UNIT I

ACCOUNTING CONCEPT: Introduction, Techniques and Conventions, Financial Statements- Understanding & Interpreting Financial Statements. **Company Accounts And Annual Reports**- Audit Reports and Statutory Requirements, Directors Report, Notes to Accounts, Pitfalls

Introduction to Accounting

Business entities and other organisations carry on activities which involve exchange of money or money's worth or economic resources. Where the volume of these activities are large in number it is necessary that these are recorded for the purpose of taking important decisions as to whether the activities are viable, gainful and are to be continued or not. Accountancy provides the basic theory, principles and methods to be followed to account for all financial activities taking place in an organisation. Accounting the financial activities in a systematic way helps in ascertaining the efficiency of performance of these activities and provides data about the state of affairs of the organisation for further analysis and planning.

Evolution of Accounting

In India, 23 centuries ago, Chandragupta Maurya's Minister Kautilya wrote a book named 'Arthashastra', wherein some references can be traced regarding the way of maintaining accounting records

In the earliest days of civilisation, accounting was done by stewards The stewardship accounting is said to be the root of accounting. Records of debit and credit were found in the 12th century itself.

In 1494, Luca Pacioli an Italian developed double-entry book-keeping system. Due to the industrial revolution in the 18th and 19th centuries, large scale operations were carried on and joint stock companies emerged as an important form of organisation which required separation of ownership from management.

In the 20th century, the need for analysis of financial information for managerial decision making caused emergence of Management Accounting as a separate branch of accounting

Though accounting was individual centric in the initial stage of evolution of accounting, it has gradually developed into Social Responsibility Accounting in the 21st century, due to the vast growth in business activities as a result of development in various fields.

Meaning and Definition of Accounting

Accounting is the systematic process of identifying, measuring, recording, classifying, summarising, interpreting and communicating financial information. Accounting gives information on:

(i) the resources available

(ii) how the available resources have been employed and

(iii) the results achieved by their use.

The profit earned or loss incurred during the accounting period, value and nature of assets, liabilities and capital can be ascertained from the information recorded in accounts.

American Institute of Certified Public Accountants "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are in part, at least of a financial character and interpreting the results thereof".

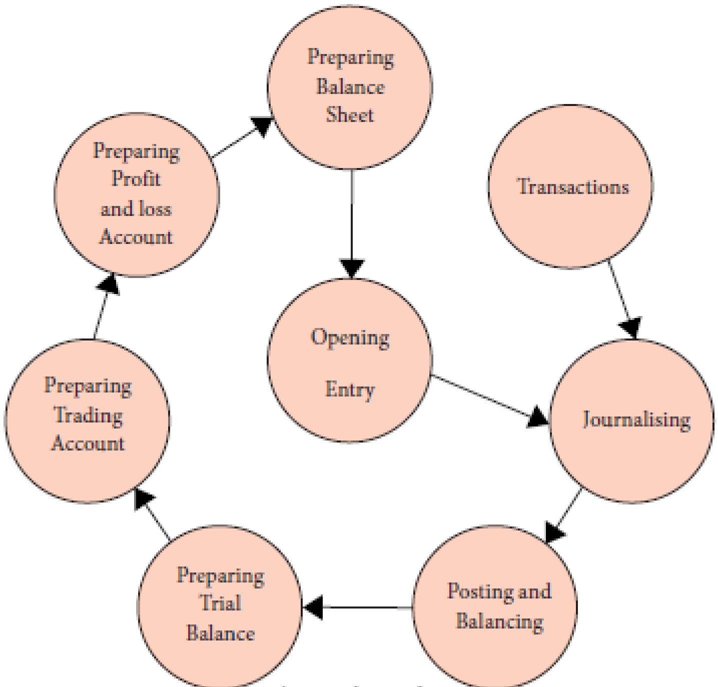
American Accounting Association has defined accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information"Thus, accounting has become inevitable in the modern world for business.

Accounting cycle

Accounting cycle is the sequence of steps involved in the accounting process. Accounting cycle starts with the identification and recording of financial transactions of an organisation and ends with the preparation of final accounts for the accounting year. The cycle continues for the next accounting year with the opening balances of assets and liabilities which are the closing balances of the preceding year. The steps involved are:

(i) Identifying the transactions and journalising

The first step in the accounting process is identifying the financial transactions of a business. All the monetary transactions are recorded in the books of original entry called journals. Recording the transactions in the journal is called journalising. Entries are made in the journals on the basis of source documents in the chronological order, i.e., the order of occurrence of the transactions



Accounting cycle

(ii) Posting and balancing

Transferring the entries from the journal to the ledger is called posting. In the ledger, entries are made in each account after classifying them under common heads. Finding the difference between the total of the debit column and credit column of all the ledger accounts is called balancing.

(iii) Preparation of trial balance

The list of ledger balances namely trial balance is prepared as the next step. On the basis of ledger balances the financial statements are prepared.

(iv) Preparation of trading account

Next step is preparation of trading account for a particular accounting period. All the direct revenues and direct expenses are transferred to trading account. The balance in the trading account is the gross profit or gross loss.

(v) Preparation of profit and loss account

Profit and loss account is prepared next for a particular accounting period. All the indirect revenues and indirect expenses along with gross profit or gross loss are transferred to profit and loss account. The balance in the profit and loss account is the net profit or net loss.

(vi) Preparation of balance sheet

A statement showing the balances of assets and liabilities namely balance sheet is prepared as the final step in the accounting process. It is prepared on a particular date, normally, on the last day of the accounting period.

The closing balances of an accounting year are taken as the opening balances for the next accounting year. The transactions identified and recorded for the next year are followed by posting and other steps.

The results are communicated to the users of accounting information for the purpose of analysis and decision making.

Objectives of Accounting

Following are the objectives of accounting:

(i) To keep a systematic record of financial transactions and events

(ii) To ascertain the profit or loss of the business enterprise

(iii) To ascertain the financial position or status of the enterprise

(iv) To provide information to various stakeholders for their requirements

(v) To protect the properties of an enterprise and

(vi) To ascertain the solvency and liquidity position of an enterprise

Functions of Accounting

The main functions of accounting are as follows:

(i) **Measurement**

The main function of accounting is to keep systematic record of transactions, post them to the ledger and ultimately prepare the final accounts. Accounting works as a tool for measuring the performance of the business enterprises. It also shows the financial position of the business enterprises.

(ii) Forecasting

With the help of the various tools of accounting, future performance and financial position of the business enterprises can be forecasted.

(iii) Comparison

Accounting helps to compare the actual performance with the planned performance. It is also possible to compare with the accounting policies. Through comparison of the actual financial results of the business enterprises with projected figures and standards, effective measures can be taken to enhance the efficiency of various operations.

(iv) Decision making

Accounting provides relevant information to the management for planning, evaluation of performance and control. This will help them to take various decisions concerning cost, price, sales, level of activity, etc.

(v) Control

As accounting works as a tool of control, the strengths and weaknesses are identified to provide feedback on various measures adopted. It serves as a tool for evaluating compliance of business policies and programmes.

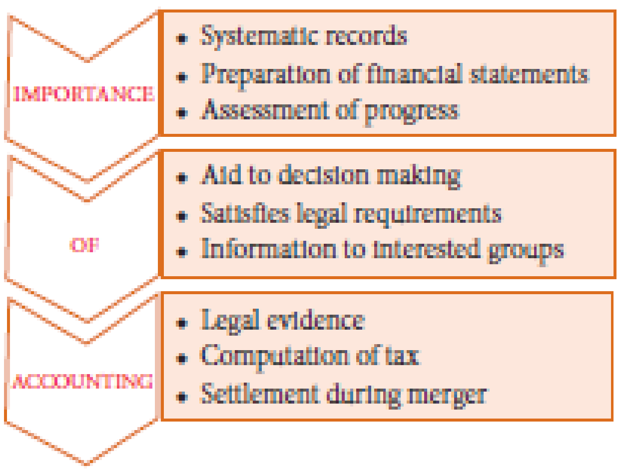
(vi) Assistance to government

Government needs full information on the financial aspects of the business for various purposes such as taxation, grant of subsidy, etc. Accounting provides relevant information about the business to exercise government control on business enterprises.

Importance of Accounting

Accounting is a basic necessity for all enterprises. Importance of accounting is enumerated as below:

(i)



All the transactions of an enterprise which are financial in nature are recorded in a systematic way in the books of accounts. The records are classified under common heads and summaries are prepared.

(ii) Preparation of financial statements

Results of business operations and the financial position of the concern can be ascertained from accounting periodically through the preparation of financial statements namely, income statement or trading and profit and loss account and balance sheet. This helps in distribution of profits to the owners and to provide funds for future growth of the business.

(iii) Assessment of progress

Analysis and interpretation of financial data can be done to assess the progress made in different areas and to identify the areas of weaknesses. Management is provided with a complete picture of the liquidity, profitability and solvency of the business.

(iv) Aid to decision making

Management of a firm has to make routine and strategic decisions while discharging its functions. Accounting provides the relevant data to make appropriate decisions. Future policies and programmes can be planned by the management based on the accounting data provided.

(v) Satisfies legal requirements

Various legal requirements like maintenance of Provident Fund (PF) for employees, Employees State Insurance (ESI) contributions, Tax Deducted at Source (TDS), filing of tax returns are properly fulfilled with the help of accounting. Preparation of accounts and financial statements as per the legal requirements is also facilitated.

(vi) Information to interested groups

Accounting supplies appropriate information to different interested groups like owners, management,creditors, employees, financial institutions, tax authorities and the government.

(vii) Legal evidence

Accounting records are generally accepted as evidence in courts of law and other legal authorities in the settlement of disputes.

(viii) Computation of tax

Accounting records are the basic source for computation and settlement of income tax and other taxes.

(ix) Settlement during merger

When two or more business units decide to merger, accounting records provide information for deciding the terms of merger and any compensation payable as a consequence of merger.

Branches of Accounting

Depending on the informational needs of various users of accou

branches or subfields of accounting have been developed.

The various branches of accounting are:

(i) **Financial Accounting**

It involves recording of financial transactions and events. It is historical in nature and records are maintained for transactions and events which have already occurred. It provides financial information to the users for taking decisions. It is concerned with identification, recording, classifying and summarising of financial transactions and events and ends up with the preparation of financial statements, namely, trading and profit and loss account or income statement and balance sheet and communication of the same to the interested users. Trading and profit and loss account shows the profit or loss made during an accounting period and the balance sheet shows the financial position of the business as on a particular date.

(ii) Cost Accounting

It involves the collection, recording, classification and appropriate allocation of expenditure for the determination of the costs of products or services and for the presentation of data for the purposes of cost control and managerial decision making.

(iii) Management Accounting

It is concerned with the presentation of accounting information in such a way as to assist management in decision making and in the day-to-day operations of an enterprise. The information collected from financial accounting, cost accounting, etc. are grouped, modified and presented as per the requirements of management for discharging their functions and for decision making.

(iv) Social Responsibility Accounting

It is concerned with presentation of accounting information by business entities and other organisations from the view point of the society by showing the social costs incurred such as environmental pollution by the enterprise and social benefits such as infrastructure development and employment opportunities created by them. It arises because of corporate social responsibility.

(v) Human Resources Accounting

It is concerned with identification, quantification and reporting of investments made in human resources of an enterprise.

Bases of Accounting

There are three bases of accounting in common usage, namely

(i) Cash basis

(ii) Accrual or mercantile basis

(iii) Mixed or hybrid basis.

Cash basis

Under cash basis of accounting, actual cash receipts and actual cash payments are recorded. In this basis, revenue is recognised when cash is received and expenses are recognised when cash is paid. Credit transactions are not recorded till cash is actually received or paid. Under this basis,

(a) Any income received

(b) Any expenditure paid

(c) Any asset purchased for which cash is paid

(d) Any liability paid during the accounting period whether related to the past, present or future is taken into account.

(ii) **Accrual or mercantile basis**

Under accrual basis of accounting, the revenue whether received or not, but has been earned or accrued during the accounting period and expenses incurred whether paid or not are recorded. In other words, revenue is recognised when it is earned or accrued and expenses are recognised when these are incurred. Under this basis,

(a) Any income earned whether received or not

(b) Any expenditure incurred whether paid or not

(c) Any asset purchased whether cash is paid or not

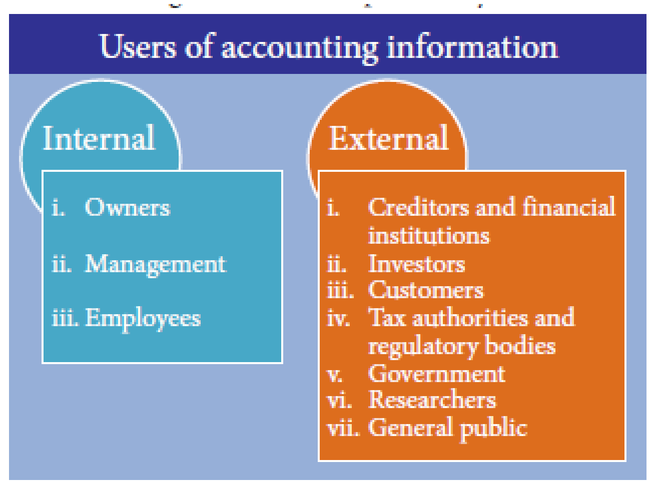
(d) Any liability incurred whether paid or not during the accounting period is recorded.

Under section 128(1) of the Indian Companies Act, 2013, all the companies are required to maintain the books of accounts according to the accrual basis of accounting.

Hybrid or mixed basis

This basis is a combination of cash basis and accrual basis of accounting. Under mixed basis of accounting, both cash basis and accrual basis are followed. Revenues and assets are generally recorded on cash basis whereas expenses and liabilities are generally taken on accrual basis.

Users of Accounting information



There are several persons who need the accounting information for various purposes. They can be classified into two:

(A) Internal users and

(B) External users

Internal Users

The internal users are owners, management and employees who are within the organisation.

(i) **Owners**

The owners of a business provide capital to be used in the business. They are interested to know whether the business has earned profit or not during a particular period and also its financial position on a particular date. They want accounting reports in order to have an appraisal of performance and also for an assessment of future prospects to ensure that they will get their expected returns from the business and get back their capital safely.

Management

Accounting data are the basis for most of the decisions made by the management. The trends in sales and purchases, relationship of expenses to the sales, efficiency of employees, comparative profitability of different departments, capital structure and solvency position are some of the vital data required by management for planning and controlling the business operations. Financial statements and other reports prepared under financial accounting provide this information to the management.

Employees

The employees are interested in the profit earning capacity of the business which will affect their remuneration, working conditions and retirement benefits and stability and growth of the enterprise.

External users

External users are the persons who are outside the organisation but make use of accounting information for their purposes. They are:

(i) **Creditors and financial institutions**

Suppliers of goods and services, commercial banks, public deposit holders and debentureholders are included in this category. They are interested in knowing the liquidity position and repaying capacity of the business to ensure the safety of getting the amount due to them or interest and the principal amount.

(ii) Investors

Persons who are interested in investing their funds in an organisation should know about the financial condition of a business unit while making their investment decisions. They are more concerned about future earnings and risk bearing capacity of the organisation which will affect the return to the investors.

(iii) Customers

Customers who buy and use the products and services of business enterprises are interested in knowing the details of the products and the prices charged to them. They are interested in knowing the stability and profitability of an enterprise to ensure continued supply of the products or services by the enterprise.

Tax authorities and other regulatory bodies

Accounting information helps the tax authorities in computing income tax and taxes on goods and services and other taxes to be collected from business units. Other regulatory bodies also require information about revenues, expenses and other financial aspects of business to ensure that the enterprises comply with statutory requirements.

Government

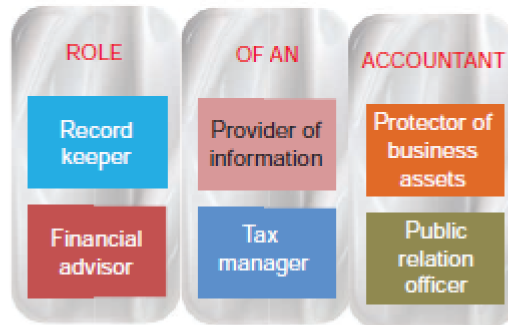
The scarce resources of the country are used by business enterprises. Information about performance of business units in different industries helps the government in policy formulation for development of trade and industry, allocation of scarce resources, grant of subsidy, etc. Government also administers prices of certain commodities. In such cases, government agencies have to ensure that the guidelines for pricing are followed.

Researchers

Researchers to carry out their research can use accounting information and make use of the published financial statements for analysis and evaluation.

General public

From accounting information, the general public at large can get a view of the earning capacity and stability of the enterprise as well as the social responsibility measures undertaken by the enterprise particularly in its area of operation and also the employment opportunities provided to the local people.



Role of an accountant

An accountant designs the accounting procedures for an enterprise. He plays several roles in an organisation as follows:

(i) **Record keeper**

The accountant maintains a systematic record of financial transactions. He also prepares the financial statements and other financial reports.

(ii) Provider of information to the management

The accountant assists the management by providing financial information required for decision making and for exercising control.

(iii) Protector of business assets

The accountant maintains records of assets owned by the business which enables the management to protect and exercise control over these assets. He advises the management about insurance of various assets and the maintenance of the same.

(iv) Financial advisor

The accountant analyses financial information and advises the business managers regarding investment opportunities, strategies for cost savings, capital budgeting, provision for future growth and development, expansion of enterprise, etc.

(v) Tax manager

The accountant ensures that tax returns are prepared and filed correctly on time and payment of tax is made on time. The accountant can advise the managers regarding tax management, reducing tax burden, availing tax exemptions, etc.

(vi) Public relation officer

The accountant provides accounting information to various interested users for analysis as per their requirements.

ACCOUNTING CONCEPTS

Business entity concept: A business and its owner should be treated separately as far as their financial transactions are concerned.

Money measurement concept: Only business transactions that can be expressed in terms of money are recorded in accounting, though records of other types of transactions may be kept separately.

Dual aspect concept: For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.

Going concern concept: In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at "fire-sale" prices.

Cost concept: The fixed assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.

Accounting year concept: Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.

Matching concept: This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.

Realisation concept: According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer

ACCOUNTING CONVENTIONS

There are four main conventions in practice in accounting: conservatism; consistency; full disclosure; and materiality.

Conservatism is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.

Consistency prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.

Materiality means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.

Full disclosure entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and debtors.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

International Financial Reporting Standards (IFRS) were established to bring consistency to accounting standards and practices, regardless of the company or the country.

They are issued by the Accounting Standards Board (IASB) and address record keeping, account reporting and other aspects of financial reporting.

IFRS benefit companies and individuals alike in fostering greater corporate transparency.

The downside of IFRS are that they are not universal, with the United States using GAAP accounting, and a number of other countries using other methods

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

Statement of Financial Position: This is also known as a balance sheet. IFRS influences the ways in which the components of a balance sheet are reported.

Statement of Comprehensive Income: This can take the form of one statement, or it can be separated into a profit and loss statement and a statement of other income, including property and equipment.

Statement of Changes in Equity: Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.

Statement of Cash Flow: This report summarizes the company's financial transactions in the given period, separating cash flow into Operations, Investing, and Financing.

GAAP

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting. The Financial Accounting Standards Board (FASB) uses GAAP as the foundation for its comprehensive set of approved accounting methods and practices.

General 10 key concepts

Principle of Regularity: GAAP-compliant accountants strictly adhere to established rules and regulations.

Principle of Consistency: Consistent standards are applied throughout the financial reporting process.

Principle of Sincerity: GAAP-compliant accountants are committed to accuracy and impartiality.

Principle of Permanence of Methods: Consistent procedures are used in the preparation of all financial reports.

Principle of Non-Compensation: All aspects of an organization's performance, whether positive or negative, are fully reported with no prospect of debt compensation.

Principle of Prudence: Speculation does not influence the reporting of financial data.

Principle of Continuity: Asset valuations assume the organization's operations will continue.

Principle of Periodicity: Reporting of revenues is divided by standard accounting time periods, such as fiscal quarters or fiscal years.

Principle of Materiality: Financial reports fully disclose the organization's monetary situation.

Principle of Utmost Good Faith: All involved parties are assumed to be acting honestly.

Financial Statements

Meaning of financial statements

Financial statements are the statements prepared by the business concerns at the end of the accounting period to ascertain the operating results and the financial position. The basic financial statements prepared by business concerns are income statement and balance sheet. Income statement includes manufacturing account and trading and profit and loss account. It shows the net results of business activities during an accounting period. Balance sheet is a statement of assets and liabilities which shows the financial position as on a particular date.

Apart from these two basic statements, business concerns may also prepare cash flow statement, funds flow statement and statement of changes in financial position.

Features of financial statements

Following are the features of financial statements:

(i) Financial statements are generally prepared at the end of an accounting period based on transactions recorded in the books of accounts.

(ii) These statements are prepared for the organisation as a whole.

(iii) Information is presented in a meaningful way by grouping items of similar nature such as fixed assets and current assets.

(iv) Financial statements are prepared based on historical cost.

(v) Financial statements are prepared based on accounting principles and Accounting Standards, which make financial statements comparable and realistic.

(vi) Financial statements involve personal judgement in certain cases. For example, selection of method of depreciation, percentage of reserve, etc.

Significance of financial statements

Financial statements reveal the operating results and financial position of the business concern. The significance of financial statements to various stakeholders is as follows:

(i) **To management:** Financial statements provide information to the management to take decision and to have control over business activities, in various areas.

(ii) **To shareholders:** Financial statements help the shareholders to know whether the business has potential for growth and to decide to continue their shareholding.

(iii) **To potential investors:** Financial statements help to value the securities and compare it with those of other business concerns before making their investment decisions.

(iv) **To creditors:** Creditors can get information about the ability of the business to repay the debts from financial statements.

(v) **To bankers:** Information given in the financial statements is significant to the bankers to assess whether there is adequate security to cover the amount of the loan or overdraft.

(vi) **To government:** Financial statements are significant to government to assess the tax liability of business concerns and to frame and amend industrial polices.

(vii) **To employees:** Through the financial statements, the employees can assess the ability of the business to pay salaries and whether they have future growth in the concern.

Limitations of financial statements

Following are the limitations of financial statements:

(i) **Lack of qualitative information:** Qualitative information that is non-monetary information is also important for business decisions. For example, efficiency of the employees, efficiency of the management, etc. But, this is ignored in financial statements.

(ii) **Record of historical data:** Financial statements are prepared based on historical data. They may not reflect the current position.

(iii) **Ignore price level changes:** Adjustments for price level changes are not made in the financial statements. Hence, financial statements may not reveal the current position.

(iv) **Lack of consistency:** Different business concerns may use different accounting methods. Hence, comparison between two business concerns becomes difficult.

(v) **Give only interim reports:** Financial statements are prepared at the end of every accounting period. But, the actual position of the business can be known only when the business is closed. Hence, financial statements may not reveal the exact position of the business concern.

(vi) **Limited access to external users:** The external users do not have detailed and frequent information of financial results as they have limited access.

(vii) **Influenced by personal judgement:** Preparation of financial statements may be influenced by personal judgements and therefore these are not free from bias.

Financial statements of companies

Following provisions of the Indian Companies Act, 2013 have to be followed while preparing the financial statements of a company:

(i) As per Section 2 (40), financial statements include balance sheet, profit and loss account / income and expenditure account, cash flow statement, statement of changes in equity and any explanatory note annexed to the above.

(ii) Section 129 (1) of the Indian Companies Act, 2013 states that the financial statements shall give a true and fair view of the state of affairs of the company and shall comply with the Accounting Standards notified under section 133.

(iii) Section 129 (1) also states that the financial statements shall be prepared in the form provided in schedule III of Indian Companies Act, 2013.

Financial statement analysis

(i) Meaning of financial statement analysis

(ii) Financial statement analysis is comparison of the various items in the financial statements by establishing and evaluating relationships among them so that, it gives a better understanding of the performance and financial status of the business concern.

(iii) It involves rearrangement of data in accordance with the purpose of analysis, application of financial tools, evaluating the relationship among the component parts and drawing conclusion based on the analysis. Thus, financial statement analysis includes both analysis and interpretation.

(iv) Analysis refers to examination of the figures computed and comparison of the same to establish relationship among them and identifying the reasons for the performance or changes. Interpretation refers to elucidation and explanation of the results of analysis.

Objectives of financial statement analysis

Financial statement analysis may be done with any of the following objectives:

1. To analyse the profitability and earning capacity

2. To study the long term and short term solvency of the business

3. To determine the efficiency in operations and use of assets

4. To determine the efficiency of the management and employees

5. To determine the trend in sales, production, etc.

6. To forecast for future and prepare budgets

7. To make inter-firm and intra-firm comparisons.

Limitations of financial statement analysis

Following are the limitations of financial statement analysis:

1. All the limitations of financial statements such as ignoring non-monetary information, ignoring price level changes, etc., are applicable to financial statement analysis also.

2. Financial statement analysis is only the means and not an end, that is, it is only a tool in the hands of management and other shareholders. Interpretation of the results has to be done only by the financial analysts with due regard to the internal and external environmental factors.

3. Expert knowledge is required in analysing the financial statements.

4. Interpretation of the analysed data involves personal judgement as different experts may give different views.

Techniques or Tools of financial statement analysis

Different tools are used for analysing the financial statements. The tool is selected based on the purpose of analysis. Following are the commonly used tools of financial statement analysis:

(i) Ratio analysis

An analysis of financial statements based on ratio is known as ratio analysis. A ratio is a mathematical relationship between two or more items taken from the financial statements. Ratio analysis is the process of computing, determining and presenting the relationship of items. It also includes comparison and interpretation of ratios and using them as basis for the future projections. Ratio analysis is helpful to management and outsiders to diagnose the financial health of a business concern. It helps in measuring the profitability, solvency and activity of a firm

(ii) Cash flow analysis

Cash flow analysis is concerned with preparation of cash flow statement which shows the inflow and outflow of cash and cash equivalents in a given period of time. Cash includes cash in hand and demand deposits with banks. Cash equivalents denote short term investments which can be realised easily within a short period of time, without much loss in value. Cash flow analysis helps in assessing the liquidity and solvency of a business concern.

(iii) Funds flow analysis

The term ‘fund’ refers to working capital. Working capital refers to the excess of current assets over current liabilities. The term ‘flow’ means movement and includes both ‘inflow’ and ‘outflow’. Funds flow analysis is concerned with preparation of funds flow statement which shows the inflow (sources) and outflow (applications) of funds in a given period of time. Funds flow analysis is useful in judging the credit worthiness, financial planning and preparation of budgets.

(iv) Comparative financial statement

A statement giving comparison of net increase or decrease in the individual items of financial statements of two or more years of a business concern is called comparative statement. It shows the actual figures at different periods of time, the increase or decrease in these figures in absolute terms and the percentages of such increase or decrease. The two basic comparative statements prepared are comparative income statement and comparative balance sheet.

(v) Common-size statements

The common–size statements show the relationship of various items with some common base, expressed as percentage of the common base. The common bases are total of assets or total of equity and liabilities or revenue from operations (net sales). The common size statements include common-size income statement and common-size balance sheet.

In the common–size income statement, revenue from operations is taken as 100 and various expenses and incomes are expressed as a percentage to the revenue from operations. In the common-size balance sheet, the total of balance sheet, that is, the total of assets or total of equity and liabilities is taken as 100 and various assets and liabilities are expressed as a percentage of the total of assets or total of equity and liabilities.

The common-size statements can be compared with those of previous years. They can also be compared with those of other similar businesses with similar accounting policies.

(vi) Networking capital analysis

Networking capital statement or schedule of changes in working capital is prepared to disclose net changes in working capitals on two specific dates (generally two balance sheet dates). It is prepared from current assets and current liabilities on the specified dates to show net increase or decrease in working capital.

(vii) Trend analysis

Trend refers to the tendency of movement. Trend analysis refers to the study of movement of figures over a period. The trend may be increasing trend or decreasing trend or irregular. When data for more than two years are to be analysed, it may be difficult to use comparative statement. For this purpose, trend analysis may be used. One year, generally, the first year is taken as the base year. The figures of the base year are taken as 100. The figures for the other years are expressed as a percentage to the base year and the trend is determined.

Preparation of comparative statements

A comparative statement has five columns. Following are the steps to be followed in preparation of the comparative statement:

(i) Column 1: In this column, particulars of items of income statement or balance sheet are written.

(ii) Column 2: Enter absolute amount of year 1.

(iii) Column 3: Enter absolute amount of year 2.

(iv) Column 4: Show the difference in amounts between year 1 and year 2. If there is an increase in year 2, put plus sign and if there is decrease put minus sign.

(v) Column 5: Show percentage increase or decrease of the difference amount shown in column 4 by dividing the amount shown in column 4 (absolute amount of increase or decrease) by column 2 (year 1 amount). That is,

Percentage increase or decrease = Absolute amount of increase or decrease x 100

Year 1 amount

COMPANY ACCOUNTS:

Introduction:

Human needs and wants are ever growing. In order to meet them production must be carried on, on a large scale. For this, large amount of capital, modern technology and managerial skills are needed for business units. Sole proprietorship and partnership firms may not be able to raise large amount of capital to equip themselves with these. To overcome this limitation, the concept of 'Company form of organisation' came into existence. The capital of companies is divided into small units called shares. Capital needed by the company could be raised by inviting the general public to buy shares and invest in the business. These investors are called shareholders or members of the company. The money raised by issuing shares is called share capital. Profits are distributed among the shareholders in the form of dividends.

It is not practical for all the members to take part in the management of the company. So, they appoint, at the annual general meeting, board of directors who take part in the management of the business. The liability of the shareholders is limited to the face value of shares. A limited company differs from other forms of business units. It has a separate legal entity.

Meaning and definition of a company

Company is a voluntary association of persons which has separate legal entity. It has perpetual succession and the liability of the members is limited.

According to Lord Justice Lindley, “A company is an association of many persons who contribute money or money’s worth to a common stock and employ it in some trade or business and who share the profit and loss arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contributed in it or form it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share”.

Characteristics of a company

Following are the characteristics of a company:

Voluntary association: A company is a voluntary association of persons. No law can compel persons to form a company.

Separate legal entity: Company is an artificial person. It has a separate legal entity which is separate and distinct from its members.

Common seal: A company may have a common seal which can be affixed on the documents.

Perpetual succession: A company continues for ever. Its continuity is not affected by the changes in its members. It can be wound up only by law.

Limited liability: The liability of the shareholders of the company is limited to the extent of face value of the shares held by them.

Transferability of shares: The shares of a company are freely transferable except incase of a private company.

Meaning and types of shares

The capital of a company is divided into small units of fixed amount. These units are called shares. The shares which can be issued by a company are of two types (i) preference shares and (ii) equity shares.

(i) Preference shares

Preference shares are the shares which have the following two preferential rights over the equity shares:

(a) Preference towards the payment of dividend at a fixed rate during the life time of the company and

(b) Preference towards the repayment of capital on winding up of the company.

(ii) Equity shares

Equity shares are those shares which are not preference shares. These shares do not enjoy any preferential rights. Rate of dividend is not fixed on equity shares and it depends upon the profits earned by the company. Incase of winding up of a company equity shareholders are paid after the payments are made to preference shareholders. Equity shares are also known as ordinary shares.

Annual Report

An annual report is a comprehensive report detailing a company's activities throughout the preceding year. Its purpose is to provide users, such as shareholders or potential investors, with information about the company's operations and financial performance.

- Annual reports are comprehensive documents designed to provide readers with information about a company's performance in the preceding year.
- The reports contain information, such as performance highlights, a letter from the CEO, financial information, and objectives and goals for future years.
- There are many users of annual reports, including shareholders and potential investors, employees, and customers.

Annual Report Contain

Annual reports provide a significant amount of information for its readers who will be able to get a good overview of the company's overall performance in the preceding year. It is important to note that many annual reports are not traditional reports with large amounts of text; many companies often incorporate a lot of graphics and images, resulting in a visually appealing document.

The structure of annual reports undoubtedly will vary according to each company, but most annual reports will generally contain the following:

- A letter from the president or CEO
- Performance highlights from the preceding year
- Financial statements
- Performance and outlook for future years

Briefly go through each item in detail below:

1. Letter from the CEO

The letter from the CEO is addressed to shareholders and provides a summary of the company's performance in the previous year. CEOs typically spend a lot of time on their letters to highlight the company's achievements, as its performance is relative to the industry it operates in. The letter would likely mention the information of interest to shareholders since they are the primary readers of the report.

2. Performance Highlights

Annual reports usually dedicate a section to highlighting some of the company's key achievements, such as special initiatives, goals reached, or awards received by the company or its employees. The main goal of the section is to ensure that shareholders are satisfied with their investment in the company and persuade potential investors to do the same.

3. Financial Statements

Financial statements are a key component of the annual report and provide its users with quantitative data regarding specific aspects of its financial performance in the previous fiscal year.

Annual reports typically include financial statements, such as balance sheets, income statements, and cash flow statements. In addition, there will often be graphs or charts included, helping break down the financials into easily readable information.

4. Outlook for Future Years

Annual reports typically include information regarding its future performance in order to provide shareholders with information on the company's future goals and objectives. Investors are able to get a thorough understanding of the company's current position in its respective industry and the company's plans for future growth. The reports also include information regarding a company's strategy and how it plans to implement that strategy in the coming years.

5. Format

While hardcopy annual reports are still common, electronic versions are increasingly popular and can be found on the websites of many companies. Electronic versions allow the reports to be made accessible to a larger audience in PDF or other formats.

Increasingly common are interactive online reports, which allow users to virtually flip through the report and expand graphics, among other things.

Users of Annual Reports

Annual reports are often publicly available and cater to a large external audience, including shareholders, potential investors, employees, and customers. The general community can also be an audience, as some companies or non-profit organizations will likely go through another company's annual report to better understand the latter's values to see if a partnership or other collaborative efforts are feasible.

While they are primarily used to convey financial and performance-related information, the annual report is also used as an advertising tool to highlight some of the company's key initiatives or goals that were recently achieved.

1. Shareholders and Potential Investors

Shareholders and potential investors use annual reports to get a better understanding of the current position of the company in order to make investing decisions. The annual report helps potential investors decide whether or not to purchase stock. It also gives insight into the future plans of the company, along with its goals and objectives.

2. Employees

Employees often use the annual report to understand some of a company's different focus areas. Many employees are also shareholders of a company due, in part, to stock option benefits and other schemes, which provide employees with incentives in being shareholders.

3. Customers

Customers of a company use annual reports to get an overview of different companies and help them decide on which one to build a relationship with. Customers are interested in working with high-quality suppliers of products or services, and an annual report enables companies to emphasize its core values and objectives.

They also make good use of the financial information contained in the annual report, which gives them a good idea of the financial position of the company.

Audit Report

Audit report is the final stage of audit process. The results of the audit are communicated through audit report. Audit report is the written opinion of an auditor regarding companies financial statements. Audit report is a document prepared by an auditor to certify the financial position and accounting records of a firm.

Meaning of Audit Report

Audit report is the statement included in the financial statements. It contains the opinion of the auditor in financial statements. The auditor reports to the shareholders who have appointed him. He has to provide his opinion on the truth and fairness of financial statements. Thus, the auditor protects the interest of shareholders through audit report.

Definition of Audit Report

Lancaster has defined a report as "a report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of subject matter of the report."

According to Cambridge Business English Dictionary, Audit report is defined as a formal document that states an auditor's judgment of a company's accounts.

Under Sec. 143(3), auditor of a company must report to its members.

(a) The accounts examined by him;

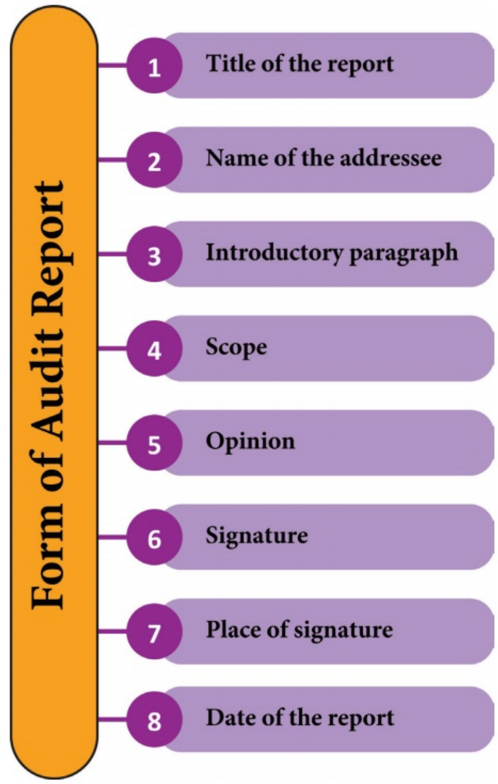
(b) Balance Sheet, Profit and Loss Account, and Cash Flow statement, which are laid in general meeting of a company during his tenure of office; and

(c) The document declared to be attached to the Balance Sheet and Profit and Loss Account.

Form of Audit Report

1. Title of the report

The title of audit report should help the reader to identify the report. It should disclose the name of the client. The title distinguishes the audit report from other reports.



2. Name of the Addressee

The addressee normally refers to the person who appoints the auditor. If a company appoints the auditor, the addressee should be shareholders. As per law, the complete address of the addressee is required. Addressee for the statutory audit shall be shareholders and in case of Special Audit, it is Central Government.

3. Introductory Paragraph

The introductory paragraph should specify that it is the auditor's opinion on financial statements audited by him. The period covered by financial statements should be stated with exact dates.

4. Scope

This part should include the matter-of-fact relating to the manner in which audit examination was made. The audit examination should cover company's accounts, Profit and Loss Account, Balance Sheet and Cash Flow Statements. The examination should be as per the relevant law. The auditor should not curtail or limit any examination task.

5. Opinion

The auditor's opinion on the books of account and financial statements examined by him is based on the information and free from bias. The auditor has to give his opinion as follows:

- Whether the financial statements are arithmetically correct and correspond to the figures recorded in the books of accounts.
- In case of unqualified opinion, whether the financial statements represent a true and fair view of the state of affairs and the results of operations.
- In case of qualified opinion, if the Balance Sheet and Profit and Loss account do not present a true and fair view, the reasons for what and where is wrong.

6. Signature

The signature part should include the manual signature of the auditor.The personal name and signature of the auditor should be given. If the auditor is a firm, the signature in the personal name and firm name should be given.

7. Place of Signature

This should include the location of the auditor or the auditor firm, which is ordinarily their city.

8. Date of the Report

The date of completion of the audit work should be mentioned in this section.

Statutory Requirements means all approvals, consents, permits, or licences necessary for the purposes of the Redevelopment from the State, any government department, authority, instrumentality or local government authority, and includes, without limiting the generality of the foregoing, all approvals, consents, permits, and licences, for engineering drawings, construction plans, earthworks and structures necessary for the purposes of the Redevelopment; “subsidiary legislation” includes any proclamation, regulation, rule, by law, order, notice, rule of court, town planning scheme, resolution, or other instrument, made under any Act of the State or of the Commonwealth of Australia or subsidiary legislation for the time being in force and having legislative effect

Director’s report

Director’s report is a financial disclosure made by director to the shareholders of the company. It is envisaged to disclose financial status of the company by disclosing company’s affairs and scope of work along with its subsidiaries. It is basically financial summary of the company for the whole financial year and future vision too.

In erstwhile companies act, 1956 provisions related to director report as defined under section 217, but in new companies act, 2013, these terms have been defined under many sections.

The objective of Directors’ report

A director of the company needs to prepare and submit a said report to shareholders of the company at every *annual general meeting* every year in order to maintain transparency in the company. It helps stakeholders of the company understand the current financial status of the company and future scope and understand:

- The current financial health of the company
- Company’s capability to diversify and grow
- Company’s status and position in the current market and future scope and growth
- Whether company is following current regulations, standards, and social responsibility as required by various regulators like ROC, RBI, SEBI, etc.

Director’s report covers

- Company’s description and details of current shareholders and other key managerial personnel’s
- Directors description submitting director’s report
- Description of companies trading activity
- Future vision and prospectus of the company
- Submission and description of financial records and statement of the company before members
- Current Balance sheet, profit and loss, and cash flow description along with auditor’s report
- Dividend recommendation for current financial year
- Any financial incidence that may affect company’s financial position in the future

Notes to Accounts

Also known notes to financial statements, footnotes, notes to accounts are supporting information that is usually provided along with a company’s final accounts or financial statements. Many such notes are required to be provided by law, including details related to provisions, reserves, depreciation, investments, inventory, share capital, employee benefits, contingencies, etc.

Other information supplied along with the financial statements may be a product of the accounting standards being followed by the business. Notes to accounts help users of accounting information to understand the current financial position of a company and act as a support for its estimated future performance.

It acts as supplementary information furnished along with the final accounts of a company and may be tremendous in size depending on the company, accounting framework and nature of the business. The information supplied depends on the accounting standards used such as IFRS or GAAP.

Pitfalls

1. Recording only monetary items

As per accounting principles, only the events measurable in terms of money are recorded in the books of accounts. But events of great importance, if not measurable in terms of money, are not accounted for. For that reason, recorded accounting information fails to exhibit the exact financial position of a business concern.

2. Time Value of Money

Under the accounting system, money value is treated constantly. But the value of money always changes due to inflation. Under existing accounting systems, accounts are maintained considering historical cost ignoring current changed value. As a result, the accounts maintained fail to exhibit the exact financial position of a business concern.

3. Recommendation of alternative methods

There exists an application of alternative methods in determining depreciation of assets and valuation of stock etc. Information regarding the activities of the business is expressed in a misleading way if an alternative method is used to achieve a particular object.

4. Restrain of Accounting Principles

Exhibited accounting information cannot always exhibit a true and fair picture of a business concern owing to limitations of the accounting principles used.

5. Recording of past events

Accounting past events are accounted for. But naturally, there is no system of recording events that may occur in the future.

6. Allocation of problem

The allocation process is an important problem in the accounting system. The value of fixed assets is exhausted, charging depreciation for the allocated period. The useful life of fixed assets is fixed up hypothetically, which does not stand accurately in most cases.

7. Maintaining secrecy

Secrecy cannot be ensured for the involvement of many employees in accounting work, although maintaining secrecy is very important.

8. The tendency for secret reserves

Often management creates secret reserves intentionally by increasing or decreasing assets and liabilities for which the total financial picture of an organization is not reflected.

9. Importance of form over substance

At the time of preparing accounts for a particular period, the emphasis is laid on the form, table, etc. instead of giving importance to an exhibition of substantial information.

UNIT II

ACCOUNTING PROCESS: Book Keeping and Record Maintenance, Fundamental Principles and Double Entry, Journal, Ledger, Trial Balance, Balance Sheet, Final Accounts ,Cash Book and Subsidiary Books, Rectification of Errors

Book-keeping-An introduction

The first tstep in the accounting process is identifying and recording of transactions in the books of accounts. This is necessary for any business as the transactions happening in a business entity must be recorded so that the information is available for further analysis.

Book-keeping forms the base for the preparation of financial statements and interpretation which are the important functions of accounting. In a broad sense, accounting includes book-keeping also. In a small business, the entire accounting work may be performed by a single accountant. In a large firm, there may be a separate person or department for book-keeping work.

Meaning of book-keeping

Book-keeping is the process of recording financial transactions in the books of accounts. It is the primary stage in the accounting process. It includes recording the transactions and classifying the same under proper heads. Book-keeping work is of routine nature. Transactions may be recorded in the accounting note books and ledgers or may be recorded in a computer.

Definition of book-keeping

“Book-keeping is an art of recording business dealings in a set of books”. - J.R.Batliboi.

“Book-keeping is the science and art of recording correctly in the books of account all those business transactions of money or money’s worth”. -R.N.Carter.

Features of book-keeping

Following are the features of book-keeping:

(i) It is the process of recording transactions in the books of accounts.

(ii) Monetary transactions only are recorded in the accounts.

(iii) Book-keeping is the primary stage in the accounting process.

(iv) Book-keeping includes journalising and ledger posting.

Objectives of book-keeping

Following are the objectives of book-keeping:

(i) To have a complete and permanent record of all business transactions in chronological order and under appropriate headings.

(ii) To facilitate ascertainment of the profit or loss of the business during a specific period.

(iii) To facilitate ascertainment of financial position.

(iv) To know the progress of the business.

(v) To find out the tax liabilities.

(vi) To fulfil the legal requirements.

Advantages of Book-keeping

Book-keeping has the following advantages:

(i) Transactions are recorded systematically in chronological order in the book of accounts. Thus, book-keeping provides a permanent and reliable record for all business transactions.

(ii) Book-keeping is useful to get the financial information.

(iii) It helps to have control over various business activities.

(iv) Records provided by business serve as a legal evidence in case of any dispute.

(v) Comparison of financial information over the years is possible. Also comparison of financial information of different business units is facilitated.

(vi) Book-keeping is useful to find out the tax liability

Limitations of book-keeping

Book-keeping has the following limitations:

(i) Only monetary transactions are recorded in the books of accounts.

(ii) Effects of price level changes are not considered.

(iii) Financial data recorded are historical in nature, i.e., only past data are recorded.

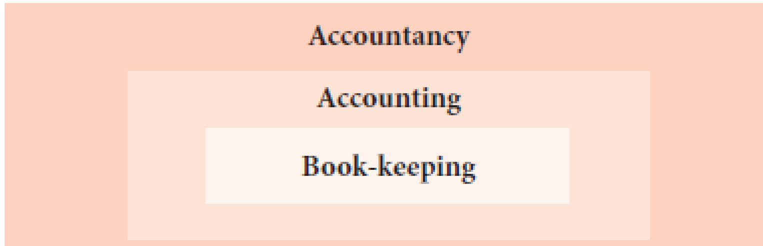
Book-keeping Vs. Accounting

Following are the differences between book-keeping and accounting:

S. No	Basis of distinction	Book-keeping	Accounting
1	Scope	It is concerned with recording and classifying the business transactions.	It is concerned with recording, classifying, summarising, analysing and interpreting the financial data.
2	Stage	Book-keeping is the primary stage in accounting. It is the base for accounting.	Apart from the primary stage, it includes secondary stage of analysis and interpretation.
3	Nature of job	It is routine and clerical in nature.	It is analytical in nature.
4	Knowledge required	It requires basic knowledge of the principles of journalising and posting.	It requires thorough knowledge of accounting principles, procedures and practices.
5	Skill required	Analytical skill is not required for book-keeping.	It requires analytical skill.

Relationship among Book-keeping, Accounting and Accountancy

Book-keeping is part of Accounting. It is the primary stage in accounting. It is the process of recording transactions in the books of accounts. Accounting is part of Accountancy. Accounting is the process of reording, classifying, analysing and interpreting of financial data. Accountancy is the systematic knowledge of accounting process and contains the standards, principles, policies and procedures to be followed in accounting.



Accounting Principles

Accounting principles are the basic norms and assumptions developed and established as the basis for accounting system. These principles are adopted by the accountants universally. These accounting principles provide uniformity and consistency in the accounting methods and process. Such accounting principles are known as Generally Accepted Accounting Principles (GAAP).

Accounting principles provide the basic framework within which the accounting records and accounting reports are to be prepared. Accounting standards have been issued by national and international regulatory authorities to ensure uniformity of accounting procedure and accounting results. These accounting standards and GAAPs provide the theoretical base of accounting. Accounting principles may be accounting concepts or accounting conventions. Accounting concepts are the basic assumptions whereas conventions are the guidelines based upon practice or usage.

Fundamental Principles & Double entry system

Types of Accounts under Accounting System

Under the rule of accounting, one of the essential aspects to know is the types of accounts coming under the system rule of accounting. With the help of account classification, you will be in a better position to understand the rules effectively.

The **three types of accounts** coming under the accounting system are as follows:

- Personal Account
- Real Account
- Nominal Account

1. Personal account

A personal account is a general ledger account related to the person, firms, and associations.

Under personal account, there are three subcategories:

Natural Personal Account connected to human beings. For example, Debtors Capital account, Creditors, Drawings account.

Artificial Personal Account who are not human beings but act as a separate legal entity in the eyes of the law. They can enter into agreements and operate the functions in the name itself—for example, companies, cooperatives, partnerships, hospitals, banks, and government bodies.

Representative Personal Account represents the accounts of natural or artificial people. In this account, the transactions either belong to the previous year or the following year. Hence, they are in a position to represent something.

For example, an outstanding salary represents the salary due from last year. In the same way, prepaid rent represents the rent paid in advance for the following year.

2. Real Account

A real account is a ledger account that represents accounts of all assets possessed by the organization. The real account appears in the balance sheet and assesses the financial position of the business. Further, the assets can be divided into two parts,

- Tangible Assets
- Intangible Assets

Tangible Assets

Tangible assets consist of those assets and properties that can be touched, seen, and measured. These assets have their physical appearance and existence—land, building furniture, fixtures, machinery, and a cash account.

Intangible Assets

Intangible assets consist of those assets and properties that can't be touched but can be felt. These assets don't have a physical experience but possess a monetary value.

For example, Goodwill, Patents Copyrights, Trademarks.

3. Nominal Account

A nominal account is a ledger account that relates to expenses, losses, incomes, and gains. All of the nominal account adjustments are made through the Trading and Profit and Loss Account at the end of the accounting year.

For example, Interest A/c, Rent A/c, Salary A/c, Commission Received

Golden rules of accounting

The golden rules of accounting apply to the types of accounts related to a financial transaction.

The rules of accounting are set differently for the different types of accounts discussed above.

Let's take a look at the **three golden rules** of accounting:

Type of Account	Golden Rule

1.	Personal Account	Debit the receiver, Credit the giver
1.	Real Account	Debit what comes in, Credit what goes out
1.	Nominal Account	Debit all expenses and losses, Credit all incomes and gains

All of the three golden rules are devised based on the nature of accounts. All of these rules are applicable for organizations and businesses that operate the business's financial activities, defining the treatment of transactions.

Double entry system

Double entry system of book keeping is a scientific and complete system of recording the financial transactions of an organisation. According to this system, every transaction has a two fold effect. That is, there are two aspects involved, namely, receiving aspect and giving aspect. It is denoted by debit (Dr.) and credit (Cr.). The basic principle of double entry system is that for every debit there must be an equivalent and corresponding credit. Debit denotes an increase in assets or expenses or a decrease in liabilities, income or capital. Credit denotes an increase in liabilities, income or capital or a decrease in assets or expenses.

Definition

"Every transaction involving money or money's worth has two fold aspects, the receiving of a value on the one hand and the giving of the same value on the other. This two fold nature in all transactions must be recorded in the books and this gives rise to the term Double Entry Book keeping".

Principles of double entry system

Following are the principles of double entry system:

(i) In every business transaction, there are two aspects.

(ii) The two aspects involved are the benefit or value receiving aspect and benefit or value giving aspect.

(iii) These two aspects involve minimum two accounts; at least one debit and at least one credit.

(iv) For every debit, there is a corresponding and equivalent credit. If one account is debited the other account must be credited.

Advantages of double entry system

Following are the advantages of double entry system:

(i) Accuracy

In this system, the two aspects of each transaction are recorded in the books of accounts. This helps in checking the accuracy in accounting.

(ii) Ascertainment of business results

Details regarding expenses, losses, incomes, gains, assets, liabilities, debtors, creditors, etc., are readily available. This helps to ascertain the net profit earned or loss incurred during an accounting period and also to know the financial position as on a particular date.

(iii) Comparative study

The business results of the current year can be compared with those of the previous years and also with other business firms. It facilitates business planning for future.

(iv) Common acceptance

The business records maintained under this system are accepted by financial institutions, government and others, because it is a systematic and scientific system.

Journal entries

The word journal has been derived from the French word 'Jour' which means day. So, journal means daily. Transactions are recorded daily in the journal as and when the transactions take place. As soon as a transaction takes place, its debit and credit aspects are analysed and recorded in the journal together with a short description called narration. This facilitates making entries in the ledger. Since transactions are first recorded in the journal, it is called book of original entry or prime entry or primary entry or preliminary entry, or first entry. Journalising is the beginning of the accounting process for the financial transactions.

Meaning

Journal is the book of original entry in which business transactions are recorded in chronological order, that is, in the order of occurrence. Transactions are recorded for the first time in the journal. Entries are made in the journal based on source documents. Record of business transactions in the journal is known as Journal entry. The process of recording the transactions in journal is called as journalising.

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

Journal Formats

In the books of..........

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹

A journal contains five columns; Date, Particulars, L.F., Debit and Credit.

Date column: In this column the date of the transaction is recorded.

Particulars column: The accounts involved in the transaction are recorded in this column. The account debited is recorded first with the word 'Dr.' entered towards the end of the row and the account credited is entered in the next line after leaving a little space on the left and preceded by the word 'To'.

Leder Folio column (L.F.): The page number of ledger in which the accounts debited and credited are maintained is recorded here. Folio means page and ledger folio means page number of ledger. This L.F. helps in cross verification of accounts in the ledger and helps in audit of accounts.

Debit column: The amount to be debited is recorded in this column. The unit of measurement, that is, amount expressed in the currency of the country is recorded in this column. For example, in India amount is recorded in rupees (`).

Credit column: The amount to be credited is recorded in this column. The unit of measurement, that is, the currency of the country is written in this column. For example, in India amount is recorded in rupees (`).

Narration: A short description of each transaction is written under each entry which is called narration.

Tutorial note

(i) While entering the date, the year may be written at the top, then the month and then the particular date.

(ii) The narration must be simple and complete. The words 'Being' or 'For' may also be prefixed before the narration.

(iii) It is customary to write 'Dr' and 'To' in the journal entries.

(iv) L.F. column is filled when the transaction is posted to the ledger. In computerised accounting, it is the reference number.

(v) The amount columns of a journal may be totalled at the end of the each page and the grand total may be given at the end of the month.

(vi) To show each journal entry separately, a line may be drawn after narration in particulars column.

(vii) When transactions of similar nature take place on the same date, they may be combined while they are journalised.

Steps in journalising

The process of analysing the business transactions under the heads of debit and credit and recording them in the journal is called journalising. An entry made in the journal is called a journal entry. The following steps are followed in journalising:

(1) Analyse the transactions and identify the accounts (based on aspects) which are involved in the transaction.

(2) Classify the above accounts under Personal account, Real account or Nominal account

(3) Apply the rules of debit and credit for the above two accounts.

(4) Find which account is to be debited and which account is to be credited by the application of rules of double entry system

(5) Record the date of transaction in the date column.

(6) Enter the name of the account to be debited in the particulars column very close to the left hand side of the particulars column followed by the abbreviation 'Dr.' at the end in the same line. Against this, the amount to be debited is entered in the debit amount column in the same line.

(7) Write the name of the account to be credited in the second line starting with the word 'To' prefixed a few spaces away from the margin in the particulars column. Against this, the amount to be credited is entered in the credit amount column in the same line.

(8) Write the narration within brackets in the next line in the particulars column.

Different types of journal entries

The journal entries may be of the following types:

(i) Single entry: Single entry is an entry in which only two accounts are involved, one account is debited and another is credited.

(ii) Compound entry: Compound entry is an entry in which more than two accounts are involved. Either more than one account is debited or more than one account is credited or both.

(iii) Opening entry: Through opening entry the balances of assets and liabilities at the end of the previous accounting year are brought forward to the current accounting year. This is dealt in unit 6.

(iv) Closing entry: At the end of the accounting period, the nominal accounts are closed by transferring to trading account or profit and loss account. All direct expenses and direct revenues are transferred to Trading Account. All indirect expenses and indirect revenues are transferred to Profit and Loss Account. This is dealt in unit 6.

(v) Rectifying entry: Rectifying entries are passed to make correction of errors in accounting. This is dealt in unit 9.

(vi) Adjusting entry: Adjusting entry is the entry made for the transactions which remain unrecorded or require adjustment after closing the accounts for the accounting year. This is dealt in unit 13.

(vii) Transfer entry: Transfer entry is the entry through which amount is transferred from one account to another account.

Advantages of journal

Following are the advantages of journal:

(i) Complete information about the business transactions can be obtained on time basis as the transactions are recorded in chronological order.

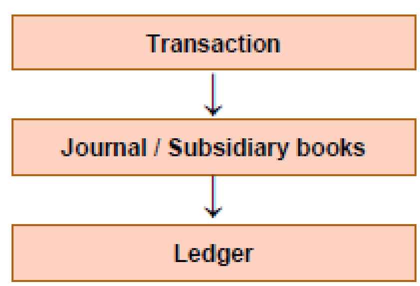
(ii) Correctness of the entry can be checked through narration.

(iii) Journal forms the basis for posting the entries in the ledger.

Golden Rules of Journal Entry

1. **Debit the "Receiver" and Credit the "Giver" (Personal Accounts)**
2. **Debit – What Comes IN and Credit – What Goes OUT (Real Accounts)**
3. **Debit – Expenses and Losses and Credit – Incomes and Gains (Nominal Accounts)**

Ledger Posting



Ledger account is a summary statement of all the transactions relating to a person, asset, liability, expense or income which has taken place during a given period of time and it shows their net effect. From the transactions recorded in the journal, the ledger account is prepared. Ledger is known as principal book of accounts. It is a book which contains all sets of accounts, namely, personal, real and nominal accounts. Accountwise balance can be determined from the ledger. The ledger accounts are prepared based on journal entries passed.

Utilities of ledger

Following are the utilities of ledger:

(i) Quick information about a particular account

Ledger account helps to get all information about a particular account like sales, purchases, machinery, etc., at a glance. For example, where there are several transactions with a debtor, the net amount due from a debtor can be known from the ledger account.

(ii) Control over business transactions

From the ledger balances extracted, a thorough analysis of account balances can be made which helps to have control over the business transactions.

(iii)Trial balance can be prepared

With the balances of ledger accounts, trial balance can be prepared to check the arithmetical accuracy of entries made in the journal and ledger.

iv) Helps to prepare financial statements

From the ledger balances extracted, financial statements can be prepared for ascertaining net profit or loss and the financial position.

Format of ledger account

The ledger account is prepared in T format. It is divided into two parts. Left side is debit side and right side is credit side. Each side contains four columns. The name or title of the account is placed at the top middle and the details are entered in the ledger. The format of ledger account is given below:

Dr. **Name of the ledger account** **Cr.**

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

Following are the details contained in the various columns in the ledger:

Date : Date of the transaction is recorded in this column.

Particulars : The account debited or credited is recorded in this column. On the debit side, the entries are made starting with 'To' and on the credit side, entries are made starting with 'By'.

Journal Folio (J.F.): In this column, the page number of the journal or subsidiary books from which the entry has been posted to the ledger is noted.

Amount : The amount of the transaction is recorded in this column.

Distinction between journal and ledger

Following are the differences between journal and ledger:

Basis	Journal	Ledger
1. Recording	As and when transactions take place entries are made in journal.	In ledger, entries may be posted either on the same day or at the end of a specified period such as weekly or fortnightly especially when subsidiary books are maintained.
2. Stage of recording	Recording in the journal is the first stage	Recording in the ledger is the second stage, which is done on the basis of entries made in the journal.
3. Order of recording	Entries are made in the chronological order, i.e., datewise in the order of occurrence.	Entries are made accountwise.
4. Process	The process of recording in journal is called journalising	The process of recording in the ledger is called posting.
5. Facilitating preparation of trial balance	Amount from the journal does not serve as the basis for preparing trial balance.	Ledger balances serve as the basis for preparing trial balance.
6. Basis of entries	Entries in the journal are made on the basis of source documents.	Posting is done in ledger on the basis of journal entries.
7. Net position	Net position of an account cannot be ascertained from journal.	Net position of an account can be ascertained from ledger account.

Procedure for posting

The process of transferring the debit and credit items from the journal to the ledger accounts is called posting. The procedure of posting from journal to ledger is as follows:

(a) Locate the ledger account that is debited in the journal entry. Open the respective account in the ledger, if already not opened. Write the name of the account in the top middle. If already opened, locate the account from the ledger index. Now entries are to be made on the debit side of the account.

(b) Record the date of the transaction in the date column on the debit side of that account.

(c) Record the name of the account credited in the journal with the prefix 'To' in particulars column.

(d) Record the amount of the debit in the 'amount column'.

(e) Locate the ledger account that is credited in the journal entry. Open the respective account in the ledger, if already not opened. Write the name of the account in the top middle. If already opened, locate the account from the ledger index. Now entries are to be made on the credit side of the account. Record the date of the transaction in the date column. Record the name of the account debited in the journal entry in the particulars column with the prefix 'By' and write the amount in the amount column.

Balancing of ledger accounts

After posting the transactions, the business person is interested to know the position of various accounts. For this purpose, the accounts are balanced at the end of the accounting period or after a certain period to ascertain the net balance in each account. Balancing means that the debit side and credit side amounts are totalled and the difference between the total of the two sides is placed in the amount column as 'Balance c/d' on the side having lesser total, so that the total of both debit and credit columns are equal.

When the total of the debit side is more than the total of credit side the difference is debit balance and is placed on the credit side as 'By Balance c/d'. If the credit side total is more than the total of debit side, the difference is credit balance and is placed on the debit side as 'To Balance c/d'.

Procedure for balancing an account

Following is the procedure for balancing an account:

(i) The debit and credit columns of an account are to be totalled separately.

(ii) The difference between the two totals is to be ascertained.

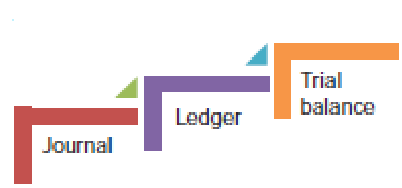
(iii) The difference is to be placed in the amount column of the side having lesser total. 'Balance c/d' is to be entered in the particulars column against the difference and in the date column the last day of the accounting period is entered.

(iv) Now both the debit and credit columns are to be totalled and the totals will be equal. The totals of both sides are to be recorded in the same line horizontally. The total is to be distinguished from other figures by drawing lines above and below the amount.

(v) The difference has to be brought down to the opposite side below the total. 'Balance b/d' is to be entered in the particulars column against the difference brought down and in the date column, the first day of the next accounting period is entered.

(vi) If the total on the debit side of an account is higher, the balancing figure is debit balance and if the credit side of an account has higher total, the balancing figure is credit balance. If the two sides are equal, that account will show nil balance.

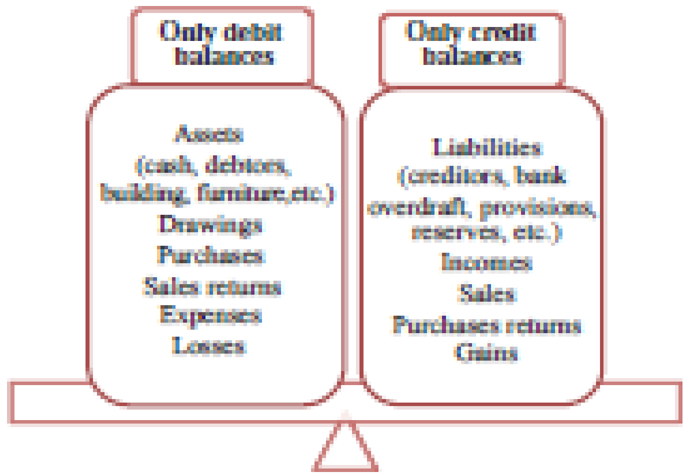
Trial balance



Trial balance is a statement containing the debit and credit balances of all ledger accounts on a particular date. It is arranged in the form of debit and credit columns placed side by side and prepared with the object of checking the arithmetical accuracy of entries made in the books of accounts and to facilitate preparation of financial statements.

Need for preparing trial balance

Trial balance helps to check the arithmetical accuracy of entries made in the accounting records. Trial balance serves as a lubricant for the smooth movement and completion of the accounting cycle, because, it is with the help of the trial balance that discrepancies in the book keeping work are detected. If these discrepancies are not detected and set right, the cycle cannot be completed properly. The trial balance helps in discovering errors which may have been committed in the accounting records. However, in computerised accounting system, once the transactions are recorded in the journals, all the other records are made simultaneously, i.e., ledger postings, trial balance and final accounts. Hence, arithmetic errors and errors in posting the entries from journal to ledger and further will not occur in computerised accounting



Definition of trial balance

"A trial balance is a statement, prepared with the debit and credit balances of the ledger accounts to test the arithmetical accuracy of the books".– J.R. Batliboi

Features of trial balance

Following are the features of trial balance:

(a) Trial balance contains the balances of all ledger accounts.

(b) It is prepared on a specific date. That is why, the word, "as on…" is used at the top.

(c) When double entry system is followed, the totals of the debit and the credit columns of the trial balance must be equal. Thus, trial balance helps to check the arithmetical accuracy of entries made in the books of accounts.

(d) If there is a difference between the totals of debit column and credit column of the trial balance, it is an indication of errors being committed somewhere.

(e) If both the debit column and the credit column of the trial balance have the same total, it does not mean that there is no mistake in accounting, since some errors are not disclosed by the trial balance.

Objectives of preparing trial balance

Trial balance is prepared with the following objectives:

(i) Test of arithmetical accuracy

Trial balance is the means by which the arithmetical accuracy of the book-keeping work is checked. When the totals of debit column and credit column in the trial balance are equal, it is assumed that posting from subsidiary books, balancing of ledger accounts, etc. are arithmetically correct. However, there may be some errors which are not disclosed by trial balance.

(ii) Basis for preparing final accounts

Financial statements, namely, trading and profit and loss account and balance sheet are prepared on the basis of summary of ledger balances obtained from the trial balance.

(iii) Location of errors

When the trial balance does not tally, it is an indication that certain errors have occurred. The errors may have occurred at one or more of the stages of accounting process, namely, journalising or recording in subsidiary books, totalling subsidiary books, posting in ledger accounts, balancing the ledger accounts, carrying ledger account balances to the trial balance, totalling the trial balance columns, etc. Hence, the errors should be located and rectified before preparing the financial statements.

(iv) Summarised information of ledger accounts

The summary of ledger accounts is shown in the trial balance. Ledger accounts have to be seen only when details are required in respect of an account.

Limitations of trial balance

The following are the limitations of trial balance:

(a) It is possible to prepare trial balance of an organisation, only if the double entry system is followed.

(b) Even if some transactions are omitted, the trial balance will tally.

(c) Trial balance may tally even though errors are committed in the books of account.

(d) If trial balance is not prepared in a systematic way, the final accounts prepared on the basis of trial balance may not depict the actual state of affairs of the concern.

(e) Agreement of trial balance is not a conclusive proof of arithmetical accuracy of entries made in the accounting records. This is because there are certain errors which are not disclosed by trial balance such as complete omission of a transaction, compensating errors and error of principle.

Methods of preparing trial balance

A trial balance can be prepared in the following methods:

(i) Balance method

In this method, the balance of every ledger account either debit or credit, as the case may be, is recorded in the trial balance against the respective accounts. The balance method is widely used, as it helps in the preparation of financial statements.

(ii) Total method

Under this method, the total amounts on the debit side of the ledger accounts and the total amounts on the credit side of the ledger accounts are ascertained and recorded in the trial balance. This method is not commonly used as it cannot help in the preparation of financial statements.

(iii) Total and Balance method

This method is a combination of both total method and balance method. Under this method, four columns are provided, namely, (a) totals of debit side of the ledger accounts, (b) totals of the credit side of the ledger accounts (c) debit balances of ledger accounts and (d) credit balances of the ledger accounts. This method is not in practice.

Balance method

Following are the steps to be followed to prepare trial balance under this method:

Step 1: Calculate the balances of all ledger accounts including the cash book.

Step 2: Record the names of the accounts in the particulars column and the amounts of debit balances in the debit column and credit balances in the credit column.

Step 3: Enter the page number of ledger from which the balance is taken in the Ledger Folio column.

Step 4: Total the debit and credit columns. It must be equal. If not equal, locate the errors and make the trial balance agree.

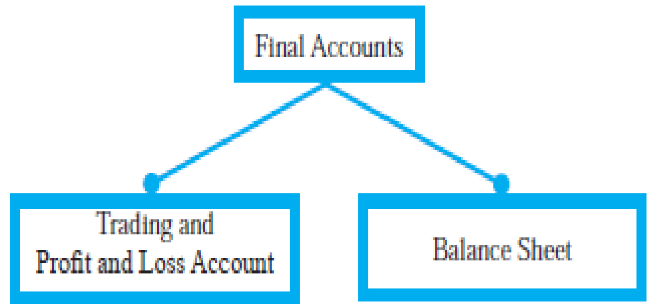
Trial balance is prepared in the following format under the balance method:

Trial balance as on ...

S. No.	Name of account / Particulars	L.F.	Debit balance ₹	Credit balance ₹

Introduction to final accounts

Business entities raise funds, acquire assets and incur various expenses for the purpose of carrying on business operations and earning income from such operations. These transactions are first recorded in the journal and then classified under common heads in the ledger. Preparation of trial balance from ledger balances helps to verify the



arithmetical accuracy of entries made in the books of accounts, but it is not the end in itself. The business entities are interested in knowing periodically the results of business operations carried on and the financial soundness of the business. In other words, they want to know the profitability and the financial position of the business. These can be ascertained by preparing the final accounts or financial statements. The final accounts are usually prepared at the end of the accounting period on the basis of balances of ledger accounts shown by the trial balance.

The final accounts or financial statements include the following:

a. Income Statement or Trading and Profit and Loss Account and

b. Position Statement or Balance Sheet.

The purposes of preparing the financial statements are:

i. To ascertain the financial performance of an enterprise and

ii. To ascertain the financial position of an enterprise.

The income statement and balance sheet are prepared for these purposes respectively. Income statement gives the manner in which the profit or loss for an accounting period is arrived at. The revenues earned and expenses incurred to earn the revenues during the period are shown in the income statement under appropriate heads as per matching principle. All the nominal accounts and accounts relating to goods during an accounting period are to be considered only in the relevant accounting period and are not to be carried forward. Moreover, only these items are to be compared for determining the financial performance. Hence, at the close of the accounting period, all nominal accounts (i.e. expenses, losses, revenues, gains, purchases, purchases returns, sales and sales returns) are to be closed by transferring to the income statement or trading and profit and loss account.

While transferring the items, it is desirable that the results of buying and selling of goods and the results of overall operations and financial performance are given separately. Hence, income statement is divided into two parts. The first part, i.e., trading account shows the results of buying and selling and the second part shows the results of overall financial performance. The second part may also be presented in such a manner to give the operating results and overall financial performance separately. All the direct expenses and items relating to goods are transferred to trading account which is the first part of income statement. All indirect expenses and losses and indirect incomes and gains are transferred to profit and loss account along with the net result of trading account.

Trading account

Trading refers to buying and selling of goods with the intention of making profit. The trading account is a nominal account which shows the result of buying and selling of goods for an accounting period. According to J. R. Batliboi, "The trading account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included."

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

Need for preparation of trading account

Preparation of trading account serves the following purposes:

(i) Provides information about gross profit or gross loss

It shows the gross profit or gross loss of the business for an accounting year. This helps the business persons to find out gross profit ratio by expressing the gross profit as a percentage of sales. It helps to compare and analyse with the ratios of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.

(ii) Provides an opportunity to safeguard against possible losses

If the ratio of gross profit has decreased in comparison to the preceding years, effective measures can be taken to safeguard against future losses. For example, the sale price of goods may be increased or steps may be taken to analyse and control the direct expenses.

(iii) Provides information about direct expenses and direct incomes

All the expenses incurred on the purchase of goods are direct expenses. They are recorded in the trading account. Trading account also shows sales revenue, which is a direct income. With the help of trading account, percentage of such expenses on sales revenue can be calculated and compared with similar ratios of the previous years. Thus, it enables the management to have control over the direct expenses.

Preparation of trading account

Trading account is a nominal account. The opening stock, net purchases and all expenses relating to purchase of goods are shown on the debit side and the net sales and closing stock are shown on the credit side of it.

A) Items shown on the debit side of the trading account

The following are the items shown on the debit side of the trading account:

(i) Opening stock

The stock of goods remaining unsold at the end of the previous year is the opening stock of the current year. This item will not be there in a newly started business. It will not appear if it is adjusted with purchases. As opening stock would have been sold during the year, the cost of opening stock is included in trading account.

(ii) Purchases and purchases returns

Goods which have been bought for resale are termed as purchases. Goods purchased which are returned to suppliers are termed as purchases returns or returns outward. Purchases include both cash purchases and credit purchases. Net purchases, i.e., purchases minus purchases returns are shown in the debit side of the trading account.

(iii) Direct expenses

All the expenses incurred on the purchase of goods and for bringing the goods to the go down or place of business and to make them to saleable condition are known as direct expenses. They are debited to trading account. Direct expenses include the following:

(a) Carriage inwards or Freight inwards

Amount paid for transporting the goods purchased to the godown or business premises is called carriage inwards or carriage on purchases or freight inwards.

(b) Wages

Amount paid to workers who are directly engaged in loading, unloading and handling of goods purchased is known as wages.

(c) Dock Charges

These are the charges levied for shipping the cargo while entering or leaving docks. When they are paid on import of goods, they are treated as direct expenses.

(d) Octroi

This is a tax levied by the local authority when the purchased goods enter the municipal limits.

(e) Import duty

Taxes paid on import of goods are known as import duties.

(f) Royalty

This is the amount paid to the owner of a mine or a patent for using owner's right. When the royalty is based on cost of production or output, it is treated as a direct expense.

(g) Coal, gas, fuel and power

Cost incurred towards coal, gas and fuel to make the goods saleable is also considered as direct expenses.

(iv) Cost of goods manufactured

If the sole proprietor is also engaged in manufacture of goods, a separate account, namely, manufacturing account is to be prepared in which expenses incurred for manufacture of goods will be entered. Examples of such expenses are raw materials, coal, gas, fuel, water, power, factory rent, packaging, factory lighting, royalty on manufactured goods, etc. The total cost of goods manufactured is transferred to the debit side of trading account.

B) Items shown on the credit side of the trading account

Following are the items shown on the credit side of the trading account:

(a) Sales and Sales returns

Both cash and credit sales of goods will be included in sales. The sales account will show credit balance whereas the sales returns account will show debit balance. The amount of net sales is shown on the credit side of the trading account by deducting sales returns from sales.

(b) Closing stock

The goods remaining unsold at the end of the accounting period are known as closing stock. They are valued at cost price or net realisable value (market price) whichever is lower as per Accounting Standard 2 (Revised).

Trading Account Format

Format of Trading Account

Trading Account

Dr. (For the period ended . . . .) Cr.

Particulars	Amount	Particulars	Amount
To Opening stock		By Sales	
To Purchases		Less: Sales returns	
Less: Purchases returns		By Closing stock	
To Wages			
To Customs and import duty			
To Carriage expenses			
To Royalty			
To Manufacturing expenses			
To Packing expenses			
Total		Total	
To gross profit transferred to profit and loss account		By gross loss transferred to profit and loss account	

Profit and loss account

Profit and loss account is the second part of income statement. It is a nominal account in nature. A business entity is interested in knowing not only the gross profit or loss but also the net profit earned or net loss incurred during the year. Hence, profit and loss account is prepared to ascertain the net profit or net loss during the year. Profit and loss account contains all the items of indirect expenses and losses and indirect incomes and gains in addition to gross profit or gross loss pertaining to the accounting period. The difference is net profit or net loss. According to Prof. Carter, "A Profit and Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa".

Need for preparing profit and loss account

Profit and loss account is prepared for the following purposes:

(i) Ascertainment of net profit or net loss

The profit and loss account discloses the net profit available to the proprietor or net loss to be borne by him. Ascertainment of profitability helps in planning for the growth and efficiency of a business enterprise. Inter-firm comparison and intra-firm comparison of profit and loss account items help in assessing efficiency in comparison with other enterprises and other departments of the same enterprise respectively.

(ii) Comparison of profit

The net profit of the current year can be compared with the profit of the previous years. It helps to know whether the business is conducted efficiently or not.

(iii) Control on expenses

Profit and loss account helps in comparing various expenses with the expenses of the previous years. The percentage of individual expenses to net sales can be calculated and compared with the similar ratios of previous years. Such a comparison will be helpful in taking effective steps for controlling unnecessary expenses.

(iv) Helpful in the preparation of balance sheet

A balance sheet can be prepared only after ascertaining the net profit or loss through profit and loss account. Net profit or loss is shown in the balance sheet. Thus, it facilitates preparation of balance sheet.

Preparation of profit and loss account

The amount of gross profit or gross loss brought down from the trading account is the first item in the profit and loss account. All the indirect expenses and losses are debited to profit and loss account. Indirect expenses include office and administrative expenses, selling expenses, distribution expenses, etc. As the profit and loss account is a nominal account, all the indirect expenses and losses are shown on the debit side and all the indirect incomes and gains are shown on the credit side.

Items shown on the debit side of profit and loss account are as follows:

(i) Gross loss

If trading account discloses gross loss, it is shown on the debit side of the profit and loss account.

(ii) Indirect expenses

Expenses which are not connected with purchase of goods are indirect expenses, i.e., expenses incurred in administration, office, selling and distribution of goods are indirect expenses.

(a) Office and administrative expenses

Expenses incurred for office and administration such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee, depreciation and maintenance of office equipment, etc. are classified as office and administrative expenses.

(b) Selling and distribution expenses

Expenses incurred for selling, promotion of sales and distribution of goods such as advertisement charges, commission to salesmen, carriage outwards, bad debts, godown rent, packing charges, etc., are classified as selling and distribution expenses.

(c) Other indirect expenses and losses

The expenses such as interest on loan, repair charges, depreciation, charity, loss on sale of fixed assets and abnormal losses such as loss due to fire, theft, etc. not covered by insurance are shown under this category.

Items shown on the credit side of profit and loss account are as follows:

(i) Gross profit

The first item on the credit side of profit and loss account is the gross profit brought down from the trading account if there is gross profit.

(ii) Other incomes and gains

All items of indirect incomes and gains are shown on the credit side of the profit and loss account. Income from investments, rent earned, discount received, commission earned, interest earned and dividend received are indirect incomes. Profit on sale of fixed assets and investments are examples of gains.

Profit & Loss Format

Profit & Loss Account

Dr. (For the year ended...) Cr.

Particulars	Amount	Particulars	Amount
To Gross loss b/d	Xxx	By Gross Profit b/d	Xxx
To Salaries	Xxx	By Discount Received	Xxx
To Office rent, rates and taxes	Xxx	By Commission Received	Xxx
To Printing & stationery	Xxx	By Bank Interest	Xxx
To Telephone expenses	Xxx	By Rent received	Xxx
To Postage & telegram	Xxx	By Dividend on shares	Xxx
To Discount Allowed	Xxx	By Interest earned on debentures	Xxx
To Insurance	Xxx	By Profit on sale of asset	Xxx
To Audit Fees	Xxx	By Net loss	Xxx
To Electricity charges	Xxx		
To Repairs & renewals	Xxx		
To Depreciation	Xxx		
To Advertisement	Xxx		
To Carriage Outwards	Xxx		
To Bad Debts	Xxx		
To Provision for Bad debts	Xxx		
To Selling commission	Xxx		
To Bank Charges	Xxx		
To Interest on loans	Xxx		
To Loss on sale of asset	Xxx		
To Net Profit	Xxx		
	xxx		xxx

Balance sheet

Balance sheet is a statement which gives the position of assets and liabilities on a particular date. Assets are the resources owned by the business. Liabilities are the claims against the business. After ascertaining the net profit or net loss of the business enterprise, a business person would like to know the financial position of the business. For this purpose, balance sheet is prepared which contains amounts of all the assets and liabilities of the business enterprise as on a particular date. The statement so prepared is called 'balance sheet' because it gives the balances of ledger accounts which are still there, after the closure of all nominal accounts by transferring to the trading and profit and loss account. Balances of all the personal and real accounts are grouped into assets and liabilities. In the balance sheet, liabilities are shown on the left hand side and assets on the right hand side.

According to J.R. Batliboi, "A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date."

Need for preparing a balance sheet

The purposes of preparing a balance sheet are as follows:

(a) The main purpose of preparing a balance sheet is to ascertain the true financial position of the business at a particular point of time.

(b) It helps in comparing the cost of various assets of the business such as the amount of closing stock, amount due from debtors, amount of fictitious assets, etc. Moreover as assets and liabilities of similar nature are grouped and presented in balance sheet, a comparative study of these assets and liabilities is facilitated. It helps in comparing the various liabilities of the business.

(c) It helps in finding out the solvency position of the firm. The firm's solvency position is favourable if the assets exceed the external liabilities. The firm's solvency position is not favourable it the external liabilities exceed the assets.

Characteristics of balance sheet

The following are the characteristics of a balance sheet:

(a) A balance sheet is a part of the final accounts. However, the balance sheet is a statement and not an account. It has no debit or credit sides and as such the words 'To' and 'By' are not used before the names of the accounts shown therein.

(b) A balance sheet is a summary of the personal and real accounts, which have balances. Personal and real accounts having debit balances are shown on the right hand side known as assets side, whereas personal and real accounts having credit balances are shown on the left hand side known as liabilities side.

(c) The totals of the two sides of the balance sheet must be equal. If the totals are not equal, it indicates existence of error. It must satisfy the accounting equation, ie., Assets = Capital + Liabilities, following the dual aspect concept.

(d) Balance sheet is prepared on a particular date and not for a fixed period. It discloses the financial position of a business on a particular date. It gives the balances only for the date on which it is prepared.

(e) It shows the financial position of the business according to the going concern concept.

Balance sheet Format

Balance Sheet of ....

Liabilities		₹	***Assets***	₹
Capital			**Fixed Assets:**	
Opening Balance	*XX*		*Goodwill*	
Add: Net Profit	*XX*		*Land*	
(Less: Net Loss)			*Building*	
Less: Drawings	*XX*	*XXX*	*Plant & Machinery*	
Long-term Liabilities:			*Furniture & Fixtures*	
Long term loan			*Investment: (long term)*	
Current liabilities:			*Current Assets:*	
Income received-in-advance			*Closing stock*	
Outstanding Expenses			*Accrued Income*	
Sundry Creditors			*Prepaid expenses*	
Bills Payable			*Sundry Debtors*	
Bank Overdraft			*Bills Receivable*	
			Cash at Bank	
			Cash in Hand	

Differences between trial balance and balance sheet

The following are the differences between trial balance and balance sheet:

Basis	Trial balance	Balance sheet
1. Nature	Trial balance is a list of ledger balances on a particular date.	Balance sheet is a statement showing the position of assets and liabilities on a particular date.
2. Purpose	Trial balance is prepared to check the arithmetical accuracy of the accounting entries made.	Balance sheet is prepared to ascertain the financial position of a business.
3. Contents	It is a summary of balances of all accounts – personal, real and nominal accounts.	It is a statement showing the closing balances of only personal and real accounts.
4. Format	The trial balance contains columns for debit balances and credit balances.	The items are grouped as assets and liabilities.
5. Stage	It is prepared before the preparation of final accounts.	It is prepared after preparing trial balance and trading and profit and loss account.
6. Period	It can be prepared periodically, say at the end of the month, quarterly, half yearly, etc.	It is generally prepared at the end of the accounting period.
7. Order	Balances shown in the trial balance need not be in order.	Balances shown in the balance sheet must be in order.
8. Compulsion	Preparation of trial balance is not compulsory.	Preparation of the balance sheet is compulsory in certain cases.

Cash Book

In any business, many transactions take place every day involving cash such as cash sales, receipts from debtors, cash purchases, payment to creditors and payment towards different expenses. It is therefore necessary, that all the cash transactions are recorded in a separate book, i.e., cash book. Cash book is the most important subsidiary book, because it keeps the initial record of cash transactions of the business. Cash book is maintained by every business, whether small or large in size. It is simply because every business is very cautious about its cash management, i.e., cash receipts and cash payments. The cash book presents the true position of cash transactions. Cash book also serves as a documentary evidence for the available cash balance.

Meaning of cash book

Cash book is the book in which only cash transactions are recorded in the chronological order. The cash book is the book of original entry or prime entry as cash transactions are recorded for the first time in it. Cash transactions here may include bank transactions also. Cash receipts are recorded on the debit side while cash payments are recorded on the credit side.

Cash Book – A subsidiary book and principal book of accounts

All the cash transactions are recorded first in the cash book. It is therefore a subsidiary book. When cash book is maintained, there is no need for preparing cash account and bank account in the ledger because in the cash book cash receipts and cash payments are compared and the cash and bank balances at the end are arrived at. Thus, it serves as a ledger account also. Hence, the cash book, unlike any other subsidiary book, is both a subsidiary book and a principal book.

Importance of cash book

Importance of cash book is discussed below:

(i) Serves as both journal and ledger

When cash book is maintained, it is not necessary to open a separate cash account in the ledger. Thus, cash book serves the purpose of a journal and a ledger.

(ii) Saves time and labour

When cash transactions are recorded through journal entries, a lot of time and labour will be involved. To avoid this, all cash transactions are straightaway recorded in the cash book, which saves time and labour.

(iii) Shows the cash and bank balance

It helps to know the cash and bank balance at any point of time by comparing the total cash receipts and cash payments.

(iv) Benefit of division of labour

As cash book is a separate subsidiary book, an independent person can maintain it. Hence, business can get the benefit of division of labour.

(v) Effective cash management

Cash book provides all information regarding total receipts and payments of the business concern during a particular period. It helps in formulating effective policy for cash management.

(vi) Prevents errors and frauds

Balance as per cash book and the balance in the cash box can be compared daily. If there is any deficit or surplus, it can be found easily. It helps in preventing any fraud or error in cash dealings.

Types of cash book

The main cash book may be of various types and following are the three most common types.

(i) Simple or single column cash book (only cash column)

(ii) Cash book with cash and discount column (double column cash book)

(iii) Cash book with cash, discount and bank columns (three column cash book).

Apart from the main cash book, petty cash book may also be prepared to enter the petty expenses, i.e., expenses involving small amount.

Single column cash book

Single column cash book or simple cash book, like a ledger account has only one amount column, i.e., cash column on each side. Only cash transactions are recorded in this book. All cash receipts and payments are recorded systematically in this book. The format of simple cash book is given as under:

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

Date	Receipts	R.N.	L.F.	Amount ₹	Date	Payments	V.N.	L.F.	Amount ₹
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

The format of simple cash book shows that it has been divided into two parts. The left hand side is 'Debit' which represents all cash receipts and the right hand side is 'Credit', showing all cash payments.

Columns (1) and (6) – Date: Date of receiving cash is recorded in the debit side and date of paying cash is recorded in the credit side.

Column (2) Receipts: Receipts column shows name of persons or parties from whom cash has been received, income received, sale of asset like plant, cash sales and other receipts.

Column (3) Receipt Number (R.N.): This column contains the serial numbers of the cash receipts.

Columns (4) and (9) – Ledger Folio (L.F.): This column is provided both on the debit and credit side of the cash book. It is used for reference. The Ledger page number of every account in the cash book is recorded in this column. This column facilitates vouching and verification of transactions recorded.

Columns (5) and (10) – Amount: This is the last column of the cash book on both the debit and credit sides. In case of cash receipt, the amount of actual cash receipts and in case of payments, the amount of actual cash payment is recorded. The opening balance of cash is recorded on the debit side and the closing balance is the balancing figure on the credit side.

Opening balance or capital contributed by cash in case of new business is the first item on the debit side and the closing balance is the last item on the credit side.

The word 'To' is conventionally used before different accounts at the debit side of cash book in particulars column. The word 'By' is used before the different accounts at the credit side of the cash book in particulars column.

Column (7) Payments: The accounts to which payments are made are recorded here such as names of persons to whom payment has been made, expenses paid, assets purchased, cash purchases, etc.

Column (8) Voucher Number (V.N.): This column contains the serial number of the voucher towards which payment is made.

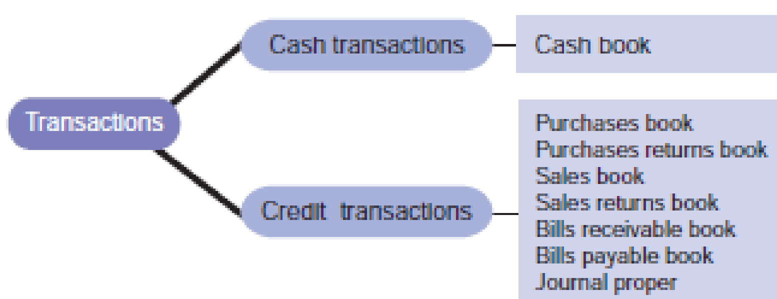
Subsidiary Book

Meaning of subsidiary books

Subsidiary books are sub-divisions of journal in each of which transactions of similar nature are recorded. These are the books of prime entry. Instead of recording in one journal, the transactions are recorded in a number of prescribed books.

Types of subsidiary books

The number of subsidiary books may vary according to the requirements of each business. Based on the nature of business and the volume of transactions, the following subsidiary books are maintained:



(i) Subsidiary book for entering cash transactions - Cash book

(ii) Subsidiary books (special journal) for entering non-cash transactions:

(a) Purchases book or purchases journal – for recording only credit purchase of goods in which the trader deals.

(b) Sales book or sales journal–for recording only credit sale of goods dealt in by the trader.

(c) Purchases returns or returns outward book – for recording return of goods purchased by the trader, for which no cash is immediately received.

(d) Sales returns or returns inward book – for recording the goods returned (out of previous sale) by customers for which no cash is immediately paid.

(e) Bills receivable book – to record bills drawn or promissory notes received.

(f) Bills payable book – to record bills accepted or promissory notes given.

(iii) Journal proper – The general journal or all purpose journal to record transactions which do not find a place in the above seven subsidiary books.

Advantages of subsidiary books

The advantages of maintaining subsidiary books can be summarised as under:

(i) Proper and systematic record of business transactions

All the business transactions are classified and grouped conveniently as cash and non cash transactions, which are further classified as credit purchases, credit sales, returns, etc. As separate books are used for each type of transactions, individual transactions are properly and systematically recorded in the subsidiary books.

(ii) Convenient posting

All the transactions of a particular nature are recorded at one place, i.e., in one of the subsidiary books. For example, all credit purchases of goods are recorded in the purchases book and all credit sales of goods are recorded in the sales book. It facilitates posting to purchases account, sales account and concerned personal accounts.

(iii) Division of work

As journal is sub-divided, the work will be sub-divided and different persons can work on different books at the same time and the work can be speedily completed.

(iv) Efficiency

The sub-division of work gives the advantage of specialisation. When the same work is done by a person repeatedly the person becomes efficient in handling it. Thus, specialisation leads to efficiency in accounting work.

(v) Helpful in decision making

Subsidiary books provide complete details about every type of transactions separately. Hence, the management can use the information as the basis for deciding its future actions. For example, information regarding sales returns from the sales returns book will enable the management to analyse the causes for sales returns and to adopt effective measures to remove deficiencies.

(vi) Prevents errors and frauds

Internal check becomes more effective as the work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of errors or fraud may be avoided or minimised.

(vii) Availability of requisite information at a glance

When all transactions are entered in one journal, it is difficult to locate information about a particular item. When subsidiary books are maintained, details about a particular type of transaction can be obtained from subsidiary books. The maintenance of subsidiary books helps in obtaining the necessary information at a glance.

(viii) Detailed information available

As all transactions relating to a particular item are entered in a subsidiary book, it gives detailed information. It is easy to arrive at monthly or quarterly totals.

(ix) Saving in time

As there are many subsidiary books, work of entering can be done simultaneously by many persons. Thus, it saves time and accounting work can be completed quickly.

(x) Labour of posting is reduced

Labour of posting is reduced as posting is made in periodical totals to the impersonal account, for example, Purchases account.

Rectification of Error

The very purpose of maintaining accounting records is to know the profit made or the loss incurred by a business entity and its financial position at the end of every accounting year. Accuracy is assured only when there are no errors in the books of accounts. To ensure accuracy, errors are identified and rectified. Many business enterprises have shifted from manual accounting to computerised accounting. Yet, errors in accounting are unavoidable. Hence, errors are to be located and rectified to find out the real profit or loss and financial position i.e., assets and liabilities at different periods, usually at the end of each financial year.

Meaning of errors

Error means recording or classifying or summarising the accounting transactions wrongly or omissions to record them by a clerk or an accountant unintentionally.

Errors at different stages of accounting

In the accounting process, errors may occur in any of the following stages:

A) At the stage of journalising

At this stage, the following types of errors may occur:

(i) Error of omission (ii) Error of commission (iii) Error of principle

B) At the stage of posting

At this stage, the following types of errors may occur:

(i) Errors of omission

(a) Error of complete omission (b) Error of partial omission

(ii) Error of commission

(a) Posting to wrong account (b) Posting of wrong amount

(c) Posting to the wrong side

C) At the stage of balancing

At this stage, the following types of errors may occur:

(i) Wrong totalling of accounts (ii) Wrong balancing of accounts

D) At the stage of preparing trial balance

At this stage, following types of errors may occur:

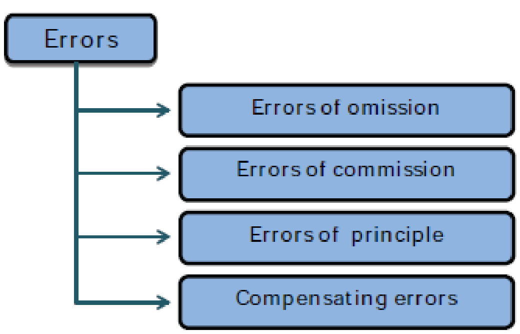
(i) Error of omission

(ii) Error of commission

(a) Entering to wrong account (b) Entering wrong amount

(c) Entering to the wrong side of trial balance, etc.

Classification of errors



Errors in computerised accounting

In the recent years, because of the technological developments, many firms have computerised their accounting. It is done to save time and to have accuracy. Though certain errors of commission such as casting errors, errors in carrying forward, etc. and errors of partial omissions can be avoided, the following errors become unavoidable:

- Errors of complete omission
- Errors of principle
- Errors of making wrong entry in the books of original entry
- Errors of entering wrong amounts in the books of original entry
- Errors of entering wrong accounts in the books of original entry
- Errors of duplication

UNIT III

FINANCIAL STATEMENTS: Form and Contents of Financial Statements, Analysing and Interpreting Financial Statements, Accounting Standards. **Class Discussion:** Corporate Accounting Fraud- A Case Study of Satyam

Introduction

Business concerns prepare income statement and balance sheet at the end of an accounting period to ascertain the profitability and the financial position respectively. These statements give the totals of different expenditures, revenues and the net result, namely, profit or loss during the given period and balances of assets and liabilities and capital as on the last date of the accounting period. Thus, financial statements are sources of financial information. However, these statements do not give the relationship among the various items or the reasons for changes in the amounts of these items between two dates and the effect of such changes. For this purpose, different tools of financial statement analysis are used.

Financial statements

Meaning of financial statements

Financial statements are the statements prepared by the business concerns at the end of the accounting period to ascertain the operating results and the financial position. The basic financial statements prepared by business concerns are income statement and balance sheet. Income statement includes manufacturing account and trading and profit and loss account. It shows the net results of business activities during an accounting period. Balance sheet is a statement of assets and liabilities which shows the financial position as on a particular date.

Apart from these two basic statements, business concerns may also prepare cash flow statement, funds flow statement and statement of changes in financial position.

Features of financial statements

Following are the features of financial statements:

(i) Financial statements are generally prepared at the end of an accounting period based on transactions recorded in the books of accounts.

(ii) These statements are prepared for the organisation as a whole.

(iii) Information is presented in a meaningful way by grouping items of similar nature such as fixed assets and current assets.

(iv) Financial statements are prepared based on historical cost.

(v) Financial statements are prepared based on accounting principles and Accounting Standards, which make financial statements comparable and realistic.

(vi) Financial statements involve personal judgement in certain cases. For example, selection of method of depreciation, percentage of reserve, etc.

Significance of financial statements

Financial statements reveal the operating results and financial position of the business concern. The significance of financial statements to various stakeholders is as follows:

(i) To management**:** Financial statements provide information to the management to take decision and to have control over business activities, in various areas.

(ii) To shareholders: Financial statements help the shareholders to know whether the business has potential for growth and to decide to continue their shareholding.

(iii) To potential investors: Financial statements help to value the securities and compare it with those of other business concerns before making their investment decisions.

(iv) To creditors: Creditors can get information about the ability of the business to repay the debts from financial statements.

(v) To bankers: Information given in the financial statements is significant to the bankers to assess whether there is adequate security to cover the amount of the loan or overdraft.

(vi) To government: Financial statements are significant to government to assess the tax liability of business concerns and to frame and amend industrial polices.

(vii) To employees: Through the financial statements, the employees can assess the ability of the business to pay salaries and whether they have future growth in the concern.

Limitations of financial statements

Following are the limitations of financial statements:

(i) Lack of qualitative information: Qualitative information that is non-monetary information is also important for business decisions. For example, efficiency of the employees, efficiency of the management, etc. But, this is ignored in financial statements.

(ii) Record of historical data: Financial statements are prepared based on historical data. They may not reflect the current position.

(iii) Ignore price level changes: Adjustments for price level changes are not made in the financial statements. Hence, financial statements may not reveal the current position.

(iv) Lack of consistency: Different business concerns may use different accounting methods. Hence, comparison between two business concerns becomes difficult.

(v) Give only interim reports: Financial statements are prepared at the end of every accounting period. But, the actual position of the business can be known only when the business is closed. Hence, financial statements may not reveal the exact position of the business concern.

(vi) Limited access to external users: The external users do not have detailed and frequent information of financial results as they have limited access.

(vii) Influenced by personal judgement: Preparation of financial statements may be influenced by personal judgements and therefore these are not free from bias.

Financial statements of companies

Following provisions of the Indian Companies Act, 2013 have to be followed while preparing the financial statements of a company:

(i) As per Section 2 (40), financial statements include balance sheet, profit and loss account / income and expenditure account, cash flow statement, statement of changes in equity and any explanatory note annexed to the above.

(ii) Section 129 (1) of the Indian Companies Act, 2013 states that the financial statements shall give a true and fair view of the state of affairs of the company and shall comply with the Accounting Standards notified under section 133.

(iii) Section 129 (1) also states that the financial statements shall be prepared in the form provided in schedule III of Indian Companies Act, 2013.

Techniques or Tools of financial statement analysis

Different tools are used for analysing the financial statements. The tool is selected based on the purpose of analysis. Following are the commonly used tools of financial statement analysis:

(i) Ratio analysis

An analysis of financial statements based on ratio is known as ratio analysis. A ratio is a mathematical relationship between two or more items taken from the financial statements. Ratio analysis is the process of computing, determining and presenting the relationship of items. It also includes comparison and interpretation of ratios and using them as basis for the future projections. Ratio analysis is helpful to management and outsiders to diagnose the financial health of a business concern. It helps in measuring the profitability, solvency and activity of a firm

(ii) Cash flow analysis

Cash flow analysis is concerned with preparation of cash flow statement which shows the inflow and outflow of cash and cash equivalents in a given period of time. Cash includes cash in hand and demand deposits with banks. Cash equivalents denote short term investments which can be realised easily within a short period of time, without much loss in value. Cash flow analysis helps in assessing the liquidity and solvency of a business concern.

(iii) Funds flow analysis

The term ‘fund’ refers to working capital. Working capital refers to the excess of current assets over current liabilities. The term ‘flow’ means movement and includes both ‘inflow’ and ‘outflow’. Funds flow analysis is concerned with preparation of funds flow statement which shows the inflow (sources) and outflow (applications) of funds in a given period of time. Funds flow analysis is useful in judging the credit worthiness, financial planning and preparation of budgets.

(iv) Comparative financial statement

A statement giving comparison of net increase or decrease in the individual items of financial statements of two or more years of a business concern is called comparative statement. It shows the actual figures at different periods of time, the increase or decrease in these figures in absolute terms and the percentages of such increase or decrease. The two basic comparative statements prepared are comparative income statement and comparative balance sheet.

(v) Common-size statements

The common–size statements show the relationship of various items with some common base, expressed as percentage of the common base. The common bases are total of assets or total of equity and liabilities or revenue from operations (net sales). The common size statements include common-size income statement and common-size balance sheet.

In the common–size income statement, revenue from operations is taken as 100 and various expenses and incomes are expressed as a percentage to the revenue from operations. In the common-size balance sheet, the total of balance sheet, that is, the total of assets or total of equity and liabilities is taken as 100 and various assets and liabilities are expressed as a percentage of the total of assets or total of equity and liabilities.

The common-size statements can be compared with those of previous years. They can also be compared with those of other similar businesses with similar accounting policies.

(vi) Networking capital analysis

Networking capital statement or schedule of changes in working capital is prepared to disclose net changes in working capitals on two specific dates (generally two balance sheet dates). It is prepared from current assets and current liabilities on the specified dates to show net increase or decrease in working capital.

(vii) Trend analysis

Trend refers to the tendency of movement. Trend analysis refers to the study of movement of figures over a period. The trend may be increasing trend or decreasing trend or irregular. When data for more than two years are to be analysed, it may be difficult to use comparative statement. For this purpose, trend analysis may be used. One year, generally, the first year is taken as the base year. The figures of the base year are taken as 100. The figures for the other years are expressed as a percentage to the base year and the trend is determined.

Preparation of comparative statements

A comparative statement has five columns. Following are the steps to be followed in preparation of the comparative statement:

(i) Column 1: In this column, particulars of items of income statement or balance sheet are written.

(ii) Column 2: Enter absolute amount of year 1.

(iii) Column 3: Enter absolute amount of year 2.

(iv) Column 4: Show the difference in amounts between year 1 and year 2. If there is an increase in year 2, put plus sign and if there is decrease put minus sign.

(v) Column 5: Show percentage increase or decrease of the difference amount shown in column 4 by dividing the amount shown in column 4 (absolute amount of increase or decrease) by column 2 (year 1 amount). That is,

Percentage increase or decrease = Absolute amount of increase or decrease x 100

Year 1 amount

Format of comparative statement

Comparative Income Statement:

Particulars	**2000 ₹**	**2021 ₹**	**Increase (+) or decrease (-) in 2000 over 2021**	
			Amount ₹	**Percentage %**
Net Sales	xxx	xxx	xxx	xxx
Less: Cost of goods sold	xxx	xxx	xxx	xxx
Gross profit (A)	**xxx**	**xxx**	**xxx**	**xxx**
Operating Expenses:				
Administrative exp	xxx	xxx	xxx	xxx
Selling	xxx	xxx	xxx	xxx
Rent				
Total Operating Expenses (B)	**xxx**	**xxx**	**xxx**	**xxx**
Operating profit (A-B)=C	**xxx**	**xxx**	**xxx**	**xxx**
Non operating expenses:				
Interest	xxx	xxx	xxx	xxx
Income tax	xxx	xxx	xxx	xxx
Total non operating expenses (D)	**xxx**	**xxx**	**xxx**	**xxx**
Profit before tax (C)-(D)= E	xxx	xxx	xxx	xxx
Provision for tax @ 50% (F)	xxx	xxx	xxx	xxx
Net profit after tax (E)-(F)	**xxx**	**xxx**	**xxx**	**xxx**
**Note: Net profit (C-D) if there is no calculation for profit before tax or provision for tax given.*				

Exercise 1

From the following particulars, prepare comparative income statement of Tharun Co. Ltd.

Particulars	2016-17	2017-18
	₹	₹
Revenue from operations	2,00,000	2,50,000
Other income	50,000	40,000
Expenses	1,50,000	1,20,000

Exercise 2

From the following particulars, prepare comparative income statement of Abdul Co. Ltd.

Particulars	2015-16 ₹	2016-17 ₹
Revenue from operations	3,00,000	3,60,000
Other income	1,00,000	60,000
Expenses	2,00,000	1,80,000
Income tax	30%	30%

Exercise 3

From the following particulars, prepare comparative income statement of Mary Co. Ltd.

Particulars	2015-16	2016-17
	₹	₹
Revenue from operations	4,00,000	5,00,000
Operating expenses	2,00,000	1,80,000
Income tax (% of the profit before tax)	20	50

Illustration 4

The following are the income statements of Jeevan ltd., for the year ending 31st December 2018 and 2019. You are required to prepare a comparative income statement for the two years

Particulars	**31.12.2013** **Rs**	**31.12.2014** **Rs.**
Net sales	1000,000	1200,000
Cost of goods sold	550,000	605,000
Operating expenses:		
Administration	80000	100,000
Selling	60000	80000
Non-Operating Expenses:		
Interest	40000	50000
Income-tax	50000	80000

Comparative Balance Sheet

Particulars	2000 ₹	2021 ₹	Increase (+) or decrease (-) in 2000 over 2021	
			Amount ₹	Percentage %
Assets				
Current Assets:				
Inventory	xxx	xxx	xxx	xxx
Stock	xxx	xxx	xxx	xxx
Bills receivable	xxx	xxx	xxx	xxx
Debtor	xxx	xxx	xxx	xxx
Cash	xxx	xxx	xxx	xxx
Total Current Assets (A)	**xxx**	**xxx**	**xxx**	**xxx**
Fixed Assets:				
Land & Buildings	xxx	xxx	xxx	xxx
Plant & Machinery	xxx	xxx	xxx	xxx
Furniture	xxx	xxx	xxx	xxx
Total Fixed Assets (B)	**xxx**	**xxx**	**xxx**	**xxx**
Total Assets (A+B)	**xxx**	**xxx**	**xxx**	**xxx**
Liabilities & Capital				
Current Liabilities:	xxx	xxx	xxx	xxx
Sundry Creditors	xxx	xxx	xxx	xxx
Bills Payable	xxx	xxx	xxx	xxx
Total Current Liabilities (A)	**xxx**	**xxx**	**xxx**	**xxx**
Long-term Liabilities:				
% Debentures	xxx	xxx	xxx	xxx
Total long-term liabilities (B)	xxx	xxx	xxx	xxx
Total liabilities (A+B)=(C)	**xxx**	**xxx**	**xxx**	**xxx**
Capital & Reserves:				
Equity share capital	xxx	xxx	xxx	xxx
Retained Earnings	xxx	xxx	xxx	xxx
Total shareholders' fund(D)	**xxx**	**xxx**	**xxx**	**xxx**
Total liabilities & capital (C +D)	**xxx**	**xxx**	**xxx**	**xxx**

Exercise 1

From the following balance sheet of Chandra Ltd, prepare comparative balance sheet as on 31st March 2016 and 31st March 2017.

Particulars	31st March 2016	31st March 2017
	₹	₹
I EQUITY AND LIABILITIES		
Shareholders' fund	1,00,000	2,60,000
Non-current liabilities	50,000	60,000
Current liabilities	25,000	30,000
Total	1,75,000	3,50,000
II ASSETS		
Non-current assets	1,00,000	2,00,000
Current assets	75,000	1,50,000
Total	1,75,000	3,50,000

Exercise 2

From the following particulars, prepare comparative balance sheet of Malar Ltd as on 31st March 2016 and 31st March 2017.

Particulars	31st March 2016	31st March 2017
	₹	₹
I EQUITY AND LIABILITIES		
1. Shareholders' fund		
a) Share capital	2,00,000	2,50,000
b) Reserves and surplus	50,000	50,000
2. Non-current liabilities		
Long-term borrowings	30,000	60,000
3. Current liabilities		
Trade payables	20,000	60,000
Total	3,00,000	4,20,000
II ASSETS		
1. Non-current assets		
a) Fixed assets	1,00,000	1,50,000
b) Non - current investments	50,000	75,000
2. Current assets		
Inventories	75,000	1,50,000
Cash and cash equivalents	75,000	45,000
Total	3,00,000	4,20,000

COMMON SIZE STATEMENTS

Preparation of common-size statements

Common-size statement can be prepared with three columns. Following are the steps to be followed in preparation of common-size statement:

(i) Column 1: In this column, particulars of items of income statement or balance sheet are written.

(ii) Column 2: Enter absolute amount.

(iii) Column 3: Choose a common base as 100. For example, revenue from operations can be taken as the base for income statement and total of balance sheet can be taken as the base for balance sheet. Work out the percentage for all the items of column 2 in terms of the common base and enter them in column 3.

Common Income Statement:

Particulars	2020		2021	
	Amount ₹	Percentage %	Amount ₹	Percentage %
Sales	Xxx	xxx	xxx	xxx
Less: Cost of goods	Xxx	xxx	xxx	xxx

Gross profit (A)	**Xxx**	**xxx**	**xxx**	**xxx**
Operating Expenses:				
Administrative	Xxx	xxx	xxx	xxx
Selling	Xxx	xxx	xxx	xxx
Distribution	Xxx	xxx	xxx	xxx
Rent	Xxx	xxx	xxx	xxx
Total Operating Expenses (B)	**Xxx**	**xxx**	**xxx**	**xxx**
Operating profit (A-B)=C	**Xxx**	**xxx**	**xxx**	**xxx**
Non operating expenses:				
Interest	Xxx	xxx	xxx	xxx
Income tax	Xxx	xxx	xxx	xxx
Total non operating expenses (D)	**Xxx**	**xxx**	**xxx**	**xxx**
Profit before tax (C)-(D)= E	Xxx	xxx	xxx	xxx
Provision for tax @ 50% (F)	Xxx	xxx	xxx	xxx
Net profit after tax (E)-(F)	**Xxx**	**xxx**	**xxx**	**xxx**

Common Size Balance Statement:

Particulars	2020		2021	
	Amount ₹	**Percentage %**	**Amount ₹**	**Percentage %**
Current Assets:				
Cash at bank	Xxx	xxx	xxx	xxx
Debtors	Xxx	xxx	xxx	xxx
Stock	Xxx	xxx	xxx	xxx
Total Current Assets (A)	**Xxx**	**xxx**	**xxx**	**xxx**
Fixed Assets:				
Buildings	Xxx	xxx	xxx	xxx
Machinery	xxx	xxx	xxx	xxx
Total Fixed Assets (B)	**xxx**	**xxx**	**xxx**	**xxx**
Total Asset (A+B)	**xxx**	**xxx**	**xxx**	**xxx**
Liabilities & Capital:				
Creditors	xxx	xxx	xxx	xxx
Bills Payable	xxx	xxx	xxx	xxx
Tax Payable	xxx	xxx	xxx	xxx
Total current liabilities (A)	**xxx**	**xxx**	**xxx**	**xxx**
Long term liabilities				
10% Debentures (B)	xxx	xxx	xxx	xxx
Total liabilities (A+B)=C	**xxx**	**xxx**	**xxx**	**xxx**
Capital & Reserves				
Share capital	xxx	xxx	xxx	xxx
Reserves	xxx	xxx	xxx	xxx

Total Shareholders fund (D)	**xxx**	**xxx**	**xxx**	**xxx**
Total liabilities & capital (C+D)	**xxx**	**xxx**	**xxx**	**xxx**

Trend analysis

The following steps can be followed to compute trend percentages:

(i) Take the earliest year as the base year.

(ii) Take the figures for the base year as 100.

(iii) Express the figures for the other years as a percentage to the base year and determine the trend.

Trend Percentage

Particulars	Year End in Rupees						Trend Percentage Base Year (2000)					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Sales	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Less: Cost of goods sold	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Stock	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Debtor	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Cash	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
GrossProfit/Total Current Assets (A)	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Office Expenses	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Selling Expenses	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Total Expenses(B) / Less Current Liabilities	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx
Net profit/loss A-B (Working Capital)	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx	xxx

Illustration 1

The following are the extracts from the income statements of XYZ ltd., for the 6 years ending 2010. You are required to calculate trend percentages, taking 2004 as the base year.

	(values in thousands)					
Particulars	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Sales	300	340	420	480	520	600
Cost of goods sold	180	204	256	287	300	330
Office Expenses	40	42	45	50	55	60
Selling Expenses	20	25	30	40	50	60
Net profit/loss	60	69	89	103	115	150

Illustration 2

From the following balance sheet extracts, compute trend percentages and comment on the liquidity position of XY ltd. You may take 2000 as base year.

	(values in thousands)					
Particulars	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Stock	150	170	190	230	220	200
Debtors	140	120	80	90	100	100
Cash	60	50	50	60	90	100
Current liabilities	300	320	300	280	240	200

Meaning and definition of ratio analysis

Ratio analysis is a tool which involves analysing the financial statements by calculating various ratios. It is a tool of financial statement analysis, in which, inferences are drawn based on the computation and analysis of different ratios.

According to Myers, "Ratio analysis is a study of relationship among various financial factors in a business".

Objectives of ratio analysis

Following are the objectives of ratio analysis:

(i) To simplify accounting figures

(ii) To facilitate analysis of financial statements

(iii) To analyse the operational efficiency of a business

(iv) To help in budgeting and forecasting

(v) To facilitate intra firm and inter firm comparison of performance

Classification of ratios

Ratios may be classified in the following two ways:

(i) Traditional classification

(ii) Functional classification

Traditional classification

Traditional classification of ratios is done on the basis of the financial statements from which the ratios are calculated. Under the traditional classification, the ratios are classified as: (i) Balance sheet ratios, (ii) Income statement ratios and (iii) Inter-statement ratios.

(i) Balance sheet ratio

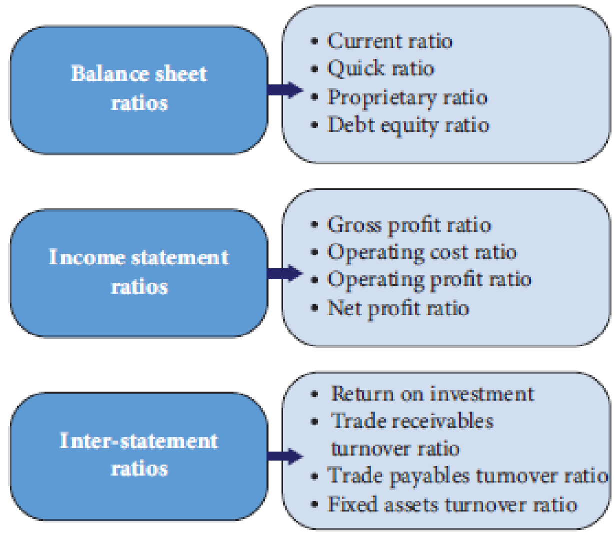
If both items in a ratio are from balance sheet, it is classified as balance sheet ratio.

(ii) Income statement ratio

If the two items in a ratio are from income statement, it is classified as income statement ratio.

(iii) Inter-statement ratio

If a ratio is computed with one item from income statement and another item from balance sheet, it is called inter-statement ratio.



Functional classification

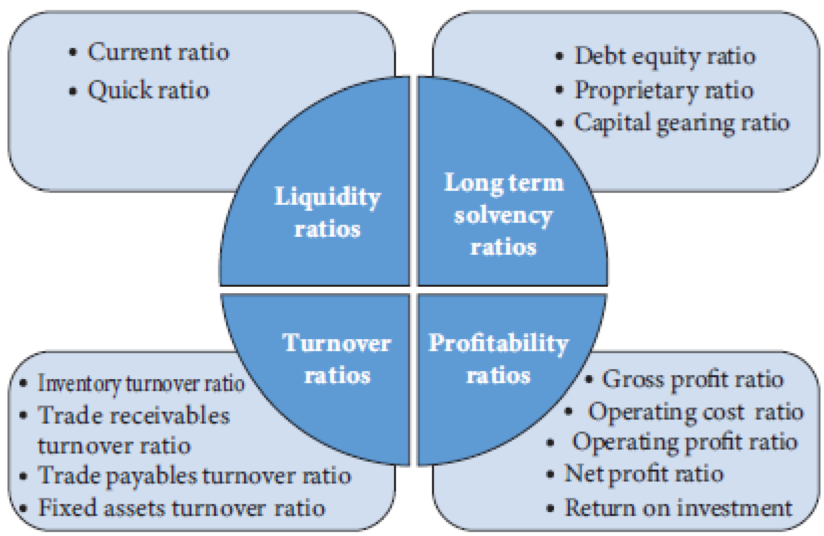
Functional classification of ratios is based on the purpose for which ratios are computed and it is the most commonly used classification. Under the functional classification, the ratios are classified as follows:

(i) Liquidity ratios

(ii) Long term solvency ratios

(iii) Turnover ratios

(iv) Profitability ratios



Computation of ratios

The ratio calculation based upon the following ratios:

1. Liquidity ratio
2. Long term solvency ratio
3. Turnover ratio
4. Profitability ratio

Liquidity ratios

Liquidity means capability of being converted into cash with ease. Liquidity ratios help to assess the ability of a business concern to meet its short term financial obligations. Short term assets (current assets) are more liquid as compared to long term assets (fixed assets). Liquidity ratios are also called as short term solvency ratios.

1 **Current ratio**: Current ratio gives the proportion of

current assets to current liabilities of a business concern. It is computed by dividing current assets by current liabilities. Current ratio indicates the ability of an entity to meet its current liabilities as and when they are due for payment.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Current assets	Current liabilities
Current assets are those assets that are either in the form of cash or cash equivalents or can be converted into cash or cash equivalents in a short time, that is, within a year or within the period of an operating cycle.	Current liabilities are those liabilities which are repayable in short time, that is, within a year or within the period of an operating cycle.
Current assets include (i) Current investments (ii) Inventories (stock) (iii) Trade receivables (Bills receivable and sundry debtors less provision for doubtful debts) (iv) Cash and cash equivalents (Cash in hand, cash at bank, etc.) (v) Short-term loans and advances given (vi) Other current assets (Prepaid expenses, accrued income, etc)	**Current liabilities include** (i) Short-term borrowings (ii) Trade payables (Bills payable and sundry creditors) (iii) Other current liabilities (Expenses payable, income received in advance, etc.) (iv) Short-term provisions

2 **Quick ratio**: Quick ratio gives the proportion of quick assets to current liabilities. It indicates whether the business concern is in a position to pay its current liabilities as and when they become due, out of its quick assets. Quick assets are current

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

assets excluding inventories and prepaid expenses. It is otherwise called liquid ratio or acid test ratio.

Quick assets = Current assets – Inventories – Prepaid expenses

CashPosition Ratio

Long term solvency ratios: Long term solvency means the firm's ability to meet its liabilities in the long run. Long term solvency ratios help to determine the ability of the business to repay its debts in the long run. The following ratios are normally computed for evaluating long term solvency of the business

Debt equity ratio: Debt equity ratio is calculated to assess the long term solvency position of a business concern. Debt equity ratio expresses the relationship between long term debt and shareholders' funds.

$$\text{Debt equity ratio} = \frac{\text{Long term debt}}{\text{Shareholders' funds}}$$

Long term debt	**Shareholders' funds**
Long term debt includes debentures, bonds, long term loans and other long term borrowings.	Shareholders' funds = Equity share capital + Preference share capital + Reserves and surplus

Proprietaryratio:

Proprietary ratio gives the proportion of shareholders' funds to total assets. Proprietary ratio shows the extent to which the total assets have been financed by the shareholders' funds.

$$\text{Proprietary ratio} = \frac{\text{Shareholders' funds}}{\text{Total assets}}$$

Capital gearing ratio: Capital gearing ratio is

$$\text{Capital gearing ratio} = \frac{\text{Funds bearing fixed interest and fixed dividend}}{\text{Equity shareholders' funds}}$$

the proportion of fixed income bearing funds to equity shareholders' funds. Fixed income bearing funds include fixed interest and fixed dividend bearing funds.

Funds bearing fixed interest or fixed dividend	Equity shareholders' funds
Preference share capital Debentures Bonds Long term borrowings carrying fixed interest	Equity shareholders' funds = Equity share capital + Reserves and surplus

Fixed Asset Ratio

Turnover ratios: Turnover ratios show how efficiently assets or other items have been used to generate revenue from operations. They are also called as activity ratios or efficiency ratios. They show the speed of movement of various items. They are expressed as number of times in relation to the item compared.

Inventory turnover ratio: It indicates the number of times inventory is turned over to make revenue from operations (sales) during a particular accounting period. It is a comparison of cost of revenue from operations (cost of goods sold) with average amount of inventory during a given period.

$$\text{Inventory turnover ratio} = \frac{\text{Cost of revenue from operations}}{\text{Average inventory}}$$

Cost of revenue from operations = Purchases of stock in trade + Changes in inventories of finished goods + Direct expenses (*Wages + Carriage inwards + Freight inwards+ Dock charges + Octroi + Import duty + Coal, gas, fuel and power + Other direct expenses)*

(or)

= Revenue from operations – Gross profit

Trade receivables turnover ratio (or) Debtor Turnover ratio

Trade receivables turnover ratio is the comparison of credit revenue from operations with average trade receivables during an accounting period. It gives the velocity of collection of cash from trade receivables.

$$\text{Trade receivables turnover ratio} = \frac{\text{Credit revenue from operations}}{\text{Average trade receivables}}$$

$$\text{Average trade receivables} = \frac{\text{Opening trade receivables} + \text{Closing trade receivables}}{2}$$

$$\text{Trade receivables} = \text{Trade debtors} + \text{Bills receivable}$$

Trade receivables turnover ratio (or) Creditor turnover ratio: Trade receivables turnover ratio is the comparison of credit revenue from operations with average trade receivables during an accounting period. It gives the velocity of collection of cash from trade receivables.

$$\text{Trade payables turnover ratio} = \frac{\text{Net credit purchases}}{\text{Average trade payables}}$$

$$\text{Net credit purchases} = \text{Total credit purchases} - \text{Purchases returns}$$

$$\text{Average trade payables} = \frac{\text{Opening trade payables} + \text{Closing trade payables}}{2}$$

$$\text{Trade payables} = \text{Trade creditors} + \text{Bills payable}$$

Fixed assets turnover ratio

Fixed assets turnover ratio gives the number of times the fixed assets are turned over during the year in relation to the revenue from operations. This ratio indicates the efficiency of utilisation of fixed assets.

$$\text{Fixed assets turnover ratio} = \frac{\text{Revenue from operations}}{\text{Average fixed assets}}$$

$$\text{Average fixed assets} = \frac{\text{Opening fixed assets} + \text{Closing fixed assets}}{2}$$

Working capital turnover ratio

Profitability ratios: Profitability ratios help to assess the profitability of a business concern. These ratios also help to analyse the earning capacity of the business in terms of utilisation of resources employed in the business. Generally these ratios are expressed as a percentage.

Gross profit ratio: Gross profit ratio is the proportion of gross profit to net revenue from operations. Gross profit ratio shows the margin of profit available out of revenue from operations.

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Revenue from operations}} \times 100$$

Gross profit = Revenue from operations – Cost of revenue from operations

Operating cost ratio: Operating cost ratio is the proportion of operating cost to revenue from operations. This ratio is a test of the operational efficiency of the business.

$$\text{Operating cost ratio} = \frac{\text{Operating cost}}{\text{Revenue from operations}} \times 100$$

Operating cost is the cost which is associated with the operating activities of the business.

Operating cost = Cost of revenue from operations + Operating expenses

Operating expenses = Employee benefit expenses + Depreciation + Other expenses related to office and administration, selling and distribution

Operating profit ratio: Operating profit ratio gives the proportion of operating profit to revenue from operations. Operating profit ratio is an indicator of operational efficiency of an organisation.

$$\text{Operating profit ratio} = \frac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$$

Alternatively, it is calculated as under.

Operating profit ratio = 100 – Operating cost ratio

Operating profit = Revenue from operations – Operating cost

Net profit ratio: Net profit ratio is the percentage of net

$$\text{Net profit ratio} = \frac{\text{Net profit after tax}}{\text{Revenue from operations}} \times 100$$

profit on revenue from operations.

Return on Investment (ROI):

Return on investment shows the proportion of net profit before interest and tax to capital employed (shareholders' funds and long term debts). This ratio measures how efficiently the capital employed is used in the business. It is an overall measure of profitability of a business concern.

$$\text{Return on Investment (ROI)} = \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$$

Capital employed = Shareholders' funds + Non current liabilities

Capital employed = Shareholders' funds + Non current liabilities

Greater the return on investment better is the profitability of a business and vice versa.

P E ratio

Illustration 1

From the profit and loss accounts of ABC Ltd., Calculate "Profitability Ratios".

Particulars	Rs	Particulars	Rs
To Opening stock	200,000	By Sales	1600,000
To Purchases	12,00,000	By Closing stock	3,20,000
To Gross profit c/d	5,20,000		
	19,20,000		**19,20,000**
To Administration	120,000	By Gross profit b/d	520,000
To Selling expenses	80000		
To Operating profit c/d	320,000		
	520,000		**520,000**
To Finance expenses	40000	By Operating profit b/d	320,000
To Loss on sale of assets	5000	By Dividend received	4000
To Net profit c/d	279,000		
	324,000		**324,000**

UNIT IV

CASH FLOW AND FUND FLOW TECHNIQUES: Introduction, How to prepare, Difference between them

Funds flow statement

The funds flow statement definition is a statement that explains the working capital change in a company. It is an analytical statement of the changes presenting its financial position between two balance sheet statements. It depicts the monetary outflow and inflow of the sources and the applications of funds during a particular period.

Meaning of fund flow statement:

A company prepares a Profit and Loss (P&L) statement and balance sheet, and then what is the need for funds flow statement? The P&L Statement and Balance sheet are two statements that portray the financial position for the past and current year. They do not explain why the financial position has changed. That's where the fund flow statement is required and its need for long and short-term funds. It also explains the following:

Fund Sources or where the funds came in from with their sources.

Fund application or where the long or short-term funds have been used.

Fund flow Statement Benefits:

- An aid to fund managers in explaining the strain on working capital and liquidity of a company, though the P&L Statement may declare it to be profitable.
- It helps the fund managers explain the financial strengths of a company despite its operational losses.
- It helps the fund managers analyse the fund flow and risk level when misusing short-term funds to finance long-term assets. Usually, this is a grey area that is not reflected in either the company's balance sheet or P&L statement

Steps for Preparing Funds Flow Statement:

The steps involved in preparing the statement are as follows:

1. Determine the change (increase or decrease) in working capital.
2. Determine the adjustments account to be made to net income.
3. For each non-current account on the balance sheet, establish the increase or decrease in that account. Analyse the change to decide whether it is a source (increase) or use (decrease) of working capital.
4. Be sure the total of all sources including those from operations minus the total of all uses equals the change found in working capital in Step 1.

General Rules for Preparing Funds Flow Statement:

The following general rules should be observed while preparing funds flow statement:

1. Increase in Current Asset – Increases Working Capital.

2. Decrease in Current Asset - Decreases Working Capital.

3. Increase in Current Liability – Decreases Working Capital.

4. Decrease in Current Liability – Increases Working Capital.

Working capital

Working capital is the money used and available for a company's day to day expenses on business operations. It shows the fluid financial liquidity of the enterprise and is crucial to the continuity and growth of the business. Hence, working capital is required to be used judiciously and managed well. We have just seen how the working capital impacts the funds flow statement and the business's health.

In the definition of fund flow statement, the working capital is shown as the current liabilities and assets and long term or short term capital funds. Let's explore what these are.

Current assets mean the assets that you can easily convert to cash in the short run. Similarly, current liabilities are those that need to be paid within a year.

Current assets are composed of the following:

- Bank balances
- Cash in hand
- Inventories
- Short-term receivables
- Accounts receivable or to be paid from goods sold. Current liabilities include the following:
- Accounts to be paid or payable to suppliers
- Short-term owed debts/loans.

Therefore, the working capital formula is the excess or deficit between the Current Assets and the Current Liabilities of a company.

Working Capital = Excess or Deficit between Current Assets and Current Liabilities.

Working capital is positive when the assets are greater and negative when the liabilities are greater.

The working capital ratio is also an essential metric providing insight into the company's health and is simply expressed as:

Working Capital Ratio = Current Assets divided by the Current Liabilities.

If the ratio of the working capital is more than 1, it is called positive capital, and the company has sufficient cash to pay its short-term debts. If the ratio of working capital is less than 1, it is termed negative capital which means that the company has issues in paying its short-term debts and needs a fresh infusion of working capital.

Schedule of Changes in Working Capital (or) Statement of Changes in Working Capital

Particulars	Year Rs.	Year Rs.	Changes in working capital	
			Increase Rs.	Decrease Rs.
Current Assets:				
	xxx	xxx	xxx	-
Cash	xxx	xxx	xxx	
Stock	xxx	xxx		-
Sundry debtors	xxx	xxx	-	xxx
Trading investments	xxx	xxx	xxx	
Prepaid expenses	**xxx**	**xxx**		
Total (A)				
	xxx	xxx	-	xxx
Current Liabilities:	xxx	xxx		
Creditors	xxx	xxx	xxx	-
Bills Payable	xxx	xxx	-	xxx
Outstanding expenses	xxx	xxx		
Short term loans Bank	**xxx**	**xxx**		
overdraft	xxx	xxx		
Total (B)	xxx		-	xxx
	xxx	xxx	xxx	xxx

CASH FLOW STATEMENT:

Cash Flow Statement is a statement that shows flow of cash and cash equivalents during a given period of time. Cash flow statement shows the net increase or net decrease of cash and cash equivalents under each activity i.e. operating activity, investing activity, financing activity.

The cash flow statement is one of the three main financial statements, the others being the income statement and the balance sheet. Businesses regularly measure their cash flow by preparing a cash flow statement.

Utility of Cash Flow Analysis

Cash flow analysis yields the following advantages:

It is very helpful in understanding the cash position of the firm. This would enable the management to plan and coordinate the financial operations properly.

Since it provides information about cash which would be available from operations the management would be in a position to plan repayment of loans, replacement of assets, etc.

It throws light on the factors contributing to the reduction of cash balance inspite of increase in income and vice versa.

A comparison of the cash flow statement with the cash budget for the same period helps in comparing and controlling cash inflows and cash outflows.

Limitations of Cash Flow Analysis

Cash flow analysis is a useful tool of financial analysis. However, it has its own limitations. These limitations are as under:

Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash flow does not necessarily mean net income of the business.

The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.

Cash flow statement cannot replace the Income Statement or the Funds Flow

In spite of these limitations, it can be said that cash flow statement is a useful supplementary instrument. It discloses the volume as well as the speed at which the cash flows in the different segments of the business. This helps the management in knowing the amount of capital tied up in a particular segment of the business. The technique of cash flow analysis, when used in conjunction with ratio analysis, serves as a barometer in measuring the profitability and financial position of the business.

However cash flow analysis is not without limitations. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments. Further cash flow statement cannot replace the income statement or funds flow statement. Each of them has a separate function to perform.

The cash flow statement reports the sources of cash, as well as its usage, in three different categories:

Operating activities

A company's operating activities are the primary means to generate revenue. Cash flow for operating activities generally means revenues and expenses. Revenue could come from sales, accounts receivable, refunds, and any settlements. Expenses could be payments to employees and suppliers, fines, fees, lawsuits, cash payments for interest, refunds to customers, etc.

Investing activities

These are less common sources of cash. Usually they are associated with buying or

selling assets. Cash inflows could come from loan collection, or sales of securities (from other entities) or long-term assets. Cash outflows could come from buying fixed assets, debt or equity (from other entities) or loans.

Financing activities

These cash flows come from changes in equity and borrowing. Cash inflows here could come from a company selling its own equity or proceeds from derivatives. Cash outflows could come from paying out dividends, debt issuance costs or outstanding debt.

Cash comprises both cash in hand and demand deposit with banks.

CashFunds- According to AS-3 issued by ICAI cash funds include: Cash in hand,Demand deposits with banks and cash equivalents.

CashEquivalent: Cash equivalent are short-term highly liquid investment that are readily convertible into known amount of cash and which are subject to an insignificant risk of changes in value. Cash equivalent are held for the purpose of meeting short-term cash obligations rather than for investment or other purpose. Therefore, an investment will be known as cash equivalent only when it has a short maturity period, say three months or less from date of its acquisition. It includes: Bank overdrafts, cash credit, short-term deposits, and Marketable securities. Treasury bills, Commercial paper, Money market funds, Investment in preference shares, if are redeemable within three months can be taken as cash equivalent, if there is no risk of the failure of the company to repay the amount at maturity.

Cash Flow Analysis vs. Funds Flow Analysis

A cash flow statement is concerned only with the changes in cash position while funds flow analysis is concerned with changes in working capital position between two balance sheet dates.

Cash flow analysis is a tool of short-term financial analysis while the funds flow analysis is comparatively a long-term one.

Cash is part of working capital and therefore an improvement in cash position results in improvement in the funds position but not vice versa. In other words "inflow of cash" results in "inflow of funds" but inflow of funds may not necessarily result in "inflowof cash".

In funds flow analysis, the changes in various current assets and current liabilities are shown in a separate statement called schedule of changes in working capital in order to ascertain the net increase or decrease in working capital. But in cash flow analysis, such changes are adjusted to funds from operations in order to ascertain cash from operations.

Format of Cash Flow Statement- A typical format of the multiple-step income statement divides the income statement into operating and non-operating sections and would contain the following components:

Operating section- Includes the revenues and expenses of the company"s primary operations A. Revenue (sales). B. Cost of goods sold or service provided. C. Selling expenses. D. General and administrative expenses. E. Other operating expenses.

Non-Operating section- Income from investments, gains and losses from the sale of operating assets, interest revenue, and interest expense are reported as arising from non- operating activities. The operating section includes sales, COGS, and operating expenses, while non- operating section includes revenues, gains, expenses, and losses stemming from activities that are not part of the main activity of the business. Therefore, according to the income statement operating activities are related to the transactions and other events entering into the determination of operating profit. As its name implies, CFS is a flow statement, like the income statement. The format of CFS is grounded on the same idea – to classify activities as operating

and non-operating (the latter are sub classified as investing and financing activities). Interpreting CFS requires an understanding of two relations, the relation between profit (net profit or operating profit) and cash flows from operations, the relation between the net cash flows from operating, investing, and financing activities.

Operating activities in CFSs can be treated as inflows and outflows of cash related to the transactions entering into the determination of

1) Net profit;
2) Net operating profit.

Consequently, depending on choice, net operating cash flow should:

1) Highlight the differences between operating profit and net cash flow from operating activities;
2) Highlight the differences between net profit and net cash flow from operating activities. It is worth mentioning that these two versions are based on different concepts of operating activities.

The first concept could be denominated as „net profit approach" and the second one as „operating profit approach". The conversion process classifies the income statement"s operating section into its major components and determines cash collections or payments for each of them. It clearly appears from the direct method of preparing CFS (especially if the so-called modified indirect method or "semi-direct" method has been used). Under the indirect method of preparing CFS the reconciliation of net profit with cash flows from operating activities is somewhat misleading because the operating activities (and therefore, the content of operating sections) on two financial statements are treated differently (and therefore, content of operating sections on the income statement and CFS is different).

Despite the endless confusion about the concept of operations and about different aspects of operations, in our opinion the treatment of an item in the income statement should determine its classification in the cash flow statement. The only reconciliation of operating profit with cash flows from really operating activities provides the link between the operating sections of two financial statements.

Cash Flow Statement for the year ending…… (Direct method)

Particulars	Rs.	Rs.
a) Cash flows from Operating Activities : Cash receipts from customers		
Cash paid to suppliers and employees* Cash generated from operating activities Income tax paid*		
Cash flow before extraordinary items (+ or – items)		
Net cash from operating activities		
b) Cash flows from Investing Activities :Purchase of fixed assets*		
Sale of fixed assets		
purchase of investment (long term)* Sale of investment (long term)Interest received		
Dividend received		
Net cash from investing activities		
C- Cash flows from Financing Activities : Proceeds from issue of share capital Proceeds from long term borrowings Repayments of long term borrowings* Interest paid*		
Dividend paid*		
Net cash from financing activities		
Net increase or decrease in the cash and cash equivalents (A+B+C)Cash and cash equivalents at the beginning of period		
Cash and cash equivalents at the end of the period		

Cash Flow Statement for the year ending…… (Indirect method)

Particulars

A- Cash flows from Operating Activities :

Net profit before tax and extraordinary itemsAdjustment for-

Depreciation

Loss on sale of fixed assets Gain on sale of fixed assets*Interest paid

Interest received*Dividend received*

Operating profit before working capital changes Add : Decrease in current assets

Increase in current liabilities

Less : Increase in current assets* Decrease in current liabilities*

Cash generated from operating activities Income tax paid*

Cash flow before extraordinary items (+ or – items)Net cash from operating activities

B- Cash flows from Investing Activities : Purchase of fixed assets*

Sale of fixed assets

purchase of investment (long term)* Sale of investment (long term) Interest received

Dividend received

Net cash from investing activities

C- Cash flows from Financing Activities : Proceeds from issue of share capital Proceeds from long term borrowings Repayments of long term borrowings* Interest paid*

Dividend paid*

Net cash from financing activities

Net increase or decrease in the cash and cash equivalents (A+B+C)Cash and cash equivalents at the beginning of period

Cash and cash equivalents at the end period

UNIT V

COSTING SYSTEMS: Elements of Cost, Cost Behavior, Cost Allocation, OH Allocation, Unit Costing, Process Costing, Job Costing, Absorption Costing, Marginal Costing, Cost Volume Profit Analysis, Budgets, ABC Analysis. Class Discussion: Application of costing concepts in the Service Sector

Marginal Costing

Marginal Costing is very important technique in solving managerial problems and contributing in various areas of decisions. In this context profitability of two or more alternative options is compared and such options is selected which offers maximum profitability along with fulfillment of objectives of the enterprise.

Marginal costing - definition

Marginal costing distinguishes between fixed costs and variable costs as convention ally classified.

The marginal cost of a product ――is its variable cost‖. This is normally taken to be; direct labour, direct material, direct expenses and the variable part of overheads.

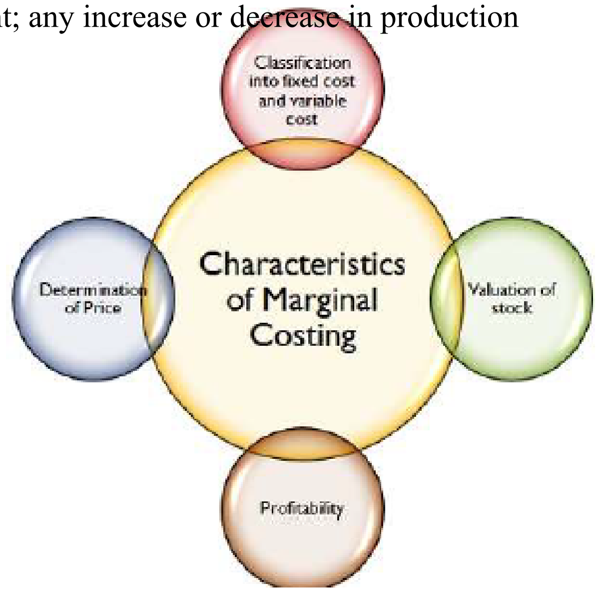
Marginal costing is formally defined as:

‗the accounting system in which variable costs are charged to cost units and the fixed costs of the period are written-off in full against the aggregate contribution. Its special value is in decision making'. (Terminology.)

The term ‗contribution' mentioned in the formal definition is the term given to the difference between Sales and Marginal cost. Need for Marginal Costing

Let us see why marginal costing is required:

- Variable cost per unit remains constant; any increase or decrease in production changes the total cost of output.
- Total fixed cost remains unchanged up to a certain level of production and does not vary with increase or decrease in production. It means the fixed cost remains constant in terms of total cost.
- Fixed expenses exclude from the total cost in marginal costing technique and provide us the same cost per unit up to a certain level of production.



Definition: Marginal Costing is a costing technique wherein the marginal cost, i.e. variable cost is charged to units of cost, while the fixed cost for the period is completely written off against the contribution.

The term marginal cost implies the additional cost involved in producing an extra unit of output, which can be reckoned by total variable cost assigned to one unit. It can be calculated as:

Classification into **Fixed and Variable Cost**: Costs are bifurcated, on the basis of variability into fixed cost and variable costs. In the same way, semi variable cost is separated.

Valuation of Stock: While valuing the finished goods and work in progress, only variable cost are taken into account. However, the variable selling and distribution overheads are not included in the valuation of inventory.

Make or Buy Decision :_Make or Buy Decision' is a problem in respect of which management has to take decision continuously, In this context, the management has to decide whether a certain product or component should be made in the factory itself or bought from outside suppliers.

Features of Marginal Costing

Features of marginal costing are as follows:

- Marginal costing is used to know the impact of variable cost on the volume of production or output.
- Break-even analysis is an integral and important part of marginal costing.
- Contribution of each product or department is a foundation to know the profitability of the product or department.
- Addition of variable cost and profit to contribution is equal to selling price.
- Marginal costing is the base of valuation of stock of finished product and work in progress.
- Fixed cost is recovered from contribution and variable cost is charged to production.
- Costs are classified on the basis of fixed and variable costs only. Semi-fixed prices are also converted either as fixed cost or as variable cost.

Ascertainment of Profit under Marginal Cost

'Contribution' is a fund that is equal to the selling price of a product less marginal cost. Contribution may be described as follows:

Contribution = Selling Price – Marginal Cost

Contribution = Fixed Expenses + Profit

Contribution – Fixed Expenses = Profit

Advantages of Marginal Costing

The advantages of marginal costing are as follows:

- Easy to operate and simple to understand.
- Marginal costing is useful in profit planning; it is helpful to determine profitability at different level of production and sale.
- It is useful in decision making about fixation of selling price, export decision and make or buy decision.
- Break even analysis and P/V ratio are useful techniques of marginal costing.
- Evaluation of different departments is possible through marginal costing.

- By avoiding arbitrary allocation of fixed cost, it provides control over variable cost.
- Fixed overhead recovery rate is easy.
- Under marginal costing, valuation of inventory done at marginal cost. Therefore, it is not possible to carry forward illogical fixed overheads from one accounting period to the next period.
- Since fixed cost is not controllable in short period, it helps to concentrate in control over variable cost.

The following are the various components of variable cost: Notes

- Direct Materials: Materials cost consumed for the production of goods.
- Direct Labour: Wages paid to the labourers who directly involved in the production of goods.
- Direct Expenses: Other expenses directly involved in the production stream.
- Variable portion of Overheads: Generally the overheads can be classified into two categories, viz. Variable overheads and Fixed overheads.

The variable overhead is the cost involved in the procurement of indirect materials, indirect labour and indirect expenses.

- Indirect Material – Cost of fuel, oil and so on
- Indirect Labour – Wages paid to workers for maintenance of the firm.

Cost-Volume-Profit (CVP) Analysis

Cost-volume-profit (CVP) analysis is a method of cost accounting that looks at the impact that varying levels of costs and volume have on operating profit.

- Cost-volume-profit (CVP) analysis is a way to find out how changes in variable and fixed costs affect a firm's profit.
- Companies can use CVP to see how many units they need to sell to break even (cover all costs) or reach a certain minimum profit margin.
- CVP analysis makes several assumptions, including that the sales price, fixed, and variable costs per unit are constant.

Breakeven Sales Volume=CM / FC

where:FC=Fixed costs

CM=Contribution margin=Sales−Variable Costs

The Cost-Volume-Profit (CVP) analysis helps management in finding out the relationship of costs and revenues to profit. The aim of an undertaking is to earn profit. Profit depends upon a large number of factors, the most important of which are the costs of the manufacturer and the volume of sales effected. Both these factors are interdependent – volume of sales depends upon the volume of production, which in turn is related to costs. Cost again is the result of the operation of a number of varying factors such as:

- Volume of production,

- Product mix,
- Internal efficiency,
- Methods of production,
- Size of plant, etc.

Analysis of cost-volume-profit involves consideration of the interplay of the following factors:

- Volume of sales
- Selling price
- Product mix of sales
- Variable cost per Chapter
- Total fixed costs

The relationship between two or more of these factors may be (a) presented in the form of reports and statements, (b) shown in charts or graphs, or (c) established in the form of mathematical deduction.

Objectives of Cost-Volume-Profit Analysis

The objectives of cost-volume-profit analysis are given below:

- In order to forecast profit accurately, it is essential to know the relationship between profits and costs on the one hand and volume on the other.
- Cost-volume-profit analysis is useful in setting up flexible budgets which indicate costs at various levels of activity.
- Cost-volume-profit analysis is of assistance in performance evaluation for the purpose of control. For reviewing profits achieved and costs incurred, the effects on cost of changes in volume are required to be evaluated.
- Pricing plays an important part in stabilising and fixing up volume. Analysis of cost-volume profit relationship may assist in formulating price policies to suit particular circumstances by projecting the effect which different price structures have on costs and profits.
- As predetermined overhead rates are related to a selected volume of production, study of cost-volume relationship is necessary in order to know the amount of overhead costs which could be charged to product costs at various levels of operation.

Profit-Volume (P/V) Ratio

The ratio or percentage of contribution margin to sales is known as P/V ratio. This ratio is known as marginal income ratio, contribution to sales ratio or variable profit ratio. P/V ratio, usually expressed as a percentage, is the rate at which profits increase with the increase in volume. The formulae for P/V ratio are:

P/V ratio = Marginal contribution/Sales

Or

Sales value – Variable cost/Sales value

Or

1 – Variable cost/Sales value

Or

Fixed cost + Profit/Sales value

Or

A comparison for P/V ratios of different products can be made to find out which product is more Notes profitable. Higher the P/V ratio more will be the profit and lower the P/V ratio, lesser will be the profit. P/V ratio can be improved by:

1. Increasing the selling price per Chapter.
2. Reducing direct and variable costs by effectively utilising men, machines and materials.
3. Switching the product to more profitable terms by showing a higher P/V ratio.

Break-even Point Profit Planning

Break-even analysis examines the relationship between the total revenue, total costs and total profits of the firm at various levels of output. It is used to determine the sales volume required for the firm to break-even and the total profits and losses at other sales level. Break-even analysis is a method, as said by Dominick Salnatore, of revenue and total cost functions of the firm. According to Martz, Curry and Frank, a break-even analysis indicates at what level cost and revenue are in equilibrium. In case of break-even analysis, the break-even point is of particular importance. Break-even point is that volume of sales where the firm breaks even i.e., the total costs equal total revenue.

It is, therefore, a point where losses cease to occur while profits have not yet begun. That is, it is the point of zero profit.

The following are the key methods of computing BEP:

$$\frac{\text{Fixed Costs}}{\text{Selling price} - \text{Variable costs per}}$$

Break-even Point (Sales Volume `)

Break-even point in sales can be found out by two methods.

- Selling Price Method
- PV Ratio Method

Selling Price Method: Under this method Break-even sales volume in rupees is found out through the product of Break-even Point in Chapters and selling price per Chapter.

BEP (`) = Break-even Point (Chapters) Selling price per Chapter

PV Ratio Method: Under this method, break-even sales volume in rupees can be determined through the following ratio

$$\text{BEP}(\text{`}) = \frac{\text{Fixed Cost}}{\text{PV ratio}}$$

$$\text{where} \qquad \text{PV Ratio} = \frac{\text{Sales} - \text{Variable cost}}{\text{Sales}} = \frac{\text{Contribution}}{\text{Sales}}$$

Assumptions of Break-even Analysis

The break-even analysis is based on certain assumptions, namely:

All costs are either perfectly variable or absolutely fixed over the entire period of production but this assumption does not hold good in practice.

The volume of production and the volume of sales are equal; but in reality they differ.

All revenue is perfectly variable with the physical volume of production and this assumption is not valid.

The assumption of stable product mix is unrealistic.

Advantages of Break-even Analysis

- It helps in determining the optimum level of output below which it would not be profitable for a firm to produce.
- It helps in determining the target capacity for a firm to get the benefit of minimum cost of production.
- With the help of the break-even analysis, the firm can determine minimum cost for a given level of output.
- It helps the firms in deciding which products are to be produced and which are to be bought by the firm.
- Plant expansion or contraction decisions are often based on the break-even analysis of the perceived situation.
- Impact of changes in prices and costs on profits of the firm can also be analysed with the help of break-even technique.

SUMMARY OF FORMULAE FOR BREAK EVEN ANALYSIS OR COST VOLUME PROFIT ANALYSIS

(1) *Marginal cost equation*

Sales – Variable cost = Fixed cost + Profit $(S - V = F + P)$

Sales – Variable cost = Contribution $(S - V = C)$

$\therefore$ Contribution = Fixed cost + Profit $(C = F + P)$

(2) *P/V Ratio*

$$P/V = \frac{\text{Contribution}}{\text{Sales}} \times 100 \text{ or } \left(\frac{C}{S} \times 100\right)$$

$$P/V = \frac{\text{Sales - Variable cost}}{\text{Sales}} \times 100 \text{ or } \left(\frac{S - V}{S} \times 100\right)$$

$$P/V = \frac{\text{Change in Profit}}{\text{Change in sales.}} \times 100$$

Note: The last formula is used only when profit/loss and sales of two periods are given.

(3) ***Break-even Point (B.E.P)***

(a) Break even volume (units)

$$= \frac{\text{Fixed cost}}{\text{Contribution per unit}} \text{ (or) } \frac{\text{Break even sales}}{\text{Selling price per unit}}$$

(b) Break even sales (in rupees)

$$= \frac{\text{Fixed cost}}{\text{P / V ratio}} \text{ (or) } \frac{F}{P / V}$$

(or) Break even volume $\times$ Selling price per unit

(4) ***Margin of Safety (MOS)***

MOS = Actual Sales – Break even sales

$$\text{MOS in rupees} = \frac{\text{Profit}}{\text{P / V Ratio}} \text{ (or) } \frac{P}{P / V}$$

$$\text{MOS in units} = \frac{\text{Profit}}{\text{Contribution per unit}}$$

(5) ***Required sales for given profit***

$$\text{Required sales in units} = \frac{\text{Required profit + Fixed cost}}{\text{Contribution per unit}}$$

$$\text{Required sales value in rupees} = \frac{\text{Required profit + Fixed cost}}{\text{P / V Ratio}}$$

(6) ***Profit from given sales***

Contribution = Given sales $\times$ P/V ratio

Profit = Contribution – Fixed cost

Note: The above formulae can be appropriately used to solve most of the problems of C.V.P. or Break even analysis.

8. You are given the following data for the coming year of a factory:

Budgeted output	– 80,000 units
Fixed expenses	– Rs. 4,00,000
Variable expenses per unit	– Rs. 10
Selling price per unit	– Rs. 20

Find out the break even point. If the selling price is reduced to Rs. 15 per unit, what will be the new break even point? Also find out the break even point if selling price is Rs. 25.

[Madras, B.Com., Oct. 1985]

[Ans:

	BEP units	BEP value
		Rs.
At selling price of Rs. 20 per unit	40,000	8,00,000
At selling price of Rs. 15 per unit	80,000	12,00,000
At selling price of Rs. 25 per unit	26,667	6,66,675]

9. The following information relating to a company is given to you.

	Rs.
Sales	4,00,000
Fixed cost	1,80,000
Variable cost	2,50,000

Ascertain how much value of sales must be increased for the company to achieve break even.

[Madras, B.Com., (ICE) May 2003, B.Com., Oct. 1998]

[Ans: Sales must be increased by Rs. 80,000; BEP = Rs. 4,80,000]

21. You are given the following data for the year 1998-99.

Variable cost	Rs. 6,00,000
Fixed cost	Rs. 3,00,000
Net profit	Rs. 1,00,000
Sales	Rs. 10,00,000

Find

(a) Break-even point

(b) Profit when sales amounted to Rs. 12,00,000

(c) Sales required to earn a profit of Rs. 2,00,000.

[Madras M.B.A., April 2000]

[Ans: (a) Rs. 7,50,000; (b) Rs. 1,80,000; (c) Rs. 12,50,000.]

22. From the following information relating to Perfect Standard Ltd., you are required to find out (i) P/V. ratio (ii) Break-even point (iii) Margin of safety.

Total fixed costs	–	Rs. 4,500
Total variable cost	–	Rs. 7,500
Total sales	–	Rs. 15,000

(iv) Also calculate the volume of sales to earn profit of Rs. 6,000.

[Madras, M.Com., AP 2005; B.Com AP 2002; BCA Oct. 2000 B.BA., April. 1998]

[Ans: (i) 50% (ii) Rs. 9,000; (iii) Rs. 6,000; (iv) Rs. 21,000.]

23. From the following data, you are required to calculate:

(a) P/V ratio (b) Break even sales with the help of P/V ratio (c) Sales required to earn a profit of Rs. 4,50,000.

Fixed expenses	:	Rs. 90,000
Variable cost per unit	:	Rs.
Direct materials		5
Direct Labour		2
Variable overheads 100% of Direct Labour		
Selling price/unit		12

[Madurai, M.B.A., Oct 2003; May 1996]

[Ans: (a) 25% (b) Rs. 3,60,000; (c) Rs. 21,60,000.]

11.108

24. Sales Rs. 1,00,000; Profit Rs. 10,000; Variable cost 70%.

Find out

(a) P/V Ratio

(b) Fixed cost

(c) Sales to earn a profit of Rs. 40,000.

[Madras, B.Com., (ICE) C & M, May 1999]

[Ans: (a) .3 or 30%; (b) Rs. 20,000; (c) Rs. 2,00,000.]

25. From the following information calculate:

(a) P/V Ratio (b) BEP (c) Margin of safety

	Rs.
Total sales	3,60,000
Selling price per unit	100
Variable cost per unit	50
Fixed costs	1,00,000

(d) If the selling price is reduced to Rs. 90, by how much is the margin of safety reduced?

[Anna MBA April/May 2004; Madras, M.Com., April 1994]

[Ans: (a) .5 or 50%; (b) 2,000 units (or) Rs. 2,00,000;
(c) Current MOS = 3,60,000 – 2,00,000 = 1,60,000;
(d) Reduction in MOS : Rs. 61,000;
New MOS = 3,24,000 – 2,25,000 = 99,000]

CVP Analysis- Practice Problem

Budgetary Analysis:

Budget:

According to CIMA (Chartered Institute of Management Accountants) UK, a budget is "A plan quantified in monetary terms prepared and approved prior to a defined period of time, usually showing planned income to be generated and, expenditure to be incurred during the period and the capital to be employed to attain a given objective."

In a view of Keller &Ferrara , "a budget is a plan of action to achieve stated objectives based on predetermined series of related assumptions."

G.A.Welsh states, "a budget is a written plan covering projected activities of a firm for a definite time period."

Budgetary Control:

Budgetary Control is a method of managing costs through preparation of budgets. Budgeting is thus only a part of the budgetary control. According to CIMA, "Budgetary control is the establishment of budgets relating to the responsibilities of executives of a policy and the continuous comparison of the actual with the budgeted results, either to secure by individual action, the objective of the policy or to provide a basis for its revision."

The main features of budgetary control are:

Establishment of budgets for each purpose of the business.

Revision of budget in view of changes in conditions.

Comparison of actual performances with the budget on a continuous basis.

Taking suitable remedial action, wherever necessary.

Analysis of variations of actual performance from that of the budgeted performance to know the reasons thereof.

Objectives of Budgetary Control:

Budgeting is a forward planning. It serves basically as a tool for management control; it is rather a pivot of any effective scheme of control.

G. A. Welsch in his book, 'Budgeting - Profit Planning and Control' has rightly pointed out that 'Budgeting is the principal tool of planning and control offered to management by accounting function.'

The objectives of budgeting may be summarized as follows:

1) **Planning:**Planning has been defined as the design of a desired future position for an entity and it rests on the belief that the future position can be attained by uninterrupted management action. Detailed plans relating to production, sales, raw-material requirements, labour needs, capital additions, etc. are drawn out. By planning many problems estimated long before they arise and solution can be thought of through careful study. In short, budgeting forces the management to think ahead, to foresee and prepare for the anticipated conditions. Planning is constant process since it requires constant revision with changing conditions.

2) **Co-ordination:** Budgeting plays a significant role in establishing and maintaining coordination. Budgeting assists managers in coordinating their efforts so that problems of the businessare solved in harmony with the objectives of its divisions. Efficient planning and business contribute a lot in achieving the targets. Lack of co-ordination in an organization is observed when a department head is permitted to enlarge the department on the specific needs of that department only, although such development may negatively affect other departments and alter their performances. Thus, co-ordination is required at all vertical as well as horizontal levels.

3) **Measurement of Success:**Budgets present a useful means of informing managers how well they are performing in meeting targets they have previously helped to set. In many companies, there is a practice of rewarding employees on the basis of their accomplished low budget targets or promotion of a manager is linked to his budget success record. Success is determined by comparing the past performance witha previous period's performance.

4) **Motivation:**Budget is always considereda useful tool for encouraging managers to complete things in line with the business objectives. If individuals have intensely participated in the preparation of budgets, it acts as a strong motivating force to achieve the goals.

5) Communication: A budget serves as a means of communicating information within a firm. The standard budget copies are distributed to all management peoplethat provides not only sufficient understanding and knowledge of the programmes and guidelines to be followed but also gives knowledge about the restrictions to be adhered to.

6) Control: Control is essential to make sure that plans and objectives laid down in the budget are being achieved. Control, when applied to budgeting, as asystematized effort is to keep the management informed of whether planned performance is being achieved or not.

Advantagesof Budgetary control:

In the light of above discussion one can see that, coordination and control help the planning. These are the advantages of budgetary control.But this tool offer many other advantages as follows:

1. This system provides basic policies for initiatives.
2. It enables the management to perform business in the most professional manner because budgets are prepared to get the optimum use of resources and the objectives framed.
3. It ensures team work and thus encourages the spirit of support and mutual understanding among the staff.

1. It increases production efficiency, eliminates waste and controls the costs.
2. It shows to the management where action is needed to remedy a position.
3. Budgeting also aids in obtaining bank credit.
4. It reviews the presentsituation and pinpoints the changes which are necessary.
5. With its help, tasks such as like planning, coordination and control happen effectively and efficiently.
6. It involves an advance planning which is looked upon with support by many credit agencies as a marker of sound management.

Limitations of Budgetary control:

1. It tends to bring about rigidity in operation, which is harmful. As budget estimates are quantitative expression of all relevant data, there is a tendency to attach some sort of rigidity or finality to them.
2. It being expensive is beyond the capacity of small undertakings. The mechanism of budgeting system is a detailed process involving too much time and costs.
3. Budgeting cannot take the position of management but it is only an instrument of management. 'The budget should be considered not as a master, but as a servant.' It is totally misconception to think that the introduction of budgeting alone is enough to ensure success and to security of future profits.
4. credit to achieve the budget targets.

5. Simple preparation of budget will not ensure its proper implementation. If it is not implemented properly, it may lower morale.

6. The installation and function of a budgetary control system is a costly affair as it requires employing the specialized staff and involves other expenditure which small companies may find difficult to incur.

Essentials of Effective Budgeting:

1) Support of top management: If the budget structure is to be made successful, the consideration by every member of the management not onlyis fully supported but also the impulsion and direction should alsocome from the top management. No control system can **be effective unless the organization is convinced that the management considers the system to be important.**

2) Team Work: This is an essential requirement, if the budgets are ready from "the bottom up" in a grass root manner. The top management must understand and give enthusiastic support to the system. In fact, it requires education and participation at all levels. The benefits of budgeting need to be sold to all.

3) RealisticObjectives: The budget figures should be realistic and represent logically attainable goals. The responsible executives should agree that the budget goals are reasonable and attainable. **It sometimes leads to produce conflicts among the managers as each of them tries to take**

4) Excellent Reporting System: Reports comparing budget and actual results should be promptly prepared and special attention focused on significant exceptions i.e. figures that are significantly different from expected. An effective budgeting system also requires the presence of a proper feed back system.

5) Structure of Budget team: This team receives the forecasts and targets of each department as well as periodic reports and confirms the final acceptable targets in form of Master Budget. The team also approves the departmental budgets.

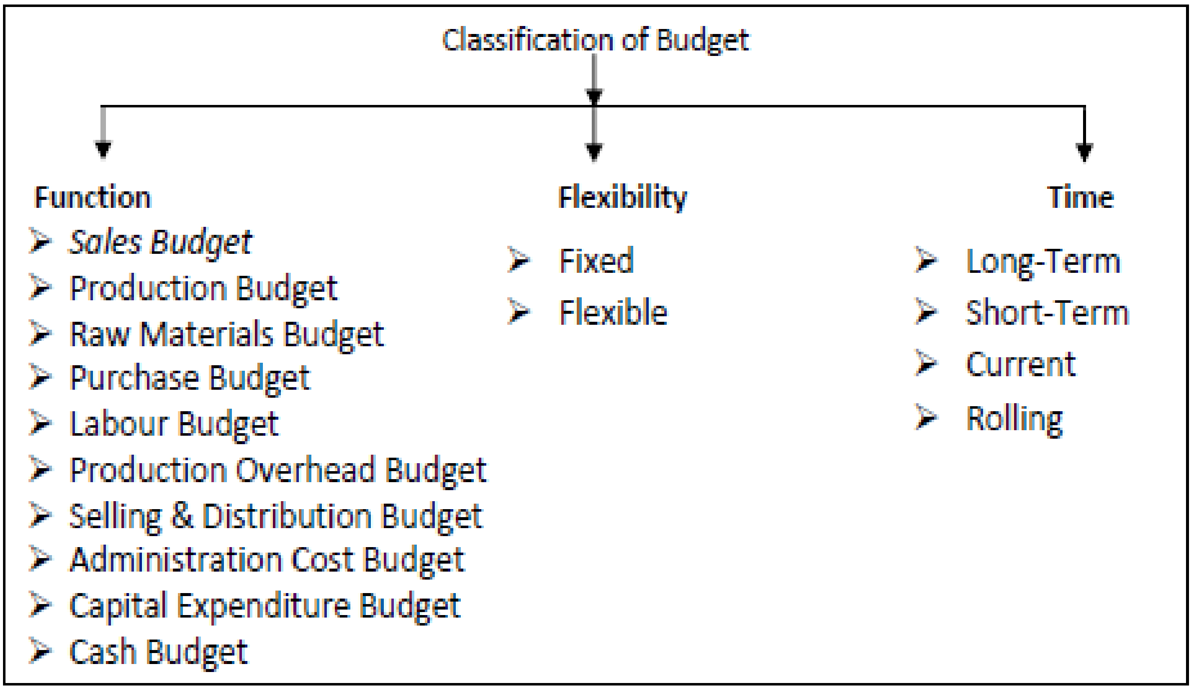
6) Well defined Business Policies: All budgetsreveal that the business policies formulated by the higher level management. In other words, budgets should always be aftertaking into account the policies set for particular department or function. But for this purpose, policies should be precise and clearly defined as well as free from any ambiguity.

7) Integration with Standard Costing System: Where standard costing system is also used, it should be completely integrated with the budget programme, in respect of both budget preparation and variance analysis.

8) Inspirational Approach: All the employees or staff other than executives should be strongly and properly inspired towards budgeting system. Human beings by nature do not like any pressure and they dislike or even rebel against anything forced upon them.

Classification of Budget:

The extent of budgeting activity varies from firm to firm. In a smaller firm there may be a sales forecast, a production budget, or a cash budget. Larger firms generally prepare a master budget. Budgets can be classified into different ways from different points of view. The following are the important basis for classification:



Functional Classification:

SALES BUDGET:

The sales budget is an estimate of total sales which may be articulated in financial or quantitative terms. It is normally forms the fundamental basis on which all other budgets are constructed. In practice, quantitative budget is prepared first then it is translated into economic terms. While preparing the Sales Budget, the Quantitative Budget is generally the starting point in the operation of budgetary control because sales become, more often than not, the principal budget factor. The factor to be consider in forecasting sales are as follows:

Study of past sales to determine trends in the market.

Estimates made by salesman various markets of company products.

Changes of business policy and method.

Government policy, controls, rules and Guidelines etc.

Potential market and availability of material and supply.

PRODUCTION BUDGET:

The production budget is prepared on the basis of estimatedproduction for budget period. Usually, the production budget is based on the sales budget. At the time of preparing the budget, the production manager will consider the physical facilities like plant, power, factory space, materials and labour, available for the period. Production budget envisages the production program for achieving the sales target. The budget may be expressed in terms of quantities or money or both. Production may be computed as follows:

Units to be produced = Desired closing stock of finished goods + Budgeted sales – Beginning stock of finished goods.

PRODUCTION COST BUDGET:

This budget shows the estimated cost of production. The production budget demonstrates thecapacity of production. These capacities of production are expressed in terms of cost in production cost budget. The cost of production is shown in detail in respect of material cost, labour cost and factory overhead. Thus production cost budget is based upon Production Budget, Material Cost Budget, Labour Cost Budget and Factory overhead.

RAW MATERIAL BUDGET:

Direct Materials budget is prepared with an intention to determine standard material cost per unit and consequently it involves quantities to be used and the rate per unit. This budget shows the estimated quantity of all the raw materials and components needed for production demanded by the production budget. Raw material serves the following purposes:

It supports the purchasing department in scheduling the purchases.

Requirement of raw materials is decided on the basis of production budget.

It provides data for raw material control.

Helps in deciding terms and conditions of purchase like credit purchase, cash purchase, payment period etc.

It should be noted that raw material budget generally deals with only the direct materials whereas indirect materials and supplies are included in the overhead cost budget.

PURCHASE BUDGET:

Strategic planning of purchases offers one of the most importantareas of reduction cost in many concerns. This will consist of direct and indirect material and services. The purchasing budget may be expressed in terms of quantity or money.

The main purposes of this budget are:

It designates cash requirement in respect of purchase to be made during budget period; and

It is facilitates the purchasing department to plan its operations in time in respect of purchases so that long term forward contract may be organized.

LABOUR BUDGET:

Human resourcesare highly expensive item in the operation of an enterprise. Hence, likeother factors of production, the management should find out in advance personnel requirements for various jobs in the enterprise. This budget may be classified into labour requirement budget and labour recruitment budget. The labour necessities in the various job categories such as unskilled, semi skilled and supervisory are determined with the help of all the head of the departments. The labour employment is made keeping in view the requirement of the job and its qualifications, the degree of skill and experience required and the rate of pay.

PRODUCTION OVERHEAD BUDGET:

The manufacturing overhead budget includes direct material, direct labour and indirect expenses. The production overhead budget represents the estimate of all the production overhead i.e. fixed, variable, semi variable to be incurred during the budget period. The reality that overheads include many different types of expenses creates considerable problems in:

1) Fixed overheads i.e., that which is to remain stable irrespective of vary in the volume of output,

2) Apportion of manufacturing overheads to products manufactured, semi variable cost i.e., thosewhich are partly variable and partly fixed.

3) Control of production overheads.

4) Variable overheads i.e., that which is likely to vary with the output.

The production overhead budget engages the preparation of overheads budget for each division of the factory as it is desirableto have estimates of manufacturing overheads prepared by those overheads to have the responsibility for incurring them. Service departments cost are projected and allocated to the production departments in the proportion of the services received by each department.

SELLING AND DISTRIBUTION COST BUDGET:

The Selling and Distribution Cost budget is estimating of the cost of selling, advertising, delivery of goods to customers etc. throughout the budget period. This budget is closely associated to sales budget in the logic that sales forecasts significantly influence the forecasts of these expenses. Nevertheless, all other linked information should also be taken into consideration in the preparation of selling and distribution budget. The sales manager is responsible for selling and distribution cost budget. Naturally, he prepares this budget with the help of managers of sub divisions of the sales department. The preparation of this budget would be bas**ed on the analysis of the market condition by the management, advertising policies, research programs and many other factors.**

CASH BUDGET:

The cash budget is a sketch of the business estimated cash inflows and outflows over a specific period of time. Cash budget is one of the most important and one of the last to be prepared. It is a detailed projection of cash receipts from all sources and cash payments for all purposes and the resultants cash balance during the budget. It is a mechanism for controlling and coordinating the fiscal side of business to ensure solvency and provides the basis for forecasting and financing required to cover up any deficiency in cash. Cash budget thus plays avital role in the financing management of a business undertaken.

Cash budget assists the management in determining the future liquidity requirements of the firm, forecasting for business of those needs, exercising control over cash. So, cash budget thus plays a vital role in the financial management of a business enterprise.

Function of Cash Budget:

It makes sure that enough cash is available when it is required.

It designates cash excesses and shortages so that steps may be taken in time to invest any excess cash or to borrow funds to meet any shortages.

It shows whether capital expenditure could be financed internally.

It provides funds for standard growth.

It provides a sound basis to manage cash position.

Advantages of Cash Budget:

1. Usage of Cash: Management can plan out the use of cash inaccord with the changes of receipt and payment. Payments can be planned when sufficient cash is available and continue the business activity with the minimum amount of working capital.

2. Allocation for Capital Investment: It is dual benefits such as capital expenditure projects can be financed internally and can get an idea for cash availability of capital investment.

3. Provision of Excess Funds: It reveals the availability of excess cash. In this regard management candecide to invest excess funds for short term or long term according to the requirements in the business.

4. Pay out Policy: This budgetary system may help the management for future pay out policy in the form of dividend. In case the cash budget liquid position is not favourable, the management may reduce the rate of dividend or maintain dividend amount or skip dividend for the year.

5. Provision for acquiring Funds: It gives the top level management ideas for acquiring funds for a particular time duration andsources to be explored.

6. Profitable Use of Cash:Business person can take decision for the best use of liquidity to make more profitable transaction. It can be used at the time of bulk purchase payments and one get the benefit of discount.

Limitation of Cash Budget:

1. Complex Assumption: Business is full of uncertainties, so it is very difficult to have near perfect estimates of cash receipts and payments, especially for a longer duration. It can be predicted for short duration such as of three to four months.

2. Inflexibility: If the finance manager fails to show flexibility in implementing the cash budget, it will incur adverse effects. If the manager follows strictly adheres to the estimates of cash inflow it

may negatively result in losing customers. Likewise, loyalty in payments may lead to deterioration of liquid position.

3. Costly:Application of this technique necessitates collecting of statistical information from various sources and expert personnel in operation research would be the costliest deal. It becomes expensive which may not be affordable to small business houses. In addition, finding out experts is not always possible. In this situation the long term predictions do not prove correct.

Methods:

1. Receipt and payment:It is most popular and is universally used for preparing cash budget. The assumption of statistical data is arrived at calculated on the basis of requirements like monthly, weekly or fortnightly. On account of elasticity, this method is used in forecasting cash at different time periods and thus it helps in controlling cash distributions.

(a) Cash receipts from customers are based on sales forecast. The term of sale, lag in payment etc., are generally taken into consideration.

(b) Cash receipts from other sources, such as dividends and interest on trade investment, rent received, issue of capital, sale of investment and fixed assets.

(c) Cash requirements for purchase of materials, labour and salary cost and overhead expenses based on purchasing, personnel and overhead budgets.

(d) Cash requirements for capital expenditure as per the capital expenditure budget.

(e) Cash requirements for other purposes such as payment of dividends, income tax liability, fines and penalties.

(i)Estimating Cash Receipts: Generally main sources of cash receipts are sales, interest and dividend, sales of assets and investments, capital borrowings etc.The Company estimates time lag on the basis of past experience of cash receipts on credit sales while cash sales can be easily determined.

(ii) Estimating Cash Payments: It can be decided on the basis of various operating budgets prepared for the payment of credit purchase, payment of labour cost, interest and dividend, overhead charges, capital investment etc.

2. Adjusted Profit and Loss Account: This method is based on cash and non cash transactions. This method estimates closing cash balance by converting profit into cash. The hypothesis of this method is that the earning of profit brings equal amount of cash into the business. The net profit shown by profit and loss account does not signify the actual cash flow into the business. This also leads to another assumption, that is the business will remain static, i.e. there will be no wearing out or increase

of assets and changes of working capital so that the total cash on hand for the business would be equal to the profit earned.

3. Budgeted Balance Sheet Method: This method looks like the Adjusted Profit and Loss Account method only, except that in this method a Balance Sheet is projected and in that method Profit and Loss Account is adjusted. In this method Balance Sheet is prepared with the projected amount of all

assets and liabilities except cash at the end of budget period. The cash balance will find out balancing amount. If assets side is higher than liability side it would be the bank overdraft while liability side is higher than assets side it gives bank balance. This method is used by the stable business houses.

4. Working Capital Differential Method:It is based on the estimate of working capital. It begins with the opening working capital and is added to or deducted from any changes made in the current assets except cash and current liabilities. At the end of the budget period balance shows the real cash balance. This method is quite similar to the Balance Sheet method.

Model of Cash Budget

Particular	January	February	March
Opening Balance	-	-	-
Add: Receipts:			
Cash Sales	-	-	-
Receipts from Debtors	-	-	-
Interest and Dividend	-	-	-
Sale of fixed assets	-	-	-
Sale of Investments	-	-	-
Bank Loan	-	-	-
Issue Shares & Debenture	-	-	-
Others	-	-	-
Total Receipts (A)	-	-	-
Less: Payments			
Cash Purchases	-	-	-
Payment to creditors	-	-	-
Salaries & wages	-	-	-
Administrative expenses	-	-	-
Selling expenses	-	-	-
Dividend payable	-	-	-
Purchase of Fixed Assets	-	-	-
Repayment of Loan	-	-	-
Payment of taxes	-	-	-
Total Payments (B)	-	-	-
Closing Balance (A - B)	-	-	-

FIXED AND FLEXIBLE BUDGET:

1. FIXED BUDGET:

A fixed budget is prepared for one level of output and one set of condition. This is a budget in which targets are tightly fixed. It is known as a static budget.According to CIMA, "A budget which is designed to remain unchanged irrespective of the level of the activity attained."It is firm and prepared with the assumption that there will be no change in the budgeted level of motion. Thus, it does not provide room for any modification in expenditure due to the change in the projected conditions and activity. Fixed budgets are prepared well in advance.

This budget is not useful because the conditions go on the changing and cannot be expected to be firm. The management will not be in a position to assess, the performance of different heads on the basis of budgets prepared by them because to the budgeted level of activity. It is hardly of any use as a mechanism of budgetary control because it does not make any difference between fixed, semi variable and variable costs and does not provide any space for alteration in the budgeted figures as a result of change in cost due to change in the level of activity. Fixed budget can be revised in the light of changing situations, yet the rigidity and control over costs and expenses would be lost in such cases. Fixed budgets should be prepared only where sales, production and costs can be accurately estimated.

2. FLEXIBLE BUDGET:

This is a dynamic budget. In comparison with a fixed budget, a flexible budget is one "which is designed to change in relation to the level of activity attained." The underlying principle of flexibility is that a budget is of little use unless cost and revenue are related to the actual volume of production. The statistics range from the lowest to the highest probable percentages of operating activity in relation to the standard operating performance. Flexible budgets are a part of the feed advance process and as such are a useful part of planning. An equally accurate use of the flexible budgets is for the purposes of control.

Flexible budgeting has been developed with the objective of changing the budget figures so that they may correspond with the actual output achieved. It is more sensible and practical, because changes expected at different levels of activity are given due consideration. Thus a budget might be prepared for various levels of activity in accord with capacity utilization.

Flexible budget may prove more useful in the following conditions:

- Where the level of activity varies from period to period.
- Where the business is new and as such it is difficult to forecast the demand.
- Where the organization is suffering from the shortage of any factor of production. For example, material, labour, etc. as the level of activity depends upon the availability of such a factor.
- Where the nature of business is such that sales go on changing.
- Where the changes in fashion or trend affects the production and sales.
- Where the organization introduces the new products or changes the patterns and designs of its products frequently.
- Where a large part of output is intended for the export.

Uses of Flexible Budget:

In flexible budgets numbers are adjustable to any given set of operating conditions. It is, therefore, more sensible than a fixed budget which is true only in one set of operating environment.

Flexible budgets are also useful from the view point of control. Actual performance of an executive should be compared with what he should have achieved in the actual circumstances and not with what he should have achieved under quite different circumstances. At last, flexible budgets are more realistic, practical and useful. Fixed budgets, on the other hand, have a limited application and are suited only for items like fixed costs.

Preparation of a Flexible Budget

The preparation of a flexible budget requires the analysis of total costs into fixed and variable components. This analysis of course is, not unusual to the flexible budgeting, is more important in flexible budgeting then in fixed budgeting. This is so because in flexible budgeting, varying levels of output are considered and each class of overhead will be different for each level. Thus the flexible budget has the following main distinguishing features:

It is prepared for a range of activity instead of a single level.

It provides a dynamic basis for comparison because it is automatically related to changes in volume.

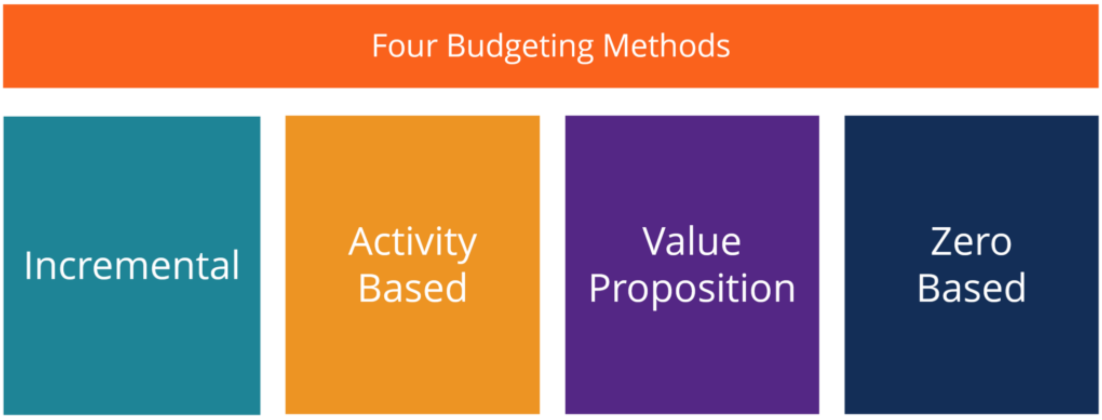
The formulation of a flexible budget begins with analyzing the overhead into fixed and variable cost and determining the extent to which the variable cost will vary within the normal range of activity.

Model of Flexible Budget

Particulars	Capacity Utilization		
	60%	80%	100%
1. Prime Cost:			
- Direct Material	-	-	-
- Direct Labour	-	-	-
- Direct expenses (if any)	-	-	-
Total (A)	-	-	-
2. Variable overheads:			
- Maintenance & repairs	-	-	-
- Indirect Labour	-	-	-
- Indirect Material	-	-	-
- Factory overheads	-	-	-
- Administrative Overheads	-	-	-
- Selling & distribution O/H	-	-	-
Total (B)	-	-	-
3. Marginal Cost (A + B)	-	-	-
4. Sales	-	-	-
5. Contribution (Sales - MC)	-	-	-
6. Fixed cost			
- Factory overheads	-	-	-
- Administrative Overheads	-	-	-
- Selling & distribution O/H	-	-	-
Total (C)	-	-	-
7. Profit or Loss (C- FC)	-	-	-

Four Main Types of Budgets/Budgeting Methods

There are four common types of budgets that companies use: (1) incremental, (2) activity-based, (3) value proposition, and (4) zero-based. These four budgeting methods each have their own advantages and disadvantages, which will be discussed in more detail in this guide.



1. Incremental budgeting

Incremental budgeting takes last year's actual figures and adds or subtracts a percentage to obtain the current year's budget. It is the most common method of budgeting because it is simple and easy to understand. Incremental budgeting is appropriate to use if the primary cost drivers do not change from year to year. However, there are some problems with using the method:

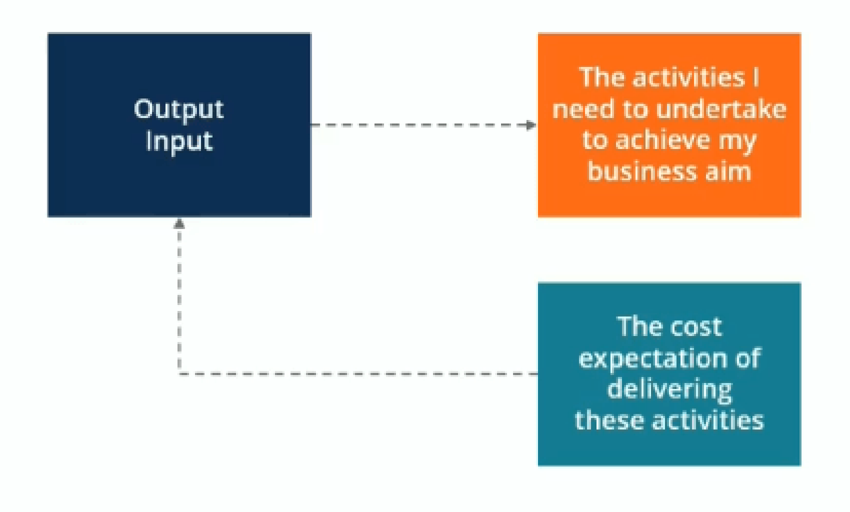
It is likely to perpetuate inefficiencies. For example, if a manager knows that there is an opportunity to grow his budget by 10% every year, he will simply take that opportunity to attain a bigger budget, while not putting effort into seeking ways to cut costs or economize.

It is likely to result in budgetary slack. For example, a manager might overstate the size of the budget that the team actually needs so it appears that the team is always under budget.

It is also likely to ignore external drivers of activity and performance. For example, there is very high inflation in certain input costs. Incremental budgeting ignores any external factors and simply assumes the cost will grow by, for example, 10% this year.

2. Activity-based budgeting

Activity-based budgeting is a top-down budgeting approach that determines the amount of inputs required to support the targets or outputs set by the company. For example, a company sets an output target of $100 million in revenues. The company will need to first determine the activities that need to be undertaken to meet the sales target, and then find out the costs of carrying out these activities.



3. Value proposition budgeting

In value proposition budgeting, the budgeter considers the following questions:

Why is this amount included in the budget?

Does the item create value for customers, staff, or other stakeholders?

Does the value of the item outweigh its cost? If not, then is there another reason why the cost is justified?

Value proposition budgeting is really a mindset about making sure that everything that is included in the budget delivers value for the business. Value proposition budgeting aims to avoid unnecessary expenditures – although it is not as precisely aimed at that goal as our final budgeting option, zero-based budgeting.

4. Zero-based budgeting

As one of the most commonly used budgeting methods, zero-based budgeting starts with the assumption that all department budgets are zero and must be rebuilt from scratch. Managers must be able to justify every single expense. No expenditures are automatically "okayed". Zero-based budgeting is very tight, aiming to avoid any and all expenditures that are not considered absolutely essential to the company's successful (profitable) operation. This kind of bottom-up budgeting can be a highly effective way to "shake things up".

The zero-based approach is good to use when there is an urgent need for cost containment, for example, in a situation where a company is going through a financial restructuring or a major economic or market downturn that requires it to reduce the budget dramatically.

Zero-based budgeting is best suited for addressing discretionary costs rather than essential operating costs. However, it can be an extremely time-consuming approach, so many companies only use this approach occasionally.

Levels of Involvement in Budgeting Process

We want buy-in and acceptance from the entire organization in the budgeting process, but we also want a well-defined budget and one that is not manipulated by people. There is always a trade-off between goal congruence and involvement. The three themes outlined below need to be taken into consideration with all types of budgets.

Imposed budgeting

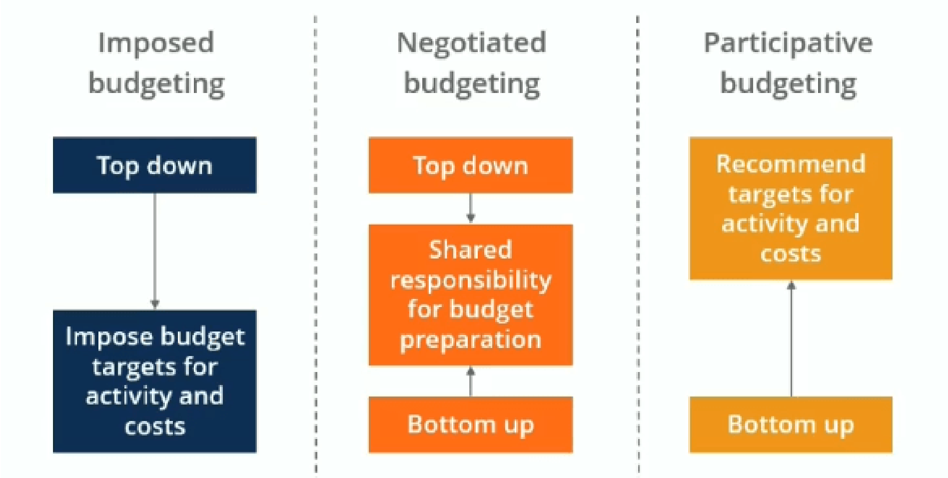
Imposed budgeting is a top-down process where executives adhere to a goal that they set for the company. Managers follow the goals and impose budget targets for activities and costs. It can be effective if a company is in a turnaround situation where they need to meet some difficult goals, but there might be very little goal congruence.

Negotiated budgeting

Negotiated budgeting is a combination of both top-down and bottom-up budgeting methods. Executives may outline some of the targets they would like to hit, but at the same time, there is shared responsibility for budget preparation between managers and employees. This increased involvement in the budgeting process by lower-level employees may make it easier to adhere to budget targets, as the employees feel like they have a more personal interest in the success of the budget plan.

Participative budgeting

Participative budgeting is a roll-up approach where employees work from the bottom up to recommend targets to the executives. The executives may provide some input, but they more or less take the recommendations as given by department managers and other employees (within reason, of course). Operations are treated as autonomous subsidiaries and are given a lot of freedom to set up the budget.



FLEXIBILE BUDGET

Illustration 1

Draw up a flexible budget for production at 75% and 100% capacity on the basis of the following data for a 50% activity

Particulars	**Per Unit in Rs.**

Materials	100
Labour	50
Variable expenses (direct)	10
Administrative expenses (50%fixed)	40000
Selling & Distribution expenses (60% fixed)	50000
Present production (50% activity)	1000

Cash Budget- Practice Problem

Flexible Budget - Practice Problem