	-	-	-	1,000 2,000	5 7	5,000 14,000
July 3 <sup>rd</sup>	Issued	-	-	-	1,000 1,500	5 7	5,000 10,500	500	7	3,500
July 4 <sup>th</sup>	Received	1,000	8	8,000	-	-	-	500 1,000	7 8	3,500 8,000
July 5 <sup>th</sup>	Issued	-	-	-	500 300	7 8	3,500 2,400	700	8	5,600
July 31 <sup>st</sup>	Shortage	-	-	-	100	8	800	600	8	4,800
July 31 <sup>st</sup>	Closing Stock	-	-	-	-	-	-	600	8	4,800

**STORES LEDGER UNDER LIFO METHOD**

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)
2008 July 1 <sup>st</sup>	Opening stock	-	-	-	-	-	-	1000	5	5,000
July 2 <sup>nd</sup>	Received	2,000	7	14,000	-	-	-	1,000 2,000	5 7	5,000 14,000
July 3 <sup>rd</sup>	Issued	-	-	-	2,000 500	7 5	14,000 2,500	500	5	2,500
July 4 <sup>th</sup>	Received	1,000	8	8,000	-	-	-	500 1,000	5 8	2,500 8,000
July 5 <sup>th</sup>	Issued	-	-	-	800	8	6,400	500 200	5 8	2,500 1,600

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)
2008 July 1 <sup>st</sup>	Opening stock	-	-	-	-	-	-	1000	5	5,000
July 2 <sup>nd</sup>	Received	2,000	7	14,000	-	-	-	3,000	5 7	19,000
July 3 <sup>rd</sup>	Issued	-	-	-	2,500	6	15,000	500	7	4,000
July 4 <sup>th</sup>	Received	1,000	8	8,000	-	-	-	1,500	7 8	12,000
July 5 <sup>th</sup>	Issued	-	-	-	800	7.50	6,000	700	8	6,000
July 31 <sup>st</sup>	Shortage	-	-	-	100	8	800	600	8	5,200
July 31 <sup>st</sup>	Closing Stock	-	-	-	-	-	-	600	8	5,200
July 31 <sup>st</sup>	Shortage	-	-	-	100	8	800	500 100	5 8	2,500 800
July 31 <sup>st</sup>	Closing Stock	-	-	-	-	-	-	600		3,300

**STORES LEDGER UNDER SIMPLE AVERAGE METHOD**

## STORES LEDGER UNDER WEIGHTED AVERAGE METHOD

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)	Units	Rate	Amount (Rs.)
2008 July 1 <sup>st</sup>	Opening stock	-	-	-	-	-	-	1000	5	5,000
July 2 <sup>nd</sup>	Received	2,000	7	14,000	-	-	-	3,000		19,000
July 3 <sup>rd</sup>	Issued	-	-	-	2,500	6.333	15,832.50	500		3,167.50
July 4 <sup>th</sup>	Received	1,000	8	8,000	-	-	-	1,500		11,167.50
July 5 <sup>th</sup>	Issued	-	-	-	800	7.445	5,956	700		5,211.50
July 31 <sup>st</sup>	Shortage	-	-	-	100	7.445	744.50	600		4,467.00
July 31 <sup>st</sup>	Closing Stock	-	-	-	-	-	-	600		4,467.00

## PROBLEMS ON VALUATION OF GOODWILL

### PURCHASE OF PAST PROFITS: (Model No.1)

X, Y and Z are partners sharing profits and losses in the ratio of 2:2:1 respectively. Z retires from the business on 30<sup>th</sup> June, 1995. Goodwill should be calculated on the basis of four year's purchase of average profits for the preceding seven years. Calculate the amount of goodwill due to Z under Average Profits Method.

Years	Profit (Rs.)
1989	32,000
1990	40,000
1991	72,000
1992	64,000
1993	32,000
1994	80,000
1995	72,000

### **SOLUTION:**

Total Profit for 7 Years = 32,000+40,000+72,000+64,000+32,000+80,000+72,000 = Rs.3,92,000

Average Profit per annum = Total profit / No. of Years

$$= 3,92,000 / 7 = \text{Rs.}56,000$$



Goodwill = Four years' Purchase of Average Profit

$$= 56,000 \times 4 = \text{Rs.}2,24,000$$

Z share in Goodwill =  $2,24,000 \times \frac{1}{5} = \text{Rs.}44,800$

**Model No.2: CAPITALISATION METHOD:**

**Problem:** A company desirous of selling its business to another company has an average profit in past of Rs.1,50,000 per annum. It is considered that such average profit fairly represents the profit likely to be earned, in the future, except that:

- i) Directors fees Rs.10,000 charged against such profit will not be payable by the purchasing company whose existing board can easily cope with the additional administrative work at present fees payable to the directors.
- ii) Rent Rs.20,000 p.a. which had been paid by the vendor company will not be a charge in future , since the purchasing company owns its own premises and can supply the accommodation necessary for staff and equipment of vendor company.
- iii) The value of the Net tangible assets of the vendor company at the proposed date of sale was Rs.15,00,000 and it was considered that the reasonable return on capital invested , for this type of commodity was 10%.
- iv) Calculate the value of Goodwill under capitalisation of expected future net profits.

**SOLUTION:**

Calculation of the value of Goodwill

Particulars	I.C (Rs.)	O.C (Rs.)
Average Net Profit		1,50,000
Add: Non-Recurring Charges:		
Directors Fees	10,000	
Rent	20,000	30,000
Estimated future Maintainable Profit		<u>1,80,000</u>
Future profit capitalised at 10% i.e., $1,80,000 \times \frac{100}{10}$		
Capitalised profit		<u>18,00,000</u>
Less: Net Tangible Assets		18,00,000
Goodwill		15,00,000
		<u>3,00,000</u>

**Model No.3: Purchase of Super Profits Method:**

**Problem:** The Asia Ltd. is to be absorbed by the India Ltd. In order to determine the purchase consideration, the two companies considered it necessary to value the goodwill attaching to the business of the Asia Ltd. It is agreed that basis of the calculation of the calculation of goodwill shall

be three years purchase of average annual profits , the profits being averaged over 5 years. The profits of Asia Ltd. for the last 5 years before charging income tax at 50% are respectively Rs.4,00,000, Rs.4,96,000, Rs.3,52,000, Rs.5,60,000 and Rs.4,32,000 for each of the above 5 years. Two directors of Asia Ltd. will be appointed to the Board of India Ltd. on absorption and it is considered that their services have been worth Rs.48,000 each per annum. In the past no charge was made against the profits of Asia Ltd. for the services of the directors concerned. The average capital invested in net tangible assets over the period is Rs.10,96,000. The normal return to be expected from the particular type of business carried on by the Asia Ltd. is 10%. Calculate the amount of Goodwill under Super Profits Method.

**Solution:**

**Calculation of Goodwill under Super Profits Method:**

$$\begin{aligned} \text{Total Profit} &= 4,00,000 + 4,96,000 + 3,52,000 + 5,60,000 + 4,32,000 \\ &= \text{Rs.22,40,000} \end{aligned}$$

$$\begin{aligned} \text{Average Profit} &= \text{Total Profit} / \text{No. of Years} \\ &= 22,40,000 / 5 = \text{Rs.4,48,000} \end{aligned}$$

	<b>Rs.</b>
<b>Average Profit</b>	= 4,48,000
Less: Directors Service Charges (48,000 X2)	= <u>96,000</u>
	3,52,000
Less: Income Tax @50% of 3,52,000	= <u>1,76,000</u>
Profit After Tax (PAT)	= 1,76,000
Less: Normal Rate of Return on Average Capital =	<u>1,09,000</u>
(10,96,000 X10 / 100) Super Profit =	<u>66,400</u>
Goodwill = Super Profit X No. of Years	
= 66,400 X 3 = <b>Rs.1,99,200</b>	

# UNIT-III

## INVENTORY VALUATION

**According to Kohler's Dictionary** for Accountants, inventory is defined as "Raw materials and supplies, goods finished and in process of manufacture and merchandise on hand, in transit and owned, in storage or consigned to other at the end of an accounting period."

**According to Accounting Standards-A(AS-2)** 'INVENTORIES' mean tangible property held For sale.

- 4) In the process of production for sale.
- 5) For computation in the production of goods or services for sale, inventories are normally classified in the financial statements as current assets as under:
  - v) Raw materials and components,
  - vi) Work-in-progress.
  - vii) Finished goods.
  - viii) Stores and spares.

### **Objectives of Inventory Control:**

- iv) To determine the cashment income.
- v) To present true and correct view of financial affairs.
- vi) To compute the ratios.

#### **1. Determination of Income:**

According to AICPA Research Bulletin No.43, a major objectives of accounting for inventories is the proper determination of income through the process of matching appropriate costs given revenues.

Gross profit is not equal to sales minus purchases. It is equal to sales minus cost of goods sold. Cost of goods sold is purchases plus opening stock and direct expenses minus closing stock. The closing stock becomes the opening stock of the next period and is debited to trading account with purchases.

#### **2. Determination of Financial position:**

In the balance sheet which is a statement showing the financial position of the undertaking. Inventory is very important item to be shown under current asset of the amount which is not correctly valued, to that extent of the balance sheet will be misleading.

Thus the primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the recognition of related revenues.

### **Importance of Valuation of Inventory:**

#### **1. Avoiding Losses of Sales:**

**In a firm maintain adequate inventories it can avoid losses on account of losing the customer for non supply of goods in time.**

#### **2. Reducing the Ordering Cost:**

The variable cost associated with individual orders. Example typing, checking, mailing the order etc., can be reduced if a firm pays a large order than numerous small orders.

### **3. Achieving Efficient Production Runs:**

Maintenance of large inventories helps firms in reducing the setup costs of production.

## **VALUATION OF SHARES**

### **MEANING OF SHARES:**

- **The Memorandum of Association of a company states the amount of the nominal capital of the company.**
- **The capital of a company is divided into a number of equal parts.**
- **Each such part is known as “share.”**
- **The owner of such a share is called as “shareholder.”**
- **The certificate issued by the company to the shareholder under its common seal as a proof of his holding some shares is called a “share certificate.”**
- **Under the companies Act, 1956, a public company can issue two types of shares, viz., 1. Equity Shares 2. Preference Shares 3. Deferred Shares**

#### **1. Equity Shares:**

1. Equity shares are those which are not preference shares.
2. Under the companies Act, 1956 the shares which are not preference shares are called equity shares.
3. They are also called as Ordinary shares.
4. These are so called because they do not enjoy any special rights.
5. These shareholders get dividend after the payment of dividend to the preference shareholders.
6. Similarly, in the event of liquidation, capital is returned to them after the return of capital to preference shareholders. Thus equity shareholders take risk both regarding payment of dividend and return of capital.
7. Equity shareholders are the real owners of the company.
8. They have voting rights in the meetings of the company.
9. They have control over the working of the company. They exercise their voice in the management and affairs of the company.

#### **2. Preference Shares:**

1. Preference shares are those shares which have (i) a preference right to be paid dividend at a fixed rate during the life time of the company and (ii) a preferential right to be repaid capital when the company goes into liquidation.
2. These shares carry special rights as to payment of dividend or repayment of capital both.
3. The rate of dividend on these shares is fixed in advance.
4. This dividend must be paid before any dividend is paid on other shares.
5. Sometimes they may also enjoy priority in the repayment of capital at the time of liquidation of the company.
6. Preference shareholders do not have voting rights. They have no say in the management of the company. However, they can vote if their own interests are affected. Those persons who want to consistent rate of return, even if the earning is less, prefer to purchase preference shares.

- **Preference shares may be of several types.**
  - 1) **Cummulative Preference Shares:**
  - **In case of such shares, if dividend in any year cannot be paid due to non-availability of profit, the holders are entitled to get such arrear dividend out of subsequent year of years.**
  - 2) **Non-Cummulative Preference Shares:**
  - **In case of such shares, if dividend in any year cannot be paid , the right to receive dividend for that year lapses and holders are not entitled to get such arrear dividend out of profits of subsequent years.**
  - 3) **Participating Preference Shares:**
  - **In case of such shares, the holders of these shares, in addition to a fixed rate of dividend and entitled to share with the equity shareholders, the balance of profits in some proportion after the rights of the equity shareholders have been reasonably met.**
  - **The holders of these shares participate in the surplus profits of the company.**
  - **They are firstly paid a fixed rate of dividend and then a reasonable rate of dividend is paid on equity shares.**
  - **If some profits remain after paying both these dividends, then preference shareholders participate in the surplus profits.**
  - **These shareholders are sometimes also allowed to share in surplus assets on the company being wound up.**
  - 4) **Non-Participating Preference Shares:**

**In case of such shares, the holders of these shares are entitled to a fixed rate of dividend only and do not share in the surplus profits or assets which all go to the equity shareholders. Holders of these shares get a fixed rate of dividend. They do not carry the additional right of sharing of profits of the company.**

#### **5) Redeemable Preference Shares:**

1. Normally the capital of a company is repaid only at the time of liquidation.
2. However, the company can issue redeemable preference shares, if the Articles of association allow such an issue.
3. The company has a right to return redeemable preference share capital after a certain period.
4. It is to be noted that redeemable preference shares are good source for raising semi-permanent finance.
5. These shares, in addition to the preferential right in respect of dividend, enjoy the right to be redeemed i.e., to be paid back to the holders within the life of the company subject to the terms of the issue and the fulfillment of certain conditions laid down in Section 80 of the Companies Act.

#### **6) Irredeemable Preference Shares:**

1. The shares which cannot be redeemed unless the company is liquidated are known as irredeemable preference shares.
2. The amount of irredeemable preference shares (like the amount of equity share) can be paid back only when the company is wound up.
3. After the commencement of companies (Amendment) Act, 1988, no company limited by shares shall issue any preference share which is irredeemable or is redeemable after the expiry of a period of ten years from the date of issue.

### **7) Convertible Preference Shares:**

1. These shares are given the right of being converted into equity shares within a specified period or at a specified date according to the terms of issue.
2. The right of conversion must be authorised by the Articles of association.

### **8) Non-convertible Preference Shares:**

1. The shares which cannot be converted into equity shares are known as non-convertible preference shares.
2. The preference shares without such right of conversion are termed as non-convertible shares.

### **9) Guaranteed Preference Shares:**

1. When the dividend on the preference shares is guaranteed for a fixed number of years by any third party, those shares are called guaranteed preference shares.
2. The purpose of guaranteeing a fixed rate of dividend is to infuse confidence in the investing public.

### **3. Deferred Shares:**

1. The rights of the deferred shareholders with regard to payment of dividend and repayment of capital are deferred (i.e., postponed in favour of preference and equity shareholders).
2. These shareholders get their dividend only when all other shareholders are fully satisfied.
3. Thus deferred shares rank last so far as payment of dividend and return of capital concerned.
4. These shares were generally of a small denomination.
5. The management of company remained in their hands by virtue of their voting rights.
6. These shareholders tried to manage the company with efficiency and economy because they got dividend only at the end.
7. These shares were earlier issued to Promoters or Founders for services rendered to the company.
8. This was supposed to be the best method of remunerating the founders shares or Promoters shares.
9. When a company issues deferred shares, maximum amount of dividend payable on ordinary shares is fixed.
10. The deferred shareholders are paid their dividend only after the maximum percentage of dividend is paid to the equity shareholders.
11. So Deferred shareholders get their dividend only when the company makes high profits.

## Differences between Preference shares and Equity shares.

<b>Preference Shares</b>	<b>Equity Shares</b>
1.The holders of these shares are entitled to receive dividend first.	1.The holders of these shares rank next to preference shareholders in the matter of receipt of dividend.
2.They enjoy first preference to receive back their capital in the event of winding up of the company.	2. They rank next to preference shareholders in receiving back their capital.
3. They have no voting rights.	3. They enjoy voting rights.
4. They do not Participate in management.	4. They may participate in management of the company.
5. Face value of share is relatively higher.	5. Face value of share is relatively lower.
6. Dividend rate is fixed.	6. Rate of dividend is not fixed.
7. Preference share capital may be paid back after a certain period.	7. Equity share capital will not be paid back as long as the company is in existence.

## Differences between Stock and Shares.

### Meaning of Stock:

- Stock is simply a set of shares put together in a bundle.
- It is expressed in money instead of as so many shares.
- It is so to say, the aggregate of fully paid-up shares, consolidated and dividend for the purpose of convenient holding into different parts.
- It may be transferred or split up into fractions of any amounts without regard to the original face value of the shares.
- A company cannot make an original issue of stock, whenm shares are fully paid up, they may be converted into stock.

### Meaning of Share:

- The capital of a company is divided into a nuber of equal parts.
- Each such part is known as “share.”
- The owner of such a share is called as “shareholder.”

### Differences between Stock and Shares.

1. A share has a nominal value, whereas stock has no nominal value.
2. A share need not necessarily be fully paid up, but stock is always fully paid up.
3. A share is transferable asa whole, while stock can be transferred in sums of any amount.
4. All shares are of equal denomination, stock may be of unequal amounts.
5. Shares are distinctively and serially numberd, whereas the stock does not have any such manner.
6. shares can be ditrectly issued to the public, but stock cannot be issued directly. Only fully paid-up shares can be converted into stock.
7. Stock may be issued to holders which are transferable by delivery like negotiable instruments. Shares are always registered and not transferable by delivery.
8. A holder of shares is a member of the company and the share certificate is a prima facie evidence of title. On the contrary, the stock holder is not necessarily a member. If the articles of

the company so provide, he may be deemed to be a member of the company for any purposes defined in the articles.

#### **4.Q. Distinguish between Stock and Share.**

<b>Stock</b>	<b>Share</b>
1. Stock is the interest of a member in the capital of the company.	1. Shares are equal proportions into which the capital of the company is divided.
2. Stock is divisible.	2. Shares are indivisible.
3. Stock has no numbers.	3. Shares have serial numbers.
4. Stock must be fully paid up.	4. Shares may be partially or fully paid up.
5. Stock can be transferred in any amount.	5. Shares can be transferred in multiples.
6. Stock can be converted into shares.	6. Only fully paid up shares can be transferred into stock.
7. Stock cannot be originally issued by the company.	7. Shares are originally issued by the company.
8. Stock may be registered or unregistered.	8. Shares are always registered.
9. Stock may be for any value. They do not have the same value.	9. Shares have uniform face value.

## **DEBENTURES**

### **1. Define Debenture. Explain the features and different types of Debentures.**

#### **Answer:**

The loan amount is divided into small units called debenture. The word debenture is derived from the Latin word debere which means to owe. Debenture bond is an instrument issued under the common seal of the company acknowledging a debt.

#### **Definitions of Debenture:**

#### **According to Thomas Evelyn**

“A Debenture is a document under the company’s seal which provides for the payment of a principal sum and interest thereon at regular intervals, which is usually secured by a fixed or floating charge on the company’s property or undertakings and which acknowledges a loan to the company”.

#### **According to Palmer**

“Debenture is an instrument under seal and evidencing a debt, the essence of it being the admission of indebtedness”.

#### **According to Section 2 (12) of the companies Act**

“Debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not ”.



### **Features of Debenture:**

1. It is issued under the common seal of the company acknowledging a debt.
2. It is issued for a certain amount.
3. Debenture holders get interest only. They do not get dividend.
4. Debenture holders do not enjoy any voting rights. They cannot take part in the management of the company.
5. Debenture holders will not be paid back after a fixed period.
6. In the event of liquidation, debenture holders get back their amount before anything is paid to preference or equity shareholders.

### **Kinds of Debentures:**

The various types of debentures may be classified from different view points; Security, Redemption, Transferability, Rank and Conversion.

#### **As Regards Security**

##### **1. Simple or Naked or Unsecured Debentures:**

The holders of these debentures are offered no security. These debentures are issued with merely a promise of payment. They are simply unsecured promissory notes. This type of debenture holders has to rank as an ordinary creditor in the event of winding up.

##### **2. Secured Debentures/ Mortgage Debentures:**

These debenture holders are secured by a charge on the assets of the company. These debenture holders have a right to recover their principal or interest or both from the assets of the company. If the company fails to pay them, these debenture holders are secured creditors. They will have priority over other creditors in the event of liquidation.

#### **As Regards Redemption**

##### **1. Redeemable Debentures:**

These debentures are repayable at the end of a certain period mentioned in the bond. These debenture holders will get back their money after the stipulated period.

**2. Irredeemable Debentures:** The time of repayment is not determined at the time of issue of debentures. Generally, they are not repaid during the lifetime of the company. So the amount of loan taken on these debentures forms a part of permanent finances of the company. They are also called perpetual debentures.

#### **As Regards Registration or Transferability**

##### **1. Registered Debentures:**

The names, addresses and particulars of the holders of these debentures are entered in the register of Debenture holders. The principal and interest thereon will be payable to the registered holders only. These debentures cannot be transferred by simple delivery. They can be transferred by a regular transfer deed. Every transfer must be registered with the company.

## **2. Bearer Debentures:**

The names of the holders of these debentures are not entered in the books of the company. They are payable to the bearer. They are transferable by mere delivery. Such transfer need not be registered with the company.

### **As Regards Priority**

#### **1. Preferred or First Debentures:**

These are the debentures which should be repaid first before other debentures in the event of liquidation of the company.

#### **2. Ordinary or Second Debentures:**

These are the debentures the amount of which will be paid after the first debentures are redeemed.

### **As Regards Conversion**

#### **1. Convertible Debentures:**

These are those in which an option is given to the debenture holders to exchange their debentures for shares in the company. This exchange is permitted during a certain fixed period.

#### **2. Non-convertible Debentures:**

These are those which cannot be exchanged for shares in the company. The debenture holders cannot change their status to shareholders.

## **MERITS AND DEMERITS OF DEBENTURES.**

### **Merits of Debentures:**

#### **From the point of view of the Investors:**

##### **1. Regular and steady income:**

The debentures carry the right of fixed rate of interest. It is a necessary charge on profits. It has to be paid whether or not the company makes profits.

##### **2. Definite security:**

The debentures are generally covered by a charge on the assets. This offers enough security for their redemption. For example, a mortgage debenture holder knows exactly what his security is. Generally, there are trustees to protect his interest.

##### **3. Priority in repayment:**

In winding up the debenture capital is paid back first, before any payment is made to the shareholders. Even otherwise, the amount of debentures is repayable after the expiry of a certain period.

## From the point of view of the Company:

### 1. Retention of control:

Debenture holders do not have any voting rights. Therefore, control of company is not surrendered to debenture holders. That is, the company is able to secure capital without giving any control to the debenture holders.

### 2. Facilitates Financial Planning:

The debentures are issued for a fairly long period. There is a certainty of finance for that specific period. Hence, the company will be in the position to adjust its financial planning accordingly.

### 3. Low Rate of Interest:

The rate of interest payable on debentures is fixed. This is lower than the rate of dividend paid on shares.

### 4. Trade on Equity:

The issue of debentures provides an opportunity to trade on equity. Consequently, the company can pay better rates of dividend to equity shareholders.

### 5. Less Tax Burden:

Interest on debentures is an allowable expenditure under Income Tax Act. Hence the incidence of tax on the company is decreased.

### 6. Wide Market:

Market for debentures is not limited as in the case of equity shares. Debentures are taken up by institutional and individual investors.

## Demerits of Debentures:

1. The debentures are not suitable for a company whose earnings are highly fluctuating.
2. They do not suit such companies whose proportion of fixed assets to total assets is low. These companies have meager security to offer to the debenture holders.
3. They may not suit a company whose products may not have potential vast market or their demand may be fluctuating.
4. Cost of raising capital through debentures is high because of high stamp duty.
5. Common people cannot buy debentures as they are of high denomination.

## Differences between Share holder and Debenture holder

Share holder	Debenture holder
1. It is a part of owner of the company's property.	1. He is a creditor of a company.
2. He does not get back the share capital from the company during its life.	2. He gets back the debenture capital after certain specified period, unless they are stated to be irredeemable.
3. He is entitled to a share in the profits of the company.	3. He is eligible to get only a fixed rate of interest.
4. He will have the right to vote of meetings. He indirectly participates in the management of the company.	4. He cannot attend and vote of meetings. He cannot take part in the meetings of the company.

5. He does not get dividend unless the company earns profits.	5. He gets interest whether the company earns profits or not.
6.He will not have a charge over the assets of the company for the share capital	6. He will have a charge over the assets of the company for principal as well as interest.
7. Shareholders will be the last persons entitled to refund of money in the event of liquidation.	7.Debenture holders will have priority over shareholders in refund of money at the time of liquidation.
8.they can expect a higher reward in the periods of prosperity.	8.they will get only a fixed rate of interest.
9.Dividend on shares is a charge against profit and loss appropriation Account.	9.interest on debentures is a charge against profit and loss Account.

# UNIT-IV

## FUNDS FLOW STATEMENT

### **Meaning of Funds Flow Statement**

Funds Flow Statement is a statement showing sources and uses of funds for a period of time.

### **Definition of Funds Flows Statement**

Foulke defines this statement as

“ A statement of sources and applications of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates.”

### **Uses of Funds Flow Statement**

#### **1. It helps in the analysis of financial Operations:**

The financial statements reveal the net effect of various transactions on the operational and financial position of a concern.

The balance sheet gives a static view of the resources of a business and the uses to which these resources have been put at a certain point of the time.

But it does not disclose the causes for changes in the assets and liabilities between two different points of time.

The funds flow statement explains causes for such changes and also effect of these changes on the liquidity position of the company.

Some times a concern may operate profitably and yet its cash position may become more and more worse.

The Funds Flow Statement gives a clear answer to such a situation explaining what has happened to the profits of the firm?

#### **2. It throws light on many Confusing Questions of general interest:**

Why were the net current assets lesser in spite of higher profits and vice-versa?

Why more dividends could not be declared in spit of available profits?

How was it possible to distribute more dividends than the present earnings?

What happened to the net profit? Where did they go?

What happened to the proceeds of sale of fixed assets or issue of shares, debentures etc.,?

What are the sources of repayment of debts?

How was the increase in working capital financed and how will it be financed in future?

#### **3. It helps in the formation of a realistic dividend policy:**

Sometimes a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquidity or cash resources.

In such cases, a funds flow statement helps in the formation of a realistic dividend policy.

#### **4. It helps in the proper allocation of resources:**

The resources of a concern are always limited and it wants to make the best use of these resources. A projected funds flow statement constructed for the future helps in making managerial decisions. The firm can plan the deployment/use of resources and allocate them among various applications.

#### **5. It acts as future guide:**

A projected funds flow statement also acts as a guide for future to the management. The management can come to know the various problems, it is going to face in near future for want of funds. The firm's future needs of funds can be projected well in advance and also the timing of these needs. The firm can arrange to finance these needs more effectively and avoid future problems.

#### **6. It helps in appraising the use of working capital:**

A funds flow statement helps in explaining how efficiently the management has used its working capital and also suggests ways to improve working capital position of the firm.

#### **7. It helps knowing overall Creditworthiness of a firm:**

The financial institutions and banks such as State Financial Institutions, Industrial Development Corporation, Industrial Finance Corporation of India, Industrial Development Bank of India etc., all ask for funds flow statement **constructed for a** number of years before granting loans to know the creditworthiness and paying capacity of the firm.

Hence a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

### **LIMITATIONS OF FUNDS FLOW STATEMENT**

1. It should be remembered that a funds flow statement is not a substitute of an income statement or a balance sheet. It provides only some information as regards changes in working capital.
2. It cannot reveal continuous changes.
3. It is not an original statement but simply an arrangement of data given in the financial Statements.
4. It is essentially historic in nature and projected funds flow statement cannot be prepared with much accuracy.
5. Changes in cash are more important and relevant for financial management than the working capital.

# CASH FLOW STATEMENT

## Meaning of Cash Flow Statement

Cash Flow Statement is a statement which describes the inflows(sources) and outflows(uses) of cash and cash equivalents in an enterprise during a specified period of time.

A Cash Flow Statement summarizes the causes of changes in the cash position of a business enterprise between two Balance Sheets.

## Advantages of Cash Flow Statement

1. Cash flow statement reveals the causes of changes in cash balances between two dates of balance sheets.
2. This statement helps the management to evaluate its ability to meet its obligations i.e., payments to creditors. The payment of bank loan, payment of interest, taxes, dividend etc.
3. It throws light on causes for poor liquidity in spite of good profits and excessive liquidity in spite of heavy losses.
4. It helps the management in understanding the past behavior of cash cycle and in controlling the use of cash in future.
5. Cash flow statement helps the management in planning repayment of loans, replacement of assets etc.
6. This statement is helpful in short-term financial decisions relating to liquidity.
7. This statement helps the management in preparing cash budgets properly.
8. This statement helps the financial institution who lend advances to business concerns in estimating their repaying capacities.
9. Cash flow statement helps in evaluating financial policies of the management.
10. Cash flow statement discloses the complete story of cash movement. The increase in, or decrease of cash and the reason therefore can be known.
11. Cash flow statement provides information of all activities such as operating, investing and financial activities.
12. Since cash flow statement provides information regarding the sources and utilizations of cash during a particular period. It is easy for the management to plan carefully for the cash requirements in the future, for the purpose of redeeming long-term liabilities or /and replacing some fixed assets.

## LIMITATIONS OF CASH FLOW STATEMENT

1. A cash flow statement only reveals the inflow and outflow of cash. The cash balance disclosed by the cash flow statement may not represent the real liquid position of the concern.
2. Cash flow statement is not suitable for judging the profitability of a firm as non-cash changes are ignored while calculating cash flows from operating activities.

3. Cash flow statement is not a substitute for income statement or funds flow statement. Each of them has separate function to perform.  
Net cash flow disclosed by cash flow statement does not necessarily show net income of the business, because net income is determined by taking into account both cash and non-cash items.
3. Cash flow statement is based on cash accounting. It ignores the basic accounting concept of accrual basis.
4. Cash flow statement reveals the movement of cash only. In preparation it ignores most liquid current assets like Sundry Debtors, Bills Receivables etc.,
5. It is difficult to precisely define the term cash. There are controversies among accountants over a number of near cash items like cheques, stamps, postal orders etc., to be included in cash.
7. Cash flow statement does not give a complete picture of financial position of the concern.

## **TYPES OF CAPITAL**

**1.Q. Define Capital. Explain its significance/ Importance.**

**Answer:**

**Capital forms the base for the business; in general, it does not mean only money.**

**It may refer to money's worth also.**

**Capital has different forms.**

**Creativity, innovation or new ideas can be considered as one form of capital.**

**Definition of capital:**

**Capital is defined as wealth, which is created over a period of time through abstinence/moderation to spend.**

**There are different forms of capital i.e., property, cash or titles to wealth.**

**It is the aggregate of funds used in the short-run and long run.**

**An economist views capital as the value of total assets available with the business.**

**Significance / Importance of Capital:**

**Capital plays very significant role in the modern production system.**

**It is very difficult to imagine the process of production without capital.**

**Capital creates and enhances the level of employment opportunities.**

**It has a strategic role in enhancing productivity.**

**Capital is necessary not only for micro-enterprises but also to the governments.**

**Capital is a scarce resource and every country has to utilise the same judiciously.**

**Need for Capital:**

1. **To promote a business:**

**Capital is required at the promotion stage.**



**A large variety of expenses have to be incurred on project reports, feasibility studies and reports, preparation and filing of various documents and for meeting various other expenses in connection with the raising of capital from the public.**

**2. To conduct business operations smoothly:**

**Business firms also need capital for the purpose of conducting their business operations such as research and development, advertising, sales promotion, distribution and operating expenses.**

**3. To expand and diversify:**

**The firm requires a lot of capital for expansion and diversification purposes.**

**This includes development expense such as purchase of sophisticated machinery and equipment and also payment towards sophisticated technology.**

**4. To meet contingencies:**

**A firm needs funds to meet contingencies such as a sudden fall in sales, major litigation (legal cases), natural calamities like fire and so on.**

**5. To pay taxes:**

**The firm has to meet its statutory commitments such as income tax and sales tax, excise duty and so on.**

**6. To pay Dividends and interests:**

**The business has to make payment towards dividends and its interests to shareholders and financial institutions respectively.**

**7. To replace the Assets:**

**The business needs to replace its assets like plant and machinery after a certain period of use.**

**For this purpose the firm needs funds to make suitable replacement of assets in place of old assets and worn-out assets.**

**8. To support welfare programmes:**

**The company may also have to take up social welfare programmes such as literacy drive and health camps.**

**It may have to donate to charitable trusts, educational institutions or public service organizations.**

**9. To Wind up:**

**At the time of winding up the company may need funds to meet the liquidation expenses.**

**Capital forms the base for the business; in general, it does not mean only money.**

**It may refer to money's worth also.**

**Capital has different forms.**

**Creativity, innovation or new ideas can be considered as one form of capital.**

**Definition of capital:**

**Capital is defined as wealth, which is created over a period of time through abstinence/moderation to spend.**

**There are different forms of capital i.e., property, cash or titles to wealth.**

**It is the aggregate of funds used in the short-run and long run.**

**An economist views capital as the value of total assets available with the business.**

Capital can broadly be divided into two types. They are I. Fixed Capital II. Working Capital.

**I. Fixed Capital:**

Fixed capital is that portion of capital which is invested in acquiring long-term assets such as land and buildings, plant and machinery, furniture and fixtures and so on.

Fixed capital forms the skeleton of the business.

It provides the basic assets as per the business needs.

These assets are not meant for resale.

**Types of Fixed Assets/ Capital:**

Fixed assets can be classified into three types.

**1. Tangible Fixed Assets:**

These are physically items which can be seen and touched.

Most of the common fixed assets are land, buildings, machinery, motor vehicles, furniture and so on.

**2. Intangible Fixed Assets:**

These do not have physical form.

They cannot be seen or touched.

But these are very valuable to the business.

Examples are goodwill, copy rights, patents and trademarks and so on.

**3. Financial Fixed Assets:**

These are investments in shares, foreign currency deposits, government bonds, sharewts held by the other companies and so on.

**II. Working Capital:**

Working capital is the flesh and blood of the business.

It is that portion of capital that makes a company work.

It is not just possible to carry on the business with only fixed assets. Working capital is must.

Working capital is also called circulating capital.

It is used to meet regular and recurring needs of the business.

The regular needs refer to the purchase of materials, payment of wages and salaries, expenses like rent, advertising, power and so on.

Working capital may be defined as the excess of current assets over current liabilities.

Current assets consist of cash in hand, cash at bank, sundry debtors, Bills receivables, closing stock, accrued income, prepaid expenses etc.

Current liabilities include creditors, bills payable, bank overdraft, outstanding expenses, income received in advance and short-term loans.

### **Types of Working Capital:**

Working capital can be classified into two types.

They are (1) Gross Working Capital (2) Net Working Capital.

**(1) Gross Working Capital:**

Gross Working capital is also known as working capital means total current assets.

**(2) Net Working Capital:**

Net working capital may be presented in two ways.

They are i) It is commonly known as excess of current assets over current liabilities.

ii) Net working capital is that portion of current assets which is financed with long term funds.

The ultimate objective of the working capital management is to maintain optimum level of net working capital so that effective balance between liquidity and profitability can be maintained.

### **Kinds of Share capital:**

The share capital of a company has different names at different stages:

They are 1. Authorised Capital

2. Issued Capital

3. Subscribed Capital

4. Called-up Capital

5. Uncalled Capital

6. Paid-up Capital

7. Reserve Capital

**1. Authorised Capital:**

This represents the amount of capital set out in the Memorandum on the basis of which the company has been registered.

It is the limit up to which the company can raise capital.

It is also known as Nominal capital or Registered capital.

**2. Issued Capital:**

This represent the nominal value of that part of the authorized capital which is (i) offered to public for subscription (ii) allotted for consideration other than cash (iii) subscribed by the signatories to the Memorandum and (iv) shares acquired by directors as qualification shares.

**3. Subscribed Capital:**

This represents the nominal value of the shares subscribed or agreed to be subscribed out of issued capital.

**4. Called-up Capital:**

**This represents that part of the subscribed capital which the shareholders have been called upon by the company to pay.**

**5. Uncalled Capital:**

**This is the uncalled portion of the subscribed capital and represents a contingent liability of the shareholders.**

**6. Paid-up Capital:**

**This represents that portion of the called-up capital that has actually been paid-up by the shareholders.**

**The paid-up capital includes the paid-up value of the shares issued to vendors, directors etc. Some of the shareholders may fail to pay to sum due from them when a call has been made.**

**The amount so owing is known as “Calls-in-arrear”. So called-up capital less calls-in-arrear represents paid-up capital.**

**7. Reserve Capital:**

**A company may by special resolution, determine that any portion of its uncalled capital shall not be capable of being called-up, except in the event of and or the purpose of the company being wound up.**

**The uncalled capital so earmarked is known as “Reserve Capital”.(Section 99)**

**Reserve capital is quite distinct from capital reserve which represents a reserve created out of profits of capital nature.**

Capital is defined as wealth, which is created over a period of time through abstinence to spend. There are different forms of capital property, cash or titles to wealth. It is the aggregate of funds used in the short run and long run. An economist views capital as the value total assets available with the business. An accountant sees the capital as the different between the assets and liabilities.

## **Significance of capital**

1. To promote a business: capital is required at the promotion stage. A large variety of expenses have to be incurred on project reports, feasibility studies and reports, preparation and filing of various documents, and for meeting various other expenses in connection with the raising of capital from the public.
2. To conduct business operations smoothly: business firms also need capital for the purpose of conducting their business operations such as research and development, advertising, sales promotion, distribution and operation expenses.
3. To expand and diversify: the firm requires a lot of capital for expansion and diversification purposes. This includes development expense such as purchase of sophisticated machinery and equipment and also payment towards sophisticated technology.
4. To meet contingencies: a firm needs funds to meet contingencies such as sudden fall in sales, major litigation, nature calamities like fire, and so on.
5. To pay taxes: the firm has to meet its statutory commitments such as income tax and sales tax, excise duty and so on.

6. To pay dividends and interests: the business has to make payment towards dividends and its interest to shareholders and financial institutions respectively.
7. To replace the assets: the business needs to replace its assets like plant and machinery after a certain period of use. For this purpose the firm needs funds to make suitable replacement of assets in place of old and worn out assets.
8. To support welfare programmes: the company may also have to take up social welfare programmes such as literacy drive, and health camps, It may have to donate to charitable trusts, educational institutions or public services organizations.
9. To wind up: at the time of winding up, the company may need funds to meet liquidation expenses

### **Types of capital**

- A) Fixed capital
- B) Working capital

### **FIXED CAPITAL**

Fixed capital is that portion of capital which invested in acquiring long term assets such as land and buildings, plant and machinery, furniture and fixtures, and so on, fixed capital forms the skeleton of the business. It provides the basic assets as per the business needs.

#### **Features of fixed assets:**

1. **Permanent in nature:** fixed capital is more or less permanent in nature, it is generally not withdrawn as long as the business carries on its business.
2. **Profit generation:** fixed asset are the sources of profits but they can never generate profits by themselves. They use stocks, cash and debtors to generate profits.
3. **Low liquidity:** the fixed assets cannot be converted into cash quickly. Liquidity refers to conversion of assets into cash.
4. **Amount of fixed capital :** the amount of fixed capital of a company depends on a number of factors such as size of the company, nature of business, method of production and so on. A manufacturing company such as steel factory may require relatively large finance when compared to a service organization such as a software company.
5. **Utilized for promotional and expansion:** the fixed capital is mostly needed at the time of promoting the company to purchase the fixed assets or at the time of expansion. In other words, the need for fixed capital arises less frequently.

#### **Types of fixed assets**

1. **Tangible fixed assets :** these are physical items which can be seen and touched. Most of the common fixed assets are land, buildings, machinery, motor vehicles, furniture and so on.
2. **Intangible fixed assets :** these do not have physical form. They cannot be seen or touched. But these are very valuable to business. Examples are goodwill, brand names, trademarks, patents, copy rights and so on.

3. **Financial fixed assets** : these are investments in shares, foreign currency deposits, government bonds , shares held by the business in other companies and so on.

## **WORKING CAPITAL**

Working capital is the flesh and blood of the business. It is that portion of capital that makes a company work. It is not just possible to carry on the business with only fixed assets. Working capital is a must, working capital is also called circulating capital. It is used to meet regular or recurring needs of the business. The regular needs refer to the purchase of materials, payment of wages and salaries, expenses like rent, advertising, power and so on. In short , working capital is the amounts needed to cover the cost of operating the business.

## **DEFINITION OF WORKING CAPITAL**

**Working capital define as a current assets excess of current liabilities**

Its also define in mathematically formula as

**working capital = current assets – current liabilities**

## **FEATURES OF WORKING CAPITAL**

1. Short life span: working capital changes in its form cash to stock, stock to debtors, debtors to cash, the cash balances may be kept idle for a week or so, debtors have a life span of a few months , raw materials are held for a short – time until they go into production, finished goods as held for a short – time until they are sold.
2. Smoothly flow of operations: adequate amount of working capital enables the business to conduct its operations smoothly. It is there fore, called the flesh and blood of the business.
3. Liquidity: the assets represented by the working capital can be converted into cash quickly within a short period of time unlike fixed assets.
4. Amount of working capital: the amount of working capital of a business depends on many factors such as size and nature of the business, production and marketing policies, business cycles and so on.
5. Utilized for payment of current expenses: the working capital is used to pay for current expenses such as suppliers of raw materials, payment of wages and salaries, rent and other expenses and so on.

### **Components of working capital:**

**Current assets:** current assets are those assets which are converted into cash with in accounting period or within the year. For example, cash in hand, cash at bank, sundry debtor, bill receivable, prepaid expenses etc.

**Current liabilities:** current liabilities are those liabilities to pay outside with in the year. For example sundry creditor, bill payable, bank overdraft, outstanding expenses.

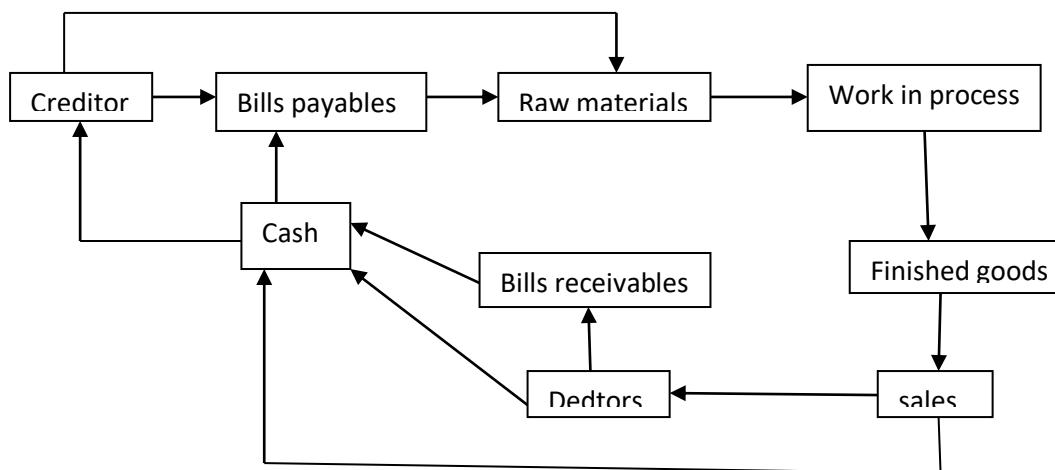
### **Gross working capital:**

In the broader sense, the term working capital refers to the gross working capital. The notion of the gross working capital refers to the capital invested in total current assets of the enterprise. Current assets are those assets, which in the ordinary course of business, can be converted into cash within a short period, normally one accounting year.

### Net working capital:

In a narrow sense, the term working capital refers to the net working capital. Networking capital represents the excess of current assets over current liabilities.

### WORKING CAPITAL CYCLE



### Factors determining the working capital requirements

1. **Nature or character of business**: The working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like electricity, water supply and railways need very limited working capital as their sales are on cash and are engaged in provision of services only. On the other hand, trading firms require more investment in inventories, receivables and cash and such they need large amount of working capital. The manufacturing undertakings also require sizable working capital.
2. **Size of business or scale of operations**: The working capital requirements of a concern are directly influenced by the size of its business, which may be measured in terms of scale of operations. Greater the size of a business unit, generally, larger will be the requirements of working capital. However, in some cases, even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantages of small size.
3. **Production policy**: If the demand for a given product is subject to wide fluctuations due to seasonal variations, the requirements of working capital, in such cases, depend upon the production policy. The production could be kept either steady by accumulating inventories during stack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak season. If the policy is to keep the production steady by accumulating inventories it will require higher working capital.

4. **Manufacturing process/Length of production cycle:** In manufacturing business, the requirements of working capital will be in direct proportion to the length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required, as the raw materials and other supplies have to be carried for a longer period.
5. **Seasonal variations:** If the raw material availability is seasonal, they have to be bought in bulk during the season to ensure an uninterrupted material for the production. A huge amount is, thus, blocked in the form of material, inventories during such season, which give rise to more working capital requirements. Generally, during the busy season, a firm requires larger working capital than in the slack season.
6. **Working capital cycle:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work-in progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash. This cycle continues again from cash to purchase of raw materials and so on. In general the longer the operating cycle, the larger the requirement of working capital.
7. **Credit policy:** The credit policy of a concern in its dealings with debtors and creditors influences considerably the requirements of working capital. A concern that purchases its requirements on credit requires lesser amount of working capital compared to the firm, which buys on cash. On the other hand, a concern allowing credit to its customers shall need larger amount of working capital compared to a firm selling only on cash.
8. **Business cycles:** Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom, i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales. On the contrary, in the times of depression, i.e., when there is a down swing of the cycle, the business contracts, sales decline, difficulties are faced in collection from debtors and firms may have to hold large amount of working capital.
9. **Rate of growth of business:** The working capital requirements of a concern increase with the growth and expansion of its business activities. The retained profits may provide for a part of working capital but the fast growing concerns need larger amount of working capital than the amount of undistributed profits.



## **UNIT-V**

# **FINANCIAL ANALYSIS-II**

## **RATIO ANALYSIS**

Alexander Wall is considered to be the pioneer of Ratio Analysis. He presented the detailed system of Ratio Analysis in 1909 and explained its usefulness in financial analysis.

Ratio Analysis is most widely used powerful tool of financial analysis. It is an important technique of analysis and interpretation of financial statements. It is also used to analyze various aspects of operational efficiency and degree of profitability.

Ratio Analysis is based on different ratios which are calculated from the accounting information contained in the financial statements. Different ratios are used for different purposes.

### **Meaning of Ratio**

Ratio is a figure expressed in terms of another.

It is an expression of relationship between one figure, two figures and the other figures which are mutually inter-dependent.

In other words a ratio is a mathematical relationship between two items expressed in a quantitative form. When ratio is explained with reference to the items shown in the financial statements.

It is called as an Accounting Ratio.

The ratio analysis facilitates easy understanding of financial statements.

### **ADVANTAGES OF RATIO ANALYSIS**

Ratio Analysis is an important technique of financial analysis.

It is used as a device to analyze and interpret the financial health of enterprises. Its usefulness is not only confined to business managers but also extends to various interested parties like government, creditors, employees, investors, consumers etc.

#### **1. Helps in Decision making:**

Though Financial Statements provide necessary data for decision making. It is not possible to take appropriate decisions merely on the basis of each data. Ratio Analysis provides a meaningful analysis and interpretation to the data contained in Financial Statements. This ratio analysis facilitates the managers to take correct decisions.

## **2. Helps in Financial Forecasting and Planning**

Ratios calculated for a number of years reveal the trends in the phenomenon. As such, it is possible to make predictions for a future period. Thus, ratio analysis helps in financial forecasting and planning

## **3. Helps in assessing the operational efficiency:**

Ratio Analysis helps in analyzing the strengths and weaknesses of a concern. It helps in diagnosing the financial health of a concern in terms of liquidity, solvency, profitability etc

## **4. Helps in controlling business:**

With the help of ratio analysis, it is possible to identify the weak spots with regard to the performance of the managers. Weakness in financial structure due to incorrect policies in the past and present is revealed by the ratios. These weaknesses may be communicated to the people concerned and as such ratio analysis helps in better communication, Coordination and control of unfavourable situations.

## **5. Helps in comparison of performance:**

Through accounting ratios comparison can be made between one departments of a firm with another of the same firm in order to evaluate the performance of various departments in the firm. This is needed for the smooth functioning of the departments.

6. Ratio analysis simplifies the complex financial data. It reveal the change in the financial position.
7. Ratio analysis may be used as instruments of management control, particularly in the area of sales and control.
8. Ratios facilitate the function of communication and enhance the value of financial statements.
9. Ratios are helpful in assessing the financial position and profitability of a concern.
10. Ratio Analysis also helps in effective control of business – measuring performance, control of costs etc., Effective control is a keystone of better management.
11. Ratio analysis helps the investors in making investment decisions to make a profitable Investment.

## **LIMITATIONS OF RATIO ANALYSIS:**

### **1. Limited use of a Single Ratio:**

A single ratio does not convey meaningful message. As such, a number of ratios will have to be calculated for a better understanding of particular situation.

Thus, a series of ratios computed may create confusion.

Ratios can be useful only when they are computed in a sufficient large number.

calculation of more ratios sometimes confuses the analysts than help him.

## **2. Lack of Adequate Standards:**

Expecting a few situations, in majority cases, universally accepted standards for ratios are not available. It renders interpretation of ratios difficult.

## **3. Lack of comparability:**

The results of two firms are comparable with the help of accounting ratios only if they follow the same accounting methods. Comparison becomes difficult if they follow different methods. Similarly, utilization of facilities, availability of facilities and scale of operation affects the Financial Statements of different firms. Comparison of such firms would be misleading.

## **4. Inherent Limitations of Accounting:**

Accounting records contain historical data. As such, ratios based on data drawn from accounting records also suffer from the inherent weaknesses of accounting records. Thus, accounting ratios of the past may not be true indicators of the future.

## **5. Changes in Accounting Procedures:**

Change in accounting procedure by a firm often makes ratio analysis misleading. E.g., a change in the valuation of methods of inventories from FIFO to LIFO increases the cost of sales and reduces the value of the closing stock which makes inventory turnover ratio to be impressive and an unfavorable gross profit ratio.

## **6. Window Dressing:**

Financial statements easily be window dressed to present a better picture of its financial and profitability position to outsiders. Hence, one has to be very careful in making a decision from ratios calculated from such Financial Statements. However, it may be difficult for an outsider to learn about the window dressing made by a firm.

## **7. Price-Level Changes:**

Since ratios are computed for historical data, no consideration is made to the changes in price levels and this makes the interpretation of ratios invalid.

## **8. Personal Bias:**

Ratios are only means of financial analysis and not an end in itself. They have to be interpreted and different people may interpret the same ratio in different ways.

## **9. Ignoring qualitative factors:**

Ratio analysis ignores the qualitative factors which generally influence the conclusions derived.

## **10. Reliability of data:**

The accuracy and correctness of ratios are totally dependent upon reliability of data contained in financial statements. If there are any mistakes or omissions in the financial statements, ratio analysis presents a wrong picture about the concern.

## **Classification of Ratios:**

I. Classification according to the nature of accounting statement from which the ratios are derived into three categories.

They are

1. Balance sheet Ratios
2. Profit and Loss Account Ratios
3. Combined or Composite Ratios

### **1. BALANCE SHEET RATIOS:**

These ratios deal with the relationship between two items appearing in the Balance sheet. Eg. Current Ratio, Liquid Ratio, Debt to Equity Ratio.

### **2. PROFIT AND LOSS ACCOUNT RATIOS:**

This type of ratios show the relationship between two items which are in the profit and loss account itself. Eg. Gross Profit Ratios, Net Profit Ratios and Operating Ratios.

### **3. COMBINED OR COMPOSITE RATIOS:**

These ratios show the relationship between items one of which is taken from profit and loss account and the other from the balance sheet.

Eg. Rate of Return on capital Employed, Debtors Turnover Ratio, creditors turnover ratio, stock/ inventory turnover ratio and capital turnover ratio etc.

## **II. CLASSIFICATION FROM POINT OF VIEW OF FINANCIAL MANAGEMENT OR OBJECTIVE.**

Ratios may be classified into four categories. They are

1. Liquidity Ratios
2. capital structure/ gearing Ratios.(Leverage / Solvency Ratios)
3. Turnover Ratios
4. Profitability Ratios +

**Current ratio:**

The current ratio is also called the working capital ratio, as working capital is the difference between current assets and current liabilities. This ratio measures the ability of a company to pay its current obligations using current assets. The current ratio is calculated by dividing current assets by current liabilities

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

This ratio indicates the company has more current assets than current liabilities. Different industries have different levels of expected liquidity. Whether the ratio is considered adequate coverage depends on the type of business, the components of its current assets, and the ability of the company to generate cash from its receivables and by selling inventory.

**Acid-test ratio / Quick ratio:**

The acid-test ratio is also called the quick ratio. Quick assets are defined as cash, marketable (or short-term) securities, and accounts receivable and notes receivable, net of the allowances for doubtful accounts. These assets are considered to be very liquid (easy to obtain cash from the assets) and therefore, available for immediate use to pay obligations. The acid-test ratio is calculated by dividing quick assets by current liabilities.

$$\text{Acid test ratio} = \text{Quick Assets} / \text{Current Liabilities}$$

The traditional rule of thumb for this ratio has been 1:1. Anything below this level requires further analysis of receivables to understand how often the company turns them into cash. It may also indicate the company needs to establish a line of credit with a financial institution to ensure the company has access to cash when it needs to pay its obligations.

**Inventory turnover ratio:**

The inventory turnover ratio measures the number of times the company sells its inventory during the period. It is calculated by dividing the cost of goods sold by average inventory. Average inventory is calculated by adding beginning inventory and ending inventory and dividing by 2. If the company is cyclical, an average calculated on a reasonable basis for the company's operations should be used such as monthly or qtrly.

$$\text{Inventory turnover ratio} = \text{Cost of goods sold} / \text{Average inventory}$$

**Profitability ratios**

Profitability ratios measure a company's operating efficiency, including its ability to generate income and therefore, cash flow. Cash flow affects the company's ability to obtain debt and equity financing.

**Profit margin:**

The profit margin ratio, also known as the operating performance ratio, measures the company's ability to turn its sales into net income. To evaluate the profit margin, it must be compared to competitors and industry statistics. It is calculated by dividing net income by net sales.

$$\text{Profit margin} = \text{Net income} / \text{Net sales}$$

**Earnings per share:**

An earnings per share (EPS) represents the net income earned for each share of outstanding common stock. In a simple capital structure, it is calculated by dividing net income by the number of weighted average common shares outstanding.

$$\text{Earnings per share} = \text{Net Income} / \text{Weighted average common shares outstanding.}$$

**Price-earnings ratio:**

The price-earnings ratio (P/E) is quoted in the financial press daily. It represents the investors' expectations for the stock. A P/E ratio greater than 15 has historically been considered high.

$$\text{Price Earnings ratio} = \text{Market price per common share} / \text{Earnings per share.}$$

**Solvency ratios**

Solvency ratios are used to measure long-term risk and are of interest to long-term creditors and stockholders.

**Debt to total assets ratio:**

The debt to total assets ratio calculates the percent of assets provided by creditors. It is calculated by dividing total debt by total assets. Total debt is the same as the total liabilities.

$$\text{Debts to total assets ratio} = \text{Total Debts} / \text{Total Assets.}$$

## UNIT-V

### FINANCIAL STATEMENT ANALYSIS-II

#### FINANCIAL STATEMENTS

Though financial statements are relevant and useful for the concern, still they do not present a final picture of the concern.

The utility of these statements is dependent upon a number of factors.

The analysis and interpretation of these statements should be done very carefully otherwise misleading conclusions may be drawn.

#### IMPORTANCE OF FINANCIAL STATEMENTS

The financial statements are mirrors which reflect the financial position and operating strength or weakness of the concern. These statements are useful to management, investors, creditors, Bankers, workers, government and public at large. George O May points out the following major uses of financial statements.

1. As a report of stewardship.
2. As a basis for fiscal policy.
3. To determine the legality of dividends.
4. As guide to advise dividend action.
5. As a basis for the granting of credit.
6. As informative for prospective investors in an enterprise.
7. As a guide to the value of investment already made.
8. As an aid to the government supervision.
9. As a basis for price or rate regulation.
10. As a basis for taxation.
11. The utility of financial statements to different parties is discussed in detail as follows:

#### 1. MANAGEMENT:

- The financial statements are useful for assessing the efficiency for different cost centre's.
- The management is able to exercise cost control through these statements.
- The efficient and inefficient spots are brought to the notice of the management.
- The management is able to decide the course of action to be adopted in future.

#### 2. CREDITORS:

- The trade creditors are to be paid in a short period.

- This liability is met out current assets.
- The creditors will be interested in current solvency of the concern.
- The calculation of current ratio and liquid ratio will enable the creditors to assess the current financial position of the concern in relation to their debts.

### 3. BANKERS:

- The banker is interested to see that the loan amount is secure and customer is also able to pay the interest regularly.
- The banker will analyse the balance sheet to determine financial strength of the concern and profit and loss amount will be studied to find out the earning position of the business concern.
- A banker has a large number of customers and it is not possible to supervise their business activity.
- It is through the financial statements that a banker can keep a watch on the business plans and performances of its customers.
- These statements also help the banker to determine the amount of securities it will ask from the customers as a cover of the loans.

### 4. INVESTORS:

- The investors include both short-term and long-term investors.
- They are interested in the security of the principal amount of loan and regular interest payments by the concern.
- The investors will study the long term solvency of the concern with the help of financial statements.
- The investors will not only analyse the present financial position but will also study future prospects and expansion plans of the concern.
- The possibility of paying back the loan amount in the face of liquidation of the concern is also taken into consideration.

### 5. GOVERNMENT:

- The financial statements are used to assess tax liability of business enterprise.
- The government studies economic situation of the country from these statements.
- These statements enable the government to find out whether the business is following various rules and regulations or not .
- These statements also become a base for framing and amending various laws for the regulation of the business.

### 6. TRADE ASSOCIATIONS:

These associations provide service and protection to the members. They may analyse the financial statements for the purpose of providing facilities to these members. They may develop standard ratios and design uniform system of accounting.



## . 7. STOCK EXCHANGE:

- The stock exchange deal in purchase and sale of securities of different companies.
- The financial statements enable the stock brokers to judge the financial position of different concerns.
- The fixation of prices of securities etc., is also based on these statements..

## LIMITATIONS OF FINANCIAL STATEMENTS

### 1. Only Interim Reports:

These statements do not give a final picture of the concern. The data given in the statements is only approximate. The actual position can only be determined when the business is sold or liquidated. However, the statements have to be prepared for different accounting periods, generally one year, during the life time of the concern. The costs and incomes be apportioned to different periods with a view to determine profits etc. the allocation of expenses and incomes will depend upon the personal judgment of the account. The existence of contingent assets and liabilities also makes the statements imprecise. So financial statements do not give the final picture and they are at the most interim reports.

### 2. Do not give Exact Position:

The financial statements are expressed in monetary values. So, they appear to give final and accurate position. The value of fixed assets in the balance sheet neither represents the value for which fixed assets can be sold nor the amount which will be required to replace these assets. The balance sheet is prepared on the presumption of a going concern. The concern is expected to continue in the future. So fixed assets are shown at cost less accumulated depreciation. There are certain assets in the balance sheet such as preliminary expenses, goodwill and discount on issue of shares which will realize nothing at the time of liquidation though they are shown in the balance sheet.

### 3. Historical Costs:

The financial statements are prepared on the basis of historical costs or original costs. The value of assets decreases with the passage of time current price changes are not taken into account. The statements are not prepared keeping in view the present economic conditions. The balance sheet loses the significance of being an index of current economic realities. Similarly, the profitability shown by the income statement may not represent the earning capacity of the concern. The increase in profits may be due to an increase in prices or due to some abnormal causes and not due to increase in efficiency. The conclusion drawn from financial statements may not give a fair picture of the concern.

### 4. Impact of Non-Monetary Factors Ignored:

There are certain factors which have a bearing on the financial position and operating results of the business but they do not become a part of these statements because they cannot be measured in monetary terms.

Such factors may include the reputation of the management, credit worthiness of the concern, sources and commitments for purchases and sales, co-operation of the employees, etc. The

financial statements only show the position of the financial accounting for business and not the financial position.

#### 5. No Precision:

- The precision of financial statement data is not possible because the statements deal with matters which cannot be precisely stated.
- The data are recorded by conventional procedures followed over the year. Various conventions, postulates, personal judgements etc., are used for developing the data.

## FINANCIAL STATEMENT ANALYSIS

Financial statements represent a formal record of financial activities of an entity. These are written reports that qualify the financial strength, performance and liquidity of a company. Financial statements reflect the financial effects of business transactions and events on the entity.

### Types of Financial Statements :

The four types of financial statements are

1. Statement of Financial Position
2. Income Statement.
3. Cash flow statement.
4. Statement of changes in Equity.

### 1. Statement of Financial Position

Statement of Financial Position is also known as the Balance sheet , presents the financial position of an entity at a given date. It is comprised of the following three elements.

- i) **Assets:** Something a business owns or controls (e.g. cash, inventories, plant and machinery)
- ii) **Liabilities:** something a business owes to someone (e.g. creditors, bank loans etc.)
- iii) **Equity:** what the business owes to its owners. This represents the amount of capital that remains in the business after its assets are used to pay off its outstanding liabilities. Equity therefore represents the difference between the assets and liabilities.

### 2. Income Statement:

Income statement also known as Profit and Loss statement , reports the company's financial performance in terms of net profit or net loss over a specified period.

Income statement is composed of the following two elements:

- i) **Income:** what the business has earned over a period (e.g. sales, revenue, dividend income etc.)
- ii) **Expenditure:** the cost of incurred by the business over a period (e.g. salaries, wages, depreciation, rent etc.)

3. **Cash Flow Statement:** cash flow statement presents the movement in cash and bank balances over a period of a business. The movement in cash flow is classified into the following segments:
  - i) Operating Activities: Represents the cash flow from primary activities of a business.
  - ii) Investing Activities: Represents cash flow from the purchase and sale of assets other than inventories.(e.g. PURCHASE OF A FACTORY PLANT)
  - iii) Financing Activities: Represents cash generated or spent on raising and repaying share capital and debt together with the payments of interest and dividends.
  
4. **Statement of Change In Equity:** Statement of change in equity also known as the statement of retained earnings, details the movement in owners equity over a period. The movement in owners equity is derived from the following components:
  - i) Net profit or net loss during the period as reported in the income statement.
  - ii) Share capital issued or repaid during the period.
  - iii) Dividend payments
  - iv) Gains or losses recognized directly in equity(e.g. revaluation surpluses)
  - v) Effects of a change in accounting policy or correction of accounting error.

### **METHODS OF TECHNIQUES OF FINANCIAL STATEMENT ANALYSIS:**

Financial statement analysis can be performed by a number of methods or techniques. The following are the important methods or techniques of financial statement analysis:

1. **Ratio Analysis:** ratio analysis is the analysis of the interrelationship between any two financial figures.
2. **Cash Flow Statement Analysis:** cash flow analysis is the analysis of the change in the cash position during a period.
3. **Comparative Financial Statements:** comparative financial statement is a analysis of financial statements of the company for two years or of the two companies of similar types.
4. **Trend Analysis:** Trend analysis is the analysis of the trend of the financial ratios of the company over the years.

The methods to be selected for the analysis depend upon the circumstances and the users need. The user or the analyst should use appropriate methods to derive required information to fulfil their needs.

### **HORIZONTAL ANALYSIS:**

This analysis refers to the study of past consecutive balance sheets, income statements or statements of cash flow at a time. The analysis can be made between two periods or over a series of periods. The relevant accounting number

of columns each represents a year. Those figures can also be graphically presented. The figures of each year are compared with those of base year i.e., the beginning year of the study. This analysis is also called Dynamic Analysis as it covers several years of the study. This analysis is very much effective for understanding the direction and trend of the organization particularly when it is undertaken for several years. Comparative statements and trend analysis are two important tools that can be employed for horizontal analysis.

### **VERTICAL ANALYSIS:**

Vertical Analysis is restricted to the financial statements of one particular period only. It is known as vertical analysis of financial statements. In this analysis each item of a particular financial statement is expressed as percentage of a base figure selected from the same statement. It is also known as Static Analysis as it concentrates solely on one year's financial statement. Common-size statements and accounting ratios are two important tools used for vertical analysis. This analysis is very much useful for understanding the structural relationship of various items in a financial statement. Vertical analysis can also be done for studying the relationship within a set of financial statements at a point of time.

## **ACCOUNTING STANDARDS**

The need for accounting standards arise on account of fast changes in socio economic environment at global level necessitating to have uniform accounting practices so that the final statements give comparable and decision useful information to the users.

### **The specific reasons for the need of accounting standards include the following:**

1. Varied accounting practices at local, regional levels gave rise to preparation of financial statements not projecting true and fair view of financial position.
2. After industrial revolution and formation of company form of organizations the size of business transaction has grown enormously.
3. The financial reports prepared by the corporation undertakings are open to the public apart from owners.
4. Now almost all countries are shifting from controlled economies to liberalized economies. This has resulted into free flow of goods, services and finance and led to establishment of multinational corporations all over the world.
5. Economic liberalization brought heavy competition among business organizations. Survival and success of these organizations depend on timely and appropriate decisions and their effective execution. This is possible when accurate, reliable and comparable timely information is provided to the executives. Information prepared on the basis of accepted accounting practices help the executives in this direction.

## **Features of Accounting Standards:**

1. Accounting standards aims at producing a set of fairly presented financial statements.
2. A standard is an argued criterion of what is proper practice in a given situation.
3. A preferred accounting treatment from the available set of methods of treating one or more accounting problems.
4. Accounting standards are uniform rules for financial reporting applicable to either all or certain class of entity.
5. Accounting standards are written statements issued from time to time by institutions of accounting profession in the form of policy document.
6. They are relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.
7. They are expected to be expressive of the deliberately chosen policies of the highest types of businessmen and the most experienced accountants.
8. Standards are not designed to conform practice with the rigid limits but rather to serve as guideposts to truth, honesty and fair dealing.
9. Standards act as basis for comparison and judgement.
10. They direct a high but attainable level of performance without precluding justifiable departures and variations in the procedures employed.

## **Standard setting process in India:**

The Institute of Chartered Accounts of India constituted Accounting Standards Board (ASB) in India in April 1977, keeping in view the need for harmonizing diverse Accounting practices and developments at international level in the field of accounting.

## **Indian Accounting Standards:**

The Institute of Chartered Accountants of India constituted the Accounting Standard Board on 21<sup>st</sup> April 1977. It recognized the need to harmonies the diverse accounting policies and practices at present in use in India and also to fall in lane with the developments in the field of accounting at International level. The main function of Accounting Standard Board of India is to develop accounting standards so that they may be established by the Council of the Institute and to ensure that the established standards are accepted and adopted by the concerned parties in the preparation and presentation of financial statements.

So far the Accounting Standards Board finalized and submitted to the council of Institute of Chartered Accountants of India , 10 Accounting Standards.

AS 1: Disclosure of Accounting Policies.

AS 2: Valuation and Presentation of Inventories.

AS 3: Change in Financial Position.

AS 4: Contingencies and Events occurring after the Balance Sheet.

AS 5: Prior Period and Extra ordinary terms.

AS 6: Depreciation Accounting.

AS 7: Accounting for constitution contracts.

AS 8: Accounting for Research and Development.

AS 9: Revenue Recognition and

AS 10: Account for Fixed Assets.

### **INTERNATIONAL FINANCIAL REPORTING:**

These are formulated by international accounting standards board. This board company of accountants and other interested parties from different countries. U.S. does not follow IFRS but there is pressure on SEC to do so.

### **US-GAAP STANDARDS:**

Generally Accepted Accounting Standards refers to the concepts , conventions or rules practiced in Accounting.

These principles are decided by regulatory agencies or professional associations. In India the accounting standards are set up by the private sector. Which has close ties with the accounting profession?

### **FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)**

The FASB is responsible for GAAP in the U.S. The FASB (estd in 1973) consists of 7 full time paid members who are mainly investors, managers, accountants and analysts. It is funded by various professional accounting associations such as the American Institute of Certified Public Accountant (AICPA). Standards are set up by FASB through a political procedure with participation by financial statement users. Therefore, standards may sometimes compromise solutions. Securities and Exchange Commission (SEC). Is an independent quasi judicial agency that administers the securities Act of 1933 and 1934 (disclosures related to public security offering)

### **FUNCTIONS OF SEC:**

1. To Regulate Information disclosure by companies with publicly traded securities.
2. Monitor and ensure conformance with accepted practices.
3. SEC can override, modify or introduce accounting , reporting and disclosure requirements by FASB.
4. SEC involvement in accounting practice is determined by current public attitude and aggressiveness of its chief accountant.

### **US-GAAP Objectives:**

1. The main objective of US-GAAP is to prepare, present and report the financial instruments in such a way that it should be useful to the potential investors and creditors in making investments.
2. The financial information should provide details of economic resources and change in them.

### **FOUNDAMENTAL QUALITIES OF FINANCIAL STATEMENTS:**

1. The financial information provided must reflect measurable and comparable financial statements between different companies.
2. The financial information should help creditors to make decision for future.
3. It should be neutral timely available and more importantly reliable to the potential investors.

### **ASSUMPTIONS OF US-GAAP:**

1. The business units of partnerships and sole trading proprietorship are separate from legal entities.
2. It also implies the going concern concept as the business prolongs for a long time.
3. It also assumes that the business operations can be separated into months Quarter's and years requiring for the comparison between past and present events.

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) RULE 203 of AICPA** code of professional ethics states that no departures can be regarded as GAAP unless the member can demonstrate that due to unusual circumstances the financial statements would be misleading.

Such departments are rare and if they do exist, the report must describe the reasons for making it. In 1959 AICAP established Accounting Principles Board (APB) to make overall conceptual framework.