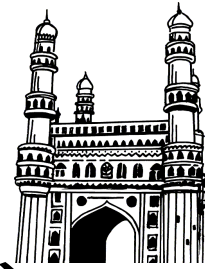


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FINANCIAL REPORTING AND ANALYSIS

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SYLLABUS

UNIT - I

Introduction to Accounting :

Importance, Objectives and Principles, Accounting Concepts and conventions, and The Generally Accepted Accounting Principles (GAAP), their implications on accounting system; Double entry system – recording business transactions – Classification of accounts – Accounting cycle.

UNIT - II

The Accounting Process :

Overview, Books of Original Record, Journal, Ledger, Trial Balance, Classification of Capital and Revenue Expenses, Final Accounts Trading, P&L Account, Balance Sheet with Adjustments. Rectification of Errors.

Accounting from Incomplete Records, Advantages and Disadvantages of Single Entry and Double Entry System and the Differences between the two, Preparation of Accounts, and Ascertainment of Profit from Incomplete Records, Accounting Treatment as per the Statement of Affairs Method and Calculation of Missing Figures.

UNIT - III

Valuation Models :

Valuation of Assets, Tangible vs. Intangible Assets. Inventory Valuation: Methods of Inventory Valuation and Valuation of Goodwill, Methods of Valuation of Goodwill. Depreciation, Methods of Depreciation, their Impact on Measurement of Business Accounting.

UNIT - IV

Financial Statement Analysis-I :

Statement of Changes in Working Capital, Funds from Operations, Paid Cost and Unpaid Costs. Distinction between Cash Profits and Book Profits, Preparation and Analysis of Cash Flow Statement and Funds Flow Statement, Horizontal Analysis and Vertical Analysis of Company.

UNIT - V

Financial Statement Analysis-II :

Analysis and Interpretation of Financial Statements, Liquidity, Leverage, Solvency and Profitability Ratios, Valuation Ratios, Du Pont Chart, Accounting Standards Issued by ICAI, Focus on INDAS, International Financial Reporting Standards (IFRS).

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Frequently Asked & Important Questions

UNIT - I

1. "Accounting is a service activity its function is to provide qualitative information".
Comment.

Ans : (Nov.-21, Nov.-20, Dec.-18)

Refer Unit-I, Q.No. 1

2. Explain briefly about Advantages and Limitations of Accounting.

Ans : (Dec.-18, Jan-18)

Refer Unit-I, Q.No. 3

3. Explain the main objectives of accounting.

Ans : (May-22, Nov.-21, Imp.)

Refer Unit-I, Q.No. 5

4. Critically examine the role of accountant in present day economy.

Ans : (May-22, Nov.-21, Dec.-18)

Refer Unit-I, Q.No. 8

5. Explain briefly the basic concepts of accounting.

Ans : (Nov.-22, Nov.-20, May-19, Dec.-18, Jan-18)

Refer Unit-I, Q.No. 12

6. Explain any three accounting conventions.

Ans : (Nov.-22, Nov.-20, Jan-20, May-19, Dec.-18)

Refer Unit-I, Q.No. 13

7. Enumerate the various institutions that influence the Indian GAAP?

Ans : (Jan-20, July-18)

Refer Unit-I, Q.No. 16

8. Discuss the implications of GAAP on accounting system.

Ans : (May-22, Nov.-21, July-18, Jan-18)

Refer Unit-I, Q.No. 19

9. Explain the rules of double entry system with suitable examples.

Ans : (May-22, Dec.-18)

Refer Unit-I, Q.No. 26

10. What is an accounting cycle? List the sequential steps in accounting process.

Ans :

(Nov.-22, July-18)

Refer Unit-I, Q.No. 27

11. Prepare Accounting Equation from the following:

S.No.	Particulars	(₹)
1.	Sandeep started business with Cash	1,00,000
2.	Purchased furniture for cash	5,000
3.	Purchased goods for cash	20,000
4.	Purchased goods on credit	36,000
5.	Paid for rent	700
6.	Goods costing ₹ 40,000 sold at a profit of 20% for cash	

Sol :

(Imp.)

Refer Unit-I, Prob. No. 2

12. Show the Accounting Equation on the basis of the following and present a balance sheet on the last new equation balances:

S.No.	Particulars	(₹)
(i)	Manu started business with cash	50,000
(ii)	Bought furniture for	500
(iii)	Purchased goods on credit	4,000
(iv)	Sold goods on cash (cost ₹ 500) for	700
(v)	Received rent	200
(vi)	Purchased goods for cash	1,000
(vii)	Withdrew for personal use	700
(viii)	Paid to creditors	400
(ix)	Paid for salaries	200

Sol :

(Imp.)

Refer Unit-I, Prob No. 3

UNIT - II

1. What is journal ? Explain the objectives of journal.

Ans :

(Imp.)

Refer Unit-II, Q.No. 2

2. Give Journal entries for the following transactions of Neeraj for the year 2017.

- (i) Started business with cash Rs. 18,000.
- (ii) paid rent in advance Rs. 400.
- (iii) Purchased goods for cash Rs. 5,000 and on credit Rs. 2,000.
- (iv) Sold goods for cash Rs. 4,000 (costing Rs. 2,400).
- (v) Rent paid Rs. 1,000 and rent outstanding Rs. 200.
- (vi) Bought motor-cycle for personal use Rs. 500.
- (vii) Purchased equipments for cash Rs. 500.
- (viii) Paid to creditors Rs. 600.

Sol :

(Nov.-21, Imp.)

Refer Unit-II, Prob No. 2

3. What is ledger? What is meant by Sub division of ledger?

Ans :

(Nov.-21, Imp.)

Refer Unit-II, Q.No. 9

4. What are the objectives of preparing trial balance?

Ans :

(July-18, Imp.)

Refer Unit-II, Q.No. 13

5. How can you validate the Balances Entered in Either Column of a Trial Balance?

Ans :

(July-18, Imp.)

Refer Unit-II, Q.No. 22

6. From the following trial balance of Goldern fair and Company, prepare trading and Profit and Loss account and Balance Sheet.

Trial Balance as on 31st December 2010.

Particulars	Debit (Rs.)	Credit (Rs.)
Cash in hand	2,400	
Purchase	2,40,000	
Stock on 1 st January 2005	70,000	
Debtor	1,00,000	
Plan and Machinery	1,20,000	
Furniture	30,000	
Bills Receivable	40,000	
Rent and Rates	20,000	
Wages	32,000	
Salaries	37,600	

Capital		2,00,000
Bills payable		44,000
Creditors		48,000
Sales		4,00,000
Total	6,92,000	6,92,000

Additional Information :

- (i) Closing inventory as on 31st December 2005 Rs. 50,000
- (ii) Outstanding wages Rs. 5,000
- (iii) Depreciation on Plant and Machinery at 10 percent and furniture at 5 percent.

Sol.:

(Nov.-21, Imp.)

Refer Unit-II, Prob. No. 25

7. From the following Trail Balance, Prepare the Trading and Profit and Loss Account of Mr. Ramu for the year ended December 31, 2015 and the Balance sheet as on the date

Particulars	Debit Rs.	Credit Rs.
Ramu Capital	-	4,000
Plant and Machinery	5,000	-
Office Furniture's and fitting	260	-
Stocks on January 1, 2015	4,800	-
Motor Van	1,200	-
Sundry Debtors	4,470	-
Cash in Hand	40	-
Cash in bank	650	-
Wages	15,000	-
Salaries	1,400	-
Purchases	21,350	-
Sales	-	48,000
Bills Receivable	720	-
Bills payable	-	560
Sundry Creditors	-	5,200
Returns Inwards	930	-
Provisions for doubtful debts	-	250
Drawings	700	-
Return outwards	-	550

Rent	600	
Factory Lighting and heating	80	-
Insurance	680	-
General Expenses	250	-
Bad debts	200	-
Discount	650	420
	58,980	58,980

The Following adjustments are to be made

- (a) Stock on December 31, 2015, Rs. 5,200/-
- (b) 3 months factory lighting and heating is due but not paid Rs. 30/-
- (c) 5% Depreciations to be written off on furniture,
- (d) Write off further bad debts Rs.70

Sol :

(Dec.-18, Imp.)

Refer Unit-II, Prob. No. 26

8. Explain the advantages and disadvantages of single entry system?

Ans :

(March-22, Nov.-20, Dec.-18, Jan-18)

Refer Unit-II, Q.No. 50

9. Discuss the accounting treatment as per the statement of affairs method.

Ans :

(Nov.-21, Jan-18)

Refer Unit-II, Q.No. 55

10. Gopal keeps his books by the single entry method. His position on 31st December 2020 and on 31st December 2021 are as follows :

Particulars	31 st Dec. 2020 Rs.	31 st Dec. 2021 Rs.
Cash in hand	30,000	20,000
Cash at Bank	2,50,000	2,80,000
Debtors	1,80,000	2,50,000
Stock	2,90,000	3,10,000
Furniture	50,000	60,000
Machinery	50,000	50,000
Creditors for goods	1,80,000	2,50,000
Expenses outstanding	15,000	-----
Prepaid insurance	-----	4,000

On 1st October 2020 Gopal introduced Rs. 50,000 as further capital in the business and withdrew on the same date Rs. 20,000 for personal use.

Depreciation is to be calculated on machinery at 10% p.a. A provision for doubtful debts is to be created on sundry debtors at 5%. Goods taken for personal use amounted to Rs. 15,000. Also provide interest on capital at 10% p.a.

Prepare the necessary statement showing the profit or loss made by him during the year ending 31st Dec. 2021.

Sol : (Nov.-22, Imp.)

Refer Unit-II, Prob. No. 33

11. Explain the accounting treatment for calculation of missing figures.

Ans : (Nov.-20, Imp.)

Refer Unit-II, Q.No. 57

UNIT - III

1. Define tangible assets. Explain the characteristics of tangible assets.

Ans : (Nov.-20, Imp.)

Refer Unit-III, Q.No. 6

2. Define Intangible assets. Explain the characteristics of intangible assets.

Ans : (Nov.-20, Imp.)

Refer Unit-III, Q.No. 7

3. Discuss various methods of Inventory Valuation with their relative merits and demerits.

Ans : (Nov.-21, Jan.-20)

Refer Unit-III, Q.No. 12

4. The following purchases and issue were made in a company :

Date	Particulars	Units	Rate
1-8-2006	Purchases	300	Rs. 15
6-8-2006	Issues	200	
10-8-2006	Purchases	400	Rs. 20
15-8-2006	Issues	450	
22-8-2006	Purchases	400	Rs. 25

What will be the value of stock on 22-8-2006 as per FIFO method ?

Sol : (Nov. - 21, Imp.)

Refer Unit-III, Prob. No.1

5. The financial year of Mr. X ends on 31st March 1995 but the stock on hand was physically verified only on 7th April 1995. You are required to ascertain the value of closing stock as on 31st March 1995 from the following information
- (a) The stock as verified on 7th April 1995 was Rs. 1,54,000
 - (b) Sales have been entered in the Sales Day Book only after the dispatch of goods and sales returns only on receipt of the goods.
 - (c) Purchases have been entered in the Purchases Day Book on receipt of the purchase invoice irrespective of the receipt of the goods
 - (d) Sales as per Sales Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 68,800 of which goods of sale value Rs. 12,000 had not been delivered) at the verification
 - (e) Purchases as per Purchase Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 58,000 of which goods for purchases of Rs. 15,000 had not been received at the date of verification and goods for purchases Rs. 20,000 had been received prior 31st March 1995
 - (f) In respect of goods costing Rs. 50,000 received prior to 31st March 1995, invoices had not been received until the date of verification of stocks
 - (g) The gross profit is 25% on sales

Sol :

(Jan. - 18, Imp.)

Refer Unit-III, Q.No. 6

-
6. Define goodwill. Explain the factors effecting goodwill.

Ans :

(Jan-20, Nov.-20, July-18)

Refer Unit-III, Q.No. 15

-
7. Explain the Methods of Valuation of Goodwill.

Ans :

(Nov.-20, Jan-20, July-18)

Refer Unit-III, Q.No. 16

-
8. Explain the concept of depreciation.

Ans :

(Nov.-21, Jan-20, Dec.-18)

Refer Unit-III, Q.No. 17

-
9. Define Fixed or Equal Installment or Straight Line Method? Explain the advantages and disadvantages of straight line method.

Ans :

(Nov.-21, Jan-20, Nov.-20)

Refer Unit-III, Q.No. 24

10. Define Diminishing or Reducing or Written down value method.

Ans :

(Nov.-21, Jan-20, Nov.-20, Jan-18)

Refer Unit-III, Q.No. 25

11. Aswin purchased a machine for Rs. 2,50,000 with an expected life of 10 years, on 1st April, 2010 and spent Rs. 20,000 towards transportation and installation. He followed straight line method for providing depreciation for 2 years and found unsuitable. On 1st April, 2012, he switched over to Diminishing balance method and continued up to 31st March, 2015. Prepare Machinery Accounts for the entire period and ascertain the book value on 1st April, 2015.

Sol :

(July-18, Imp.)

Refer Unit-III, Q.No. 18

UNIT - IV

1. Explain the differences between cash profit and book profit.

Ans :

(Jan-18, Imp.)

Refer Unit-IV, Q.No. 13

2. What information can be Obtained from Cash Flow.

Ans :

(Nov.-22, Jan.-20, Dec.-18, Jan-18)

Refer Unit-IV, Q.No. 14

3. How are cash flows classified as per AS-3.

Ans :

(Nov.-20, May-19, Dec.-18, July-18)

Refer Unit-IV, Q.No. 15

4. What is Funds Flow in Accounting

Ans :

(Nov.-22, Jan-20)

Refer Unit-IV, Q.No. 17

5. "Is a Funds flow statement a better substitute for an income statement". Comment.

Ans :

(Nov.-21, Imp.)

Refer Unit-IV, Q.No. 20

6. What are the differences between funds flow statement and cash flow statement.

Ans :

(May-22, Jan-20, May-19, July-18)

Refer Unit-IV, Q.No. 24

7. The following information and the balance sheet relate to Shyam sons Ltd.

Particulars	Year 1 Rs.	Year 2 Rs.
Assets		
Cash	10,000	15,000
Receivables	20,000	25,000
Inventory	20,000	35,000
Plant and machinery at cost	85,000	85,000
Less : Accumulated depreciation	(15,000)	(10,000)
	1,20,000	1,20,000
Liabilities and Capital		
Sundry creditors	8,000	10,000
Outstanding expenses	7,000	10,000
Debenture payable	10,000	5,000
Long terms loans	5,000	25,000
Capital	50,000	50,000
Retained earnings	40,000	50,000
	1,20,000	1,50,000

Net profit for the period after charging Rs. 5,000 on account of depreciation was Rs. 20,000. A piece of equipment costing Rs. 25,000 on which depreciation accumulated in the amount of Rs. 10,000 was sold for Rs. 10,000. Dividend paid during the year amounted to Rs. 10,000.

Prepare a source and use of funds statement.

Refer Unit-IV, Prob.15

UNIT - V

1. Explain the advantages of ratio analysis.

Ans :

(Nov.-21, Imp.)

Refer Unit-V, Q.No. 9

2. What are the Limitations of Ratio Analysis.

Ans :

(Nov.-21, Imp.)

Refer Unit-V, Q.No. 10

3. Discuss briefly the various types of Solvency Ratios.

Ans :

(May-19, July-18)

Refer Unit-V, Q.No. 13

4. From the balance sheet given below, calculate:

i) Working capital,

ii) Current Ratio,

iii) Acid test Ratio

iv) Debt Equity Ratio,

v) Assets Proprietorship Ratio

BALANCE SHEET OF ABC COMPANY LTD.,

as on 31st December 2006

Liabilities	Amount	Assets	Amount
Shareholders fund:		Fixed assets	1,80,000
Equity share capital:	1,50,000	Current assets:	
12% Preference share capital:	30,000	Cash in Hand:	2,000
Reserves and surplus:	24,000	Cash at bank:	4,000
	2,04,000	Sundry Debtors:	10,000
15% Debentures	48,000	Stores:	12,000
Bank overdraft:	12,000	Stock-in-Trade:	32,000
	60,000		
Sundry creditors:	16,000	Preliminary expenses	48,000
Proposed dividend:	2,000		
Provision for taxation:	10,000		
Discount on issue of Debenture	4,000		
	2,92,000		2,92,000

Sol.:

(Oct.-2020, Imp.)

Refer Unit-V, Prob.No. 7

5. 12. With the help of the following Ratio regarding Narmadha Text, draw the Trading Profit and Loss A/c and balance Sheet of the company for the year 2017

- (a) Current Ratio : 2.5
- (b) Liquidity Ratio : 1.5
- (c) Net working capital : Rs. 3,00,000
- (d) Stock Turnover Ratio : 6 times (cost of sales / Closing stock)
- (e) Gross Profit Ratio : 20%
- (f) Fixed assets Turnover Ratio (on cost of sales) : 2 times
- (g) Debt Collection Period : 2 Months
- (h) Fixed Assets to Shareholder's Net worth : 0.80
- (i) Reserves and Surplus to Capital : 0.5

Sol.:

(Dec.-18, Imp.)

Refer Unit-V, Prob. No. 12

6. Draw Du Point Chart by providing required data.

Ans : (Nov.-21, Jan.-20, Dec.18)

Refer Unit-V, Q.No. 17

7. Bring out a general view on financial accounting practices issued by ICAI.

Ans : (Nov.-21, Nov.-20, July-18)

Refer Unit-V, Q.No. 20

8. Explain Accounting Standard 6 (Revised) related to Depreciation Accounting.

Sol : (Jan.-18, Imp.)

Refer Unit-V, Q.No. 21

9. What are International Financial Reporting Standards (IFRS)? Explain.

Ans : (Nov.-20, Imp.)

Refer Unit-V, Q.No. 27

UNIT I

Introduction to Accounting: Importance, Objectives and Principles, Accounting Concepts and conventions, and The Generally Accepted Accounting Principles (GAAP), their implications on accounting system; Double entry system – recording business transactions – Classification of accounts – Accounting cycle.

1.1 INTRODUCTION TO ACCOUNTING

Q1. Define Accounting.

(OR)

What is accounting?

(OR)

“Accounting is a service activity its function is to provide qualitative information”. Comment.

Ans : (Nov.-21, Nov.-20, Dec.-18)

Meaning

Accounting deals with the measurement or provision of assurance about financial information used by different persons, viz., lenders, managers, investors, tax authorities and other decision-makers. It measures the various economic activities which affect inflow and outflow of economic resources to develop useful information. In another words, it can be said that it serves as a language of business since it communicates the results of business operations.

Definitions

- (i) **According to American Accounting Association** “Accounting is the process of identifying, measuring and communicating information to permit judgement and decisions by the users.”
- (ii) **According to Milagros B. Hernane,** “Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, and in making reasoned choices among alternate courses of action.”

(iii) **According to 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.”

(iv) **According to Smith and Ashburne,** “Accounting is a means of measuring and reporting the results of economic activities”.

(v) **According to Bierman and Derbin,** “Accounting may be defined as the identifying, measuring, recording and communicating of financial information”.

The most common technical definitions of accounting have been published by different accounting bodies. The Accounting Standards Council (ASC) in its old Statement of Financial Accounting Standards (SFAS) No. 1 defines accounting as follows:

“It is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.

From the above definitions and the meaning of book-keeping, it may be concluded that the book-keeping involves only the recording of transactions. The accounting starts where the function of book-keeping ends.

Q2. What are the Functions of Accounting.

(or)

Elucidate the functions of Accounting.

Ans :

Accounting deals with recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the end results to the interested parties.

The functions of accounting are as follows:

(i) Recording

Recording is a primary function of accounting. It mainly deals with recording all the financial transactions of business in a sequential order. All financial transactions are recorded in a book called as 'Journal'. Journal is further divided into many subsidiary books and the number of subsidiary books to be maintained depends upon nature and size of the business.

(ii) Classifying

Classification deals with the organized analysis of recorded data, with an intention to group all the related entries at one place. Ledger account is the book where in all the similar entries are recorded. Ledger contains different accounts on different pages and accordingly related entries are recorded under one particular account. It helps in identifying the total expenditure incurred in one specific account.

(iii) Summarizing

Summarizing includes presenting the classified data in an acceptable and practical manner which is useful to both the internal and the external users of accounting statements. The process of summarizing involves preparing trial balance, income statement and the balance sheet.

(iv) Associated with Financial Transactions

In accounting, only those transactions are recorded which are financial in nature and are in terms of money. Transactions which are not expressed in terms of money and are non-financial in nature are not recorded in the books of account.

(v) Analyzing and Interpreting

Analyzing and interpreting is the last function of accounting. The financial data which was recorded earlier is now being analyzed and interpreted so that it can be effectively used by the end users in making various decisions related to the financial condition and profitability of the business. The data is also useful in preparing the future plans and designing the policies for accomplishing those plans.

(vi) Communicating

When accounting information is thoroughly analyzed and interpreted, it must be communicated in an effective manner to the right person. The accounting information can be communicated by preparing and distributing the accounting reports which includes the income statement and the balance sheet along with some additional information in the form of ratios, graphs, funds flow statement, etc. An accountant must effectively utilize his innovative and imaginative abilities in this process.

Q3. Explain briefly about Advantages and Limitations of Accounting.

Ans :

(Dec.-18, Jan-18)

Advantages

Following are main advantages of accounting:

1. Replacement of Memory

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

2. Evidence in Court

Properly maintained accounts are often treated as a good evidence in the court to settle a dispute.

3. Settlement of Taxation Liability

If accounts are properly maintained, it will be of great assistance to the businessman in settling the income tax and sale tax liability

otherwise tax authorities may impose any amount of tax which the businessman will have to pay.

4. **Comparative Study**

It provides the facility of comparative study of the various aspects of the business such as profits, sales, expenses etc. with that of previous year and helps the businessman to locate significant factor leading to the change, if any.

5. **Sale of Business**

If accounts are properly maintained, it helps to ascertain the proper purchase price in case the businessman is interested to sell his business.

6. **Assistance to the Insolvent Person**

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

7. **Assistance to Various Parties**

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

8. **Facilitate in Raising Loans**

Accounting facilitates raising loans from lenders by providing them the required financial information.

9. **Assistance to the Management**

Accounting assists the management in taking managerial decisions. For example, Projected Cash Flow Statement facilitates the management to know the future receipts and payments and to take decisions regarding anticipated surplus or shortage of funds.

10. **Facilitate Control Over Assets**

Accounting facilitates control over assets by providing information regarding Cash Balance, Bank Balance, Stock, Debtors, Fixed Assets, etc.

Limitations / Disadvantages

Following are the main limitations of accounting:

1. **Records only Monetary Transactions**

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

2. **Effect of Price Level Changes not Considered**

Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of the various years becomes difficult.

For example, the sales to total assets in 2007 would be much higher than in 2002 due to rising prices, fixed assets being shown at cost and not at market price.

3. **No realistic information**

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

4. **Personal bias of the Accountant affects the accounting statements**

Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortisation of fixed assets, treatment of deferred revenue expenditure. Such judgement based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

5. Permits alternative treatments

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

6. Profit no real test of managerial performance

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

7. Historical in nature

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

8. Window Dressing in Balance Sheet

When an accountant resorts to window dressing in the Balance Sheet, then Balance Sheet cannot exhibit the true and fair view of the state of affairs of the business.

1.1.1 Importance of Accounting**Q4. Explain the Importance of accounting.**

Ans :

1. Business Forecasting

Every business tries to forecast its future activities on the basis of the past experience

and present practices. It wants to determine the policies and programmes well in advance.

For example, a business may like to know the quantity and quality of goods to be manufactured in future. Accounting provides this facility to the business.

2. Correct Decision-Making

Every business house has to take many economic and financial decisions, **for example,** determination of price on the basis of cost, imports-exports, increase, or decrease in investments, distribution of dividend, bonus, etc. All such decisions should be taken with utmost care. Any wrong decision taken may bring in many difficulties and problems. An appropriate and consistent accounting system helps in taking various decisions in the business.

3. Correct Taxation

A business house has to pay many taxes such as income-tax, sales tax, excise duty, customs, etc. The quantum of all taxes depends on the results shown by the financial accounts. A proper accounting system followed in the business helps in determining correct amount of taxes.

4. Helpful in Solving Business Disputes

The accounts maintained as per rules are documentary proof in courts of law. On the basis of the accounts a business house can sue the other and can defend itself in case of any dispute between the two. A concern can also proceed for getting declared insolvent in case its liabilities exceed its assets. Accounting helps the concern in all disputes and in the situation of insolvency.

5. Replacing Memory

Business transactions are innumerable, varied, and complex, as such it is quite impossible to memorize each and every transaction. Accounting records these transaction in writing and thus it is not necessary that the businessman should memorize all the transactions.

6. Assessing the Performance of the Business

Accounting keeps proper and systematic record of all business transactions. Income statements are prepared with these records and one is able to know the profit earned and the loss suffered by the business.

7. Assessing the Financial Status of the Business: Financial position of the business is displayed through position statement, i.e., balance sheet of the business. The statement is prepared at the end of the accounting year and reflects the true position of assets and liabilities of the business on a particular date.**8. Documentary Evidence**

Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. That is why; the court accepts these records as evidence.

9. Assisting in Realization of Debts

We, in 'Accounts' prepare personal ledger accounts of all the parties. The personal account shows the exact amount due from the debtors. One can send the debtors their statement of accounts and thus enable them to verify entries and also to make early payment of the amount due. The account can also be used to prove the claim of the business against the debtors in the court.

10. Preventing and Detecting Frauds

The proper accounting system and effective arrangement of internal check prevents leakage of goods and cash. In case cheating takes place, theft or embezzlement is made and fraud is committed, accounting helps in detection of these losses and also fixes responsibility for it. Proper accounting prevents employees from committing fraud.

11. Helpful to Management

Accounting is useful to the management in various ways. It enables the management to assess the achievements of its performance. Actual performance can be compared with

the desired performance or with the performance of previous years. The weaknesses of the business can be identified and corrective measures can be applied to remove them. Various profitability, sales, and liquidity ratios can be calculated, the actual performance can be evaluated and effective line of action can be decided for the future. Funds flow statement can also be prepared to understand the additional funds earned during the year and their application.

1.1.2 Objectives of Accounting**Q5. Explain the main objectives of accounting.**

Ans : (May-22, Nov.-21, Imp.)

Following are the main objectives of accounting:

1. Keep Systematic Records

Accounting is done to keep systematic records of financial transactions. In the absence of a scientific method of accounting, there would have been tremendous burden on the human memory which, in most cases, would have been impossible to bear.

2. Protect Business Properties

Accounting provides protection to business properties from unjustified and unwanted use. This is possible by providing the following information to the management:

- (i) The amount of owner's fund invested in the business;
- (ii) How much the business owes to others;
- (iii) How much the business has to recover from others; and
- (iv) How much business owns the assets;

3. Ascertain Operational Profit or Loss

Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expenses of a particular period.

4. Ascertain Financial Position of the Business

The profit and loss account reflects the performance of the business during a particular period. However, it is also necessary to know the financial position, i.e., where do we stand. What we owe and own. The objective is met by balance sheet, which shows the state of affairs of assets and liabilities as on a given date. It serves as barometer for ascertaining the financial health of the business.

5. Facilitate Rational Decision-Making

Accounting these days has taken itself the task of collection, analysis and reporting of information at the required points of time to the required level of authority in order to facilitate rational decision-making

Q6. "Accounting is classified into different branches" Explain.

Ans:

Accounting provides information to different end- users which helps them in analyzing the financial position. It is classified into three types. They are,

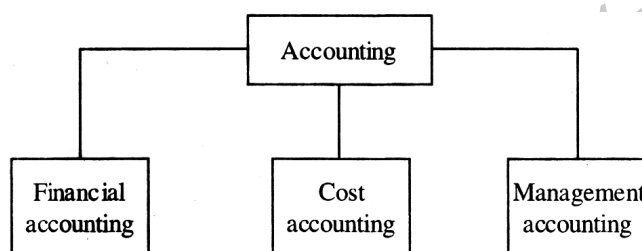


Fig: Classification of Branches of Accounting

1. Financial Accounting

Financial accounting deals with the preparation of financial statements such as profit and loss account (P & L a/c) and balance sheet. It helps in communicating the accounting information of the business to its end users such as shareholders employees etc. The main objective of financial accounting is to analyze profit or loss and to depict the financial position of the business. In order to accomplish these objectives, it is very essential to maintain a systematic record of business transactions in accounting books.

2. Cost Accounting

For overcoming the drawbacks of financial accounting a new branch of accounting known as cost accounting was developed. The main aim of cost accounting is to evaluate the actual cost incurred by the business in producing goods and services. With the help of cost accounting a businessman can decide the price of product and can eliminate losses and wastes by controlling the cost.

3. Management Accounting

Management accounting helps in providing accounting information to the management so that effective decisions can be taken for carrying out the business smoothly. It facilitates the management in developing policies and monitoring the functions of the business.

Q7. Compare and contrast financial accounting, Cost accounting and Management accounting.*Ans :*

Sl. No.	Point of Difference	Financial Accounting	Cost Accounting	Management Accounting
1.	Objective	Financial accounting records all the transactions relating to finance.	Cost accounting records by the firm in producing a product or service.	Management accounting helps the management in designing plans and policies.
2.	Periodicity	It is prepared at the end of the financial year.	It prepares its report weekly or monthly.	It provides information when ever it is required by the management.
3.	Importance	It is compulsory to prepare final accounts in every organization.	It is compulsory to prepare cost accounts only in some undertakings.	It is not compulsory. Principles and procedures are not followed in management accounting.
4.	Principles	It follows only some accounting principles and standards.	It is compulsory to follow all the principles and procedures in cost accounting.	
5.	Analysis or report	It discloses the financial position of the company as a whole.	It discloses the profits with regard to each process, product or service.	It prepares the budget and tax plans from the reports provided by financial and cost accounting.
6.	Nature	It mainly deals with the historical data.	It makes use of the historical data provided and outlines it.	It deals with the future plans and policies.
7.	Scope	In financial accounting, trading account, profit and loss account and balance sheet are prepared.	Cost accounting ascertaining the cost of a product or service.	It formulates policies for effective performance of management and covers cost and financial accounting.

Q8. Critically examine the role of accountant in present day economy.*Ans :***(May-22, Nov.-21, Dec.-18)****1. Maintenance of Books of Accounts**

Role of Accountant is very crucial in maintaining systematic records of financial transactions in order to calculate the net profit or loss for an accounting period and the financial position of an entity as on a particular date.

Maintaining proper books of accounts in the manner required by law and accounting policies followed by the entity is important for the entity. The books of accounts of the entity also support the future planning of business operations.

2. Statutory Audit

Usually, a Chartered Accountant audits the books of the entities like Limited companies, firms etc. according to the law. He ensures that the entities prepare the financial statements in accordance with generally accepted accounting principles, standards, and legal considerations. He also ensures that the financial statements show a true and fair view of the financial position of an entity.

3. Internal Audit

Accountants, internal staff are engaged in an internal audit by large-sized entities (like listed companies, companies required to conduct an internal audit under any law etc.) to ensure that all the accounting

transactions related to respective accounting year are recorded, classified and summarized in accordance with the accounting policies followed by the entity. It also enables management to check whether all the instructions given by it is followed or not.

4. Budgeting

Budgeting refers to the planning of various business activities, transactions before their occurrence. Accountants and management prepare various plans to balance their business incomes and expenses.

Actual results are compared with the budgeted to find out the variation if any. Role of accounting is very important while preparing the budget.

5. Taxation

Another very important role of the accountant is to plan the tax liabilities of an entity. Accountants are capable to manage the tax matters of an entity, file returns, make representations before tax authorities, and settle the tax liabilities of an entity under various laws. Various tax planning advice, investments etc services can be provided by accountants.

6. Investigation

The accountants also carry an investigation to ascertain the financial position of some parties. They perform this function either by themselves or by hiring external professionals.

However, external professionals are more preferable than the internal staff due to their independence, which enhances the confidentiality of investigation report.

7. Management Advisory Services

Reporting internal controls to management, long-term plans, advisory regarding the business operation of an entity are the major responsibilities of an accountant.

An accountant also provides the management consultancy services in the areas of Management information systems, expenditure control and evaluation of appraisal techniques.

8. Other Activities

The accountant also performs activities such as acting as a liquidator, cost accountant, arbitrator for settlement of disputes etc. Thus, these activities make the role of accountants important.

Q9. Describe the applications of accounting.

(OR)

Who are the users of financial statements?

Ans :

(Dec.-18)

Accounting provides useful information about the activities of an entity to various individuals or groups for their use in making informed judgements and decisions. The users of accounting information can be broadly divided into three categories:

1. Management or managers
2. Users with direct financial interest
3. Users with indirect financial interest

1. Management

Management is a group of people who are responsible for using the resources and managing the affairs of an entity to achieve certain predetermined goals and objectives. Managers perform many managerial functions such as planning, controlling, directing, measuring, evaluating and taking corrective action. Business managers need to decide continuously what to do, how to do it and whether the actual results tally the original plans and targets. Accounting provides timely and useful information to the management for planning, control, performance measurement, decision making and for performing many activities and functions in the company. Thus, management is one of the most important users of accounting information and a major function of accounting is to provide useful information to the managers and management.

2. Users with Direct Financial Interest

Users who have direct financial interest in a company include existing and potential

investors and creditors. These users do not participate in the actual management of the company but have interest in how a business has performed because they have invested, or are thinking of investing in a company. Existing and potential investors are obviously interested in the past performance of a company and its earning potential and growth prospects in the future. For this, the company's financial statements and other information should be analysed to decide and select a profitable investment opportunity.

3. Users with an Indirect Financial Interest

There are some other users who have indirect interest in a company's business or who use accounting information to help others having direct interest in a company's profitability and financial position. Such users are customers, taxation authorities, governmental and regulatory agencies, labour unions, financial analysts and advisers; stock exchanges and brokers, underwriters, economists; planners; consumers groups; general public and the financial press.

Customers may use financial statement data to forecast the likelihood and/or timing of a firm going bankrupt or being unable to meet its commitments. This information may be important in estimating the value of a warranty or in predicting the availability of supporting services or continuing supply of goods over an extended period of time.

Taxation authorities require financial statements to ascertain tax liability of a company, Governmental and regulatory agencies are concerned with the financial activities of business organisations for purposes of regulation to protect the public interest. Labour unions are also vitally interested in the stability and the profitability of the organisation that hires them or in which the employees are working. Stockbrokers, financial analysts, investment advisers have an indirect interest in the financial performance and prospects of a company as they advise investors and creditors in their investment and lending decisions.

Economic planners use accounting information to set economic policies, to forecast economic activities and to evaluate economic programmes undertaken in the country. The other users such as consumers groups, economists, financial press and the general public have become more concerned about business enterprises as well as with the effects that these enterprises have on the environment, social problem, inflation, and the quality of life.

Q10. "Accounting is an information system". Explain the statement.

Ans :

The term 'system' may be defined as a set of elements which operate together in order to attain a goal. A system does not consist of random sets of elements but elements which may be identified as belonging together because of a common goal. A system contains three activities:

- (i) Input
- (ii) Processing of Input
- (iii) Output

A business organisation is regarded as an open system which has a dynamic interplay with its environment from which it draws resources, and to which it consigns its product and services.

Accounting comprises a series of linked activities. These accounting activities form a progression of steps, beginning with observing, then collecting, recording, analysing, and finally communicating information to users. In other words, the accounting process involves the accumulation, analysis, measurement, interpretation, classification, and summarisation of the results of each of the many business transactions that affected the entity during the year. After this processing, accounting then transmits or projects messages to potential decision makers. The messages are in the form of financial statements, and the decision makers are the users. Accounting generally does not generate the basic information (raw financial data), rather the raw financial data results from the day-to-day transactions of the enterprise.

Figure displays how accounting as an information system aids business and economic decisions made by user-decision-makers. In this service activity, as shown in Figure accounting assumes a link between business activities and transactions and the decision makers.

First, accounting measures business activities and transactions through recording data.

Second, the recorded data is processed and stored until needed. Processing can be done in such a manner or format as to become useful information. Alternatively, sometimes, the processed data are further processed or prepared to provide the required information to the user.

Thirdly, processed and prepared information is communicated to users and decision makers in the forms of financial statements, other statements, reports, etc. In this accounting system, business transactions and activities are the input and statements and reports generated for the decision makers comprise the output.

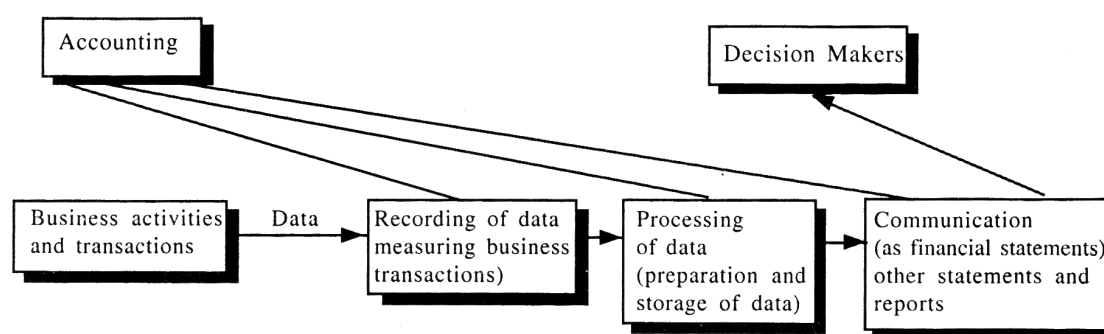


Fig. : Accounting as an information system in business and economic decision-making

1.2 ACCOUNTING PRINCIPLES

Q11. What are Accounting Principles?

(OR)

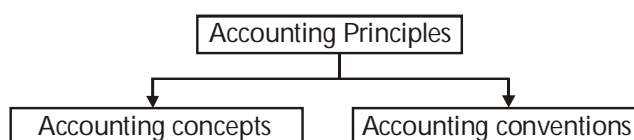
Explain the basic accounting principles.

Ans :

(Nov.-22, Nov.-21, Dec.-18)

As accounting acts as a language which is used to communicate the accounting information to the interested parties, it must follow some standards so that it runs smoothly. These standards are nothing but the accounting principles.

Accounting principles are those rules and regulations which are followed by the accountants at the time of recording the accounting transactions. Accounting principles are defined as "a list of principles that are usually linked with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist".



These principles are categorized into two groups.

- (i) Accounting concepts and
- (ii) Accounting conventions.

1.2.1 Accounting Concepts

Q12. Explain in detail the various accounting concepts.

(OR)

Discuss the various accounting concepts.

(OR)

Explain briefly the basic concepts of accounting.

Ans. : **(Nov.-22, Nov.-20, May-19
Dec.-18, Jan-18)**

Accounting is based on few concepts which follows assumptions or rules for recording the transactions. Some important accounting concepts are as follows.

(a) Separate Entity Concept

In accounting, proprietor treats its business as a separate entity so that his business transactions does not get mixed up with his personal life. If business and personal activities are mixed up then it would be difficult to derive/draw meaningful accounting information. The separate entity concept is applicable to all forms of business organizations for the accounting purpose. Usually, this concept seems to be unreasonable but it is very useful in drawing out the accounting information.

(b) Going Concern Concept

In this concept, the proprietor assumes that business will continue for a longer period of time in future. There is no intention of winding up the business in the near future. In this concept, accountant values the assets by calculating depreciation on the basis of expected life instead of the market values and he does not take into account the forced sale value of assets.

(c) Money Measurement Concept

This concept implies that only monetary transactions are taken into consideration at the time of preparation of accounting records. Books of account does not consider any transaction which cannot be expressed in

terms of money even though it may be useful for business but it is not recorded in the books of account.

(d) Cost Concept

The cost concept is similar to going concern concept. This concept implies that,

- Only the actual price of the asset is being recorded in books of accounts and,
- This actual cost is considered as a basis for further calculations of asset. This concept explains that an asset is recorded at its cost at the time of purchase but as the time passes on its value gets reduced due to depreciation charged on it. The preparation and presentation of financial statements becomes flawless and impartial with the help of cost concept.

(e) Dual Aspect Concept

The dual aspect concept is a primary concept of accounting, it implies that every business transaction has two-fold effect i.e., dual effect. The double effect of this concept can be expressed in form of an accounting equation as,

$$\text{Capital} + \text{Liabilities} = \text{Assets}$$

or

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

This equation can also be written as,

$$\text{Equities} = \text{Assets}$$

Hence, accounting equation explains the relationship between equities and assets. It implies that every debit has a credit which is equal to the sum of the debit.

(f) Accounting Period Concept

This concept explains that even though the life of business is very long but proprietor must calculate its position regularly after certain period of time usually after one year, this is known as accounting period. At the end of every accounting period, accountant is supposed to prepare the income statement which displays the profit or loss earned during the accounting period and the balance sheet

which shows the financial condition of the business till the last day of the accounting period. During the preparation of the statement, the capital and revenue expenditures must be taken carefully.

(g) Periodic Matching of Costs and Revenue Concept

The matching concept is based on the accounting period concept. According to this concept, a business in order to achieve its prime objective of profit maximization should always maintain a match between the costs and revenue within the accounting period. The term 'matching' refers to the adequate association of related revenues and expenditures.

(h) Realization Concept

According to this concept revenue is generated only through sales. The point of time when the property in goods is passed on to buyer and when he is legally entitled/liable to pay, it is considered as sales. The realization concept is not applicable for hire-purchase and contracts account.

1.2.2 Accounting Conventions

Q13. Explain in detail the various accounting conventions.

(OR)

Explain briefly the basic conventions of accounting.

(OR)

Explain any three accounting conventions.

Ans : (Nov.-22, Nov.-20, Jan-20, May-19, Dec.-18)

Accounting conventions involves those rituals and practices which helps the accountant in the preparation of accounting statements.

Some of the important accounting conventions are,

(a) Convention of Conservatism

According to this convention, accountant must adopt the policy of playing safe and follow the rule "anticipate no profit but provide for all possible losses".

This implies that accountant must make a provision for all possible or expected losses but unearned or unrealized profit must not be included. When convention of conservatism is used inventory is valued at lower price, either at cost or market price and provision is made for bad or doubtful debts.

The main objective of this convention is to misrepresent the true financial position of the company in order to show lower net income and understated assets and liabilities.

(b) Convention of Full Disclosure

According to this convention, financial statements must provide the complete and true information about the company. Financial statements must be prepared in accordance to the laws so that it can be effectively used by proprietors, present and potential creditors and investors.

The convention of full disclosure add notes to the accounting statements.

(c) Convention of Consistency

According to this convention, a company must follow same accounting practices and methods from one period to another.

Any changing the accounting practices would result in several problems in calculating the true financial position of the company.

If suppose for calculating depreciation a company follows a straight line method in one year and diminishing reducing balance method in another year, it becomes difficult to evaluate and compare the true financial position of the company. If any advanced technique is introduced, it must be mentioned clearly in the financial statements.

(d) Convention of Materiality

According to this convention, the accountant must give importance to material details and must avoid unnecessary/unimportant details. Kohler defined "materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person".

Q14. Explain the features of accounting principles.*Ans :*

The features of accounting principles are as follows:

1. Accounting Principles are Based on General Rules

The accounting principles are based on general rules, conventions, and assumptions which are widely accepted by accountants, auditors, managers, and government agencies. It is noteworthy here that the accounting principles are neither cent percent fool-proof nor can their accuracy be tested in any laboratory.

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

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

3. Accounting Principles are Widely Accepted

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

Q15. What are the limitations of accounting principles.*Ans :***(July-18)**

The limitations of accounting principles are as follows:

1. Lack of Complete Set of Principles

Though the American Institute of Certified Public Accountants has explained some

accounting principles, yet they are not complete in themselves. That is why the accountants use different methods in accounting and try to solve their problems as per their own convenience.

3. Lack of General Acceptance of Principles

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

3. Difference in the Application of Principles

One limitation of accounting principles is that all accountants do not use these principles in a similar manner. **For example**, all the accountants agree on the principle that depreciation must be charged on fixed assets, but some of them charge it on 'Straight Line Method', some on 'Diminishing Balance Method' while others use some other methods. Similarly, there are a number of systems for valuation of assets. The accountants of different business houses are implementing the accounting principles according to their need, convenience and nature of business.

1.3 THE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)
Q16. Explain the meaning of GAAP and identify the institutions that influence the development of GAAPs.**(OR)**

What are generally accepted accounting principles (GAAP) issued by ICAI?

(OR)

Enumerate the various institutions that influence the Indian GAAP?

Ans :

(Jan-20, July-18)

Generally Accepted Accounting Principles (GAAP) may be defined as those rules of action or conduct which are derived from experience and practice and when they prove useful, they become accepted as principles of accounting. According to the American Institute of Certified Public Accountants (AICPA), the principles which have substantial authoritative support become a part of the generally accepted accounting principles. The GAAP depends on how well they meet these following criteria.

(a) Relevance

A principle is relevant to the extent, it results in information that is meaningful and useful to the user of the accounting information.

(b) Objectivity

Objectivity connotes reliability and trust worthiness. A principle is objective to the extent, the accounting information is not influenced by personal bias or judgement of those who provide it. It also implies verifiability which means that there is some way of ascertaining the correctness of the information reported.

(c) Feasibility

A principle is feasible to the extent, it can be implemented without much complexity or cost.

Institutions that influence GAAP

The various institutions that influence Indian GAAP are,

(i) Department of Company Affairs (DCA)

Companies Act was administered by Indian Government to prescribe the rules and principles for the conduct of business. This act also prescribes the proforma and content for preparation and reporting the financial reports. DCA prescribes accounting requirements of government and controls both the Indian and foreign companies that are operating in India with the assistance of National Advisory Committee on Accounting Standards. Government has issued accounting standards for reporting financial statements.

(ii) SEBI

The main objectives for the establishment of SEBI were,

- To protect the investors interest in securities and
- To promote and regulate the securities market and listed companies.

It prescribes rules and provisions for the preparation and presentation of financial information for the companies listed in SEBI with the assistance of ICAI and other institutions, SEBI has issued accounting standards for true and fair disclosure of financial statements such as cash flow statement, segment reporting and consolidated financial statements.

(iii) ICAI (Institute of Chartered Accountants of India)

"The ICAI, being a member of International Federation of Accountants (IFAC), is supposed, inter alia to develop the International Accounting Standards Boards (IASB) pronouncements in the nation with an aim to facilitate global harmonization of the accounting standards. Thus, during the formulation of accounting standards, ASB would greatly take into consideration IAS's issued by the International Accounting Standards Committee or International Financial Reporting Standards (IFRS) which are issued by IASB, any one of these and would attempt to integrate them fully, in the light of the circumstances and practices existing in India".

ICAI till date has issued 31 accounting standards.

(iv) Income Tax Authorities

Income tax authorities have administered "Income Tax Act" to supervise and control the collection of income tax. Each and every firm should follow the provisions of Income Tax Act for the computation of tax on business income, they can even minimize the tax using some of the tax rules. Firm should

adopt accounting practices and policies as per the Income Tax Act, as the tax rules have a substantial effect on the accounting practice of the firm.

(v) RBI

RBI supervises and controls the financial sector of India. RBI also issued standard accounting and reporting requirements for financial institutions.

(vi) Controller and Auditor General of India (CAG)

President of India has a right to appoint CAG in order to audit and review the accounts of government organizations and to submit the review report to parliament. Most of the government organizations follow the standards prescribed by CAG.

(vii) International Accounting Standards Board (IASB)

IASB was initially known as IASC (International Accounting Standards Committee) in the year 1973. In the year 2001, after its restructuring IASC was changed to IASB. This organization aimed at framing and spreading the standards among the general public which were used in preparing financial statements.

IASB also aims at promoting the accounting standards all over the world. Nearly 140 countries are its members. Till date, IASC has issued 41 standards, out of which 11 standards have been withdrawn and 30 standards have been in practise. IASB has also issued 7 standards to date.

The standards issued by IASB were initially called as International Accounting Standards (IASs) and now currently are known as International Financial Reporting Standards (IFRSs).

IASB does not hold any power to mandate the compliance of its standards by its member countries but simultaneously plays an important role in effecting the accounting standards formulation on par with its country's standards.

(viii) International Federation of Accountants (IFAC)

It is associated with harmonization of aspects such as education, ethics and auditing practices across the globe.

(xi) International Organization of Securities Commissions (IOSCO)

It is one of the association of securities regulators like SEBI, SEC of US which plays a predominant role in development of uniformity in accounting and disclosure requirements in securities market across the world.

Q17. Explain the features of GAAP.

Ans :

The salient features of Generally Accepted Accounting Principles (GAAP) are as follows,

1. GAAP are formulated to ensure easy understanding and uniformity of accounting information.
2. GAAP are common rules but not final statements.
3. GAAP are not static. They may get change as the changes made in government regulations or legislations.
4. GAAP are not laboratory tested principles. They are formulated for experiences of personnels i.e., man made.
5. GAAP are very useful and meaningful for the users of accounting information.
6. GAAP can be easily implemented without any complexity or cost.
7. GAAP are helpful in verifying the accuracy of accounting books.
8. GAAP provide the basis for recording business transaction in accounting books.

Q18. What are GAAP inadequacies? What are the reasons for GAAP inadequacies?

Ans :

GAAP Inadequacies

The main objective behind the establishment of GAAP is to ensure the stakeholders that the

financial statements of the firm are true and fair. According to GAAP, firms may utilize the funds of absentee creditors/investors legally and honestly. But some of the firms create the accounts in order to mislead the decisions of stakeholders of the firm. In this view GAAPs fail to protect the interest of stakeholders.

Reasons for Inadequacies

The following are the reasons for the inadequacies of GAAP,

- (i) In GAAP, one can use high degrees of personal judgement and estimations while accounting the business activities such as depreciation and inventory valuation.
- (ii) The principles and rules of GAAP are highly flexible and can be changed according to the changing conditions. This flexible nature of GAAP principles resulted in loopholes for the benefit of unscrupulous management.
- (iii) Though these principles follow the regulations of law they do not consider the aspects of real world while preparing financial statements which will mislead the investors of the firm.
- (iv) GAAP differ from natural/statutory laws as they are man-made whereas natural laws are made by legislative bodies. GAAP can be avoided without any punishment.
- (v) There exists wide differences between GAAP and real world with the frequent changes and flexible nature of GAAP. With the passage of time, the principles may become redundant.
- (vi) GAAP does not provide any formal standards
- (vii) GAAP that are established by different professional bodies are not accurate and they may lead to misrepresentation of reports.
- (viii) The deceptive auditors of some of the professional bodies associated with GAAP helps the management in creating misleading reports against the provisions of GAAP.
- (ix) GAAP fail to meet the needs of different segments of investors such as, long term and short term investors.
- (x) GAAP is inadequate to meet specific needs of users as it is general in nature.

1.3.1 Implications on Accounting System

Q19. What is accounting system. Explain the implications of GAAP on accounting system.

(OR)

Discuss the implications of GAAP on accounting system.

Ans : (May-22, Nov.-21, July-18, Jan-18)

An accounting system is a set of accounting processes with integrated procedures and controls. The intent of an accounting system is to record business transactions, summarize those transactions into an aggregated form, and create reports that can be used by decision makers to monitor, analyze, and improve operations.

1. Uniformity

Accounting standards maintain uniformity in the preparation and reporting of financial statements so that the misleading deviations or changes in accounting treatment can be avoided while developing financial statements.

2. Comparability

As the accounting principles are uniform or consistent, the accounting standards can be used for comparing the financial statements of various organizations or various accounting periods of the same organization.

3. Reliability

The firmness or steadiness of economic system relies on the trust and confidence which the users have on the fairness of financial statements. Accounting standards helps in developing such type of confidence by producing a standard framework within which the financial statements can be prepared.

4. Useful to Investors

Accounting standards helps the investors in analyzing the growth of different companies depending on the financial statements so that the best alternative is selected for taking investment decision.

5. Useful to Auditors

Accounting standards must be followed while preparing financial statements as it helps the auditors to manage their clients. If clients are not following the accounting standards, then the auditor must specify this point in the report for avoiding different penal provisions under the Companies Act, 1956.

6. Useful to Government

The financial statements which are prepared by following accounting standards can be easily combined and used by government officials and others.

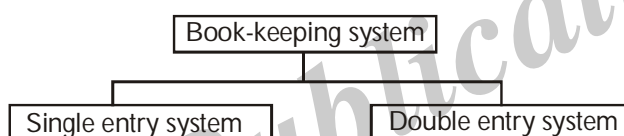
1.4 DOUBLE ENTRY SYSTEM – RECORDING BUSINESS TRANSACTIONS

Q20. Explain the classification of book keeping.

Ans :

Book-keeping is an art which records the business transactions in a significant and an organized way. An accountant can record the transactions with the help of systems of book-keeping. Systems of book-keeping are of two types.

They are, single entry system and double entry system.



Q21. Define book keeping? What are the objectives of book keeping?

Ans :

(Jan-20)

Meaning

Book-Keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. Book-Keeping is the record making phase of accounting. Accounting is based on a careful and an efficient book-keeping system.

Definitions

Book-Keeping is defined by different authors. A few of such definitions are given below. Carter in his Advanced Accounts defined Book-keeping as "the Science and art of correctly recording in books of account are those business transactions that result in the transfer money or money's worth".

- (i) **According to B.G. Vickery :** In his 'principles and Practice of Book-Keeping' defined Book-keeping as "The art of recording pecuniary or business transactions in a regular and systematic manner."
- (ii) **According to Kohler** in his book 'A Dictionary for Accountant's defined Book-keeping as "the process of analysing, classifying and recording transactions in accordance with preconceived plan."

Objectives

- (i) Book-keeping is concerned with recording of the financial transactions of business in a methodical manner so that information on any point in relation to them may be quickly obtained.

- (ii) Book-keeping activity is responsible for keeping all the financial records of a business (or only a minor segment such as maintenance of the customer's accounts).
- (iii) Book-keeping is to prepare original books of accounts trial balance and final accounts.
- (iv) To avoid financial frauds in business entity.

Q22. What are the differences between Book Keeping and Accounting ?

Ans :

Book-keeping is recording of the financial transactions of a business in a methodical manner so that information on any point in relation to them may be quickly obtained. A book-keeper may be responsible for keeping all the financial records of a business or only a minor segment such as maintenance of the customers' accounts in a departmental store. Much of the work of a book-keeper is clerical in nature and can be accomplished through the use of mechanical and electronic equipment.

On the other hand, Accounting is primarily concerned with the design of the system of records, the preparation of reports based on the recorded data, the interpretation of the reports and finally communicating the results of the interpretation to persons who are interested in such results. Accountants often direct and review the work of book-keepers. The work of accountants at the beginning may include some book-keeping but accountants must possess a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keepers.

The main differences between Book-keeping and Accounting are as follows :

S.No.	Basis of Difference	Book-Keeping	Accounting
1.	Scope	Recording and maintenance of books of accounts.	It is not only recording and maintenance of books of accounts but also includes analysis, interpreting and communicating the information.
2.	Stage	Primary stage.	Secondary stage.
3.	Objective	To maintain systematic records of business transactions.	To ascertain the net result of the business operation.
4.	Nature	Often routine and clerical in nature.	Analytical and executive in nature.
5.	Responsibility	A book-keeper is responsible for recording business transactions.	An accountant is also responsible for the work of a book-keeper.
6.	Knowledge level	The book-keeper is not required to have higher level of knowledge than that of an accountant.	The accountant is required to have higher level of knowledge than that of book-keeper.
7.	Supervision	The book-keeper does not supervise and check the work of an accountant.	An accountant supervises and checks the work of the book-keeper.
8.	Staff involved	Work is done by the junior staff of the organization.	Senior staff performs the accounting work.
9.	Principle of accountancy	In book-keeping, accounting concepts and conventions are followed.	The methods of reporting and interpretation accounting may vary from firm to firm.

Q23. What do you understand by double entry system? Discuss its features.

(OR)

What is double entry system of accounting?

Ans :

(Nov.-22, May-22)

Double entry system is an accounting technique that records the two-folds aspects of the transactions i.e., it records each transaction as a debit and a credit. Credit entries represent the sources of finance and debit entries represent the usage of that finance. In the double entry system, the transactions and events are recorded with the help of 'debit - credit rule'. This rule provides instructions for recording or making changes in the elements of balance sheets (assets, liability and equity). The double entry system explain the two fold effect of every transaction. For example, Person receives something to the other person. This is called as two-fold effect/dual-aspect concept.

All the transactions or events changes/ fluctuates the carrying amounts or composition of assets, liabilities or both but it in case the amount of change in an asset or a liability does not totally with the corresponding change in other assets and liabilities then the difference leads to a change in equity.

Features

The features of double entry system are as follows :

1. Set Rules

Every transaction is recorded as per the set rules of personal, real and nominal accounts. For this purpose every transaction is divided in two parts.

2. Entry in Two Accounts

Each transaction affects two accounts whether it is a cash or credit transaction.

3. Scientific System

Each transaction is divided in two parts which are personal and impersonal and then the rules of these accounts are applied. Since it has certain rules, it can be called as a scientific system.

4. Preparation of Trial Balance

Under double entry system, a trial balance is prepared to check the arithmetical accuracy of the accounts. If the total of debit column is equal to the total of credit column, then it means the accounts are arithmetically accurate.

5. Preparation of Final Accounts

Under double entry system, the final accounts are prepared through which one can know the profit and loss earned during the year. It also tells the final position of the business on the date of preparation of final accounts.

Q24. Explain advantages and disadvantages of double entry system.

(OR)

What are the advantages of double entry system.

Ans :

(Nov.-22)

Advantages

It has the following advantages :

1. Scientific System

Double entry is treated as a scientific system since there are certain principles and rules of recording the transaction according to which entries are made in the books of accounts.

2. Complete Record of Transactions

All types of transactions whether they are related with personal, real, nominal accounts are recorded in the books of accounts on the basis of specified rules. Thus, it is called a complete system and helps to narrate the transactions in future easily.

3. Knowledge about Different Accounts

This system gives the information and knowledge about the different types of accounts which are maintained in the ledger. Therefore, any information relating to any person, expense or income can easily be obtained.

4. Knowledge about Financial Position

This system also enables the businessman to know the financial position of his business. It also presents the assets and liabilities of the business on a certain date.

5. Elasticity

This system is flexible in nature and it can be expanded or contracted as per the changed

requirements of the business. For example, if the number of transactions in the business increases, the subsidiary books can be used.

6. **Less Possibility of Fraud and Mistakes**

Since this system is scientific in nature, each transaction is recorded on two sides. Thus there is less possibility of fraud, mistakes and misappropriation. In case of any fraud and mistake it can be detected and rectified quickly.

7. **Suitable for all types of Businesses**

This system can be used for all types of business houses whether they are sole proprietorship firms or partnership firms or joint stock companies. That's why this system of accounting is used throughout the world as it is adequate for all.

8. **Comparative Study is Possible**

The accounts of current year can be compared with the accounts of previous year in the double entry system. Thus, the progress of business can be measured along with accounting. It also helps in controlling the unnecessary expenses.

9. **Proof as Evidence**

The books prepared under this system are recognised as evidences since they are treated as accurate, reliable and scientific.

10. **Facility of Adjustments**

Under this system, adjustments relating to unearned incomes, outstanding expenses, prepaid expenses and accrued income, etc. can be made at the end of the year. This helps in ascertaining the true profit or loss and actual financial position of the business.

Disadvantages

The double entry system has the following disadvantages :

1. **Costlier System**

A number of accounting books such as journal, ledger, cash book and subsidiary journals, etc. are maintained under this system. Therefore this system becomes costlier especially for small business houses.

2. **Accounting Errors**

Only the arithmetical accuracy of accounts can be checked by preparing the trial balance. But many of accounting errors, like error of omission, error of principle, error of commission and compensating errors may remain uncorrected despite the agreement of trial balance.

3. **Requires Practical Knowledge**

A person without the knowledge of accounts cannot record and understand the transactions. Therefore, the system needs a well educated, practical and trained professional to maintain and understand the accounts under this system.

Q25. What are business transaction? What are the principles used for recording business transactions?

Ans :

Meaning

When money or money's worth, is exchanged in the form of goods and services between two parties is known as "Business Transaction". All the business transactions are recorded in the books known as accounting books.

Business transactions are of two types,

1. **Cash Transaction**

When payment of business transaction is made as and when it takes place it is known as cash transaction.

2. **Credit Transaction**

When payment of transaction is delayed and agreed in order to make payment on specific future date is known as credit transactions.

Principles

There are some basic principles to be followed in order to enter the daily transactions in journal as follows,

Step 1: Ascertain the two accounts involved in the business transactions.

Step 2: Ascertain the nature of accounts involved.

Step 3: Apply the golden rule of accounts for "Debit" and "Credit" and find out which is to be debited and which is to be credited.

1.5 CLASSIFICATION OF ACCOUNTS

Q26. Briefly describe the classification of accounts.

(OR)

Explain the rules of double entry system with suitable examples.

(OR)

Give the classification of accounts.

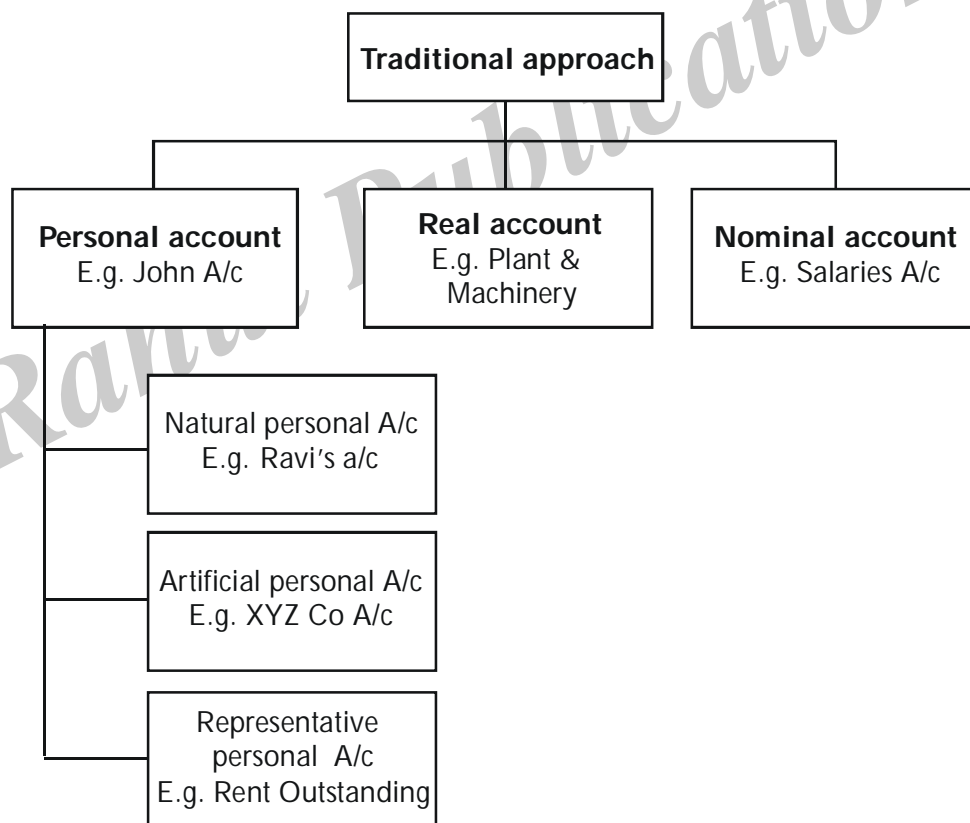
Ans :

(May-22, Dec.-18)

An account is a summary of relevant transaction and events at one place under a particular head. It records the amount of the transactions and also depicts their effect and direction. Classification of accounting is broadly divided into two heads:

1. Classification according to Traditional approach
2. Classification according to accounting equation

1. Classification of Accounts according to traditional approach



A) Personal Account

Account related to individual, banks, firm, companies, etc. are known as personal account. The personal accounts are related to natural person, artificial persons and representative person. It may be classified into three categories:

1. **Natural Personal Account** : Account of individuals (natural person) such as Rakesh a/c is known as natural personal account.
2. **Artificial Personal Account** : Accounts of firms, companies, banks, are artificial accounts. For examples, Tata Groups A/c, Coca Cola Corporation bank A/c.
3. **Representative Account** : The account related to outstanding expenses, prepaid expenses, income received in advance, accrued income is representative personal accounts. For examples, Rent outstanding, insurance Prepaid, Interest due but not paid, etc.

Rule

Debit the Receiver Credit the Giver
--

B) Real Account

Real Account is related to tangible or intangible assets. Tangible assets are one which can be touch and seen such as building, plant, cash etc. Intangible assets are related to intangible objects which neither be touched or seen. For example, goodwill, trademarks, etc.

Rule

Debit what comes in Credit what goes out

C) Nominal Account

The account related to income, expense, losses, and gains are classified as nominal accounts. For examples, wage accounts, salaries account, etc.

Rule

Debit all expenses and losses Credit all incomes and gains (or) profits
--

2. Classification of account according to Accounting Equations

There are five types of accounts:

1. **Assets A/c** : It relates to tangible or intangible assets. Ex. Plant A/c
2. **Liabilities A/c** : These accounts represent the final obligation of the enterprise towards outsiders. Ex. Trade creditors, bills payable
3. **Capital A/c** : These accounts relates to owners of an enterprise. Ex. Capital A/c, Drawings A/c
4. **Revenue A/c** : These accounts relate to amount earned by the enterprise by rendering goods and services. Ex. Sales A/c, Discount received A/c
5. **Expense A/c** : These accounts relate to the amount of loss or incurred in the process of earning revenue. Ex. Purchase A/c, Loss by Theft A/c.

PROBLEMS

1. Classify the following under Personal, Real and Nominal account.

- | | | |
|--------------------------|----------------------|----------------------------------|
| (a) Capital account | (b) Accrued interest | (c) Interest on capital |
| (d) Interest on drawings | (e) Goodwill | (f) Patent and trade marks |
| (g) Salary | (h) Rent | (i) Current account of a partner |
| (j) Fixtures | | |

Sol.:

(May-19)

- | | |
|-----------------------------|----------------|
| (a) Capital a/c | – Personal A/c |
| (b) Accrued interest | – Personal A/c |
| (c) Interest on capital | – Nominal A/c |
| (d) Interest on drawings | – Nominal A/c |
| (e) Goodwill | – Real A/c |
| (f) Patents and Trade marks | – Real A/c |
| (g) Salary | – Nominal A/c |
| (h) Rent | – Nominal A/c |
| (i) Current a/c | – Personal A/c |
| (j) Fixtures | – Real A/c |

1.6 ACCOUNTING CYCLE

Q27. What is accounting cycle ? Explain the various steps involved in it.

(OR)

What is an accounting cycle? List the sequential steps in accounting process.

Ans.:

(Nov.-22, July-18)

Meaning

The process which starts with the transactions taking place and ends up with preparation of final accounts is known as accounting process. This process involves a sequence of activities which are repeated in every accounting period, so it is also known as accounting cycle.

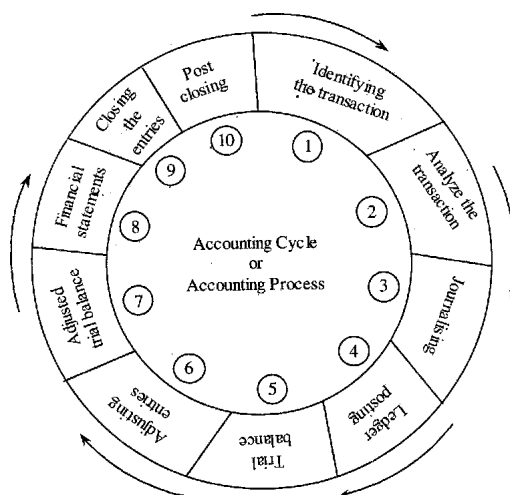


Fig : Accounting Cycle/Process

Various Steps of Accounting Cycle

Following are the steps involved in accounting cycle,

(i) Identifying Transaction

The first step in accounting cycle is to identify the transaction and ascertain its source document like purchase order or sales invoice i.e., from where the transaction has been recorded.

(ii) Analyzing Transaction

In this step transactions which are expressed in terms of money i.e., monetary transactions and the accounts which are affected by these transactions are identified and analyzed.

(iii) Journalizing

After analyzing the transaction they are recorded in journal in the form of entries. These entries are based on principle of double entry in which every transaction has a two fold effect i.e., dual effect.

(iv) Ledger Posting

When all the transactions are journalized they must be posted into ledger account. Ledger is a book wherein similar transactions are being recorded in one particular account.

(v) Trial Balance

After posting the entries into ledger the entries must be posted in the trial balance in order to evaluate whether the balance of credit and debit side are equal to each other. All the ledger accounts which has debit balance are recorded in the left column and ledger accounts with credit balance are posted on the right column of the trial balance.

(vi) Adjusting Entries

The accrued, deferred and estimated amounts are recorded with the help of adjustment entries. These adjustment entries are journalized and recorded into respective ledger account.

(vii) Adjusted Trial Balance

The next step in accounting cycle after adjusting the accrued and deferred accounts

is to prepare new trial balance which is similar to unadjusted trial balance with the only difference that the adjusting entries are included in the new trial balance.

(viii) Financial Statements

In order to analyze the financial position of the company financial statements are prepared which include,

(a) Income Statement : The income statement is prepared with the help of revenues and incomes earned by the company and losses and expenses incurred by the company.

(b) Balance Sheet : Balance sheet is prepared with the help of assets, liabilities and equity accounts.

(c) Statement of Retained Earning : It is prepared by using net income and dividend information.

(d) Cash Flow Statement : Either direct or indirect method is used to extract cash flow statement from other financial statements of the company.

(ix) Closing the Entries

After the preparation of financial statements the balances of temporary accounts are transferred to owner's equity.

(x) After-closing Trial Balance

After closing the entries a new trial balance is prepared in order to verify whether the Debit balance is equal to the credit balance or not.

Q28. What is accounting equation?

(OR)

What is the fundamental accounting equation? Express it in two different forms.

(OR)

What is basic accounting equation?

Ans :

(May-19)

The end result of the accounting process for a business entity is the financial statements such as balance sheet, profit and loss account, statement of changes in financial position. These statements are presented in a condensed (highly summarised) form and cannot be prepared until the financial transactions of the business entity have been recorded, classified and summarised. The framework of the financial statements and the elements shown in these statements rests on important and basic relationship, referred to as basic or fundamental accounting equation, basic accounting model. This basic equation is expressed by the balance sheet equation, and therefore, is known as the balance sheet equation also. The balance sheet equation indicates that

Sources of Funds = Uses of Funds Or

Equities = Assets Or

Proprietor's Equity (Capital) + Outside Liability = Assets

The above accounting equation signifies that assets of a business are always equal to the total of outside liabilities and proprietor's equity. It means that the accounting equation should always be in balance. This fundamental equality is always true because the left side of the equation is simply another view of the right side. This is because whatever funds are raised by the business, either through capital or business operations or from outsider will be tied up in one or other form of uses (assets). Assets represent resources owned by the business entity; equity represents the claims of those who supplied the assets. Thus, the fundamental accounting equation emphasises accounting equivalence or duality concept, i.e., each financial transaction has a dual nature and affects both the assets and liabilities side of the balance sheet.

Algebraically the equations can be expressed as:

$$A = L + P$$

Where A = Assets

L = Outside liabilities

P = Proprietor's equity

The above equation can also be expressed as

$$P = A - L \quad \dots (1)$$

$$L = A - P \quad \dots (2)$$

$$A - L - P = \text{Zero} \quad \dots (3)$$

ASSETS AND LIABILITIES

The aforesaid Accounting Equation is concerned with assets and equities (outside liabilities and proprietor's equity). Following is the list of some assets and equities:

Assets:

1. Cash
2. Cash at Bank
3. Bills Receivable
4. Prepaid expenses
5. Debtors or accounts receivable

6. Stock (stock of raw materials, work-in-progress, finished goods etc.)
7. Loose tools
8. Office equipments and furniture
9. Patents, copyrights
10. Machinery
11. Buildings
12. Land
13. Goodwill

Equities (Outside liabilities and Proprietor's equity).

(a) Outside Liabilities

1. Bank overdraft
2. Outstanding expenses
3. Bills payable
4. Creditors on accounts
5. Loan — short-term as well as long-term
6. Debentures

(b) Proprietorship Equity

- (i) Capital (Plus additions less withdrawals)
- (ii) Reserves and surplus of profits/accumulated profits.

Effects of Financial Transactions on Accounting Equation

Every business transaction can be analysed by or expressed in terms of its effect on the balance sheet equation. A business transaction results into a change in all or any of the components of the equation. Whatever may be the change, the Accounting Equation remains in balance. Different types of business transactions may result into a maximum of nine possible effect combinations of the components of accounting equation.

These nine possible combinations of changes or effects are:

- (i) Increase in one asset; decrease in another asset.
- (ii) Increase in one liability; decrease in another liability.
- (iii) Increase in one item of proprietor's equity; decrease in another item of proprietor's equity.
- (iv) Increase in one item of proprietor's equity; decrease in liability.
- (v) Increase in a liability; decrease in proprietor's equity.
- (vi) Increase in asset; increase in liability.
- (vii) Increase in asset; increase in proprietor's equity.
- (viii) Decrease in asset; decrease in liability.
- (ix) Decrease in asset; decrease in proprietor's equity.

PROBLEMS

2. Prepare Accounting Equation from the following:

S.No.	Particulars	(₹)
1.	Sandeep started business with Cash	1,00,000
2.	Purchased furniture for cash	5,000
3.	Purchased goods for cash	20,000
4.	Purchased goods on credit	36,000
5.	Paid for rent	700
6.	Goods costing ₹ 40,000 sold at a profit of 20% for cash	

Sol :

ACCOUNTING EQUATION

S.No.	Transaction	Assets			=	Liabilities	+	Capital
		Cash	+ Furniture	+ Stock	=	Creditors		
(i)	Sandeep started business with cash	1,00,000					+	1,00,000
		1,00,000			=		+	1,00,000
(ii)	Purchased furniture for cash	-5,000	+5,000					
		95,000	+ 5,000		=		+	1,00,000
(iii)	Purchased goods for cash	-20,000		+20,000				
		75,000	+ 5,000	+ 20,000	=		+	1,00,000
(iv)	Purchased goods on credit			+36,000		+36,000		
		75,000	+ 5,000	+ 56,000	=	36,000	+	1,00,000
(v)	Rent paid	-700						-700
		74,300	+ 5,000	+ 56,000	=	36,000	+	99,300
(vi)	Goods costing Rs 40,000 sold at a profit of 20% for cash	+48,000		-40,000				+8,000
		1,22,300	+ 5,000	+ 16,000	=	36,000	+	1,07,300

Working Note:

Calculation of Sale Price

Cost of Goods Sold	=	40,000
Add : Profit 20% of Rs. 40,000	=	8,000
∴ Selling Price	=	<u>48,000</u>

3. Show the Accounting Equation on the basis of the following and present a balance sheet on the last new equation balances:

S.No.	Particulars	(₹)
(i)	Manu started business with cash	50,000
(ii)	Bought furniture for	500
(iii)	Purchased goods on credit	4,000
(iv)	Sold goods on cash (cost ₹ 500) for	700
(v)	Received rent	200
(vi)	Purchased goods for cash	1,000
(vii)	Withdrew for personal use	700
(viii)	Paid to creditors	400
(ix)	Paid for salaries	200

Sol :

ACCOUNTING EQUATION

S.No.	Transaction	Assets			=	Liabilities +		Capital
		Cash	+ Furniture	+ Stock	=	Creditors		
(i)	Manu started business with cash	+50,000						+50,000
		50,000			=	+		50,000
(ii)	Purchased Furniture	-500	+500					
		49,500	+ 500			+		50,000
(iii)	Purchased goods on credit			+4,000		+4,000		
		49,500	+ 500	+ 4,000	=	4,000	+	50,000
(iv)	Sold goods costing Rs 500 for Rs 700	+700		-500				+200 (Profit)
		50,200	+ 500	+ 3,500	=	4,000	+	50,200
(v)	Rent received	+200						+200 (Income)
		50,400	+ 500	+ 3,500	=	4,000	+	50,400
(vi)	Purchased goods for cash	-1,000		+1,000				
		49,400	+ 500	+ 4,500	=	4,000	+	50,400
(vii)	Withdrew for personal use	-700						-700 (Drawings)
		48,700	+ 500	+ 4,500	=	4,000	+	49,700
(viii)	Paid to creditors	-400				-400		
		48,300	+ 500	+ 4,500	=	3,600	+	49,700
(ix)	Salaries paid	-200						-200
		48,100	+ 500	+ 4,500	=	3,600	+	49,500

Balance Sheet

as on

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Creditors	3,600	Cash	48,100
Capital	49,500	Furniture	500
		Stock	4,500
	<u>53,100</u>		<u>53,100</u>

4. Prepare Accounting Equation from the following:

S.No.	Particulars	(₹)
(a)	Kunal started business with cash	2,50,000
(b)	He purchased furniture for cash	35,000
(c)	He paid commission	2,000
(d)	He purchased goods on credit	40,000
(e)	He sold goods (Costing ? 20,000) for cash	26,000

*Sol.:***ACCOUNTING EQUATION**

S.No.	Transaction	Assets			=	Liabilities	+	Capital
		Cash	+ Furniture	+ Stock	=	Creditors		
(i)	Kunal started business with cash	+2,50,000					+	2,50,000
		2,50,000			=			2,50,000
(ii)	Purchased furniture for cash	-35,000	+35,000					
		2,15,000	+ 35,000		=			2,50,000
(iii)	Commission paid	-2,000						-2,000 (Expense)
		2,13,000	+ 35,000		=		+	2,48,000
(iv)	Purchased goods on credit			+40,000		+40,000		
		2,13,000	+ 35,000	+ 40,000	=	40,000	+	2,48,000
(v)	Sold goods costing Rs 20,000 for Rs 26,000	+26,000		-20,000				+6,000 (Profit)
		2,39,000	+ 35,000	+ 20,000	=	40,000	+	2,54,000

5. Mohit has the following transactions, prepare Accounting Equation:

S.No.	Particulars	(₹)
(a)	Business started with cash	1,75,000
(b)	Purchased goods from Rohit	50,000
(c)	Sold goods on credit to Manish (costing ₹ 17,500)	20,000
(d)	Purchased furniture for office use	10,000
(e)	Cash paid to Rohit in full settlement	48,500
(f)	Cash received from Manish	20,000
(g)	Rent paid	1,000
(h)	Cash withdrew for personal use	3,000

Sol :

ACCOUNTING EQUATION

S.No.	Transaction	Assets				=	Liabilities	+	Capital
		Cash	+	Stock	+	Debtors	+	Furniture	= Creditors
(i)	Started business with cash	+1,75,000						+	1,75,000
		1,75,000					=		+ 1,75,000
(ii)	Purchased goods from Rohit			+50,000				+50,000	
		1,75,000	+	50,000			=	50,000	+ 1,75,000
(iii)	Sold goods costing Rs 17,500 for Rs 20,000 to Manish			-17,500		+20,000			+2,500 (Profit)
		1,75,000	+	32,500	+	20,000		=	50,000 + 1,77,500
(iv)	Purchased furniture for office use	-10,000						+10,000	
		1,65,000	+	32,500	+	20,000	+	10,000	= 50,000 + 1,77,500
(v)	Cash paid in full settlement to Rohit	-48,500						-50,000	+1,500 (Gain)
		1,16,500	+	32,500	+	20,000	+	10,000	= 0 + 1,79,000
(vi)	Cash received from Manish	+20,000				-20,000			
		1,36,500	+	32,500	+	0	+	10,000	= + 1,79,000
(vii)	Rent paid	-1,000							-1,000 (Expense)
		1,35,500	+	32,500	+		+	10,000	= + 1,78,000
(viii)	Withdrew cash for private use	-3,000							-3,000 (Drawings)
		1,32,500	+	32,500	+		+	10,000	= + 1,75,000

6. Prove that the accounting equation is satisfied in all the following transactions of Suresh.
- Commenced business with a cash Rs. 36,00,000
- Paid rent in advance Rs. 30,000
- Purchased goods for cash Rs. 18,00,000 and credit Rs. 12,00,000.
- Sold goods for cash Rs. 18,00,000 costing Rs. 12,00,000.
- Paid salary Rs. 30,000 and salary outstanding Rs. 6,000.
- Bought secondhand car for personal use Rs. 3,00,000.

Sol.:

(Nov. - 22)

ACCOUNTING EQUATION

S.No.	Transaction	Assets			=	Liabilities		+ Capital	
		Cash	+ Prepaid Rent	+ Stock	=	Liabilities	+ Capital	+ Creditors	+ Salary Outstanding
1.	Commenced business with a cash Rs. 36,00,000	+36,00,000					+36,00,000		
2.	Paid rent in advance Rs. 30,000	+36,00,000 - 30,000	+ 30,000		=				
3.	Purchased goods for cash Rs. 18,00,000 and credit Rs. 12,00,000.	35,70,000	+ 30,000		=		+ 36,00,000		
4.	Sold goods for cash Rs.18,00,000 costing Rs.12,00,000.	- 18,00,000		+ 30,00,000	=		+ 36,00,000	+ 12,00,000	
		17,70,000	+ 30,000	+ 30,00,000	=		+ 36,00,000	+ 12,00,000	
5.	Paid salary Rs. 30,000 and salary outstanding Rs. 6,000.	+18,00,000		- 12,00,000			+ 6,00,000		
		35,70,000	+ 30,000	+ 18,00,000	=		+ 42,00,000	+ 12,00,000	
6.	Bought secondhand car for personal use Rs. 3,00,000.	- 24,000							+ 6,000
		35,46,000	+ 30,000	+ 18,00,000	=		+ 42,00,000	+ 12,00,000	+ 6,000
		- 3,00,000					- 3,00,000		
		32,46,000	+ 30,000	+ 18,00,000	=		39,00,000	+ 12,00,000	+ 6,000

Short Question and Answers

1. Explain any three accounting conventions.

Ans :

Some of the important accounting conventions are,

(a) Convention of Conservatism

According to this convention, accountant must adopt the policy of playing safe and follow the rule "anticipate no profit but provide for all possible losses".

This implies that accountant must make a provision for all possible or expected losses but unearned or unrealized profit must not be included. When convention of conservatism is used inventory is valued at lower price, either at cost or market price and provision is made for bad or doubtful debts.

The main objective of this convention is to misrepresent the true financial position of the company in order to show lower net income and understated assets and liabilities.

(b) Convention of Full Disclosure

According to this convention, financial statements must provide the complete and true information about the company. Financial statements must be prepared in accordance to the laws so that it can be effectively used by proprietors, present and potential creditors and investors.

The convention of full disclosure add notes to the accounting statements.

(c) Convention of Consistency

According to this convention, a company must follow same accounting practices and methods from one period to another.

Any changing the accounting practices would result in several problems in calculating the true financial position of the company.

If suppose for calculating depreciation a company follows a straight line method in one year and diminishing reducing balance method in another year, it becomes difficult to evaluate and compare the true financial position of the company. If any advanced technique is introduced, it must be mentioned clearly in the financial statements.

2. Define Accounting.

Ans :

Meaning

Accounting deals with the measurement or provision of assurance about financial information used by different persons, viz., lenders, managers, investors, tax authorities and other decision-makers. It measures the various economic activities which affect inflow and outflow of economic resources to develop useful information. In another words, it can be said that it serves as a language of business since it communicates the results of business operations.

Definitions

- (i) According to American Accounting Association** "Accounting is the process of identifying, measuring and communicating information to permit judgement and decisions by the users."
- (ii) According to Milagros B. Hernane,** "Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, and in making reasoned choices among alternate courses of action."
- (iii) According to 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."

(iv) **According to Smith and Ashburne**, "Accounting is a means of measuring and reporting the results of economic activities".

(v) **According to Bierman and Derbin**, "Accounting may be defined as the identifying, measuring, recording and communicating of financial information".

3. Give the classification of accounts.

Ans :

An account is a summary of relevant transaction and events at one place under a particular head. It records the amount of the transactions and also depicts their effect and direction. Classification of accounting is broadly divided into two heads:

- (i) Classification according to Traditional approach
- (ii) Classification according to accounting equation

4. Limitations of Accounting

Ans :

Following are the main limitations of accounting:

(i) Records only Monetary Transactions

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

(ii) Effect of Price Level Changes not Considered

Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of the various years becomes difficult.

For example, the sales to total assets in 2007 would be much higher than in 2002 due to rising prices, fixed assets being shown at cost and not at market price.

(iii) No realistic information

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

(iv) Personal bias of the Accountant affects the accounting statements

Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortisation of fixed assets, treatment of deferred revenue expenditure. Such judgement based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

(v) Permits alternative treatments

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

5. Functions of Accounting.

Ans :

Accounting deals with recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the end results to the interested parties.

The functions of accounting are as follows:

(i) Recording

Recording is a primary function of accounting. It mainly deals with recording all

the financial transactions of business in a sequential order. All financial transactions are recorded in a book called as 'Journal'. Journal is further divided into many subsidiary books and the number of subsidiary books to be maintained depends upon nature and size of the business.

(ii) **Classifying**

Classification deals with the organized analysis of recorded data, with an intention to group all the related entries at one place. Ledger account is the book where in all the similar entries are recorded. Ledger contains different accounts on different pages and accordingly related entries are recorded under one particular account. It helps in identifying the total expenditure incurred in one specific account.

(iii) **Summarizing**

Summarizing includes presenting the classified data in an acceptable and practical manner which is useful to both the internal and the external users of accounting statements. The process of summarizing involves preparing trial balance, income statement and the balance sheet.

(iv) **Associated with Financial Transactions**

In accounting, only those transactions are recorded which are financial in nature and are in terms of money. Transactions which are not expressed in terms of money and are non-financial in nature are not recorded in the books of account.

(v) **Analyzing and Interpreting**

Analyzing and interpreting is the last function of accounting. The financial data which was recorded earlier is now being analyzed and interpreted so that it can be effectively used by the end users in making various decisions related to the financial condition and profitability of the business. The data is also useful in preparing the future plans and designing the policies for accomplishing those plans.

(vi) **Communicating**

When accounting information is thoroughly analyzed and interpreted, it must be communicated in an effective manner to the right person. The accounting information can be communicated by preparing and distributing the accounting reports which includes the income statement and the balance sheet along with some additional information in the form of ratios, graphs, funds flow statement, etc. An accountant must effectively utilize his innovative and imaginative abilities in this process.

6. **Objectives of Accounting.**

Ans :

Following are the main objectives of accounting:

1. **Keep Systematic Records**

Accounting is done to keep systematic records of financial transactions. In the absence of a scientific method of accounting, there would have been tremendous burden on the human memory which, in most cases, would have been impossible to bear.

2. **Protect Business Properties**

Accounting provides protection to business properties from unjustified and unwanted use. This is possible by providing the following information to the management:

- (i) The amount of owner's fund invested in the business;
- (ii) How much the business owes to others;
- (iii) How much the business has to recover from others; and
- (iv) How much business owns the assets;

3. **Ascertain Operational Profit or Loss**

Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expenses of a particular period.

4. Ascertain Financial Position of the Business

The profit and loss account reflects the performance of the business during a particular period. However, it is also necessary to know the financial position, i.e., where do we stand. What we owe and own. The objective is met by balance sheet, which shows the state of affairs of assets and liabilities as on a given date. It serves as barometer for ascertaining the financial health of the business.

7. "Accounting is an information system". Explain the statement.

Ans :

The term 'system' may be defined as a set of elements which operate together in order to attain a goal. A system does not consist of random sets of elements but elements which may be identified as belonging together because of a common goal. A system contains three activities:

- (i) Input
- (ii) Processing of Input
- (iii) Output

A business organisation is regarded as an open system which has a dynamic interplay with its environment from which it draws resources, and to which it consigns its product and services.

8. What are Accounting Principles?

Ans :

As accounting acts as a language which is used to communicate the accounting information to the interested parties, it must follow some standards so that it runs smoothly. These standards are nothing but the accounting principles.

Accounting principles are those rules and regulations which are followed by the accountants at the time of recording the accounting transactions. Accounting principles are defined as "a list of principles that are usually linked with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist".

9. Accounting has been often called the language of business. Do you agree? What could be deficient with this description?

Ans :

Yes I agree that accounting is a language of business. The primary purpose of any language is to act as a means of communication and accounting communicates the financial position of the business. It is a art of Recording the business transactions.

10. Accounting Equation

Ans :

The end result of the accounting process for a business entity is the financial statements such as balance sheet, profit and loss account, statement of changes in financial position. These statements are presented in a condensed (highly summarised) form and cannot be prepared until the financial transactions of the business entity have been recorded, classified and summarised. The framework of the financial statements and the elements shown in these statements rests on important and basic relationship, referred to as basic or fundamental accounting equation, basic accounting model.

11. Full Disclosure.

Ans :

According to this convention, financial statements must provide the complete and true information about the company. Financial statements must be prepared in accordance to the laws so that it can be effectively used by proprietors, present and potential creditors and investors.

The convention of full disclosure add notes to the accounting statements.

Choose the Correct Answers

1. Accounting provides data or information on _____. [d]
(a) Income and cost for the managers
(b) Financial conditions of the institutions
(c) Company's tax liability for a particular year
(d) All the above
2. The primary qualities that make accounting information useful for decision making are _____. [b]
(a) Relevance and freedom from bias (b) Reliability and comparability
(c) Comparability and consistency (d) None of the above
3. The amount drawn by a businessman for his personal use is _____. [b]
(a) Capital (b) Drawing
(c) Expenditure (d) Loss
4. During a lifetime of an entity, accounting produces financial statements in accordance with which basic accounting concept? [c]
(a) Conservation. (b) Matching
(c) Accounting period (d) None of the above
5. In India, the accounting standard board was set up in the year _____. [b]
(a) 1972 (b) 1977
(c) 1956 (d) 1932
6. A concept that a business enterprise will not be sold or liquidated in the near future is known as _____. [a]
(a) Going concern (b) Economic entity
(c) Monetary unit (d) None of the above
7. Meaning of credibility of going concern is _____. [c]
(a) Closing of business (b) Opening of business
(c) Continuing of business (d) None of the above
8. When information about two different enterprises has been prepared presented in a similar manner, the information exhibits the characteristics of _____. [d]
(a) Verifiability (b) Relevance
(c) Reliability (d) None of the above
9. The basic accounting postulates are denoted by _____. [a]
(a) Concepts (b) Bookkeeping
(c) Accounting standards (d) None of the above
10. Generally, the duration of an Accounting period is of _____. [c]
(a) Six months (b) Three months
(c) Twelve months (d) One month

Fill in the Blanks

1. _____ plays a vital role in the process of decision making.
2. _____ is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner.
3. _____ accounting has been developed in order to overcome the limitations of Financial Accounting with regard to the historical costs.
4. _____ are as good as other physical or intangible assets.
5. The main function of _____ is ascertainment of cost in relation to different activities of the business.
6. _____ accounting is the application of professional information in such a way as to assist the management in the formation of policies.
7. GAAP stands for _____.
8. _____ It is assumed that the business will continue for a fairly long time to come.
9. Assets = _____ + _____.
10. FASB stands for _____.

ANSWERS

1. Accounting
2. Book-Keeping
3. Inflation
4. Human Resources
5. Cost Accounting
6. Management
7. Generally Accepted Accounting Principles
8. Going Concern Concept
9. Liabilities + Capital
10. Financial Accounting Standard Board

One Mark Questions & Answers

1. Accounting

Ans :

Accounting deals with the measurement or provision of assurance about financial information used by different persons, viz., lenders, managers, investors, tax authorities and other decision-makers. It measures the various economic activities which affect inflow and outflow of economic resources to develop useful information.

2. Dual Aspect Concept

Ans :

The dual aspect concept is a primary concept of accounting, it implies that every business transaction has two-fold effect i.e., dual effect. The double effect of this concept can be expressed in form of an accounting equation as,

$$\text{Capital} + \text{Liabilities} = \text{Assets}$$

3. Going Concern Concept

Ans :

In this concept, the proprietor assumes that business will continue for a longer period of time in future.

4. Separate Entity Concept

Ans :

In accounting, proprietor treats its business as a separate entity so that his business transactions does not get mixed up with his personal life. If business and personal activities are mixed up then it would be difficult to derive/draw meaningful accounting information.

5. Convention of Materiality

Ans :

According to this convention, the accountant must give importance to material details and must avoid unnecessary/unimportant details.

6. Book Keeping

Ans :

Book-Keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner.

7. Personal Account

Ans :

Account related to individual, banks, firm, companies, etc. are known as personal account. The personal accounts are related to natural person, artificial persons and representative person.

8. Real Account

Ans :

Real Account is related to tangible or intangible assets. Tangible assets are one which can be touch and seen such as building, plant, cash etc. Intangible assets are related to intangible objects which neither be touched or seen. For example, goodwill, trademarks, etc.

UNIT II

The Accounting Process: Overview, Books of Original Record, Journal, Ledger, Trial Balance, Classification of Capital and Revenue Expenses, Final Accounts Trading, P&L Account, Balance Sheet with Adjustments. Rectification of Errors.

Accounting from Incomplete Records, Advantages and Disadvantages of Single Entry and Double Entry System and the Differences between the two, Preparation of Accounts, and Ascertainment of Profit from Incomplete Records, Accounting Treatment as per the Statement of Affairs Method and Calculation of Missing Figures.

2.1 THE ACCOUNTING PROCESS

Q1. Write an overview of Accounting Process.

Ans :

For Answer Refer Unit-I, Q.No. 27

2.2 BOOKS OF ORIGINAL RECORD/JOURNAL

Q2. What is journal ? Explain the objectives of journal.

Ans :

(Imp.)

Meaning

A journal is known as a primary book of accounts or a book of original entry. With the increase in the size of business, the number of business transactions also increases. It is very difficult for a human-being to remember all those transactions. Therefore, to overcome this drawback, journal is prepared. Although, as stated above, the transactions can be recorded directly in the ledger. But such procedure will be cumbersome and confusing. Under this process, it will be very difficult to locate a transaction after several recordings. But in journal, the transactions can easily be located as it provides chronological record of transactions.

Definitions

- (i) **According to Carter says,** "The journal or daily record as originally used, is a book of prime entry in which transactions are copied in order of date from a memorandum or a waste book. The entries as they are copied, classified into debit and credit, so as to facilitate their being correctly posted afterwards in the ledger."

- (ii) **According to L.C. Cropper,** "A journal is a book employed to classify or sort out transactions in a form convenient for their subsequent entry in the ledger."

- (iii) **According to Roland,** "Journal means a day book, diary or a log book. It is called prime subsidiary book of double entry system."

Objectives

The following are the objectives and importance of journal:

1. Complete Record of Each Transaction

Date-wise complete record of each business transaction is recorded in the journal. Summary of each transaction is also written which is known as narration. This narration is helpful in getting full information about the transaction.

2. As a Proof

Journal is treated as a proof in the eye of the court for settling down the disputes among two or more parties. In some countries like France, Italy, Germany, etc. it is mandatory to prepare ledger.

3. Ledger Hosting

To prepare ledger from the journal is easier than preparing directly from vouchers or memorandum book. Chances of mistakes or errors are very less when we post the entries in the ledger from journal.

4. Correct Knowledge

Each and every transaction is recorded by debiting and crediting two accounts. This helps in knowing which two accounts are affected by the transaction.

Q3. Explain the Proforma (or) Format of Journal*Ans :***JOURNAL**

Date	Particulars	Ledger Folio	Amount Dr.	Amount Cr.

The description of the above columns is as follows :

- 1. Date:** The date on which a particular transaction takes place is recorded here. The year is written on the top and the month and dates are written afterwards.
- 2. Particulars:** The two aspects of transactions, i.e., debit and credit are recorded in first two lines. Every debit aspect is written in the first line with a word 'Dr.' at the end of column. The second line starts with 'To' and the credit aspect is written in this line. The second line starts a few spaces away from the margin of the first line. 'Cr.' is not written at the end of this column.
- 3. Ledger Folio or L.F:** Ledger folio is the page number of the ledger on which the corresponding entry is posted. It shows whether an entry has been posted or not. If a page number does not appear against an entry, it indicates that the entry has not been posted to ledger.
- 4. Debit Amount:** The amount to be debited is recorded against debit amount in this column.
- 5. Credit Amount:** The amount to be credited is recorded against credit amount in this column.

Q4. Explain the Procedure of Journalising.*Ans :*

The procedure of journalising is as follows :

1. Nature of Transaction

First of all, we should see or classify the nature of transaction from the business point of view. Whether it has taken place or not, whether it can be expressed in money or money's worth or not and the effect of transaction on the business.

2. Selection of Two Aspects of Accounts

In the next step, where two or more accounts will be affected by the transaction are, selected.

3. To Know the Type of Accounts

Afterwards, the type of selected accounts is determined, whether they are personal or real or nominal.

4. To Determine the Effect of Account

After selecting the type of account, the effect of account is determined, i.e., whether the items are coming in or going out of the business or business is the receiver or giver, or whether business has made expenses or earned income, etc.

5. Application of Rules

At the end, the rules of journalising are applied as per their type and effect.

Q5. Explain the advantages of journal.

Ans :

Recording of business transaction in journal book on the basis of double entry system has following advantages:

1. **Complete Information about the Business:** The journal gives complete information about business transaction in chronological order. Accounts to be debited and credited are recorded at one place.
2. **Explanation of the Transaction:** An entry in the journal book includes a brief explanation of the transaction called '**narration**'.
3. **Minimum Errors:** Double entry system used for recording is clearly visible in journal as both debit and credit aspects are recorded at one place. It also makes posting into ledger accounts easier. This ultimately reduces possibility of errors.
4. **Permanent Record:** The journal has permanent record. It has date-wise record of every transaction and can be used for auditing, whenever required.
5. **Convenient Distribution of Work:** Division of journal into subsidiary books helps the administration in the distribution of work among employees.
6. **Location of Errors:** Errors can be easily located through journal.

Q6. Explain various types of journal entries.

Ans :

1. Simple Entry

When one account is debited and one account is credited in an entry. That entry is called as simple entry.

2. Compound Entry

When similar nature of transactions take place on the same date, then in place of passing a separate entry for each transaction, we pass only one combined entry, which is known as the compound entry.

3. Opening Entry

It is that entry which is passed to bring forward the balances of previous year on the first day of the new year. In this entry, all assets are debited and liabilities are credited. If the total of debit side is more than the credit side, the difference is known as capital. This amount is credited to the capital reserve account. If the total of credit is more than the total of debit, the difference will be debited in goodwill account.

4. Adjustment Entries

For the preparation of final accounts at the end of each year, every businessman has to make adjustments for outstanding and prepaid expenses, accrued and unearned incomes, depreciation of fixed assets, interest on loan and capital, provision for bad debts, etc. The entries, passed for this purpose are known as adjustment entries. For example, if the salaries are outstanding at the end of the year, the following entry will be passed :

Salaries A/c	Dr.
To Outstanding Salaries A/c	

PROBLEMS ON JOURNAL

1. State the accounts involved in the following transactions and which account is to be debited and which account is credited.

April 2016

1. Karthik commences business with Rs. 1,00,000.
2. Purchase furniture for Rs. 5,000.
3. Sold goods for cash Rs. 5,000.
4. Sold goods to Raj for Rs. 20,000.
5. Paid salaries Rs. 10,000.
6. Purchased goods from Ram for cash Rs. 9,000.
7. Commission received Rs. 800.
8. Paid outstanding expenses Rs. 900.

Sol :

(Nov.-20)

Journal entries

S.No.	Particulars	L.F.	Debit Amount	Credit Amount
1.	Cash A/c Dr. To Capital A/c (Being commenced business with cash)		1,00,000	1,00,000
2.	Furniture A/c Dr. To Cash A/c (Being furniture purchased)		5,000	5,000
3.	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		5,000	5,000
4.	Cash A/c Dr. To Sales A/c (Being goods sold to cost)		20,000	20,000
5.	Salaries A/c Dr. To Cash A/c (Being salaries paid)		10,000	10,000
6.	Purchases A/c Dr. To Cash A/c (Being goods purchased from ram)		9,000	9,000
7.	Commission A/c Dr. To Cash A/c (Being commission received)		800	800
8.	Outstanding expenses A/c Dr. To Sales A/c (Being outstanding expenses paid)		900	900

2. Give Journal entries for the following transactions of Neeraj for the year 2017.

- (i) Started business with cash Rs. 18,000.
- (ii) paid rent in advance Rs. 400.
- (iii) Purchased goods for cash Rs. 5,000 and on credit Rs. 2,000.
- (iv) Sold goods for cash Rs. 4,000 (costing Rs. 2,400).
- (v) Rent paid Rs. 1,000 and rent outstanding Rs. 200.
- (vi) Bought motor-cycle for personal use Rs. 500.
- (vii) Purchased equipments for cash Rs. 500.
- (viii) Paid to creditors Rs. 600.

Sol :

(Nov.-21)

Journal Entries for the year ending 2017

S.No.	Particulars	LF	Debit	Credit
1.	Cash A/c Dr. To Capital A/c (Being started business with cash)		18,000	18,000
2.	Cash A/c Dr. To Rent A/c (Being rent paid in advance)		400	400
3.	Purchases A/c Dr. To Cash A/c (Being purchased goods for cash)		5,000	5,000
4.	Purchases A/c Dr. To Account Payable A/c (Being purchased goods on credit)		2,000	2,000
5.	Cash A/c Dr. To Sales A/c (Being goods sold for cash only)		4,000	4,000
6.	Rent A/c Dr. To Cash A/c (Being rent paid)		1,000	1,000
7.	Cash A/c Dr. To Outstanding Rent A/c (Being outstanding rent)		200	200
8.	Drawings A/c Dr. To Cash A/c (Being purchased equipment for cash)		500	500
9.	Payable A/c Dr. To Cash A/c (Being paid to creditor)		600	600

3. Journalise the following transactions:

Date	Particulars	(Rs.)
2008		
July 1	X started business with cash	80,000
July 3	Goods purchased for cash	30,000
July 5	Goods purchased from A	5,000
July 7	Goods sold for cash	10,000
July 10	Goods sold to P	30,000
July 12	Cash paid to A	3,000
July 15	Cash received from P	10,000
July 21	Paid for wages	1,500
July 25	Purchased furniture from Sunil Kumar for cash	5,000
July 28	Paid rent	5,000
July 31	Paid for salaries	2,000

Sol :

Journal entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2008				
July 1	Cash a/c Dr. To Capital a/c (Started business with cash)		80,000	80,000
July 3	Purchases a/c Dr. To Cash (Being the purchase of goods for cash)		30,000	30,000
July 5	Purchases a/c Dr. To A a/c (Being goods purchased from A)		5,000	5,000
July 7	Cash a/c Dr. To Sales a/c (Being goods sold on cash)		10,000	10,000
July 10	P a/c To Sales a/c (Being goods sold to P)	Dr.		30,000 30,000

July 12	A To Cash a/c (Being cash paid to A)	Dr.	3,000	3,000
July 15	Cash a/c To P a/c (Being cash received from P)	Dr.		10,000 10,000
July 21	Wages a/c To Cash a/c (Being wages paid)	Dr.	1,500	1,500
July 25	Furniture a/c To Cash a/c (Being furniture purchased from Sunil Kumar)	Dr.	5,000	5,000
July 28	Rent a/c To Cash (Being rent paid)	Dr.	5,000	5,000
July 31	Salaries a/c To Cash (Being salaries paid)	Dr.	2,000	2,000

4. Journalise the following transactions in the books of Khanu and Co.

Date	Particulars	(Rs.)
2008		
Jan. 2	Started the business with	8,00,000
Jan. 3	Bought furniture for	1,20,000
Jan. 6	Bought stationery for	5,000
Jan. 7	Purchased goods for cash at	2,00,000
Jan. 9	Sold goods for cash worth	50,000
Jan. 11	Sold to R. Desai goods worth	1,00,000
Jan. 14	Bought goods from Mundra Bros at	80,000
Jan. 18	Paid office cleaning charges	1,500
Jan. 20	Bought goods from Hari worth	1,00,000
Jan. 22	Sold to Sharma and Co. goodsworth	60,000
Jan. 24	Received from R. Desai	50,000
Jan. 25	Paid to Hari	90,000
Jan. 28	Bought typewriter for	80,000
Jan. 31	Paid house rent of	7,500
Jan. 31	Paid light charges of	5,000
Jan. 31	Paid salary amounting to	50,000
Jan. 31	Received commission to	15,000

Sol.:

Journal entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
Jan. 2	Cash Dr. To capital a/c (Started business with Rs. 8,00,000)		8,00,000	8,00,000
Jan. 3	Furniture a/c Dr. To cash (Purchased furniture)		1,20,000	1,20,000
Jan. 6	Stationery a/c Dr. To cash (Purchased stationery)		5,000	5,000
Jan. 7	Purchases a/c Dr. To cash a/c (Being the purchase of goods)		2,00,000	2,00,000
Jan. 9	Cash a/c Dr. To sales a/c (Being the sale of goods)		50,000	50,000
Jan. 11	R. Desai Dr. To sales a/c (Being the sale of goods to R. Desai)		1,00,000	1,00,000
Jan. 14	Purchases a/c Dr. To Mundra Brothers (Being the purchases of goods from Mundra Bros.)		80,000	80,000
Jan. 18	Office cleaning charges a/c Dr. To cash (Being the office cleaning charges paid)		1,500	1,500
Jan. 20	Purchases a/c Dr. To Hari (Being the purchase of goods)		1,00,000	1,00,000
Jan. 22	Sharma & Co. Dr. To Sales a/c (Being the sale of goods)		60,000	60,000

Jan. 24	Cash a/c To R. Desai (Being amount received from R. Desai)	Dr.	50,000	50,000
Jan. 25	Hari a/c To Cash a/c (Being the amount paid to Hari)	Dr.	90,000	90,000
Jan. 28	Typewriter a/c To Cash a/c (Being the purchase of typewriter)	Dr.	80,000	80,000
Jan. 31	Rent a/c Lighting a/c Salary a/c To cash a/c (Being the payment made for rent, lighting and salary)	Dr. Dr. Dr.	7,500 5,000 50,000	62,500
Jan. 31	Cash a/c To Commission a/c (Being the amount of commission received)	Dr.	15,000	15,000

5. From the following data pass necessary journal entries.

2005

- Jan 1. **Business commenced with cash Rs. 10,000**
- Jan 3. **Goods purchased from 'x' Rs. 5,000**
- Jan 4. **Goods sold to Mahesh Rs. 2,500**
- Jan 5. **Cash received from Raghu Rs. 3,000**
- Jan 6. **Cash paid to Shiva Rs. 4,000**
- Jan 7. **Cash sales Rs. 2,000**
- Jan 8. **Goods purchased from 'x' Rs. 1,500 for cash**
- Jan 9. **Cash withdrawn from bank for personal use Rs. 1,000**
- Jan 10. **Rent paid Rs. 2,000**
- Jan 11. **Salaries paid Rs. 3,000**

*Sol/:***Journal Entries**

Date	Particulars	L.F.	Debit Amount	Credit Amount
Jan 1	Cash A/c Dr To Capital A/c (Being Business Commenced with cash)		10,000 –	– 10,000
Jan 3	Purchases A/c Dr To 'x' A/c (Being goods purchased from 'x')		5,000 –	– 5,000
Jan 4	Maresh A/c Dr To Sales A/c (Being goods sold to Maresh)		2,500 –	– 2,500
Jan 5	Cash A/c Dr To Raghu A/c (Being cash received from Raghu)		3,000 –	– 3,000
Jan 6	Shiva A/c Dr To Cash A/c (Being cash paid to Shiva)		4,000 –	– 4,000
Jan 7	Cash A/c Dr To Sales A/c (Being goods sold for cash)		2,000 –	– 2,000
Jan 8	Purchases A/c Dr To Cash A/c (Being goods purchased for cash)		1,500 –	– 1,500
Jan 9	Drawings A/c Dr To Bank A/c (Being Cash withdrawn for personal use)		1,000 –	– 1,000
Jan 10	Rent A/c Dr To Cash A/c (Being rent paid)		2,000 –	– 2,000
Jan 11	Salaries A/c Dr To Cash A/c (Being salaries paid)		3,000 –	– 3,000

6. Journalize the following transactions in the journal of Mr. Ranbir Malhotra. 2004**Nov. 1st Ranbir commenced business with a capital of ₹ 1,00,000****Nov. 4th Bought furniture for cash ₹ 10,000****Nov. 6th Purchased goods for cash ₹ 5,000****Nov. 7th Sold goods to Mr. Mahesh ₹ 25,000****Nov. 10th Purchased a cycle for office use ₹ 2,000****Nov. 15th Paid insurance premium ₹ 800****Nov. 19th Purchased goods from Mr. Suresh ₹ 10,000****Nov. 21st Rent paid ₹ 5,400****Nov. 25th Returned goods to Mr. Suresh ₹ 1,250****Nov. 30st Paid salaries ₹ 4,200.***Sol.:***Journal Entries in the books of Mr. Ranbir Malhotra**

Date	Particulars	L.F	Debit Amount	Credit Amount
Nov. 1 st	Cash a/c Dr To Capital a/c (Being the amount invested in business)		1,00,000 –	– 1,00,000
Nov. 4 th	Furniture a/c Dr To Cash a/c (Being furniture purchased)		10,000 –	– 10,000
Nov. 6 th	Purchases a/c Dr To Cash a/c (Being goods purchased for cash)		5,000 –	– 5,000
Nov. 7 th	Mahesh a/c Dr To Sales a/c (Being goods sold to Mahesh on credit)		25,000 –	– 25,000
Nov. 10 th	Cycle a/c Dr To Cash a/c (Being cycle purchased for office use)		2,000 –	– 2,000

Nov. 15 th	Insurance a/c	Dr	800	–
	To Cash a/c		–	800
	(Being insurance premium paid)			
Nov. 19 th	Purchases a/c	Dr	10,000	–
	To Suresh a/c		–	10,000
	(Being goods purchased from Suresh on credit)			
Nov. 21 st	Rent a/c	Dr	5,400	–
	To Cash a/c		–	5,400
	(Being rent paid)			
Nov. 25 th	Suresh a/c	Dr	1,250	–
	To Purchase return a/c		–	1,250
	(Being goods returned to Suresh)			
Nov. 30 th	Salaries a/c	Dr	4,200	–
	To Cash a/c		–	4,200
	(Being salaries paid)			

7. Explain the following :

(i) Cash Vs Credit transactions

(ii) Sundry debtors Vs. Bills Receivables

Ans. :

(Jan.-20)

(i) Cash Vs Credit transactions

Sl. No	Cash transaction	Credit transaction
1	Settled in cash.	Settled in cash at a future date.
2	Immediate settlement.	Settlement at subsequent date (to transaction date).
3	Applicable to both cash and mercantile basis of accounting.	Applicable only to accrual basis.
4	Single or fewer entries per transaction.	Multiple entries per transaction.
5	There is an impact on cash flow.	Cash flow has no impact.
6	Suitable for small or retail business.	In the balance sheet, it has impact through asset creation of liability
7	In the balance sheet, it has an impact through cash/bank accounts.	Suitable for larger business.

(ii) Sundry debtors Vs. Bills Receivables

S.No.	Nature	Sundry Debtors	Bill Receivables
1.	Definitions	Debtor is the customer of our business. He bought goods from us on credit and we have to get money from him.	Bill receivables are those bills whose amount will be received on due date from debtor or the person whose name in it as drawee.
2.	Bad Debts or Dishonor	If debtor does not pay our money. It means receivable money will be converted into bad debts. It will be loss of our business. At that time, we pass following journal entry. Bad Debts Account Dr. Respective Debtor Account Cr.	If we do not get the money of bill from debtor, it will be the dishonor of bill and our debtor will be responsible for paying that money. We will pass following entry that money. We will pass following entry Debtor or Drawee a/c Dr. B/R a/c Cr.
3.	Discount	When we give discount to our debtor for getting money fastly, it will be our loss and discount allowed account is opened.	When we discount a bill from bank at discount, this discount will be different from discount account. Still this is also our loss. At that time, we can open discount on Collection Bills.

8. Explain the following :**(i) Current Assets Vs. Fixed Assets****(ii) Cash Expenses Vs. Non-cash expenses***Ans :***(Jan.-20)****(i) Current Assets Vs. Fixed Assets**

S.No.	Nature	Fixed Assets	Current Assets
1.	Definitions	Fixed assets can be contemplated as long term assets which are obtained by the enterprise for the intention of pursuing to earn income	Current assets refer to such type of resources which an enterprise possess for being dealt with and which are not possessed for more than a year
2.	Easy to convert convert to cash	Not easy	Very easy
3.	How is it valued	Its value is calculated by subtracting depreciation from the cost	Its value is calculated on the lesser value between cost and market value
4.	Type of financing involved	For financing of fixed assets long term funds are used	For current assets financing short term funds are used

(ii) Cash Expenses Vs. Non-cash expenses

S.No.	Basis	Cash Expenses	Non-cash Expenses
1.	Meaning	Cash expenses are also known as cash cost in accounting. They are the expenses paid in each.	Non-cash expenses are also called as non-cash charges. They are the expenses which are not paid in cash.
2.	Uses	Cash expenses helps those firms which uses huge amount of credits to minimize their expenses.	Non-cash expenses helps those firms which uses accrual accounting method.

2.3 LEDGER**Q9. Define****(i) Ledger****(ii) Sub division of ledger****(OR)****What is ledger? What is meant by Sub division of ledger?***Ans :***(Nov.-21)****(i) Ledger**

Ledger is a book where the journalized transactions are being classified. Ledger is a set of accounts and includes all the accounts of business i.e., personal, nominal or real.

A company can maintain ledger in two forms i.e., Bound Ledger and Loose-leaf Ledger. The process of transferring the debit and credit items from the journal to the ledger in their respective accounts is known as posting. Posting must be made/done before the preparation of final accounts. The accounts which are active in nature must be updated on the timely basis.

(ii) Sub division of ledger

Practically, ledger can only be divided into two types. One is personal and other is impersonal. Personal is divided into creditors and debtors. While impersonal is divided into cash book and general.

(a) Personal ledger

There is mainly two types of ledger in the books of accounting. We will start with the personal. This, as the name suggests, is more personal and related to people.

Also, here you will find all the details related to the transactions about the person who is related to units of accounting.

Furthermore, these transactions are also recorded and that is why this is called personal. It is described earlier is further divided into debtors and creditors.

In debtors, the details related to all the transactions about the people to whom the products and goods are sold, cash is gained, etc. are recorded.

Thus, this as the name suggests records the entry of a person receiving the cash. In creditors, the details of all the transactions related to the person involved in the purchasing the goods on credit, paying to them etc are the record

(b) Impersonal ledger

Here the details of transactions where people are not involved are recorded. Thus, the details of transactions here are moreover related to incomes, assets, expenses, etc.

So, this is known as the impersonal ledger. Furthermore, the impersonal is divided into cash book and general ledger.

In cash book, all the bank transactions and cash related transactions are recorded. While in the general one all the transactions related to the nominal accounts, real accounts, details of debtors and creditors are recorded.

This is called general because all the general entries are recorded here. Furthermore, the general is divided into categories namely private and nominal.

In private ledger, all the transactions related to liabilities and assets are recorded. While in nominal all the transactions related to expenses and incomes of a person are recorded.

Q10. Explain the advantages of ledger.

Ans :

The main advantages of ledger are as follows:

1. Knowledge of Business Results

With the help of ledger the important information relating to business can easily be obtained as all the business transactions relating to an item are recorded in the form of separate accounts in the ledger in such a way as their effect on assets, liabilities and capital can easily be understood.

2. Knowledge of Incomes and Expenses

A separate account is opened for each item of income and expense. Thus, it enables to understand that what are the sources of income and where the amount is spent.

3. Helpful in Preparing Trial Balance

Ledger is also helpful in the preparation of trial balance. Without preparing the ledger, trial balance cannot be made.

4. Helpful in Preparing Final Accounts

It is mandatory for the businessman to prepare final accounts. Ledger helps in preparing the final accounts as the total or balances of accounts appear in Trading A/c, P/L A/c and balance sheet.

5. Overcoming the Limitations of Journal

Ledger fulfills all those objects which lack in journal. Journal does not provide complete description of all the transactions relating to an account in classified and summarised form, but the ledger provides it.

Q11. How is posting done in ledger accounting.

Ans :

(Nov.-21)

The bookkeeper posts the transactions from Journal to the Ledger by using any of the following methods,

- (i) Bookkeeper can post any specific side either debit or credit first and post all the transactions of that side in the ledger accounts. For instance, if the credit side is selected then all the entries of the credit side must be posted into the ledger first.
- (ii) Bookkeeper can post entries on basis of specific account and can complete all the debits and credits of that specific account and then move onto the other account.
- (iii) Bookkeeper can post entries in accounts in a sequence of journal entries. This method is effective as entries are posted as and when they are recorded in the journal.

Similar to Ledger Folio (L.F) in journal, a column of folio is prepared in ledger also for recording the page number of journal from which the posting is being done it is called as J.F (Journal Folio). The proforma of a ledger account is as follows,

Dr.				Name of the Account				Cr.			
Date	Particulars	JF	Amount	Date	Particulars	JF	Amount	Date	Particulars	JF	Amount

The following rules and principles should be kept in mind while posting:

1. An account has two sides Debit and Credit. Debit side is marked as Dr. at the top of left hand side and right hand side is marked as Cr. at the top.
2. Name of the account is mentioned at the top in the centre of the account. The account in the centre of it.
3. All postings on debit side starts with 'To' and credit side with 'By'.
4. All transactions relating to an account are recorded at one place in that particular account.
5. The A/c word is not written after the name of personal account.
6. If an account is debited in journal, then posting is made on the debit side of the account in which posting is made with the name and amount appearing in the credit of journal entry and vice-versa.

Q12. Distinguish between Journal Vs Ledger.

(OR)

What is the difference between Journal and Ledger.

Ans :

(Jan-20, Imp.)

S.No.	Nature	Journal	Ledger
1.	Meaning	Journal is a primary book wherein all the business transactions are recorded on a daily basis in a systematic manner.	Ledger is a book where the journalized transaction are being classified.
2.	Type of book	It is a book of primary record.	It is a book of final entry.
3.	Process	The process of recording transactions in a journal is called as 'Journalizing'.	The process of recording transactions in a ledger is called as posting.
4.	Organization of data	The organising of each of the data within journal is known as the transaction.	The organising of each of the data within ledger is known as the account.
5.	Nature	Journal is not balanced except for the cash book.	Every account in the ledger is balanced.
6.	Accuracy	It is very difficult to test the accuracy of the books.	The availability of lists of balances ensures easy accuracy testing.
7.	Narration	Narration is required for each entry.	Narration is not required.
8.	Record	It maintains the record in sequential manner.	It maintains the record in conclusive manner.
9.	Folio	It includes the ledger folio.	It includes the journal or sub-journal folio.
10.	Preparation of final accounts	It does not facilitate the preparation of final accounts.	It serves as a basis for the preparation of final accounts.

11.	Required information	It does not provide a ready information with relation to any accounts.	It enables easy availability of information with relation to any accounts, as the similar nature are recorded in a specific transactions of group.
12.	Recording transaction	The transactions debit and credit amount are recorded in two adjacent columns.	The transactions debit and credit amounts are recorded in two different sides of two different accounts.
13.	Appearance	Journal includes one debit column and one credit column.	Ledger includes two sides, the left side is known as the debit side and the right side is known as credit side.
14.	Importance	Computerization of accounting eliminates the importance of journal for recording routine transaction such as sales, purchases, etc.	Computerization of accounts cannot eliminate the importance of ledger. Ledger cannot be avoided as it is must.

PROBLEMS**7. Journalise the following transactions and prepare the following accounts**

(a) Purchase (b) Sales (c) Cash (d) Hari (e) Discount

1-Jan-2014 Giridhar commenced business with cash Rs. 7,500/-

3-Jan-2014 Goods purchase for cash Rs.1,000/-

4-Jan-2014 Bought goods from Hari Rs. 250/-

8-Jan-2014 Furniture purchased from murari for cash Rs. 50/-

9-Jan-2014 Furniture purchased from murari 250/-

12-Jan-2014 Cash paid to Hari in full settlement of this account Rs.240/-

15-Jan-2014 Goods purchase from Anil and he allowed us Discount 10%
Rs. 350/-

20-Jan-2014 Paid cash to Anil in full satisfaction Rs. 300/-

21-Jan-2014 Prince Behari bought from us Rs. 115/-

22-Jan-2014 Cash paid by Prince Behari Rs. 15/-

25-Jan-2014 Prince Behari became insolvent, a financial composition of
50p in the rupee received from his official receiver out of a
debit of Rs. Rs. 100/- Rs. 50/-

26-Jan-2014 Paid for miscellaneous expenses Rs. 25/-

28-Jan-2014 Withdrawn by Giridhar for his personal use Rs. 100/-

*Sol.:***Journal Entries**

Date	Particulars	LF	Amount	Amount
Jan.-1	Cash A/c Dr. To Giridhar capital A/c (Being commenced business)		7,500 –	– 7,500
Jan.-3	Purchase A/c Dr. To Cash A/c (Being purchases on cash)		1,000 –	– 1,000

Jan.-4	Purchases A/c To Hari A/c (Being goods purchased from Hari)	Dr.	250 –	– 250
Jan.-8	Furniture A/c To Cash A/c (Being furniture purchased from murari)	Dr.	50 –	– 50
Jan.-9	Furniture A/c To Murari A/c (Being furniture purchased on credit)	Dr.	250 –	– 250
Jan.-12	Hari A/c To Cash A/c To Discount Received A/c (Being cash paid and discount received)	Dr.	250 – –	– 240 10
Jan.-15	Purchase A/c To Anil A/c To Discount Received A/c (Being goods purchased and discount received)	Dr.	350 – –	– 315 35
Jan.-20	Anil A/c To Anil A/c To Discount Received A/c (Being cash paid and discount received)	Dr.	315 – –	– 300 15
Jan.-21	Prince Behari A/c To Sales A/c (Being goods sold to prince Behari on credit)	Dr.	115 –	– 115
Jan.-22	Cash A/c To Prince Behari A/c (Being cash received from prince Behari)	Dr.	15 –	– 15
Jan.-25	Bad debts A/c Cash A/c To Prince Behari A/c (Being insolving of price Behari)	Dr. Dr.	50 50 –	– – 100

Jan.-26	Miscellaneous expenses A/c	Dr.		25	–
	To Cash A/c			–	25
	(Being miscellaneous expenses paid)				
Jan.-28	Drawings A/c	Dr.		100	–
	To Cash A/c			–	100
	(Being Giridhar withdrawn cash)				

Ledger A/c**Dr.****Cash A/c****Cr.**

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Jan.-1	To Giridhar's Capital A/c		7,500	Jan.-3	By Purchase		1,000
Jan.-22	To Prince Behari A/c		15	Jan.-8	By Furniture		50
Jan.-25	To Prince Behari A/c		100	Jan.-12	By Hari		240
				Jan.-20	By Anil		300
				Jan.-26	By Expenses		25
				Jan.-28	By Drawings		100
				Jan.-31	By Balance c/d		5900
			7,615				7,615
Feb.-1	To Balance b/d		5,900				

Dr.**Purchase A/c****Cr.**

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Jan.-3	To Cash A/c		1,000	Jan.-31	By Balance c/d		1,600
Jan.-4	To Hari A/c		250				
Jan.-15	To Anil A/c		315				
Jan.-15	To Discount Received A/c		35				
			1,600				1,600
Feb.-1	To Balance b/d		1,600				

Dr.**Sales A/c****Cr.**

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Jan.-31	To Balance c/d		115	Jan.-21	By Prince Behari A/c		115
			115				115
				Feb.-1	By Balance b/d		115

Dr. **Discount Received A/c** Cr.

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Jan.-31	To Balance c/d		60	Jan.-12	By Hari		10
				Jan.-15	By Purchases		35
				Jan.-20	By Anil		15
			60				60
				Feb.-1	By Balance b/d		60

Dr. **Hari A/c** Cr.

Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Jan.-12	To Cash A/c		240	Jan.-4	By Purchase A/c		250
Jan.-12	To Discount Received A/c		10				
			250				250

8. Record the following transactions in the journal of Divakar and post them to appropriate Ledger account,

2007	Particulars	
1-1-07	Capital brought in for the commencement of the business	2,50,000
3-1-07	Rental advance	50,000
3-1-07	Purchased furniture	30,000
5-1-07	Purchased goods	1,00,000
6-1-07	Purchased goods from Raman	50,000
7-1-07	Sold goods for cash	40,000
10-1-07	Sold goods to Ravi	60,000
12-1-07	Goods returned to Raman	2,000
15-1-07	Cash paid to Raman	40,000
18-1-07	Received cash from Ravi	40,000
22-1-07	Deposited cash in Bank	60,000
30-1-07	Paid Rent	5,000
31-1-07	Paid Salaries	10,000
31-1-07	Paid Electricity Bill	2,000
31-1-07	Insurance paid	5,000

*Sol :***Journal Entries in the Books of Ravi**

Date	Particulars	LF	Debit Amount `	Credit Amount `
1 Jan 07	Cash a/c Dr To Capital a/c (Being capital brought into the business by Divakar)		2,50,000 –	– 2,50,000
3 Jan 07	Rent a/c Dr To Cash a/c (Being rent paid in advance)		50,000 –	– 50,000
3 Jan 07	Furniture a/c Dr To Cash a/c (Being the furniture purchased for cash)		30,000 –	– 30,000
5 Jan 07	Purchases a/c Dr To Cash a/c (Being goods purchased in cash)		1,00,000 –	– 1,00,000
6 Jan 07	Purchases a/c Dr To Raman a/c (Being goods purchased from Raman)		50,000 –	– 50,000
7 Jan 07	Cash a/c Dr To Sales a/c (Being cash sales made)		40,000 –	– 40,000
10 Jan 07	Ravi's a/c Dr To Sales a/c (Being goods sold to Ravi on credit)		60,000 –	– 60,000
12 Jan 07	Raman a/c Dr To Purchase returns a/c (Being purchase returns made to Raman)		2,000 –	– 2,000
15 Jan 07	Raman a/c Dr To Cash a/c (Being cash paid to Raman)		40,000 –	– 40,000
18 Jan 07	Cash a/c Dr To Ravi a/c (Being cash received from Ravi)		40,000 –	– 40,000
22 Jan 07	Bank a/c Dr To Cash a/c (Being cash deposited in bank)		60,000 –	– 60,000

30 Jan 07	Rent a/c	Dr	5,000	–
	To Cash a/c		–	5,000
	(Being rent paid in cash)			
31 Jan 07	Salaries a/c	Dr	10,000	–
	To Cash a/c		–	10,000
	(Being salaries paid in cash)			
31 Jan 07	Electricity Bills a/c	Dr	2,000	–
	To Cash a/c		–	2,000
	(Being electricity bill paid in cash)			
31 Jan 07	Insurance a/c	Dr	5,000	–
	To Cash a/c		–	5,000
	(Being insurance premium paid in cash)			

Dr.

Cash Account

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
1.Jan.07	To Capital a/c		2,50,000	3.Jan.07	By Prepaid Rent a/c		50,000
7.Jan.07	To Sales a/c		40,000	3.Jan.07	By Furniture a/c		30,000
18.Jan.07	To Ravi a/c		40,000	5Jan.07	By Purchases a/c		1,00,000
				15.Jan.07	By Raman a/c		40,000
				22.Jan.07	By Bank a/c		60,000
				30.Jan.07	By Rent a/c		5,000
				31.Jan.07	By Salaries a/c		10,000
				31. Jan.07	By Electricity Bills a/c		2,000
				31.Jan.07	By Insurance a/c		5,000
				31. Jan.07	By balance c/d		28,000
			3,30,000				3,30,000
1.Feb.07	To Balance b/d		28,000				

Dr.

Capital a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan 07	To Balance c/d		2,50,000	1 Jan 07	By Cash a/c		2,50,000
			2,50,000				2,50,000
				1 Feb 07	By Balance b/c		2,50,000

Dr. Prepaid Rent a/c Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
3 Jan 07	To Cash a/c		50,000	31 Jan 07	To Balance c/d		50,000
			50,000				50,000
1 Feb 07	By Balance b/d		50,000				50,000

Dr. Furniture a/c Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
3 Jan 07	To Cash a/c		30,000	31 Jan 07	To Balance c/d		30,000
			30,000				30,000
1 Feb 07	By Balance b/d		30,000				

Dr. Purchases a/c Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
5 Jan 07	To Cash a/c		1,00,000	31 Jan 07	By Balance c/d		1,50,000
	To Raman's a/c		50,000				1,50,000
			1,50,000				
	To Balance b/d		1,50,000				

Dr. Raman's a/c Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
12 Jan 07	To Purchase returns a/c		2,000	6 Jan 07	To Purchase a/c		50,000
15 Jan 07	To Cash a/c		40,000				
31 Jan 07	To Balance c/d		8,000				50,000
			50,000	1 Feb.07	By Balance b/d		8,000

Dr. Purchase Returns a/c Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan 07	To Balance c/d		2,000	12 Jan 07	By Raman a/c		2,000
			2,000				2,000
				1 Feb 07	By Balance b/ d		2,000

Dr

Sales a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan 07	To Balance c/d		1,00,000	7 Jan 07	By Cash a/c		40,000
			1,00,000	10 Jan 07	By Ravi a/c		60,000
							1,00,000
				1 Feb 07	By Balance b/d		1,00,000

Dr.

Ravi's a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
10 Jan 07	To Sales a/c		60,000	18 Jan 07	By Cash a/c		40,000
			60,000	31 Jan 07	By Balance c/d		20,000
							60,000
1 Feb 07	To Balance b/d		20,000				

Dr.

Bank a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
22 Jan 07	To Cash a/c		60,000	31 Jan 07	By Balance c/d		
			60,000				60,000
							60,000
1 Feb 07	To Balance b/d		60,000				

Dr.

Rent a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
30 Jan.07	To Cash a/c		5,000	31 Jan.07	By Balance c/d		
			5,000				5,000
							5,000
1 Feb.07	To Balance b/d		5,000				

Dr.

Salaries a/c

Cr.

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan.07	To Cash a/c		10,000	31 Jan.07	By Balance c/d		
			10,000				10,000
							10,000
1 Feb.07	To Balance b/d		10,000				

Dr. Electricity Bill a/c				Cr.			
Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan.07	To Cash a/c		2,000	31 Jan.07	By Balance c/d		2,000
			2,000				2,000
1 Feb.07	To Balance b/d		2,000				

Dr. Insurance a/c				Cr.			
Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
31 Jan.07	To Cash a/c		5,000	31 Jan.07	By Balance c/d		5,000
			5,000				5,000
1 Feb.07	To Balance b/d		5,000				

2.4 TRIAL BALANCE

Q13. Define trial balance. What are the objectives of trial balance?

(OR)

What are the objectives of preparing trial balance?

Ans :

(July-18)

Meaning

Trial balance is a worksheet in which the balances of all ledgers are compiled into debit and credit columns. Under the double entry system, the total of debits must be equal to total of credits. This worksheet helps in evaluating whether or not the total debits for the period are equal to total number of credits generated for the same period.

Every businessman prepares the trial balance after journal and ledger. It is a tradition to prepare the trial balance before the preparation of the final accounts. It serves as a tool to detect errors. If the trial balance is balanced, it means there are no mathematical errors in the ledgers. However this does not mean that there are no errors in a company's accounting system. By preparing a trial balance on a regular basis makes it possible to quickly identify a specific accounting period where the imbalance took place and correct it quickly. Therefore many businessman choose to prepare a trial balance on monthly basis.

Definitions

- (i) According to Carter,** "Trial Balance is a statement of debit and credit balances derived from the ledger, including cash and bank balances."
- (ii) According to William Pickles,** "The statement prepared with the help of ledger balances, at the end of financial year or at any other date, to find out whether debit total agrees with credit total, is called a Trial Balance."
- (iii) According to J. R. Battiboi,** "Trial Balance is a statement prepared with the help of debit and credit balances derived from the ledger, the objective of which is to check the arithmetical accuracy of the ledger."

- (iv) **According to M.S. Gosar**, "Trial Balance is a statement containing the balances of all ledger accounts, as at any given date, arranged in the form of debit and credit columns placed side by side and prepared with the object of checking the arithmetical accuracy of ledger posting."

Objectives

The objectives of preparing trial balance are as follows:

1. Checking the Arithmetical Accuracy

One of the main objective or advantage of preparing the trial balance is to check the arithmetical accuracy of the ledger postings before the preparation of final accounts.

2. Knowledge of Balances

A main objective for preparing the trial balance is to know the balances of different accounts.

3. Full Proof of Recording

Another objective of preparing the trial balance is to know whether the double entry for all the transactions is complete or not. It is revealed by tallying of trial balance.

4. To Take Comparative Decisions

By comparing the balances of two or more years of different accounts, the comparative decisions can be taken.

5. Preparation of Final Accounts

Every businessman wants to check the arithmetical accuracy of the accounts before the preparation of final accounts. It is done with the help of trial balance. If the trial balance agrees, it means the accounts are arithmetically accurate.

6. Detection of Errors

Preparation of trial balance is also helpful in detecting the errors, e.g., error in totalling, error of omission and commission, etc.

Q14. Explain the advantages of trial balance.

Ans :

The trial balance has the following advantages:

1. It ensures that the transactions recorded in the books of accounts have identical debit and credit amount.
2. Balance of each ledger account has been computed correctly.
3. It helps in preparation of final accounts.
4. It makes the work of bookkeeping more active.
5. It summarises the business information.

Q15. Explain the Proforma of Trial Balance.

Ans :

Trial Balance as on

Date	Particulars (Name of Account)	L.F.	Dr. Amount	Cr. Amount

1. **Name of Account** : Names of all the accounts are given in this column.
2. **Ledger Folio** : It is the page number of the ledger on which a particular account is opened.
3. **Debit Amount** : In this column, the balance of that account will be shown that has debit balance or the total of the debit side of the account will be written.
4. **Credit Amount** : In this column, the balance of that account will be shown that has credit balance or the total of the credit side will be written.

Important Points to Remember While Preparing Trial Balance

1. All assets have debit balance and all liabilities have credit balance.
2. Capital Account has credit balance.
3. Closing stock is not included in trial balance.
4. All incomes and gains appear in the debit column of trial balance.
5. Drawing account has debit balance.
6. Purchases and Sales Return Account has debit balance and sales account and purchases return account has credit balance.
7. If a difference in the debit and credit column appears, it is transferred to suspense account.

Q16. Explain the Methods of Preparing Trial Balance.

Ans :

There are four methods of preparing trial balance:

1. Total Method

Under the total or Gross Method, the two sides of all the ledger accounts are totalled up. The total of debit side and credit side of each account is placed on 'Debit Amount' column and 'Credit Amount' column respectively of the trial balance. Then the two columns are added separately to see whether they are equal or not. This method is a simple one. But it is not followed widely.

2. Balance Method

It is the most popular method and generally followed by accountants. Under this method, balances of all ledger accounts are drawn first of all. Then the debit balances are recorded in 'Debit Amount' column and the credit balances are recorded in 'Credit Amount' column respectively. Therefore, the two columns are added separately to see whether they are equal or not.

3. Total Method but excluding Closed Accounts

This method is similar to total method except one difference. In this method, the closed accounts are not included in the trial balance. Closed accounts are those accounts which have equal debit and credit totals.

4. Total and Balance Method

This is not a separate method, rather it is a combination of first two methods. In this method, four columns of amount are made. The first two columns are made for balance method and the balance two are made for total method. This method is also not widely used.

Q17. What are the limitations of trial balance.

Ans :

One should note that the agreement of trial balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types :

1. Transaction has not been entered at all in the journal.
2. A wrong amount has been written in both columns of the journal.

3. A wrong account has been mentioned in the journal.
4. An entry has not at all been posted in the ledger.
5. Entry is posted twice in the ledger.

Still, the preparation of the trial balance is very useful; without it, the preparation of financial statement, the profit and loss account and the balance sheet, would be difficult.

PROBLEMS

9. Prepare a trial balance as on 31st July 2009 from the following balances of Mr. Rajvansh.

Particulars	Amount	Particulars	Amount
Capital	10,000	Bank overdraft	8,700
Sales returns	1,000	Opening stock	15,000
Drawings	5,000	Cash	2,500
Bills payable	5,000	Purchases	9,000
Sales	15,000	Rent	1,000
Furniture	2,000	Bad debts	700
Creditors	12,000	Bills Receivable	3,500
Interest received	1,500	Debtors	14,500
Purchase returns	2,500		
Wages	500		

Sol :

Trial Balance of Mr. Rajvansh as on 31st July 2009

Particulars	Debit (₹)	Credit (₹)
Capital		10,000
Sales returns	1,000	-
Drawings	5,000	-
Bills payable	-	5,000
Sales	-	15,000
Furniture	2,000	-
Creditors	-	12,000
Interest received	-	1,500
Purchase returns	-	2,500
Wages	500	-
Bank overdraft	-	8,700
Opening stock	15,000	-
Cash	2,500	-
Purchases	9,000	-
Rent	1,000	-
Bad debts	700	-
Bills receivable	3,500	-
Debtors	14,500	-
Total	54,700	54,700

10. The total debit side of a Trial balance of a company as at 31st Dec 2017 is 25,000 and credit side is Rs.5,000

The following mistakes were discovered.

Particulars	Correct fig. Rs	Fig. in Trial Balance R.s
Opening stock	17,500	25,700
Rent and rates	250	520
Sundry creditors	15,000	5,000
Commission received taken on the debit side	750	750
Miscellaneous income	60	30

Ascertain the correct total of Trial balance.

Sol.:

(May-19)

Ascertainment of correct total of Trial balance as on 31/12/2017

Debit	Amount	Credit	Amount
Total as per Trial balance	25,000	Total as per Trial balance	5,000
(-) Wrong amount of opening stock	25,700	(-) Wrong amount of sundry creditors	5,000
	(700)		Nil
(+) Correct amount of opening stock	17,500	(+) Correct amount of creditor	15,000
	16,800		15,000
(-) Wrong amount of rent and rates	520	(+) Commission received	750
	16,280		15,750
(+) Correct amount of rent and rates	250	(-) Wrong amount of miscellaneous income	30
	16,530		15,720
(-) Commission received	750	(+) Correct amount of miscellaneous income	60
	15,780		15,780

11. Below are selected transactions from journal of PFM Co. Ltd. during the past month. Post them to respective accounts and then prepare a Trial Balance.

Date	Account Title	Debit Rs.	Credit Rs.
Sep. 01	Cash	18,55,000	
	Common Stock		18,55,000
01	Photo equipment	17,50,000	
	Cash		4,00,000
	Bills payable		13,50,000
15	Cash	5,25,000	
	Service revenue		5,25,000
26	Bills receivable	11,82,500	
	Services revenue		11,82,500
30	Cash	1,65,000	
	Bills receivable		1,65,000

Sol :

(Nov.-22)

Following are the ledger accounts of PFM Co. Ltd.

- Cash a/c
- Common Stock A/c
- Photo Equipment A/c
- Bills Payable A/c
- Service Revenue A/c
- Bills Receivable A/c

(i)

Dr. Cash A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 1	To Common stock a/c		18,55,000	Sep. 1	By Photo equipment a/c		4,00,000
Sep. 15	To Service revenue		525,000	Sep. 30	By Balance c/d		21,45,000
Sep. 30	To Bills receivable		1,65,000				
			25,45,000				25,45,000
Oct. 1	To Balance b/d		21,45,000				

(ii)

Dr. Common Stock A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 30	To Balance c/d		18,55,000	Sep. 1	By Cash a/c		18,55,000
			18,55,000				18,55,000
				Oct. 1	By Balance b/d		18,55,000

(iii)

Dr. Photo Equipment A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 1	To Cash		40,00,000	Sep. 30	By Balance c/d		17,50,000
Sep. 1	To Bills payable		13,50,000				
			17,50,000				17,50,000
Oct. 1	To Balance b/d		17,50,000				

(iv)

Dr. Bills Payable A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 30	To Balance c/d		13,50,000	Sep. 1	By Photo equipment		13,50,000
			13,50,000				13,50,000
				Oct. 1	By Balance b/d		13,50,000

(v)

Dr. Service Revenue A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 30	To Balance c/d		17,07,500	Sep. 15	By Cash		5,25,000
				Sep. 26	By Bills receivable a/c		11,82,500
			17,07,500				17,07,500
				Oct. 1	By Balance b/d		17,07,500

(vi)

Dr. Bills Receivable A/c				Cr.			
Date	Particulars	LF	Amount	Date	Particulars	LF	Amount
Sep. 26	To Service revenue		11,82,500	Sep. 30	By Cash		1,65,000
				Sep. 30	By Balance c/d		10,17,500
			11,82,500				11,82,500
Oct. 1	To Balance b/d		10,17,500				

Trial Balance of PFM Co. Ltd

Particulars	Debit	Credit
Cash a/c	21,45,000	
Common stock a/c		18,55,000
Photo equipment a/c	17,50,000	
Bills payable a/c		13,50,000
Service revenue a/c		17,07,500
Bills receivable a/c	10,17,500	
	49,12,500	49,12,500

2.5 RECTIFICATION OF ERRORS

Q18. Define error ? Explain different types of errors.

Ans :

The fundamental principle of the double-entry system is that every debit has a corresponding credit of equal amount and vice-versa. Therefore, the total of all debit balances in different accounts must be equal to the total of all credit balances in different accounts, i.e., the total of the two columns should tally (agree). The tallying of the two totals (debit balances and credit balances) of the trial balance ensures only arithmetic accuracy but not accounting accuracy. If however, the two totals do not tally, it implies that some errors have been committed while recording the transactions in the books of accounts.

Errors are those mistakes which are committed in the process of recording Journal entries, costing them into Ledger or in the preparation of Trial Balance. It is essential to detect and rectify the errors in the accounting process to get the correct results of the financial statements i.e. the correct profit or loss and the real financial position of the business.

Errors may occur at any stage of the accounting process:

1. At the stage of Recording of transactions in Journal

- i) Error of Principle,
- ii) Error or omission,
- iii) Error of commission.

2. At the stage of Posting in Ledger

- i) Error of omission
 - a) Partial omission,
 - b) Complete omission
- ii) Error of Commission
 - a) Posting to wrong account
 - b) Posting on the wrong side
 - c) Posting of wrong amount

3. At the stage of balancing the ledger accounts

- i) Wrong totaling of accounts,
- ii) Wrong balancing of accounts.

4. At the stage of Preparing the trial balance

- i) Error of omission,
- ii) Error of commission.
 - a) Taking wrong account
 - b) Taking wrong amount
 - c) Taking to the wrong side

1. Types of Errors

On the basis of the impact of the errors on trial balance, errors may be classified into two categories Errors disclosed by trial balance, and Errors not disclosed by trial balance.

Types of Errors

1. Errors not disclosed by Trial Balance
2. Errors disclosed by Trial Balance.

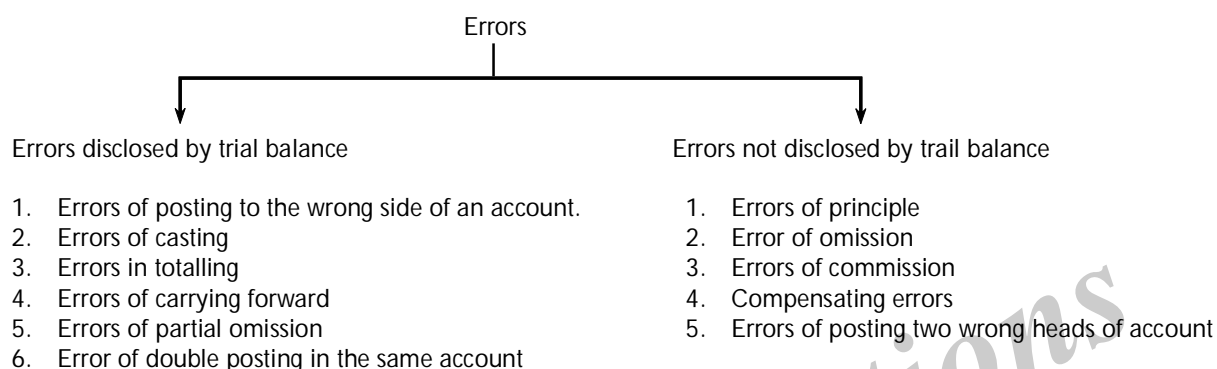


Fig.: Types of Errors Bold

(I) Errors not disclosed by Trial Balance

This type of Errors cannot be traced out in the preparation of Trial Balance, because these errors can not affect the agreement of Trial Balance.

1. Error of Principle

Transactions are recorded as per generally accepted accounting principles. If any of these principles are violated or ignored, errors resulting from such violation are known as errors of principle.

For example, Purchase of machinery recorded in the purchases book. It is an error of principle, because the purchases book is meant or recording credit purchases of goods meant for resale and not fixed assets. Atrial balance will not disclose errors of principle. These errors may arise, when the distinction is not made between the Capital and Revenue nature items.

Example

- i) Purchase of Machinery, debited to purchases a/c

Machinery a/c is - Capital nature

Purchase a/c is - Revenue nature

Instead of debiting capital nature A/c (Machinery A/c), debiting a Revenue nature a/c (Purchases A/c) is an error of principle.

- ii) Rent paid to land lord, debited to his personal A/c

Rent A/c is - Nominal Account

Land lord A/c is - Personal Account

If Land lord A/c is debited instead of Rent A/c, it becomes an error of principle

2. Error of Omission

When a transaction is completely or partly omitted from the books of accounts such error is known as Error of Omission.

- (i) **Error of Complete Omission:** This error arises when a transaction is totally omitted in the books of accounts.

For example, Furniture purchased from Saketh & Co. completely not recorded. This error does not affect the trial balance.

- (ii) **Error of Partial Omission:** This error arises when only one aspect of the transaction either debit or 'credit is recorded.

For example, a credit sale of goods to Sunder is recorded in sales book but not posted in Sunder's account. This error affects the trial balance.

3. Error of Commission

This error arises due to wrong recording, wrong posting, wrong casting, wrong balancing, wrong carrying forward etc. Errors of commission may be classified as follows:

- (i) **Error of Recording:** This error arises when a transaction is wrongly recorded in the books of original entry.

For example. Goods of ₹ 8,500, purchased on credit from Praveen, is recorded in the book as ₹ 5,800. This error does not affect the trial balance.

- (ii) **Error of Posting:** This error arises when information recorded in the books of original entry are wrongly entered in the ledger. Error of posting may be

- (a) Right amount in the right side of wrong account
- (b) Right amount in the wrong side of correct account
- (c) Wrong amount in the right side of correct account
- (d) Wrong amount in the wrong side of correct account
- (e) Wrong amount in the wrong side of wrong account
- (f) Wrong amount in the right side of wrong account etc.

These errors may or may not affect the trial balance.

4. Compensating Errors

The errors arising from excess debits or under debits of accounts being neutralized by the excess credits or under credits to the same extent of some other account is compensating error. Since the errors in one direction are compensated by errors in another direction, arithmetical accuracy of the trial balance is not at all affected. In other words, If two or more errors are committed and one error nullifies another error, the net effect is unchanged.

Committing an error to compensate the previous or another error is known as compensating error.

Example: Amount paid to Ram ₹ 5000 recorded as ₹ 4500, and amount received from Syam ₹ 10,000 recorded as ₹ 9,500.

5. Error of Posting to Wrong Head of A/c

Instead of recording in one account, recording in another account is known as error of posting to wrong head of a/c

Example: Paid to Mahesh ₹ 1000 is debited to Suresh A/c.

II. Errors disclosed by Trial Balance

The errors which are revealed by the trial balance are known as errors disclosed by trial balance.

The following are the errors disclosed by trial balance:

1. Error of Posting of transaction to the wrong side of an account

Example: Discount allowed posted to the credit side of discount account

2. Error of Posting of wrong amount

Example: Sales of ₹ 25,000 posted as ₹ 2,500 to Sales account

3. Errors in totaling

Wrong totaling made either in subsidiary books or in ledgers affects the agreement of Trial Balance

Example:

1. Sales Returns Book over cast by ₹ 100
2. Furniture account totaled as ₹ 1,750 instead of ₹ 1,500.

4. Errors of Carrying Forward

If a mistake is committed in Carrying forward a total of one page to the next page. This error affects the agreement of Trial Balance.

Example: Purchase Book total is carried forward ₹ 1,500 instead of ₹ 150.

5. Error of partial omission

Some times accountant may post only one aspect of the entry to the ledger account.

Example: Purchase of goods from Ramesh ₹ 2,000 posted to Purchases account only

6. Error of double posting

An account may be recorded twice in the journal.

Example: Paid Salaries ₹ 600 debited twice to Salaries account.

Q19. What do you understand by rectification of errors.

Ans :

In accounting errors should not be corrected by overwriting. Correction of errors in the books of accounts is not done by erasing, rewriting or striking the figures which are incorrect. For Correcting the errors appropriate entry is passed or suitable explanatory note is written in the respective account or accounts to neutralize the effect of errors. From the point of rectification, errors may be classified as follows:

- i) Single sided errors are errors which affect one side of an account.
- ii) Double sided errors are errors which affect both the accounts in a transaction.

Errors which affect one account are called as one sided error, for which any journal entry is not required whereas. Errors which affect two accounts simultaneously are called two sided errors for which the following rules should be observed, while passing entries for rectifying the two sided errors.

- i) The account which is given an excess debit should be credited with similar amount in the rectifying entry.

- ii) The account which is given a short or lesser debit should be debited with similar amount in the rectifying entry.
- iii) The account which is given an excess credit should be debited with similar amount in the rectifying entry.
- iv) The account which is given a short credit should be credited in the rectifying entry.

The above discussed errors can be rectified and explained with the help of examples given below:

i) When an account has wrongly been debited in place of another account

Example: Machinery purchased for Rs. 5000 has been debited to purchases account. While rectifying this mistake machinery account will be debited because it was not debited earlier and the purchases account will be credited because wrongly debited.

Rectifying entry:

Machinery a/c	Dr.	5000	
	To Purchase a/c		5000

(Being the purchase of machinery debited to purchases a/c is rectified).

ii) The following procedure should be followed for the rectification of entries

a) Original Entry: Correct entry which should have been passed earlier

Machinery a/c	Dr.	5000	
	To Cash a/c		5000

b) Wrong Entry: Wrong entry which has been actually passed:

Purchases a/c	Dr.	200	
	To Sarayu a/c		200

c) Rectification Entry

Purchases a/c	Dr.	1800	
	To Sarayu a/c		1800

iii) When there is an excess debit in one account and an excess credit in another account

Example: Goods sold to Manikantha for Rs.380 on credit was recorded in sales book as ` 830.

While rectifying this mistake Manikantha will be credited by ` 450 because it has been excess debited by a similar amount and Sales a/c will be debited by ` 450 because it has been "excess credited" by a similar amount.

a) Original Entry	Manikantha A/c	Dr.	380	
	To Sales A/c			380

b) Wrong Entry	Manikantha A/c	Dr.	830	
	To Sales A/c			830

c) Rectification Entry	Sales A/c	Dr.	450	
	To Manikantha A/c			450

Q20. What are the various stages of rectification?

Ans :

The stage in which rectification is done depends on identification or beating the error. Rectification of errors may be explained in two stages.

- i) **Rectification before the preparation of trial balance:** In this stage errors are located before transferring the difference in the trial balance to Suspense Account.
- ii) **Rectification after the preparation of trial balance:** In this stage the difference in the trial balance would have been transferred to Suspense Account. So wherever applicable suspense account is used while passing rectification entries.

Q21. Define Suspense Account.

(OR)

What is Suspense Account?

Ans :

When a combination of the various errors mentioned above have been committed, the mismatch in the totals of the Trial Balance will be totally different for the amounts of the individual transactions and only through scrutiny and checking of the books of accounts will help in detecting the errors. Sometimes, when the Trial Balance disagrees and sufficient time is not available to scrutinize the books, the accountant will include 'Suspense A/c' in the Trial Balance to make it agree and proceed with the preparation of 'Profit and Loss A/c' and Balance Sheet. For instance, if the totals of the credits in a Trial Balance exceeds the debits by Rs. 2,550 then a suspense a/c with a debit balance of 2,550 will be included in the Trial Balance. At a later date, the books may be scrutinised to detect the errors and the rectification entries passed to clear the balance in the Suspense A/c.

Q22. How can you validate the balances entered in either column of a trial balance?

Ans :

(July-18)

The validating of balances entered in either column of trial balance is explained in the following points,

Location of Errors

The location of errors of omission, compensation and people is difficult and it takes time when compared to the errors of commission as these errors do not affect the agreement of trial balance. Based on the case of location errors have been classified into two types,

- (a) Errors that do not affect the agreement of trial balance.
- (b) Errors that affect the agreement of trial balance.

(a) Errors that do not Affect the Agreement of Trial Balance

The following are the errors that do not affect the agreement of trial balance,

1. Errors due to omission of an entry in the journal books.
2. Errors due to entry of wrong amount or wrong posting in the books of accounts.
3. Errors due to entry of amount in wrong accounts.
4. Errors of principle such as,

- (i) Treating capital expenditure as revenue expenditure and vice-versa.
- (ii) Treating an expense as an asset and vice-versa.
- (iii) Treating an income as.

5. Errors of compensating nature.

(b) Errors Affecting the Agreement of Trial Balance

The following are the errors that have a substantial effect on the agreement of trial balance,

1. Errors occurring due to wrong totalling of balance in trial balance.
2. Errors due to entry of wrong amount in the books of accounts.
3. Errors due to entry of correct amount but in wrong side i.e., credit amount on debit side and vice-versa.
4. Errors due to omission of an entry in the ledger or trial balance.

Procedure for Locating Errors

Following are the steps involved in locating the errors in trial balance,

1. Checking the total amount of trial balance on both sides.
2. Checking of all the balances of trial balance and even balances of individual account.
3. In case of major difference in trial balance, it should be compared with that of previous year.
4. Checking the position of entries in trial balance.
5. One should re-post or re-enter or re-check the journal entries and ledgers.

Q23. What type of errors cannot be disclosed in a trial balance.

Ans :

(July-18)

The following errors are not disclosed by the trial balance. It means that the trial balance may agree inspite of some errors. These errors are :

1. Error of Omission

If any entry is not recorded in the books of original entry at all or omitted to be recorded, then the trial balance shall not be affected, e.g., furniture purchased from Ram Rs. 2,000 is not recorded in the journal at all, it means neither purchase account is debited nor Ram's account has been credited. Since neither account is debited nor credited, therefore trial balance will agree.

2. Error of Commission

If the correct amount is recorded in the wrong account but on the correct side, it is called as error of commission. For example, goods are sold to Ram for Rs. 1,000 but Ravi's A/c is debited instead of Ram's A/c with Rs. 1,000, it is the error of commission.

3. Error of Principle

When the rules of double entry system are not followed properly then it is called error of principle. or whenever any income and expenditure is not properly allocated between capital and revenue. For example, installation charges of machinery are not debited to machinery account but debited to Wages A/c or sale of newspaper is credited to sales account, etc. the trial balance shall remain unaffected by such errors.

4. Compensating Errors

These errors compensate each other and neutralizes the fact of errors. When one error is committed which affects the total of trial balance but at the same time another error of opposite effect neutralizes the effect of earlier errors. For example, over-posting of Rs. 1,000 in the debit side of one account may be compensated if there is underposting of Rs. 1,000 on the credit side of some other account.

PROBLEMS ON RECTIFICATION OF ERRORS**12. Rectify the following errors**

- a) Salary paid to Pavan ` 1200 has been debited to his account.
- b) Paid rent to owner of the house Mr. Murali ` 5,000, has been debited to his account.
- c) ` 2,000 paid for the repairs of building was debited to building a/c.
- d) ` 850 used by proprietor for his personal use has been debited to Trade Expenses a/c.
- e) Goods amounting to ` 235 returned by Ramesh were taken into stock, but no entry was made in the books.

*Sol.:***Rectification Entries**

S.No.	Particulars	L.F	Debit (`)	Credit (`)
a)	Salaries a/c Dr. To Pavan a/c (Being salary paid to Pavan debited to his a/c is rectified)		1200	1200
b)	Rent a/c Dr. To Murali's a/c (Rent paid to Murali, debited to his a/c by mistake, rectified)		5,000	5,000
c)	Repair's a/c Dr. To Buildings a/c (Being entry to rectify the mistake of debiting Building instead of repairs)		2,000	2,000
d)	Drawings a/c Dr. To Trade Expenses A/c (Being entry to rectify the mistake of debiting Trade Expenses for instead of drawing account)		850	850
e)	Sales Returns a/c Dr. To Ramesh a/c (Being the omission of the entry is brought into books).		235	235

13. Rectify the following through passing Journal Entries:

- Office Furniture bought for ` 7200 wrongly debited to Office Expenses A/c.
- A credit sale ` 1500 to Pradeep has been passed through purchases book.
- Received cheque for amount ` 1600 from Venkat is dishonoured and wrongly entered in Sales Return Book.
- Goods sold to Sudha ` 4000, not recorded in the Books.
- 12000 received from Sudheer has been wrongly credited to Sandeep's A/c.

*Sol.:***Rectification Entries**

S.No.	Particulars	L.F	Debit (₹)	Credit (₹)
a)	Office Furniture a/c Dr. To Office Expenses a/c (Being purchase of office Furniture debited to office expenses in rectified)		7,200	7,200
b)	Pradeep's a/c Dr. To Sales a/c To Purchases a/c (Being Credit sales wrongly recorded in purchases a/c rectified)		3,000 1,500 1,500	
c)	Venkat a/c Dr. To Sales Returns a/c (Being received cheque from venkat dishonored, debited to sale return book is rectified)		1,600	1,600
d)	Sudha's a/c Dr. To Sales a/c (Being omission recording of credit sale to Mr. Sudha is rectified)		4,000	4,000
e)	Sandeep's a/c Dr. To Sudheer's a/c (Being cash received from Sudheer, credited to Sandeep a/c is rectified)		2,000	2,000

14. Pass journal entries to rectify the following errors discovered while preparing the trial balanced

- Commission of ` 200 received was wrongly credited to Interest account.
- Return outwards book was undercast by ` 500
- Furniture worth ` 600 purchased was debited to Purchases a/c.
- An amount of ` 300 received from Sri Bhima Raju was wrongly credited to the account of Sri Rama Raju.

*Sol.:***Rectification Entries**

S.No.	Particulars	L.F	Debit (°)	Credit (°)
a)	Interest a/c Dr. To Commission a/c (Being correction of wrong credit given to interest account instead of commission a/c)		200	200
b)	Suspense a/c Dr. To Return a/c (Being Return outward undercast by 500 now rectified)			
c)	Furnitures a/c Dr. To Purchase a/c (Being correction of wrong debit to purchases a/c for furniture purchased)		600	600
d)	Sri Rama Raju a/c Dr. To Sri Bhima Raju a/c (Being correction of wrong credit given to Sri Rama Raju instead of Sri Bhima Raju).		300	300

15. Pass the rectifying entries for the following:

- Rs. 3,000 spent on erection of factory plant were charged to repairs a/c.
- A cheque for Rs. 2,500 from Ramarao was dishonoured, its amount was posted to allowance A/c.
- A customer cheque of Rs. 1,500 received through Sitaram was credited to Sitaram's Account.

*Sol.:***Rectification Entries**

S.No.	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(a)	Plant a/c Dr. To Repairs a/c (Being the rectification of plant wrongly posted to repairs a/c)		3,000	3,000
(b)	Ramarao Dr. To Allowance a/c (Being the cheque of Ramarao dishonoured Previously posted to Allowance a/c)		2,500	2,500
(c)	Sitaram Dr. To Customer a/c (Being the cheque received from a customer wrongly posted to Sitaram's a/c)		1,500	1,500

16. Write out the journal entries to rectify the following errors using suspense account:

- (a) Goods of the value of Rs. 100 returned by Mr. Sharma were entered in the Sales Day Book and posted therefrom to the credit of his account.
- (b) An amount of Rs. 150 entered in the Sales Returns Book has been posted to the Debit of Mr. Philip, who returned the goods.
- (c) A sale of Rs. 200 made to Mr. Gupta was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Gupta's account for Rs. 20.

Sol.:

Rectification Entries

S.No.	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(a)	Sales a/c Dr.		100	
	Sales Returns a/c Dr.		100	
	To Suspense a/c (Being the goods returned by Mr. Sharma wrongly entered in Sales Day Book)			200
(b)	Suspense a/c Dr.		300	
	To Mr. Philip (Being the goods returned by Mr. Philip wrongly posted to the debit of his account)			300
(c)	Mr. Gupta Dr.		180	
	To Suspense a/c (Being the goods sold to Mr. Gupta posted to his account with wrong amount)			180

17. Give the journal entries necessary to rectify the following errors detected in the books.

- (i) A payment of Rs. 2,500 for purchase of a typewriter for office use has been debited to purchase account from the cash book.
- (ii) A credit sale of Rs. 1,270 to Sri Chandra Bose has been posted to the debit of Sri Chandra Guha's account from the sales day book.
- (iii) A payment of Rs. 960 for whitewashing the office room has been charged to building account.

*Sol :***Rectification Entries**

S.No.	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
1.	Typewriter a/c To Purchase a/c (Being the payment of Rs. 250 for purchase of type writer debited to purchase a/c now rectified)		2,500	2,500
2.	Sri Chandra Bose Dr. To Sri Chandra Guha (Being the wrong posting of credit sale to the debit of Sri Chandra Guha now rectified)		1,270	1,270
3.	Whitewashing charges a/c Dr. To Building a/c (Being the white washing charges wrongly debited to building a/c now rectified)		940	940

2.6 CLASSIFICATION OF CAPITAL AND REVENUE EXPENSES

Q24. What do you understand by capital expenditure? Give some examples of capital expenditure.

*Ans :***Meaning**

It consists of expenditure the benefit of which is not fully consumed in one period but spread over several periods. It includes assets acquired for the purpose of earning and not for resale, improving and extending fixed assets, increasing the earning capacity of the business and raising capital for the business. Purchase of new plant, additions to the building, cost of removing the business to more spacious and better suited premises, brokerage and commission paid for procuring long term loans are few examples of such expenditure. Such expenses are taken to Balance Sheet and are determined by the fact whether:

- (i) The expenditure made is for the purpose of acquiring fixed assets and in placing the business in a position in which it can commence or continue operation;
- (ii) The expenditure results in some more or less long term benefit to the business;
- (iii) Expenditure increases the earning capacity of the business or reduces working expenses. Prima-facie it must be established whether the expenditure results in the acquisition of permanent asset and that the asset is to be used for the purpose of earning revenue. Suppose a permanent asset has been acquired for the business and that in addition to the cost of the asset, certain other expenditures were incurred on account of installation and erection etc., and travelling expenses for a trip abroad for the purchase of the asset. The cost of the asset is a capital expenditure, no doubt, but other expenditures are also capital as these are incurred direct in connection with the acquisition of a permanent asset.

Examples

1. Purchase of land, building, plant and machinery, furniture, vehicles and any other fixed asset.
2. Cost of replacing a petrol driven engine to a diesel driven engine.
3. Expenditure incurred for increasing the sitting accommodation in a cinema hall or restaurant.
4. Amount spent on erection of plant and machinery.
5. Expenditure incurred for acquiring some right to carry on business, e.g., copyright, goodwill, trade mark, patent rights etc.
6. Expenditure incurred for reconditioning an old fixed asset.
7. Expenditure incurred on major repairs and replacement of plant and machinery or any other fixed asset which results in increased efficiency.

Q25. State the features of capital expenditure.

Ans :

Special features of capital expenditure are as under :

1. Capital expenditure is incurred for acquiring fixed assets.
2. It increases the values of assets.
3. It increases the profit earning capacity of business.
4. These expenditures are casually incurred.
5. The assets acquired through these expenditures are not meant for sales.
6. These expenditures are shown at the assets side of the balance sheet.

Q26. What do you understand by Revenue expenditure? Give some examples of revenue expenditure

Ans :

Meaning

It consists of expenditure incurred in one period of account, the full benefit of which is consumed in that period. It includes purchasing assets required for resale at a profit or for being made into saleable goods, maintaining fixed assets in good working order, meeting the day-to-day expenses of carrying on business. Cost of goods, raw materials and stores, replacements, renewals, repairs, depreciation of the fixed assets, rent, rates and taxes, wages and salaries, carriage, insurance and other trade expenses are few examples of such expenditures. Such items appear in the Trading and Profit and Loss Account and may be determined from the test as to whether the expenditure made is incurred for the maintenance of the earning capacity or for the upkeep of fixed asset in an efficient condition.

Examples

1. Cost of purchases and carriage paid on
2. Cost of manufacture, Wages paid to labourers, Fuel etc.
3. Expenditure incurred in the normal course of business.
 - (a) **Office and Administration:** Salaries, Rent and Rates, Insurance, Postage, printing and Stationery etc.
 - (b) **Selling expenses:** Salaries of salesmen, advertisements etc.

(c) **Distribution expenses:** Salaries paid to distribution personnel, running expenditure of distribution vehicles.

(d) **Financial expenses:** Interest, depreciation etc.

4. Up keep of fixed assets : ex. Repairs, Renewals etc.

5. Loss on sale of fixed assets

Revenue expenditure appears on the debit side Trading and Profit and Loss Account.

Q27. Explain the features of revenue expenditure.

Ans :

Special features of these expenditures are as follows :

1. These are routine expenses.
2. It is usually incurred
3. It does not add to the value of assets but maintain it, i.e., white washing and repairs.
4. Revenue expenditure does not increase the profit earning capacity of the firm but simply maintains it.
5. Current assets acquired through these expenditures are meant for sale.
6. Revenue expenses are shown at the debit side of the trading and profit and loss account.

Q28. Distinguish between capital expenditure and revenue expenditure.

Ans :

(Imp.)

S.No.	Capital Expenditure	Revenue Expenditure
1.	It results in acquisition of fixed assets which are meant for use and not for resale. The assets acquired are used for earning profit as long as they can serve the purpose of the business and sold only when they become unfit or obsolete for business.	It does not result in acquisition of any fixed asset. This expenditure is incurred for meeting the day- to-day expenses of carrying on operations of business.
2.	It results in improving the earning capacity of the fixed assets, assets, e.g., over-hauling the machinery for improving the business by increasing the earning capacity of the machinery.	It results in maintenance of business assets such as repairs and maintenance of machinery. It is helpful in maintaining the existing capacity of the asset.
3.	It represents unexpired cost i.e., cost of benefit to be taken in future.	It represents expired cost i.e., benefit of cost has been taken.
4.	It is a non-recurring expenditure.	It is a recurring expenditure.
5.	The benefit of such expenditure will be for more than one year. Only a portion of such expenditure known as depreciation is charged to Profit and Loss Account and balance amount of such expenditure unless it is written off is shown in the Balance Sheet as an asset.	The benefit of such expenditure expires during the year and the amount is charged to Revenue Account, (i.e., Trading and profit and Loss Account) of the same year.
6.	All items of capital expenditure which are not written off are shown in the Balance Sheet as assets and are carried forward to the next year.	All items of revenue expenditure the benefit of which has exhausted during the year are transferred to Trading and Profit and Loss Account and the accounts representing such items are closed by transferring them to Trading and Profit and Loss. Such items are not carried forward to the next year because their benefit has been taken during the year. Only a portion of the deferred revenue expenditure, (i.e., heavy advertisement) the benefit of which has not expired during the year is carried forward to the next year.

Q29. What do you understand by Deferred revenue expenditure?

Ans :

It is expenditure which would normally be treated as revenue expenditure but it is not written off in one period as its benefit is not completely exhausted in the year in which it is incurred or is of a non-recurring and special nature and is large in amount. It may be spread over a number of years, a proportionate amount being charged to the Profit and Loss Account of each year and the balance is carried forward to subsequent years as deferred revenue expenditure and is shown as an asset in the balance sheet.

Suppose for an advertisement campaign a sum of ₹ 20,000 has been spent and the benefit of this campaign does not exhaust in the year, the expenses made should be spread over the estimated years during which the benefit is to be derived. Such expenditures are called deferred revenue expenditures. The determining factor, therefore, is whether the particular revenue expenditure has the element of deriving benefit over some years and that the benefit does not exhaust within the particular accounting year.

The basis of charge should usually be proportionate to the benefit consumed/reaped. The deferred revenue expenditure not yet written off is shown on the assets side of the balance sheet.

Deferred revenue expenditure is revenue in character but:

- (i) The benefit of which is not exhausted in the same year; or
- (ii) Is applicable either wholly or in part to the future years; or
- (iii) Is accidental and heavy and it is not prudent to charge against the profit of one year.

Deferred revenue expenditure may be classified into the following three categories:

- (a) Expenditure where a portion of the benefit has been derived within the accounting period, the balance yet being unused and therefore, shown in the balance sheet as an asset.

Example: Special advertising expenditure for a new product.

- (b) Expenditure in respect of service rendered which for any sound reason is considered as an asset or more properly not considered to be allocable to the accounting period.

Example: Cost of experiments, discount on issue of debentures etc.

- (c) Amounts representing loss of an exceptional nature.

Example: Property confiscated in a foreign country, loss on uninsured assets, etc.

Q30. In what situations revenue expenditure becoming capital expenditure.

(OR)

Under what conditions, Revenue expenditure becomes capital expenditure.

Ans :

(July-18)

Following are some of the examples of revenue expenditure becoming capital expenditure:

1. Repairs

They are usually a revenue charge, but if we purchase a second hand plant and pay for immediate repairs necessary to make it efficient for our purpose, then such repairs become capital expenditure and must be added to the plant as part of its cost.

2. Wages

They are revenue item, but the wages paid to workmen to erect and fit some new machinery, the firm has bought, must be considered as an addition to the cost of the machinery. Similarly wages of workmen employed in the construction of any fixed asset are capital expenditure and must be treated as part of the cost of the asset.

3. Legal Expenses

They are revenue charge, but the legal expenses incurred in connection with the purchase of fixed asset must be treated as a part of the cost of the asset.

4. Transport Expenses

They are usually a revenue charge but payment made for transporting any plant and machinery is added on as part of the cost of plant and machinery.

5. Interest on Capital

Such interest, if paid, during the construction of works or buildings or plant may be capitalised.

6. Raw Materials and Stores

They are usually a revenue charge but if consumed in making of a fixed asset, must be treated as a part of the cost of the asset.

7. Carriage and Freight

Such expenses in connection with the acquisition of a fixed asset are capital expenditure.

8. Advertising

The cost of special advertising undertaken for the purpose of introducing a new line of goods may be treated as capital expenditure as the benefit of such advertising will be available in future also.

9. Development Expenditure

Some concerns such as tea and rubber plantations, horticulture, collieries etc. require a very long period of development before they can begin to earn any income. All such expenditure incurred during the period of development is called as development expenditure and must be treated as capital expenditure.

10. Preliminary or Formation Expenses

All expenses incurred before incorporation of a company are called Preliminary or Formation Expenses and must be treated as Capital Expenditure as the benefit of such expenses Will be available in future years also.

2.7 FINAL ACCOUNTS

Q31. Define final accounts. What are the objectives of final accounts ?

Ans :

Introduction

One of the main objectives of maintaining accounts is to know the profit or loss made by the business organization in a particular period. This period may be a year, half year to quarter of a year. for non statutory business concerns, it will be as per the convenience of the trader. But in general it is at the end of either calender year or financial year. Further one must know that by mere preparation of trial balance one may not be able to find out the profit or loss of a business entity. Hence it is needed to prepare the final accounts.

Meaning

The term final accounts means statements which result finally from the preparation of accounts showing the profit earned or loss suffered by the firm and the financial state of affairs of the firm at the end of the period concerned. As already stated, the statement showing the profit or loss is known as Profit and Loss Account and the statement showing the financial state of affairs is called the Balance Sheets. The

student must realise that in every concern, big or small, the accountant will be required to prepare these statements. Therefore, those who learn accountancy should become proficient in this. It is the trial balance that is the basis of these two statements and unless the student has mastered the preparation of the various books and ledger accounts and also of the trial balance, he will not be able to fully grasp the significance of the profit and loss account and the balance sheet and master the technique of preparing them.

Objectives

The main objectives of preparation of final accounts are :

- The ascertain the profit or loss of the business for a particular period (By preparing Trading and Profit & Loss Account)
- To find out the financial position of the business concern on a specified date or period. (By preparing of the Balance Sheet)

Q32. What are the features of final accounts?

Ans :

1. Based on Facts

On the basis of the facts and transactions recorded in accounting books, the final accounts are usually being prepared.

2. Implements Accounting Conventions

Accounting conventions act as the basis for preparing the final accounts/statement.

For instance, closing stock valuation at the market price or cost price which ever is less.

3. Follows Accounting Assumptions

The final accounts are prepared on the basis of few accounting assumptions such as, going concern assumption, money measurement assumption.

4. Laid on Personal Opinion, Judgements and Estimates

The final accounts are laid on the personal opinion, judgements and estimates like creation of provision for doubtful debts, valuation of the closing stock either at cost price or at market price which ever is less.

Q33. Explain the uses of final accounts?

Ans :

1. It is used in evaluating approximately the organisation's earning ability.
2. It facilitates the investors to take appropriate investment decisions.
3. It assists in giving complete information about the cash inflows and outflows of the organisation to the financial institutions.
4. It helps in ascertaining the true and fair financial position of the organisation and helps in deciding about the credit worthiness of the organisation.
5. It also helps in making various fiscal policies for the organisation.

Q34. State the advantages and disadvantages of final accounts?

Ans :

Advantages

1. Business profit or loss can be known to the trader through the trading account and profit and loss account (Income statements).
2. Financial position can be revealed by the preparation of Balance Sheet.
3. Final accounts are important source of finance information and this help the trader or management to plan the financial activities of the business concern for any period or time.
4. Financial statement help the trader to take business decisions by comparing current year results with the results of the previous year statements.
5. As the profit & loss account discloses either profit or loss, based on which a trader prepare himself to pay the taxes correctly.
6. Tax authorities also needs financial statements to determine the amount of tax exactly.
7. As financial statements reveals the solvency position of the organization, the banks and other lending organizations may consider for extending the loan facility.

Disadvantages

1. Do not reflect the current prices as they are based on the historical costs.
2. Do not consider qualitative data, such as, quality, efficiency of workforce, employee and employer relationship, motivation level of employees, value of human resources etc.
3. Do not reveal the accurate picture of the business, as certain values of assets and some expenses and income items are based on the judgement of the management, who may have prejudice.

2.7.1 Preparation of Trading Account**Q35. Define trading account ? What are the advantages of trading account.**

Ans :

Meaning

Preparation of trading account is the first stage in final accounts. It is prepared to ascertain the 'Gross Profit or Gross Loss'. In other words, it is prepared to find out the difference between the actual cost of goods sold and sale proceeds. Generally the business organization purchases goods from others and incur certain expenditure and sell the same to earn profit. This process is known as trading activity. Hence trading account is prepared to know the results of trading activities carried during any specified accounting period.

Trading Account is a 'nominal account' in nature. All the trading expenses should be debited and trading incomes should be credited to this trading account. The balance in the trading account is either gross profit or gross loss.

$$\text{Cost of Goods Sold} = \text{Purchase price of the goods} + \text{Expenses incurred on purchases}$$

If opening stock of goods and closing stock of goods are given,

$$\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Net Purchases (Cash + Credit - Returns)} + \text{Direct expenses} - \text{Closing stock of goods}$$

$$\text{Gross Profit / Loss} = \text{Net Sales} - \text{Cost of Goods Sold}$$

If the selling price of goods is more than cost price, it is known as gross profit. If the selling price of goods is less than cost price, it is known as gross loss. The gross profit or gross loss of trading account will be transferred to profit & loss account.

Advantages

1. It reveals either Gross Profit or Gross Loss
2. It helps in computing the Gross Profit / Loss Ratio
3. Trading expenses and incomes of the current year can be compared with that of the previous year or with any other year. This helps the trader in estimating his trade revenue for future years.

Q36. Explain the proforma of trading account.

Ans :

Trading Account for the year ending

Dr.			Cr.		
Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening stock		XX	By Sales	XXX	
To Purchases	XXX		Less: Sales Returns	XX	XX
Less: Purchase returns	XX	XXX	By Closing stock		XX
Purchase expenses:		XX			
To Carriage		XX			
To Cartage		XX			
To Freight		XX			
To Customs duties		XX			
To Import duties		XX			
To Clearing charges		XX			
To Octroi		XX			
To Excise duties		XX			
Direct Expenses:		XX			
To Wages		XX			
To Factory Rent		XX			
To Factory Insurance		XX			
To Gas and Coal		XX			
To Water Charges		XX			
To Factory Manager's Salary		XX			
To Works Manager's Salary		XX			
To Oil & fuel		XX			
To Manufacturing Expenses		XX			
To Heating and lighting		XX			
To Gross Profit			By Gross loss		
(Balancing figure)			(Balancing figure)		
(Transferred to Profit and Loss account)		XX	(Transferred to Profit & Loss a/c)		XX
		XXX			XXX

Items Appearing in Trading Account**1. Opening Stock**

The stock which remains unsold at the end of previous year becomes the opening stock of next year. There will be no opening stock in the first year. In a manufacturing concern, there may be opening stock of raw material, work-in-progress and finished goods. All are shown on the debit side of the trading account.

2. Purchases and Purchase Returns

Net purchases are shown on the debit side of the trading account. Net purchases mean the purchases less returns outward (if any). Purchases include both cash as well as credit purchases.

3. Sales less Returns Inward

Net sales of goods are shown on the credit side the trading account. Net sales are arrived by deducting sales return from the gross sales.

4. Closing Stock

The unsold stock at the end of the year is known as closing stock. It appears on the credit side of the trading account. Like opening stock, it may be of raw-material, work-in-progress and finished goods. It is calculated at the end of the year and therefore no account is maintained for it in the ledger. If it is valued before the preparation of trial balance, then it appears in trial balance. When it is given in trial balance, it is shown in the balance-sheet only.

If it is valued after the preparation of trial balance, then it appears in adjustments. When it appears in adjustments, then it appears on the credit side of trading account and asset side of balance sheet. Different methods are followed for the valuation of closing stock, like FIFO, LIFO, average price, etc. Whatever may be the method adopted, it must be followed consistently. A principle should be kept in mind while showing it in the books. That principle is cost price or market price whichever is less. This principle is based on the convention that prospective profits should not be shown in the books of accounts while prospective losses are to be provided for in the books.

5. Power, Coal, Gas, Water, Fuel, etc.

These expenses are incurred on the conversion of raw-material into finished goods. They are shown on the debit side of trading account.

6. Royalty

These expenses are paid for using the rights of a property. For example, royalty paid to the owner of mine for extracting minerals, coal, etc. It is also debited to trading account.

7. Custom Duty, Dock-Charges

These are paid for bringing the raw-material from another country to our country. These are also debited to trading account.

8. Other Expenses

Other expenses, which are paid for manufacturing or upgrading the raw-material into saleable condition, are also shown on the debit side of trading account. These may be wages, freight, carriage inward, factory rent and factory lighting, etc.

PROBLEMS ON TRADING ACCOUNT

18. Ascertain gross profit from the following :

	Rs.
Opening Stock	5,570
Purchases	13,816
Sales	15,284
Purchases Returns	390
Returns Inwards	524
Warehouse Wages Paid	1,400
Import Charges	252
Closing Stock	8,880

Sol.:

Dr	Trading Account		Cr
Particulars	Rs.	Particulars	Rs.
To Opening Stock	5,570	By Sales	15,284
To Purchases	13,816	Less : Returns	524
Less: Returns	390	By Closing Stock	8,880
To Warehouse Wages	1,400		
To Import Charges	252		
To Gross profit (transferred to profit and loss account)	2,992		
	23,640		23,640

19. Prepare Trading Account of Raji & Co. for the year ended 31 st March. 1989

Particulars	Rs.	Particulars	Rs.
Purchases	42,500	Wages	5,000
Manufacturing expenses	1,950	Opening stock	10,000
Carriage inwards	100	Sales returns	50
Sales	67,500	Purchase returns	200
Freight and duty	5,000	Stores consumed	200
Power	300	Closing stock	12,000

Sol :

Dr. **Trading Account for the year ending 31 st March, 1989.** Cr.

Particulars	Rs.	Particulars	Rs.
To Opening Stock	10,000	By Sales	67,500
To Purchases	42,500	Less : Returns	50
Less: Returns	200	By Closing Stock	12,000
To Wages	5,000		
To Stores consumed	200		
To Manufacturing expenses	1,950		
To Carriage inwards	100		
To Freight and duty	5,000		
To Power	300		
To Gross profit (transferred to P & L Account)	14,600		
	79,450		79,450

2.7.2 Profit & Loss Account

Q37. What is Profit & Loss Account? State the advantages of Profit & Loss Account.

Ans :

Meaning

After trading account, the second stage of the preparation of final account is the preparation of Profit & Loss account. It is prepared to find out the Net Profit or Net Loss of the business. This is also a nominal Account, so all the revenue expenses and losses should be debited and all the revenue incomes and gains are to be credited to this Profit & Loss a/c. The balance of Profit & Loss Account is either net profit or net loss, which will be transferred to balance sheet. The net profit will be added to the capital account in the balance sheet at liabilities side and the net loss will be deducted from Capital Account.

$$\text{Net Profit / Loss} = \text{Gross Profit} + \text{Incomes and Gains} - \text{Expenses and Losses}$$

Advantages

1. It Reveals net profit or net loss.
2. It helps to find out net profit ratio.
3. It assists in comparison of Current year's administrative, selling and other expenses with the previous year's amounts.
4. It facilitates for the preparation of balance sheet.

Q38. Explain the proforma of Profit & Loss Account.

Ans :

Profit & Loss A/c of XXX for the year ending xx, xx, xxxx

Dr.			Cr.		
Particulars	Amount ()	Amount ()	Particulars	Amount ()	Amount ()
To Gross Loss b/d		XXX	By Gross Profit b/d		XXX
To Administrative Expenses			By Discount received	XXX	
To Salaries	XXX		By Interest received	XXX	
To Rent	XXX		By Commission received	XXX	
To Rates & Taxes	XXX		By Rent received	XXX	
To Insurance	XXX		By Interest on Drawings	XXX	
To Printing & Stationary	XXX		By Apprentice Premium	XXX	
To Audit Expenses	XXX		By Profit on sale of assets	XXX	
To Legal Expenses	XXX		By Bad Debt recovered	XXX	
					XXX
To General Expenses	XXX				
To Repairs	XXX	XXX			
To Selling & Distribution Expenses					
To Carriage Outwards	XXX				
To Advertisements	XXX				
To Bank Charges	XXX				
To Commission	XXX				
To Bad Debts	XXX				
To Travelling Expenses	XXX				
To Packing Expenses	XXX	XXX			
To Financial Expenses:					
To Discount Allowed	XXX				
To Interest on Capital	XXX				
To Interest on Loans	XXX	XXX			
To Losses:					
To Loss on sale of assets	XXX				
To Depreciation	XXX				
To Loss due to Fire Accident	XXX				
To Net Profit (transferred to Capital Account)	XXX	XXX	By Net Loss (Transferred to Capital Account)		XXX
(Balance figure)			(Balance figure)		
		XXXX			XXXX

PROBLEMS ON PROFIT & LOSS ACCOUNT

20. From the following balances prepare a profit and loss account for the year ending 31-12-1995.

Particulars	Rs.
Salaries	3,000
Carriage outwards	1,000
Discount allowed	500
Commission allowed	1,500
Bad debts	1,000
Repairs	1,000
Advertisements	1,000
Audit fee	500
General charges	1,000
Postage	1,000
Printing and stationery	1,500
Commission received	1,000
Rents received	1,000
Insurance premium paid	1,000
Office electricity charges	500
Gross profit	24,000

Sol:

Dr

Profit and Loss Account for the year ending 31-12-1995

Cr

Particulars	Rs.	Particulars	Rs.
To Salaries	3,000	By Gross profit b/d	24,000
To Carriage outwards	1,000	By Commission Received	1,000
To Discount allowed	500	By Rent Received	1,000
To Commission allowed	1,500		
To Bad debts	1,000		
To Repairs	1,000		
To Advertisements	1,000		
To Audit fee	500		
To General charges	1,000		
To Postage	1,000		
To Printing and Stationery	1,500		
To Insurance Premium Paid	1,000		
To Office Electricity Charges	500		
To Net profit	11,500		
(Transferred to capital account & of Balance Sheet)			
	26,000		26,000

21. From the following ledger balances prepare a profit and loss account of Genetic sports company for the year ending 31-12-1995

Particulars	Rs.
Rent paid	3,000
Salaries	4,000
Commission paid	1,000
Discount paid	1,000
Advertisements	1,000
Telephone charges	1,000
Interest paid on loans	2,000
Bad debts	1,000
Telephone charges paid	1,000
Printing and Stationery	1,000
Office Insurance	1,000
Postage	500
Repairs	500

The Gross profit was 40% of sales and sales amounted to Rs. 1,00,000

Sol :

Genetic Sports Company

Dr		Profit and Loss Account for the year ending 31 -12-1995		Cr	
Particulars		Rs.	Particulars		Rs.
To Rent Paid		3,000	By Gross Profit b/d		40,000
To Salaries		4,000	$\left(1,00,000 \times \frac{40}{100}\right)$		
To Commission Paid		1,000			
To Discount Paid		1,000			
To Advertisements		1,000			
To Telephone charges		1,000			
To Interest Paid on Loans		2,000			
To Bad debts		1,000			
To Telephone charges paid		1,000			
To Printing and Stationery		1,000			
To Office Insurance		1,000			
To Postage		500			
To Repairs		500			
To Net Profit		22,000			
(transferred to capital account & of Balance Sheet)					
		40,000			40,000

2.7.3 Preparation of Balance Sheet

Q39. What do you understand by balance sheet?

Ans :

Meaning

A Balance Sheet is a statement prepared with a view to measure the financial position of a business on a certain fixed date. The financial position of a concern is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company. A Balance Sheet is also described as a 'statement showing the sources and applications of capital'. It is a statement and not an account and prepared from real and personal accounts. The left hand side of the balance sheet may be viewed as a description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

On the left hand side of the Balance Sheet, the several liability items describe how much capital was obtained from trade creditors, from banks, from bill holders and other outside parties. The owner's equity section shows the capital supplied by the owner.

Capital obtained from various sources has been invested according to management's best judgement of the optimum mix or combination of assets for the business. A certain fraction is invested in buildings, another fraction in stock, another fraction is retained as cash for current needs of the business and so on. The assets side of the Balance Sheet, therefore, shows the result of these management judgements as on the date of the Balance Sheet.

A properly drawn up Balance Sheet gives information relating to (i) the nature and value of assets (ii) the nature and extent of liabilities, (iii) whether the firm is solvent, (iv) whether the firm is overtrading.

If assets exceed the liabilities, the firm is solvent i.e., able to pay its debts in full. A business is, therefore, solvent by the amount of ownership capital in it, as it is the excess of assets over liabilities. The last point i.e., (iv) concerns the stability of the business. If the total of the debts due to creditors (including bank overdraft) is greater than the liquid assets (i.e., cash, investments, bills etc.) the position of the firm may be financially unsound. Where the debts are being incurred without sufficient means of payment, the firm is said to be overtrading. For the position to be quite sound, there should be some working capital i.e., some spare liquid assets available for current expenditure. It is not a wise policy to lock up the entire capital in fixed assets. The concern may be solvent without being sound.

Q40. Explain the Characteristics of a Balance Sheet.

Ans :

Following are the main characteristics :

1. It is prepared on a particular date and not for a particular period.
2. It is prepared after the preparation of Trading and Profit & Loss Account.
3. As assets must be equal to total liabilities, the two sides of the Balance Sheet must have the same total.
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets (debit balances) and liability (credit balances) and not an account. Information that Balance Sheet Convey to Outsiders

Following are the main items of information that the Balance Sheet convey to an outsider:

1. The nature and the value of assets.
2. It shows the nature and extent of liabilities.
3. It shows the owners' equity (i.e., assets - liabilities = capital)
4. It tells about creditworthiness and solvency of the firm.
5. It reflects the liquidity of a firm.
6. It reveals the financial position of a firm at a particular point of time.

Q41. Explain the Classification of various Assets and Liabilities.

Ans :

A) Assets

Assets are property and possession of a business. Stock, land, buildings, books debts, cash, bills receivable are some examples of assets. The classification of assets depends on their nature. The various types of assets are:

- (i) **Fixed Assets** : Those assets which are acquired and held permanently in the business and are used for the purpose of earning profits are called fixed assets. Land and buildings, machinery, furniture and fixtures are some examples of these assets.
- (ii) **Current (or Floating) Assets** : Those assets such as cash, debtors and stock that can be realised and readily available to discharge liabilities within an operating cycle of one year or are meant to be converted into cash as soon as possible are called current assets.
- (iii) **Tangible Assets** : These are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc.
- (iv) **Fictitious Assets** : These assets are fictitious in nature i.e., they are virtually not assets are valueless but shown in financial statements. These are either the past accumulated losses or expenses which are incurred once in the life of a business and are capitalized for the time being. Profit and Loss Account (debit balance), organisation expenses, discount on the issue of shares and advertisement expenses capitalized for the time being are examples of such assets.
- (v) **Intangible Assets** : Those assets which cannot be seen, touched and have no volume but have value are called intangible assets. Goodwill, patents, licences and trade marks are examples of such assets but quite valuable to the undertaking. An intangible asset may not be fictitious. If on account of the past goodwill purchased along with an existing concern, sales are readily effected and profit is readily earned, the asset is certainly not fictitious though it is intangible. However, if the amount of goodwill was paid in respect of a losing concern, the asset would be fictitious.
- (vi) **Wasting Assets** : Those fixed assets which have a fixed contact like mines, quarries etc. that become exhausted or reduce in value by their working are called wasting assets.
- (vii) **Liquid Assets** : These current assets which are already in the form of cash or such items as marketable securities which can be converted into cash quickly.
- (viii) **Contingent Asset** : It is an asset the existence, value and ownership of which is dependent on the occurrence or non-occurrence of a specified act. Suppose a firm has filed a suit for some specified property now in possession of someone else. If the suit is decided in firm's favour, the firm will get the property. At the moment it is a contingent asset. Similar would be the position of a patent applied for arising of a firm's own research effort. Contingent liability in respect of a contract for

capital expenditure already entered into will give rise to an asset on payment, at present it is only a contingent asset.

- (ix) Working Capital is the difference between current assets and current liabilities.
- (x) Accounts Receivable will include sundry debtors and bills receivable.

B) Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. Liabilities may be classified into four categories :

- (i) **Fixed Liabilities** : These are those liabilities which are payable only on the termination of the business such as capital which is a liability to the owner.
- (ii) **Long term Liabilities** : Those liabilities which are not payable within the next accounting period but will be payable within next five to ten years are called long term liabilities such as debentures.
- (iii) **Current Liabilities** : Those liabilities which are payable out of current assets within the next accounting period usually year or already due are called current liabilities. Sundry creditors, bills payable, short term bank overdraft are examples of such liabilities.
- (iv) **Contingent Liabilities** : A contingent liability is one which is not an actual liability but which will become an actual one on the happening of some event which is uncertain. Thus such liabilities have two characteristics : (a) uncertainty as to whether the amount will be payable at all, and (b) uncertainty about the amount involved. It is sufficient if the amount of such liability is stated on the face of the Balance Sheet by way of a note unless there is a probability that a loss will materialise. In that event it is no more a contingent liability and a specific provision should be made therefor. Examples of such liabilities are:
 - (a) Claims against the firm not acknowledged as debts.
 - (b) Uncalled liability on partly paid up shares.
 - (c) Arrears of fixed cumulative dividend.
 - (d) Estimated amount of contracts remaining to be executed on capital account and not provided for.
 - (e) Liability of a case pending in the court.
 - (f) Bills of exchange, guarantees given against a particular firm or person.

Owners' Equity (or net worth) is the difference between assets and outside liabilities. It includes both capital and retained earnings.

Q42. Explain the uses of the Balance Sheet.

Ans :

The Balance Sheet is regarded as a prominent accounting report. The different interested parties may derive different information for their own use. Generally the following information can be derived from the Balance Sheet:

1. It enables us to ascertain the proprietary interest of a person or business organization.
2. It enables us to calculate the actual capital employed in the business.
3. The lender can ascertain the financial position of the business.
4. It may serve as the basis for determining purchase consideration of the business.

5. The trends of working capital of the business can be determined by comparison of Balance Sheet of successive years and corrective measures can be taken, where necessary.
6. Different ratios can be calculated from the Balance Sheet and these ratios can be utilised for better management of the business.

Q43. Explain Limitations of the Balance Sheet.

Ans :

Though the Balance Sheet is prepared by every organisation for disclosing its financial position, yet it is suffering from the following limitations :

1. Fixed assets are shown in the Balance Sheet at historical cost less depreciation upto date. A conventional Balance Sheet cannot reflect the true value of these assets. Again intangible assets are shown in the Balance Sheet at book values which may bear no relationship to market values.
2. Sometimes, Balance Sheet contains some assets which command no market value such as preliminary expenses, debenture discount, etc. The inclusion of these fictitious assets unduly inflate the total value of assets.
3. The Balance Sheet cannot reflect the value of certain factors such as skill and loyalty of staff.
4. A conventional Balance Sheet may mislead untrained readers in inflationary situations.
5. The value of majority number of current assets depend upon some estimates, so it cannot reflect the true financial position of the business.

Q44. Distinction between Profit and Loss Account and Balance Sheet.

Ans :

The main points of differences between a Profit and Loss Account and a Balance Sheet are as follows:

1. Profit and Loss Account is an account prepared with balances of nominal accounts whereas a Balance Sheet is a statement of assets and liabilities.
2. Profit and Loss Account discloses the profits earned or losses incurred for the accounting period usually a year whereas a Balance Sheet shows the financial position of the business on the last day of the accounting period.
3. Balances of nominal accounts are transferred to the Profit and Loss Account. Personal accounts and real accounts are shown in the Balance Sheet. Balance of Profit and Loss Account (i.e., net profit) is also shown on the liabilities side of the Balance Sheet.
4. Nominal accounts are closed by transferring them to the Profit and Loss Account. But the accounts that are shown in the Balance Sheet do not close and become the opening balances for the next accounting period.

Q45. Explain the various forms of balance sheets.

Ans :

Form of Balance Sheet

Assets Accounts show debit balances, where as liabilities show credit balances. All Assets are shown on the Assets side and all liabilities are shown on the Liabilities side. It is customary to show the assets and liabilities in a specific order. Arrangement of Assets and Liabilities in the Balance Sheet is called *Marshalling*. There are two methods of arranging the assets and liabilities.

1. The order of liquidity or releasability
2. The order of performance.

1. Balance Sheet under order of Liquidity

Generally Sole Trading Concerns and partnership firms follow the order of liquidity or realisability. The principle followed in this case is that those assets which can be easily converted into cash come first and then the assets which are more difficult to realise. Liabilities will be shown in the order in which they are payable, the most pressing liabilities being placed first and follows the less pressing liabilities. Following is the specimen of Balance Sheet where assets are arranged in the order of liquidity. Specimen Balance Sheet is given below.

Balance Sheet Under Order of Liquidity

Balance Sheet as at

Capital and Liabilities	Rs.	Assets	Rs.
Current Liabilities		Current Assets	
Sundry Creditors	xxx	Cash in hand	xxx
Bills payable	xxx	Cash at bank	xxx
Bank overdraft	xxx	Bills receivable	xxx
Mortgage	xxx	Sundry debtors	xxx
Outstanding expenses	xxx	Investments	xxx
Income received in advance	xxx	Closing stock	xxx
Loans		Unexpired expenses	xxx
Short term loans	xxx	Accrued income	xxx
Long term loans	xxx	Fixed Assets	
Reserve Fund		Furniture and Fittings	xxx
Capital	xxx	Plant and Machinery	xxx
Opening Balance	xxx	Land and Buildings	xxx
Add : Additional		Leasehold property	xxx
Capital introduced	xxx	Freehold property	xxx
Interest on capital	xxx	Motor vehicles	xxx
Net Profit	xxx	Intangible or Invisible Assets	
	xxx	Patents	xxx
Less : Drawings	xxx	Trade Marks	xxx
Interest on Drawings	xxx	Copy rights	xxx
Income tax	xxx	Goodwill	xxx
Insurance premium of			
Proprietor	xxx		xxx
	xxx		

2. Balance Sheet under Order of Performance

Under the second method i.e., where the order of performance is followed, the Balance Sheet appears as given below.

Balance Sheet as at

Capital and Liabilities	Rs.	Assets	Rs.
Capital		Intangible or Invisible	
Opening Balance	xxx	Assets	
Add : Additional		Goodwill	xxx
Capital introduced	xxx	Copy rights	
Interest on capital	xxx	Trade marks	xxx
Net Profit	xxx	Patents	xxx
		Fixed Assets	
		Motor vehicles	xxx
Less : Drawings	xxx	Freehold property	xxx
Interest on		Leasehold property	xxx
Drawing	xxx	Land & Buildings	xxx
Income Tax	xxx	Plant and Machinery	xxx
Insurance	xxx	Furniture and Fittings	xxx
Premium of		Current Assets	
properties	xxx	Accrued Income	xxx
Reserve Fund	xxx	Unexpired expenses	xxx
Loans		Closing stock	xxx
Long term loans	xxx	Investments	xxx
Short term loans	xxx	Sundry debtors	xxx
Current Liabilities		Bills Receivable	xxx
Income received in advance	xxx	Cash at bank	xxx
Outstanding expenses	xxx	Cash in hand	xxx
Mortgage	xxx		
Bank overdraft	xxx		
Bills payable	xxx		
Sundry creditors	xxx		
	xxx		xxx

PROBLEMS ON BALANCE SHEET

22. From the following particulars, prepare a Balance Sheet as on 31st March, 2013:

Particulars	₹	Particulars	₹
Capital	50,000	Loan to Smith	5,000
Business Premises	55,000	Investments	3,000
Furniture & Fixtures	2,500	Cash in Hand	200
Bills Receivable	3,500	Cash at Bank	3,500
Bills Payable	2,500	Proprietor's withdrawals	3,000
Sundry Debtors	20,000	Net Profit	38,900
Sundry Creditors	15,800	Closing Stock	7,000
Packing Machinery	4,500		

Sol :

BALANCE SHEET
as on 31st March, 2013

Liabilities	₹	Assets	₹
Sundry Creditors	15,800	Cash in Hand	200
Bills Payable	2,500	Cash at Bank	3,500
Capital	50,000	Investments	3,000
Add: Net Profit	38,900	Sundry Debtors	20,000
	88,900	Bills Receivable	3,500
Less: Drawings	3,000	Closing Stock	7,000
	85,900	Loan to Smith	5,000
		Packing Machinery	4,500
		Furniture & Fixtures	2,500
		Business Premises	55,000
	1,04,200		1,04,200

23. Following balances are extracted from the books of Kautilya & Co. on 31st March, 2013. You are required to make the necessary closing entries and to prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date :

Particulars	₹	Particulars	₹
Opening Stock	500	Commission (Cr.)	200
Bills Receivable	2,250	Returns Outward	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inward	400	Rent & taxes	550
Commission (Dr.)	400	Carriage Outward	725
Interest on Capital	350	Sales	25,000
Stationery	225	Bills Payable	1,500
Returns Inward	650	Creditors	9,825
		Capital	8,950

The Closing Stock was valued at ₹ 12,500.

Sol.:

Trading & Profit & Loss A/c of Kautilya & Co.
for the year ended 31st March, 2013

Particulars		Particulars	
To Opening Stock	500	By Sales	25,000
To Purchases	19,500	Less: Returns Inward	650
Less: Returns Outward	250		
	19,250		24,350
To Wages	1,400	By Closing Stock	12,500
To Carriage Inward	400		
To Gross Profit c/d	15,300		
	36,850		36,850
To Insurance	550	By Gross Profit b/d	15,300
To Commission	400	By Commission	200
To Interest on Capital	350		
To Stationery	225		
To Trade Expenses	100		
To Rent and Taxes	550		
To Carriage Outward	725		
To Net Profit transferred to Capital A/c	12,600		
	15,500		15,500

Balance Sheet of Kautilya & Co.

as on March 31, 2013

Liabilities		Assets	
Creditors	9,825	Cash in Hand	250
Bills Payable	1,500	Cash at Bank	2,375
Capital		Bill Receivable	2,250
April 1, 2012	8,950	Stock	12,500
Add: Net Profit	12,600	Sundry Debtors	15,000
	21,550	Office Fixtures	500
	32,875		32,875

2.7.4 Adjustments

Q46. What do you mean by Adjustments? Explain the objectives of Adjustments.

Ans :

Every adjustment has two fold effect according to the principle of double entry system. Hence, every item given as adjustment is to be shown two times i.e., one time either in Trading Account or in Profit and Loss Account and second time, it should be shown in the Balance Sheet. However, the items given in the Trial Balance should be shown only one time while preparing the final accounts.

Objective of Adjustments

1. To rectify the errors done in the recording of transactions in the books of accounts.
2. To record those transactions which are omitted to be recorded.
3. To record such expenses and incomes which have accrued but have not been paid or received.
4. To find out the correct profit or loss and financial position of the business.

Q47. Explain the various adjustments in the treatment of final accounts.

Ans :

Some of the important adjustments are explained as follows :

These adjustments will be recorded at two places because these are not recorded or wrongly recorded in the books. These are :

1. Closing Stock

These are the goods which remain unsold at the end of the year. It is valued at cost price or market price whichever is less. Since it is not valued at the time of preparing trial balance, therefore it appears outside the trial balance. The following entry is passed for it.

Entry : Closing Stock A/c Dr.

 To Trading A/c

Treatment : (i) Once it will appear on the Credit side of Trading A/c and secondly on the Assets side of Balance Sheet, (ii) If the Closing Stock is given in Trial balance, then only in Assets side of Balance Sheet.

2. Outstanding Expenses or Unpaid Expenses or Expenses due but not paid

The expenses which have become due but have not been paid at the end of the accounting year are called as outstanding expenses.

Entry: Expenses A/c Dr.

 To Outstanding Expenses

 (being expenses due)

Treatment: (i) If they are appearing outside the trial balance, once they will be added to particular related expenses in trading or profit & loss account and secondly they will appear on the liability side of balance sheet, (ii) If they are appearing inside the trial balance, They will appear on the liability side of balance sheet.

3. Prepaid Expenses (or) Unexpired Expenses or Expenses Paid in Advance

Such expenses are the reverse of outstanding expenses. It means the expenses which have been paid but the benefit of which is not taken are called prepaid expenses.

Entry: Prepaid Expenses A/c Dr.

To Expenses A/c

(being expenses paid in advance)

Treatment: (i) If they are appearing as adjustments, once they will be deducted from the particular related expenses appearing on the debit side of trading or profit & loss account and will appear on the assets side of balance sheet, (ii) If they are given in Trial Balance, they will appear only on the asset side of balance sheet.

4. Depreciation

It is the decrease in the value of fixed assets due to use, accident or passage of time.

Entry: Depreciation A/c Dr.

To Asset A/c

(being depreciation charged on particular asset)

Treatment: (i) If it is given as adjustment, it will appear on the debit side of profit & loss account and will be subtracted from the particular asset in the balance sheet, (ii) If it is given in trial balance, then only on the debit side of profit and loss account.

5. Outstanding Income or Accrued Income

The income which is earned but not received during the year is called accrued income.

Entry: Accrued Income A/c Dr.

To Income A/c

(being income receivable)

Treatment: (i) Outside the Trial Balance: It will be added to particular income on the credit side of profit and loss account and will be shown on the asset side of balance sheet, (ii) Given in the Trial Balance: In this case, it will appear on the asset side of balance sheet only.

6. Unearned Income or Income Received in Advance

It is the reverse of accrued income. It is the income which is received during the year but no services have been rendered for it in the year. This income is related for the next year.

Entry : Income A/c Dr.

To Unearned Income A/c

(being income received in advance)

Treatment : (i) Outside the Trial Balance: If these are given as adjustment, once these are to be deducted from particular income appearing on the credit side of profit & loss account and on the liability side of balance sheet, (ii) In the Trial Balance: If it is given in the trial balance, it will appear on the liability side of balance sheet.

7. Interest on Capital

The amount which is to be given to owner for interest on the amount invested by him in the business is called interest on capital.

Entry : Interest on Capital A/c Dr.
 To Capital A/c
 (being interest on capital allowed)

Treatment: It will be shown on the debit side of profit & loss account and will be added in capital on the liability side of balance sheet.

8. Interest on Drawings

The amount or the goods withdrawn by proprietor for personal use are called drawings. The business charges interest on these drawings from him. This is called as interest on drawings.

Entry: Drawings A/c Dr.
 To Interest on Drawings A/c
 (being interest charged on drawings)

Treatment: (i) It will appear on the credit side of profit & loss account and will be subtracted from the capital on the liability side of balance sheet.

9. Interest on Loan

If any amount is borrowed from the outside source, then the interest is to be paid on that amount. This is called as interest on loan. If this is not paid, then it will become outstanding interest.

Entry: Interest on Loan A/c Dr.
 To Loan A/c
 (Being interest due on loan)

Treatment: Since they are the expenses, they will be shown on the debit side of profit and loss account and will be added in the amount of loan on the liability side of the balance sheet.

10. Bad Debts

These are the amounts which are not received from the debtors or there is no possibility of realising them:

Entry: Bad Debts A/c Dr.
 To Debtors A/c
 (being bad-debts written off)

Treatment: (i) Outside the Trial Balance: If they are given outside the trial balance once they will be shown on the debit side of profit & loss account and secondly will be subtracted from the debtors on the assets side of balance sheet.

(ii) In the Trial Balance: If they are given in trial balance, then it will be shown on debit side of profit & loss account only.

11. Provision for Bad and Doubtful Debts

Doubtful debts are those debts about which there is an uncertainty and their recovery is doubtful. It is only anticipation of future loss. Therefore, it cannot be treated as bad debts. For such type of amounts, we create a reserve or provision which is called as provision for bad and doubtful debts.

Entry : Profit and Loss A/c Dr.
 To Provision for Bad and
 Doubtful Debts A/c
(Being provision for doubtful debts created)

Treatment: It will be debited to profit and loss account and will be subtracted from the amount of debtors on the asset side of the balance sheet.

Both Bad Debts and Provision for Doubtful Debts are given in Adjustments as well as in Trial Balance.

In this case, the following equation should be made

$$\begin{array}{ccccccc} \text{Bad Debts} & + & \text{Further Bad Debts} & + & \text{New Provision} & - & \text{Old Provision} \\ (\text{T.B.}) & & (\text{Adjustment}) & & (\text{Adjustment}) & & (\text{T.B.}) \end{array}$$

If this equation comes +ve, then it will appear on the debit side of profit and loss account.

If this equation comes -ve, then after taking -ve sign common and it will become as follows and will appear on the credit side of the profit and loss account.

Old Provision - Bad Debts - Further Bad Debts - New Provision (T.B.) (T.B.) (Adjustments)(Adjustment)

Note: Only the amount of Bad Debts and Provision for Doubtful Debts given in adjustment will be subtracted from Debtors in the balance sheet. Firstly, the amount of bad debts will be subtracted from debtors and on the balance amount, the provision will be created.

12. Provision for Discount on Debtors

It is the amount which is allowed to debtors for making a prompt payment. It is a probable loss for the business.

Entry: Profit and Loss A/c Dr.
To Provision for Discount on Debtors A/c
(Being provision for discount on debtors created)

Treatment: It will be shown on the debit side of profit and loss account and will be subtracted from the amount of debtors on the asset side of balance sheet.

The following sequence should be kept in mind.

	Rs.
Amount of Debtors as per T.B.	—
Less : Further Bad Debts (Adjustment)	—
Less : Provision for Doubtful Debts (Adjustment)	—
on the amount (a)	
Less : Provision for Discount on Debtors	
(Adjustment) on (b)	
Amount to be shown in Balance Sheet	

13. Provision for Discount on Creditors

Just like we allow discount to our debtors, similarly our creditors allow us the discount. It is the profit for the firm.

Entry: Provision for Discount on Creditors A/c Dr.
To Profit and Loss A/c
(Being provision for discount on creditors created)

Treatment: It is the income for the business, therefore it will appear on the credit side of profit and loss account and will be subtracted from the amount of creditors on the liability side of balance sheet.

14. Implied Interest

If the amount of loan is appearing in trial balance and the rate of interest is also mentioned there, then the interest on that amount is to be paid as per time period. Now it should be ascertained whether the full amount of interest is given in trial balance or not. If the full amount is not included in trial balance, then the left out amount should be treated as outstanding interest. Since nothing will be mentioned in adjustments in this regard, therefore it is called as implied interest.

15. Sales Tax

Sales tax is the amount which is to be paid by seller to the government. Seller collects this amount from the buyers.

Treatment :

- (i) If 'Sales Tax Collected' or 'Sales Tax' is mentioned and the amount is given on the credit side of trial balance, it will be shown on the liability side of the balance sheet.
- (ii) If 'Advance Sales Tax' is mentioned on the debit side of trial balance, it will be shown on the asset side of balance sheet.
- (iii) If 'Sales Tax Paid' is mentioned on the debit side of Trial Balance, it will be written on the debit side of Profit and Loss Account.
- (iv) If 'Sales Tax Paid' and 'Sales Tax Collected' both are given, and collected amount is more than paid, the balance amount after subtracting paid amount from collected amount will be shown on the liability side of balance sheet. But if the amount paid is more than the amount collected, the balance amount after their adjustment will be shown on the asset side of balance sheet.

16. Drawings in the Form of Goods

If the proprietor has withdrawn the goods for personal use, it is called as drawings :

Entry : Drawings A/c Dr.

To Purchases A/c

(Being goods withdrawn for personal use)

Treatment: The amount of goods withdrawn will be deducted out of purchases in the trading account and will also be deducted from capital on the liabilities side of balance sheet.

17. Use of Goods in Business

If the proprietor has used a part of goods in business, it becomes asset of the business.

Entry: Assets A/c Dr.

To Purchases A/c

(Being goods taken for business use)

Treatment: The goods withdrawn will be subtracted from purchases in the trading account and will be added or shown separately on the assets side of balance sheet.

Sometimes proprietor distributes the goods as free samples for the purpose of advertisement or for increasing the sales.

(Being goods distributed as free samples)

Treatment: The goods distributed as free samples will be deducted from purchases in the trading account and will appear on debit side of profit and loss account.

Sometimes proprietor uses the goods for charity purposes. For example, proprietor of electric goods shop gives the fans to dharamshala for the sale of charity.

(Being goods given away as charity)

Treatment: Goods given as charity will be subtracted from the purchases in the trading account and will appear on the debit side of profit and loss account.

Sometimes commission on net profit is paid to manager in addition to his salary for making extra efforts to increasing the profitability of the firm.

(Being commission to be paid to manager)

Treatment: It is a business expense, therefore, it will appear on the debit side of profit and loss account and since it is yet to be paid, it will also appear on the liability side of balance sheet.

i) On net profit before charging such commission :

$$\text{Commission} = \text{Net Profit before Commission} \times$$

$$= \text{Net Profit after Commission} \times$$

i) Make all other adjustments in P/L A/c.

ii) Make total of credit side of P/L A/c and write it in working notes.

iii) Make a rough total of debit side of P/L A/c and write it in working notes.

iv) Deduct their total of debit from the total of credit. The difference is used for calculating commission.

v) Apply formula as per condition given and write down the calculated commission on the debit side of profit and loss account.

vi) Now calculate the net profit.

The liability which is not a liability yet, but can become a liability on the happening of a certain event, e.g.,

- i) Pending cases in the court;
- ii) Guarantee of a loan of friend;
- iii) B/R discounted but not matured;
- iv) Liability for contracts undertaken till they are completed.

22. Deferred Revenue Expenditure

Entry: Profit and Loss A/c Dr.
 To Particular Expenditure A/c
(Being expenses written off)

Treatment: The amount calculated after dividing the total amount by number of years will be shown to debit of profit and loss account and the balance amount will be shown on the debit side of balance sheet.

If the goods are sold to a customer but omitted to be recorded in the books, the following journal entry will be passed. This generally happens when the sales are made on credit basis.

Entry: Debtors A/c Dr.
 To Sales A/c
(Being goods sold)

Treatment: Once the amount is added to sales on the credit side of trading account and secondly it is added to debtors on the assets side of balance sheet.

When the goods are sold on sales or return basis and if this is treated as sales it is an error and has to be rectified.

Entry: Sales A/c Dr.
 To Debtors A/c
(Being error of good

Treatment: Once it will be deducted from sales in trading account and debtors in assets in balance sheet and secondly it will be added to closing stock in trading account and in balance sheet. The selling price is to be deducted from debtors and sales and cost price of goods is to be added in closing stock at both places.

25. Dishonour of Bills of Exchange

If the payment against the bills receivable is not received on maturity date, it is called as dishonour of bills of exchange.

Entry: Debtors A/c Dr.

To Bills Receivable A/c

(Being B/R dishonoured)

Treatment: The amount will be subtracted from bills receivable on the asset side of balance sheet and will be added in the amount of debtors in balance sheet.

26. Capital Expenditure treated as Revenue Expenditure or vice-versa

Sometimes capital expenditure is treated as revenue expenditure or revenue expenditure is treated as capital expenditure, it is error of principal and hence has to be rectified.

Treatment:

- i) If the capital expenditure is treated as revenue expenditure, then the amount will be subtracted from the particular expenses appearing in the debit or trading or profit and loss account and will be added in particular asset in the balance sheet.
- ii) If the revenue expenditure is treated as capital expenditure, the amount will be deducted from the particular asset and will be added to the debit side of trading or profit and loss account.

PROBLEMS ON FINAL ACCOUNTS WITH ADJUSTMENTS**24. Following are the extracts from the Trial balance of a firm as on 31st March 2017**

Name of the account	Dr. (Rs.)	Cr. (Rs.)
Furniture and fittings	4,00,000	–
Motor vehicles	2,00,000	–
Plant	2,00,000	–

Additional information :

- a) Furniture of Rs. 20,000 was purchased on 1st July 2016. Write 10% off the furniture.
- b) Motor vehicle of Rs. 20,000 was acquired on 1st July 2016. Depreciate the motor vehicles at 20% p.a.
- c) The plant of Rs. 20,000 was acquired during the year, charge depreciation on plant at 10% p.a.

Pass necessary journal entries and show how the items will appear in the firms's final accounts.

Sol :

(May-19)

Working notes :

$$\begin{aligned} \text{➤ Furniture} &= 20,000 \times \frac{10}{100} = 2,000 \\ (4,00,000 - 20,000) &3,80,000 \times \frac{10}{100} = 38,000 \\ &\underline{40,000} \end{aligned}$$

$$\begin{aligned} \text{➤ Motor vehicles} &20,000 \times \frac{20}{100} \times \frac{9}{12} = 3,000 \\ (2,00,000 - 20,000) &1,80,000 \times \frac{20}{100} = 36,000 \\ &\underline{39,000} \end{aligned}$$

$$\begin{aligned} \text{➤ Plant and Machinery} &20,000 \times \frac{10}{100} \times \frac{6}{12} = 1,000 \\ (2,00,000 - 20,000) &= 1,80,000 \times \frac{10}{100} = 18,000 \\ &\underline{19,000} \end{aligned}$$

Journal entries

Date	Particulars	LF	Debit	Credit
	Depreciation a/c Dr.		98,000	
	To Furniture a/c			40,000
	To Motor vehicles a/c			39,000
	To Plant a/c			19,000
	(Being Depreciation charged on furniture, vehicles and plant)			

Dr.

P & L a/c for the year ending 31/3/2017

Cr.

Particulars	Amount	Particulars	Amount
To Depreciation on furniture	40,000		
To Depreciation on motor vehicles	39,000		
To Depreciation on plant	19,000		
	<u>98,000</u>		<u>98,000</u>

Balance sheet as on 31/3/2017

Liabilities	Amount	Assets	Amount
		Furniture 4,00,000	
		(-) Depreciations 40,000	
			3,60,000
		Motor vehicles 2,00,000	
		(-) Depreciations 39,000	
			1,61,000
		Plant 2,00,000	
		(-) Depreciations 19,000	
			1,81,000

25. From the following trial balance of Goldern fair and Company, prepare trading and Profit and Loss account and Balance Sheet.

Trial Balance as on 31st December 2010.

Particulars	Debit (Rs.)	Credit (Rs.)
Cash in hand	2,400	
Purchase	2,40,000	
Stock on 1 st January 2005	70,000	
Debtor	1,00,000	
Plan and Machinery	1,20,000	
Furniture	30,000	
Bills Receivable	40,000	
Rent and Rates	20,000	
Wages	32,000	
Salaries	37,600	
Capital		2,00,000
Bills payable		44,000
Creditors		48,000
Sales		4,00,000
Total	6,92,000	6,92,000

Additional Information :

- (i) Closing inventory as on 31st December 2005 Rs. 50,000
- (ii) Outstanding wages Rs. 5,000
- (iii) Depreciation on Plant and Machinery at 10 percent and furniture at 5 percent.

Sol.:

(Nov.-21)

Dr.

Trading and P & L A/c of Golden fair and company

Cr.

Particulars	Amount	Particulars	Amount
To Opening Stock	70,000	By Sales	4,00,000
To Purchases	2,40,000	By Closing Stock	50,000
To Wages 32,000			
(+) Outstanding 5,000	37,000		
To Gross Profit c/d	1,03,000		
	4,50,000		4,50,000
To Depreciation on Plant & Machinery	10,000	By Gross Profit b/d	1,03,000
To Depreciation on furniture	1,500		
To Rent and Rates	20,000		
To Salaries	37,600		
To Net profit c/d	33,900		
	1,03,000		1,03,000

Balance Sheet as on 31/12/2000

Liabilities	Amount	Assets	Amount
Capital 2,00,000		Cash in hand	2,400
(+) Net profit 33,900	2,33,900	Debtors	1,00,000
Outstanding Wages	5,000	Plant & Machinery 1,20,000	
Bills Payable	44,000	(-) Depreciation 10,000	1,10,000
Creditors	48,000	Furniture 30,000	
		(-) Depreciation 1,500	28,500
		Bills Receivable	40,000
		Closing Stock	50,000
	3,30,900		3,30,900

26. From the following Trail Balance, Prepare the Trading and Profit and Loss Account of Mr. Ramu for the year ended December 31, 2015 and the Balance sheet as on the date

Particulars	Debit Rs.	Credit Rs.
Ramu Capital	-	4,000
Plant and Machinery	5,000	-
Office Furniture's and fitting	260	-
Stocks on January 1, 2015	4,800	-
Motor Van	1,200	-
Sundry Debtors	4,470	-
Cash in Hand	40	-
Cash in bank	650	-
Wages	15,000	-
Salaries	1,400	-
Purchases	21,350	-
Sales	-	48,000
Bills Receivable	720	-
Bills payable	-	560
Sundry Creditors	-	5,200
Returns Inwards	930	-
Provisions for doubtful debts	-	250
Drawings	700	-
Return outwards	-	550
Rent	600	-
Factory Lighting and heating	80	-
Insurance	680	-
General Expenses	250	-
Bad debts	200	-
Discount	650	420
	58,980	58,980

The Following adjustments are to be made

- Stock on December 31, 2015, Rs. 5,200/-
- 3 months factory lighting and heating is due but not paid Rs. 30/-
- 5% Depreciations to be written off on furniture,
- Write off further bad debts Rs.70

Sol.:

(Dec.-18)

Dr. Trading and Profit and Loss A/c for the year ending 31/12/2015 Cr

Particulars	Amount	Particulars	Amount
To Opening stock	4,800	By Sales	48,000
To Purchases	21,350	(-) Returns	930
(-) Returns	550	By Closing stock	5,200
To Wages	15,000		
To Factory lighting	80		
(+) Outstanding	30		
To Gross profit c/d	11,560		
	52,270		52,270
To Salaries	1,400	By Gross profit b/d	11,560
To Rent	600	By Discount Received	420
To Insurance	680		
To General Expenses	250		
To Bad debts	270		
To Discount allowed	650		
To Depreciation on furniture	13		
To Net profit	8,117		
	11,980		11,980

Balance sheet as on 31/12/2015

Liabilities	Amount	Assets	Amount
Capital	4,000	Plant	5,000
(-) Drawings	700	Furniture	260
	3,300	(-) Depreciation	13
(+) Net profit	8117	Motor Van	1,200
		Cash in hand	40
Outstanding lighting	30	Cash at bank	650
		Bills Receivable	720
Creditors	5,200	Debtors	4,470
		(-) Bad debts	70
Bills payable	560	(-) Provision	250
		Closing stock	5,200
	17,207		17,207

27. From the following Trial Balance of Shri Chandershekar, prepare Trading and Profit and Loss Account for the year 31st March, 2008 and Balance Sheet as on that date after taking into account the adjustments given at the bottom of the trial balance.

Debit Balance	Dr. (Rs.)	Credit Balance	Cr. (Rs.)
Chandershekar's Drawings	4,500	Chandershekar's Capital	24,000
Purchases	20,000	Sales	30,500
Returns Inwards	1,500	Discount	1,900
Stock (1-4-2007)	8,000	Sundry Creditors	10,000
Salary	4,200	Bills Payable	2,500
Wages	1,200		
Rent	350		
Bad Debts	400		
Discounts	700		
Sundry Debtors	14,000		
Cash in Hand	260		
Cash at Bank	5,940		
Insurance	400		
Trade Expenses	300		
Printing	150		
Furniture	2,000		
Machinery	5,000		
	68,900		68,900

Adjustments:

- Closing stock was valued at Rs. 7,000.
- Insurance was prepaid to the extent of Rs. 60.
- Outstanding liabilities were: Salary Rs. 200, wages Rs. 200.
- Make provision for doubtful debts at 5% on sundry debtors.
- Calculate Interest on Capital 5% p.a.
- Depreciate machinery at 5% and Furniture at 10%.
- Provide for discount on creditors at 1%.

Sol :

Trading A/c for the year ending 31st March, 2008

Particulars	Rs.	Particulars	Rs.
To Opening Stock	8,000	By Sales	30,500
To Purchases	20,000	Less: Returns	1,500
To Wages	1,200	By Closing Stock	7,000
Add: O/S	200		
	1,400		
To Gross Profit transferred to Profit & Loss A/c	6,600		
	36,000		36,000

Profit and Loss Account for the year ending 31st March, 2008

Particulars	Amount	Particulars	Amount
To Salary 4,200		By Gross Profit	6,600
Add: O/S 200	4,400	By Discounts	1,900
To Rent	350	By Discount on Creditors	100
To Bad Debts 400		By Net Loss	
Add: New Provision 700	1,100	transferred to capital a/c	390
To Discount	700		
To Insurance 400			
Less: Prepaid 60	340		
To Trade Expenses	300		
To Printing	150		
To Interest on capital	1,200		
To Depreciation on Machinery	250		
To Depreciation on Furniture	200		
	8,990		8,990

Balance Sheet as at 31st March, 2008

Liabilities	Rs.	Assets	Rs.
Capital 24,000		Machinery 5,000	
Add: Interest on capital 1,200		Less/Depreciation 250	4,750
25,200		Furniture 2,000	
Less: Net loss 390		Less: depreciation 200	1,800
24,810		Sundry Debtors 14,000	
Less: Drawings 4,500	20,310	Less: New provision 700	13,300
Sundry Creditors 10,000		Closing Stock	7,000
Less: Discount 100	9,900	Prepaid Insurance	60
Bills Payable	2,500	Cash In Hand	260
O/S Salary	200	Cash at Bank	5,940
O/S Wages	200		
	33,110		33,110

28. The following Trial Balance was extracted from the books of Mr. X as on 31st December, 2007.

Debit Balance	Dr. (Rs.)	Credit Balance	Cr. (Rs.)
Plant and machinery	20,000	Opening Stock	34,200
Manufacturing Wages	34,500	Motor Car	12,000
Salaries	15,850	Sales Return	3,100
Furniture	10,000	Purchases	1,02,000
Freight on Purchases	1,860	Bad Debts	1,400
Building	24,000	Interest and Bank Charges	400
Freight on Sales	2,140	Cash at Bank	4,200
Manufacturing Expenses	9,500	Cash in hand	1,120
Insurance and Tax	4,250	Credit Balances	
Goodwill	25,000	Capital Account	80,000
General Expenses	8,200	Sundry Creditors	44,560
Factory Fuel and Power	1,280	Bank Loan	15,000
Sundry Debtors	78,200	Purchases returns	1,740
Factory Lighting	950	Sales	2,50,850
		Reserve for Bad debts	2,000

Prepare Trading and Profit and Loss Account for the year ended 31st December, 2007 and the balance Sheet as on that date taking into consideration the following information:

- Stock in hand on 31st December, 2007 was valued at Rs. 30,500.
- Depreciate Plant and Machinery by 10% Furniture by 5% and Motor car by Rs. 1,000.
- Bring provision for Bad debts to 5% on Sundry Debtors.
- A commission of 1% on the gross profit is to be provided for Works Manager.
- A commission of 2% (two percent) on net profit (after charging the Works Manager's Commission but before charging General Manager's Commission) is to be paid to the General Manager.

*Sol :***Trading A/c for the year ending 31st December, 2007**

Particulars	Rs.	Particulars	Rs.
To Opening Stock	34,200	By Sales	2,50,850
To Purchases	1,02,000	Less: Returns	3,100
Less: Returns	1,740	By Closing Stock	30,500
To Freight on Purchases	1,860		
To Manufacturing Wages	34,500		
To Manufacturing expenses	9,500		
To Factory, fuel & Power	1,280		
To Factory Lighting	950		
To Gross Profit transferred			
to Profit and Loss A/c	95,700		
	2,78,250		2,78,250

Profit and Loss Account for the year ending 31st December, 2007

Particulars	Rs.	Particulars	Rs.
To Salaries	15,850	By Gross Profit b/d	95,700
To Freight on Sales	2,140		
To Insurance & Tax	4,250		
To General Expenses	8,200		
To Bad Debts	1,400		
Add: New Provision	3,910		
	5,310		
Less: Old Provision	2,000		
To Intt./Bank Charge	400		
To Dep. On P&M	2,000		
To Dep. On Furniture	500		
To Dep. On Motor car	1,000		
To Work Manager	957		
Commission			
To GM Commission	1,142		
To Net Profit	55,951		
	95,700		95,700

Balance Sheet as at 31st December, 2007

Liabilities		Rs.	Assets		Rs.
Capital	80,000		Plant & machinery	20,000	
Add: Net Profit	55,951	1,35,951	Less: Depreciation	(2,000)	18,000
Sundry Creditors		44,560	Furniture	10,000	
Bank Loan		15,000	Less: Depreciation	(500)	9,500
Work Manager			Building		24,000
Commission		957			
G.M. Commission		1,142	Motor Car	12,000	
			Less: Depreciation	1,000	11,000
			Goodwill		25,000
			Closing Stock		30,500
			Debtors	78,200	
			Less: New Provision	3,910	74,290
			Cash in Hand		4,200
			Cash at Bank		1,120
		1,97,610			1,97,610

2.8 ACCOUNTING FROM INCOMPLETE RECORDS

Q48. What do you mean by incomplete Records. Explain the features of Incomplete Records.

Ans :

(Jan-20, July-18, Jan-18)

Meaning

Single entry system is actually an incomplete state of a double entry system. It is also known as "Incomplete Records System".

Definition

(i) **According to Kohler**, "It is a system of book-keeping in which as a rule, only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances".

Mostly single entry system is used by small business organizations in order to maintain some important records. The performance of single entry system is not dependable.

Features

Following are the salient features of Incomplete records system,

1. Incomplete records system is suitable for sole trading concerns. Limited companies cannot use this systems due to legal requirements.
2. Only personal accounts are maintained in this system.
3. This system maintains one single cash book which comprises a mix-up of business and private transactions.
4. It does not have uniformity in maintaining the records. It may change from industry to industry as per the requirements of the firm.

5. In this system, systematic and scientific method of accounting/recording transactions are not accurate.
6. As the data is not recorded in subsidiary books and relevant information can only be stored in vouchers.
7. The determination of profit / loss is based on estimates. It does not show the true status of the firms, (i.e., Financial position of the firm).

Q49. What are the possible reasons for keeping incomplete records?

Ans :

The incompleteness of Accounting records could be due to the following reasons,

1. The business persons may not maintain proper accounts intentionally so as to avoid taxation.
2. Damage of account books due to flood or fire etc.
3. The business person may be unaware of the separate legal entity assumptions.
4. The business persons may not be aware of double entry accounting principles.

2.8.1 Advantages and Disadvantages of Single Entry and Double Entry System**Q50. What are the advantages and disadvantages of single entry system?**

(OR)

Describe the limitations of single entry system of accounting.

(OR)

Discuss advantages and disadvantages of single entry system.

(OR)

Explain the advantages and disadvantages of single entry system?

Ans :

(March-22, Nov.-20, Dec.-18, Jan-18)

Advantages

The various advantages of single entry system are as follows,

1. The system is economical to small business entities with few assets and liabilities and limited transactions.
2. Single entry system is quite a simple method for the organizations who do not involve in the complexity of double entry system.
3. Some businessmen intentionally use this system to avoid taxation.
4. Using this system, it is easier to determine profit or loss.
5. Unlike double entry system, this system does not require practical knowledge of the principles of book keeping.
6. Accounting records can be easily maintained under this system.

Disadvantages

The following are the disadvantages of single entry system,

1. Single entry system does not record both debit and credit of every transaction. Therefore, it is called "Incomplete Records System".
2. Frauds can be easily committed due to the absence of proper control and checks.
3. Under this system, Financial position of the business cannot be ascertained because of the absence of real accounts.
4. Joint stock companies do not adopt this system because of legal requirements.
5. This system does not maintain nominal accounts which makes it difficult to prepare the P & LA/c and determine the net profit or net loss of the business.
6. At the time of assessment, it becomes difficult to manage the tax authorities regarding the profit/loss of the business.

Q51. Explain how the profit can be determine under single entry system.

Ans :

(Jan.-18)

Under single entry system, profit can be determined by following the below format,

Format of Statement of Profit and Loss

Particulars	Amount (₹)	Amount (₹)
(A) Capital at the end of Accounting year (closing capital)	x x	
(B) Add: Drawings	x x	
	xxx	
(C) Less: Additional capital introduced during the year	x x	xxx
(D) Adjusted capital at the end of year ($D = A + B - C$)		xxx
(E) Capital at the beginning of year (opening capital)		xxx
(F) Profit if (D) is greater than (E), $= (D - E)$		xxx
Loss if (D) is less than (E), $= (E - D)$		

Q52. Explain the advantages and disadvantages of double entry system.

Ans :

For Answer Refer Unit - I, Q.No.

2.8.2 Differences between single entry system and double entry system

Q53. Compare and contrast Double entry and Single entry system.

Ans :

S.No.	Double Entry System	Single Entry System
1.	It is a complete system of accounting	It is an incomplete system of accounting.
2.	It records both the aspects of a transaction Debit and Credit.	It records double aspects for some transactions, single for some and does not record some transaction.
3.	Accurate Trial balance is prepared since errors can be identified easily.	Trial balance cannot be prepared because it is not systematically maintained.
4.	Since the Trial balance is accurate the income and the position statements will also be accurate.	Since there is an inaccurate Trial balance Financial statements cannot be prepared.
5.	It is generally accepted and used.	It is not generally used.

2.9 PREPARATION OF ACCOUNTS AND ASCERTAINMENT OF PROFIT FROM INCOMPLETE RECORDS

Q54. Explain the concept of Preparation of Accounts (or) Ascertainment of Profit or Loss From Incomplete Records.

(OR)

Explain the process of ascertainment of profit.

Ans :

(Nov.-21)

Under Incomplete record system, transactions are not recorded with reference to any standardized Accounting principle due to which final accounts (Trading profit/loss Account and Balance sheet) are difficult to prepare. Therefore, Financial position of a business organization through single entry system cannot be ascertained accurately. However, to ascertain the profits /losses of business, two methods are used under this system.

Q55. Define statement of affairs method. Explain the format of statement of affairs method.

(OR)

Discuss the accounting treatment as per the statement of affairs method.

Ans :

(Nov.-21, Jan-18)

Statement of Affairs Method (Net Worth Method)

Statement of Affairs refers to that statement which shows all the transactions related to various assets and liabilities. The main objective behind the preparation of statement of affairs is to calculate the amount of capital in the beginning and at the end of the Financial year/period. Capital is the difference of total Assets and Total liabilities. This statement is quite similar to the Balance sheet.

The statement of affairs method uses the following sources of Accounting:

- (i) Cash and pass book
- (ii) Personal ledgers of debtors and creditors
- (iii) List of Fixed assets (improper records)
- (iv) Outstanding income/expenses (improper records).
- (v) Prepaid income/expenses (improper records)

Generally, statement of Affairs method (Networth method) is used to ascertain and evaluate the profits and losses of the business during a particular Accounting period. For this purpose, two statements need to be prepared, such as,

(a) Statement of Affairs

The purpose of preparing statement of Affairs is to ascertain the capital (differences between assets and liabilities) on a particular Accounting period. However, to compute or ascertain capital, organization is required to prepare two statement of affairs. One is to find out the capital at the beginning of Accounting period and second is to find out the capital at the end of Accounting period. These two statements will show the increase and decrease in the capital during a particular Accounting period.

Format of Statement of Affairs

Liabilities	Amount (`)	Assets	Amount (`)
Capital (Balancing figure)	xx	Cash in hand	xx
Creditors	xx	Cash at bank	xx
Bills payable	xx	Debtors	xx
Bank overdraft	xx	Bills receivable	xx
Outstanding expenses	xx	Fixed assets	xx
		Stock	xx
		Prepaid expenses	xx
	xxx		xxx

(b) Statement of Profit and Loss

The purpose of preparing statement of profit and loss is to make the adjustment in the Accounts for ascertaining the actual amount of capital during a particular Accounting period. The adjustments may include Drawings, interest on capital, additional capital introduced, interest on drawings, partner salary, provisions, depreciation, outstanding income/expenses and prepaid income/expenses.

Thus, after preparing the above two statements, actual capital and profit/loss of business during an Accounting period can be ascertained.

Format of Statement of Profit and Loss

Particulars	Amount (`)	Amount (`)
(A) Capital at the end of Accounting year (closing capital)	xx	
(B) Add : Drawings	xx	
	xxx	
(C) Less : Additional capital introduced during the year	xx	xxx
(D) Adjusted capital at the end of year (D = A + B – C)		xxx
(E) Capital at the beginning of year (opening capital)		xxx
(F) Profit if (D) is greater than (E), = (D – E)		xxx
Loss if (D) is less than (E), = (E – D)		xxx

2.9.1 Accounting Treatment as per the Statement of Affairs Method

Q56. Discuss the accounting treatment as per the statement of affairs method with its various models.

Ans :

(Nov.-21)

The Accounting treatment and the computation of profit/loss as per the statement of Affairs method involves the following steps,

Step 1 : Preparation of Statement of Affairs

In the first step, statement of Affairs needs to be prepared for the beginning of accounting period.

Step 2 : Transfer of Asset's Items

In this step, items related to the assets should be recorded or transferred to the asset side of the statement of Affairs.

Step 3 : Transfer of Liability's Items

In this step, items related to the liabilities should be recorded or transferred to the liabilities side of statement of Affairs.

Step 4 : Opening Capital Ascertainment

In the fourth step, capital is ascertained by deducting assets - Liabilities (i.e., $\text{Capital} = \text{Total assets} - \text{Total liabilities}$). The balancing figure between assets and liabilities is referred as opening capital of beginning Accounting period.

Step 5 : Closing Capital Ascertainment

Closing capital can be ascertained by repeating the above four steps (1 to 4).

Step 6 : Preparation of Profit and Loss Statement

Statement of profit and loss is prepared after determining or ascertaining the opening and closing capital of Accounting period.

Step 7 : Adjustment of Drawings and Additional Capital Introduced

In this step, drawings should be added to the closing capital and then additional capital introduced must be deducted from the remaining amount. The balancing figure would be referred as 'Adjusted closing capital'.

Step 8 : Ascertain Profit or Loss

To ascertain the profit or loss, adjusted closing capital should be deducted from the opening capital. Business would be in profit, if adjusted closing capital is greater than opening capital. If adjusted closing capital is less than opening capital business would be in losses.

There are various models involved in the statement of Affairs method. They are as follows,

Model 1 - Computation of capital

Model 2 - Ascertainment of profit/loss

Model 3 - Computation of net profit (After adjustments)

Model 4 - Cheques issued but not presented

Model 5 - Bank transactions - Adjustments

Model 6 - Net increase in assets or net decrease in liabilities

Model 7 - Incomplete records and partnership firms.

PROBLEMS

29. Opening Capital Rs 50,000; drawings Rs 15,000; capital introduced during the year Rs 25,000; Closing Capital Rs 1,05,000. Ascertain the profit/loss for the year 2008.

Sol.:

Statement of Profit or Loss for the year ending 2008

Particulars	Rs
1. Capital at the end	1,05,000
2. Add: Drawings	15,000
	1,20,000
3. Less: Additional Capital	25,000
4. Adjusted Capital at the end	95,000
5. Less: Opening Capital	50,000
6. Profit (4 > 5; 4 - 5)	45,000

30. Mr. Sameer keeps his accounts on Single Entry System from the following figures available, compute profits made by him for the year ended Dec 31, 2008.

Particulars	As on 31.12.2007 Rs.	As on 31.12.2008 Rs.
Cash in hand	10,000	15,000
Cash at bank	50,000	80,000
Furniture	10,000	10,000
Stock in trade	75,000	1,00,000
Sundry Creditors	30,000	35,000
Sundry Debtors	20,000	30,000

During the year 2008, he withdrew Rs 500 every month for his personal use and invested on June 15, 2008 Rs 10,000 as additional capital.

Sol.:

Particulars are available for two years. So, Statement of Affairs - one for the year ending on Dec 31, 2007 and the other one for the year ending on Dec 31, 2008 - have to be prepared. Remember the steps and proceed accordingly.

Stage 1 : Computation of Opening Capital**Statement of Affairs as on 31.12.2008**

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	30,000	Cash in hand	10,000
		Cash at bank	50,000
Capital (Balancing figure)	1,35,000	Sundry Debtors	20,000
		Stock in trade	75,000
		Furniture	10,000
	1,65,000		1,65,000

Stage II : Computation of Closing Capital**Statement of Affairs as on 31.12.2008**

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	35,000	Cash in hand	15,000
Capital (Balancing figure)	2,00,000	Cash at bank	80,000
		Sundry Debtors	30,000
		Stock in trade	1,00,000
		Furniture	10,000
	2,35,000		2,35,000

Stage III : Ascertainment of profit or loss

Remember the steps involved in computing the profit or loss (preparation of the Statement of Profit or Loss).

Particulars	Rs.
Step 1: Capital at the end, i.e. on 31.12.88	2,00,000
Step 2: Add: Drawings (Rs 500 per month \times 12)	6,000
	2,06,000
Step 3: Less: Additional capital, introduced on June 15	10,000
Step 4: Adjusted capital at the end of 2008	1,96,000
Step 5: Less: Capital in the beginning, i.e. on 31.12.2007	1,35,000
Step 6: Profit (4 - 5) (4 > 5)	61,000

31. (a) Calculate the missing figure :

Capital at the	Rs. 18,000
Capital introduced during the year	Rs. 3,000
Drawings	Rs. 4,000
Loss	Rs. 1,000
Capital at the beginning	?

- (b) Calculate the capital of Mr. Ganesh as at 31st December 2015 from the following information.

Sol :

(May-19)

Calculation of missing figure

Particulars	Amount
Capital	18,000
(+) Drawings	4,000
	22,000
(-) Introduced during the year	3,000
	19,000
(+) Loss	1,000
Capital at the beginning	20,000

32. Shri Shankar keeps his book on single entry and following is disclosed from his records.

Particulars	31.12.06 Rs.	31.12.07 Rs.
Balance at bank	(Cr) 2,1000	(Cr) 5,600
Stock in trade	15,000	20,000
Sundry debtors	30,000	28,500
Furniture	5,000	5,000
Investments	5,000	5,000
Cash in hand	100	400
Sundry creditors	25,000	27,000
Bills payable	1,000	500
Loan from Dayalan		3,000

Shri Shankar transferred Rs. 250 each month during first half year and Rs. 200 each month for the remaining period from the business to his daughters banking account by way of drawings. In addition he withdraws Rs. 5000 for his daughters marriage and Rs. 1000 for charitable purpose. He also withdraws goods worth Rs. 5000 of which he invested into the business Rs. 4000. he sold his private car Rs. 3500 and proceeds were utilized for business.

He wants his furniture to be depreciated at 10% and reserve for doubtful debts to be created at 5%. He does not paid two months salary to his clerk @Rs. 150 P.m and two months rent of shop was outstanding amounting to Rs. 200. Commission earned but not yet received by him was Rs. 24000, prepare statement of profit (or) loss for the year ending 31.12.2007.

Sol.:

(Dec.-18)

Statement of affairs as on 31/12/2006

Liabilities	Amount	Assets	Amount
Creditors	25,000	Stock	15,000
Bills payable	1,000	Debtors	30,000
Bank O.D	2,100	Furniture	5,000
Opening capital	27,000	Investments	5,000
		Cash in hand	100
	55,100		55,100

Statement of affairs as on 31/12/2007

Liabilities	Amount	Assets	Amount
Creditors	27,000	Stock	20,000
Bills payable	500	Debtors	28,500
Loan	3,000	Bank	5,600
		Furniture	5,000
Closing balance	34,000	Investments	5,000
		Cash in hand	400
	64,500		64,500

Statement of affairs as on 31/12/2007

Particulars	Amount	Amount
Closing capital		34,000
(+) Drawings (2700 + 1000 + 5000 + 5000)		13,700
		47,700
(-) Additional capital (4000 + 3500)		7,500
		40,200
(-) Opening balance		27,000
Profit		13,200
(-) Expenses		
Depreciation on furniture	500	
Reserve for doubtful debts	1,425	
Outstanding Salary	300	
Outstanding Rent	200	2,425
		10,775
(+) Commission		2,400
Net profit		13,175

33. Gopal keeps his books by the single entry method. His position on 31st December 2020 and on 31st December 2021 are as follows :

Particulars	31 st Dec. 2020 Rs.	31 st Dec. 2021 Rs.
Cash in hand	30,000	20,000
Cash at Bank	2,50,000	2,80,000
Debtors	1,80,000	2,50,000
Stock	2,90,000	3,10,000
Furniture	50,000	60,000
Machinery	50,000	50,000
Creditors for goods	1,80,000	2,50,000
Expenses outstanding	15,000	-----
Prepaid insurance	-----	4,000

On 1st October 2020 Gopal introduced Rs. 50,000 as further capital in the business and withdrew on the same date Rs. 20,000 for personal use.

Depreciation is to be calculated on machinery at 10% p.a. A provision for doubtful debts is to be created on sundry debtors at 5%. Goods taken for personal use amounted to Rs. 15,000. Also provide interest on capital at 10% p.a.

Prepare the necessary statement showing the profit or loss made by him during the year ending 31st Dec. 2021.

Sol :

(Nov.-22)

Statement of affairs as on December 2020

Liabilities	Amount	Assets	Amount
Creditors for goods	1, 80,000	Cash in hand	30,000
		Cash at bank	2,50,000
		Debtors	1,80,000
Expenses out standing	15000	Stock	2,90,000
		Furniture	50,000
Capital (Balance figure)	6,55,000	Machinery	50,000
	8,50,000		8,50,000

Statement of affairs as on December 2021

Liabilities	Amount	Assets	Amount
Creditors for goods	2,50,000	Cash in hand	20,000
		Cash at bank	2,80,000
		Debtors	2,50,000
		Stock	3,10,000
		Furniture	60,000
Capital (Balance figure)	7,24,000	Machinery	50,000
		Prepaid insurance	4000
	9,74,000		9,74,000

Statement of Profit (or) Loss for the year ended 31/12/2021

Particulars	Amount
Capital of the end	7,24,000
(+) Drawings	35000
	7,59,000
(-) Additional capital	50,000
Profit before adjustment	7,09,000
(-) Depreciation on Machinery	5000
$\left(50,000 \times \frac{10}{100} \right)$	
(-) Provision for doubtful debts	12,500
$\left(2,50,000 \times \frac{5}{100} \right)$	
Net profit for the year	6,91,500

2.9.2 Calculation of Missing Figures

Q57. Discuss the various transactions involved in ascertainment of missing figures.

(OR)

Explain the accounting treatment for calculation of missing figures.

Ans :

(Nov.-20)

The following transactions are involved in ascertainment of missing figures,

S.No.	Missing Figures	Method of Calculating Missing Figures
1.	Opening and closing balance [Cash and bank account]	Proforma of cash book is drawn i.e., cash and bank account summary. All figures are transferred to this account, the result will be the balancing figure.
2.	Cash purchases [Cash or Bank account]	Cash purchases or balancing figure = Total purchases - Net credit purchases.
3.	Cash sales [Cash or bank account]	Cash sales or balancing figure = Total sales - Net sales.
4.	Net purchases [Stock account]	Net purchases = Cash purchases + Credit purchases - purchases returns. (or) Closing of goods sold + Closing stock - Opening stock
5.	Net credit purchases [Total creditors account]	Net credit purchases = Total purchases - Cash purchases - Purchases returns (or) Closing creditors $\times 12 \div$ Credit period
6.	Net sales	Net sales = Cash sales + Credit sales - Sales return (or) Cost of goods sold + Gross profit (or) $G.P \times 100 \div$ Rate of G.P. on sales.
7.	Net credit sales [Total debtors account]	Net credit sales = Total sales - Cash sales - sales return (or) Closing debtors $\times 12 \div$ Credit period (in months)
8.	Current year sale	Previous years sales \pm changes in sales price, sales quantity
9.	Current years revenue income [Revenue income a/c]	Income received + Accrued at the end + Unaccrued in the beginning - Accrued in the beginning - unaccrued at the end
10.	Current years revenue expenses [Revenue expenses a/c]	Expenses paid + Outstanding at the end + Prepaid in the beginning - Outstanding in the beginning - Prepaid at the end
11.	Opening capital [Opening balance sheet]	Balancing figure
12.	Additional capital [Cash or bank account]	Balancing figure i.e., preparing cash/bank account summary is adequate.
13.	Drawings [Cash or bank account]	Balance figure i.e., Preparing cash/bank account summary is adequate
14.	Operating expenses [Cash or bank account]	Balancing figure i.e., preparing cash/book account summary is adequate.
15.	Income received [Cash or bank account]	Balancing figure: i.e, preparing cash/bank account summary is adequate.
16.	Load raised [Cash or bank account]	Balancing figure : i.e., preparing cash/bank account summary is adequate.

17.	Collection from debtors [Cash or bank a/c and creditors account]	Balancing figure + Total debtors account.
18.	Bills receivable collected [Cash or bank a/c and b/p a/c]	Balancing figure + Bills receivable account
19.	Bills receivable drawn [B/R a/c, total debtors a/c]	Balancing figure.
20.	Bills receivable dishonoured [B/R a/c, total debtors a/c]	Balancing figure
21.	Bills payable accepted [B/p a/c, total creditors a/c]	Balancing figure
22.	Bills payable discharged [B/p a/c cash or bank account]	Balancing figure + B/p a/c.
23.	Repayment of loan [Cash or bank account]	Balancing figure : i.e., preparing cash/bank account summary is adequate
24.	Payment to creditors [B/R a/c, cash or bank account]	Balancing figure + Total creditors account.
25.	Gross profit	$G.P = \text{Net sales} - \text{Cost of goods sold}$ (or) $\text{Net sales} \times \text{Rate of G.P} \div 100.$
26.	Cost of goods sold [Stock account]	$C.O.G.S = \text{Opening stock} + \text{Purchases} + \text{Direct expenses} - \text{Closing stock}$ (or) $\text{Net sales} - \text{Gross profit}$ (or) Preparing stock a/c and from balancing figure.
27.	Other items opening and closing balance [Respective accounts need to be prepared]	Balancing figure

Exercise Problems

1. Rectify the following errors:
 - (a) A purchase of Rs. 200 from Ram was omitted to be entered in the Purchase book.
 - (b) A credit sale of Rs. 527 to John was recorded as Rs. 725.
 - (c) A purchase of office furniture for Rs. 1,000 from Salwan Furniture was entered through Purchase Book.
 - (d) Rent paid to landlord Rs. 600 was debited to his personal account.
 - (e) Purchases Book was undercast by Rs. 200.

2. Give Journal Entries to rectify the following errors:
 - (i) An account of Rs. 4,000 spent for the extension of machinery has been debited to wages A/c.
 - (ii) Rs. 150 paid as cartage for the newly purchased furniture posted to cartage A/c.
 - (iii) A builder's bill for Rs. 6,000 for erection of a small cycle shed was debited to repairs A/c.
 - (iv) A cheque of Rs. 2,000 received from Ashok was dishonoured and had been posted to the debit side of 'Allowance A/c.'
 - (v) Rs. 1,000 paid for the newly purchased 'cooler' posted to 'purchase account.'

3. Make the necessary correcting entries and show the Suspense Account.
 - (i) The Purchases Book was undercast by Rs. 1,000.
 - (ii) The Sales Book was overcast by Rs. 50.
 - (iii) Rs. 20 received from Kiran were posted to the debit of his A/c.
 - (iv) The total of the credit of Ajay's A/c has been over added by Rs. 500.
 - (v) A discount of Rs. 18 allowed to a customer has been credited to his account as Rs. 81.
 - (vi) Goods for Rs. 1,000 returned to Sharma, though entered in the Return Book has been posted to his account.

4. From the following Trial Balance of Shri Ram, prepare Trading and Profit and Loss Account for the year ended 31st December, 2007 and a Balance Sheet as on that date:

Dr.

Cr.

Balances	Rs.	Balances	Rs.
Opening Stock	20,000	Sales	2,70,000
Purchases	80,000	Purchase Returns	4,000
Sales Return	6,000	Discount	5,200
Carriage Inwards	3,600	Sundry Creditors	25,000
Carriage Outwards	800	Bills Payable	1,800
Wages	42,000	Capital	75,000
Salaries	27,500		

Plant & Machinery	90,000		
Furniture	8,000		
Sundry Debtors	52,000		
Bills Receivable	2,500		
Cash in Hand	6,300		
Travelling Expenses	3,700		
Lighting (Factory)	1,400		
Rent & Taxes	7,200		
General Expenses	10,500		
Insurance	1,500		
Drawings	18,000		
Total	3,81,000	Total	3,81,000

Adjustments:

- (a) Stock on 31st December, 2007 was valued at Rs. 24,000 (Market value Rs. 30,000).
 (b) Wages outstanding for December, 2007 amounting to Rs. 3,000.
 (c) Salaries outstanding for December, 2007 amounted to Rs. 2,500.
 (d) Prepaid insurance amounted to Rs. 300.
 (e) Provide depreciation on plant and machinery at 5% and on furniture at 20%.

[Ans : Gross Profit Rs. 1,42,000, Net Profit Rs. 87,700, Balance Sheet Rs. 1,77,000]

5. Following is the trial balance of Mr. A as at 31st December, 2007:

Dr.		Cr.	
Balances	Rs.	Balances	Rs.
Mr. A's building	1,500	Capital Account	12,500
Purchase	4,000	Sales	28,020
Furniture	1,320	Returns outwards	800
Scooter	2,000		
Returns inward	1,150		
Stock on 1st January, 2007	16,900		
Bad debts	150		
Carriage inward	350		
General expenses	600		
Bad debts provision	350		
Bank loan	2,500		
Interest on bank loan	150		

Commission	450		
Insurance & Taxes	1,000		
Scooter expenses	1,300		
Salaries	2,200		
Cash in hand	1,000		
Debtors and creditors	1,500		4,000
	48,620		48,620

Prepare the final accounts for the year ending 31st December, 2007 taking into accounts the following adjustments:

- Closing stock 31-12-2007 was valued at Rs. 2,170.
- Commission include Rs. 150 being commission received in advance.
- Salaries have been paid for 11 months.
- Bank Loan has been taken at 10% p.a. interest.
- Depreciate building by 5% and Scooter by 15%.
- Write off Rs. 100 as further bad debts and maintain bad debts provision at 5% on debtors.
- Scooter is used for business as well as for private purposes equally.

[Ans : Gross Profit Rs. 8,590/-, Net Profit Rs. 3,120/-, Balance Sheet Rs. 21,700/-]

- From the following prepare Trading and Profit and Loss account for the year 2007 and Balance sheet as on 31st December, 2007:

	Dr. (Rs.)	Cr. (Rs.)
Building	25,000	–
Machinery	11,000	–
Furniture	5,000	–
Bank	4,500	–
Cash	5,500	–
Loan (since 1-1-2007)	–	15,000
Capital	–	26,000
Debtors/Creditors	25,000	20,000
Opening stock	6,000	–
Purchases>Returns	1,25,000	5,000
Sales>Returns	6,000	1,61,000
Rent	3,000	–
Establishment	3,000	–
P.F. deducted from salaries	–	500
Interest (10%)	1,000	–

Electricity	500	–
Phone	500	–
Commission	3,000	–
Insurance premium	500	–
Bad debts	1,000	–
Bills receivable	2,000	–
	2,27,500	2,27,500

Provide depreciation on building at 5% Machinery at 15% and furniture at 10%. Stock was not taken on 31-12-2007 but only on 7-1-2008. The transactions from 1-1-2008 to 7-1-2008 are sales Rs. 12,500, Purchase Rs. 7,500, stock on 7.1.2007 Rs. 9,000 and Gross Profit 20%. During the year machinery to the value of Rs. 5,000 was destroyed by Fire and insurance claim was settled Rs. 4,000 and credited to machinery account. Also provide for Employer's share of P. F. Rs. 500: provision for bad debts at 5%, commission to the Manager at 10% on net profit after providing the commission.

[Ans : Gross Profit Rs. 40,500/-, Net Profit Rs. 15,000/-, Balance Sheet Rs. 79,000/-, Closing Stock Rs. 23,000/-]

7. From the following trial balance prepare trading and profit and loss account and a balance sheet as on 31st December, 2007:

Dr.

Cr.

Balances	Rs.	Balances	Rs.
Purchases	90,000	Sales	1,77,000
Returns Inwards	2,250	Returns Outwards	3,100
Carriage on Purchases	1,300	Creditors	14,000
Carriage on sales	750	Interest on Investments	1,800
Stock 1.1.2007	16,100	Provision for Bad Debts	1,450
Cash	1,500	Commission Received	3,750
Building	75,000	Sales Tax Collected	3,000
Machinery	36,000	Accumulated Depreciation	10,000
Fuel and Power	4,250	A's Capital	60,000
Debtors	40,750	B's Capital	45,000
Investment	18,000		
Rent	2,000		
General expenses (including insurance premium of Rs. 1,000/- paid for one year ending 30th June 2007)	7,500		
Wages and Salaries	10,500		
Sales Tax Paid	2,200		
A's Drawings	5,000		
B's Drawings	6,000		
	3,19,100		3,19,000

Adjustments:

- (a) Write off Rs. 750 as bad debts and create a provision for doubtful debts @ 5% on debtors.
- (b) Provide 2% for discount on debtors and creditors.
- (c) Depreciate building by 5% and machinery by 10%.
- (d) Rent is payable at the rate of Rs. 200 per month.
- (e) One-third of the commission received is in respect of work to be done next year.
- (f) Interest on Drawings is to be provided as follows:
Interest on A's Drawings: Rs. 250/- and Interest on B's Drawings Rs. 300/-
- (g) Closing stock was valued at Rs. 28,350/-.

[Ans : Gross Profit Rs. 84,050/-, Net Profit Rs. 69,620/-, Balance Sheet Rs. 1,96,590/-]

Rahul Publications

Short Question and Answers

1. What is the difference between Journal and Ledger?

Ans :

S.No.	Nature	Journal	Ledger
1.	Meaning	Journal is a primary book wherein all the business transactions are recorded on a daily basis in a systematic manner.	Ledger is a book where the journalized transaction are being classified.
2.	Type of book	It is a book of primary record.	It is a book of final entry.
3.	Process	The process of recording transactions in a journal is called as 'Journalizing'.	The process of recording transactions in a ledger is called as posting.
4.	Organization of data	The organising of each of the data within journal is known as the transaction.	The organising of each of the data within ledger is known as the account.
5.	Nature	Journal is not balanced except for the cash book.	Every account in the ledger is balanced.
6.	Accuracy	It is very difficult to test the accuracy of the books.	The availability of lists of balances ensures easy accuracy testing.
7.	Narration	Narration is required for each entry.	Narration is not required.
8.	Record	It maintains the record in sequential manner.	It maintains the record in conclusive manner.
9.	Folio	It includes the ledger folio.	It includes the journal or sub-journal folio.
10.	Preparation of final accounts	It does not facilitate the preparation of final accounts.	It serves as a basis for the preparation of final accounts.
11.	Required information	It does not provide a ready information with relation to any accounts.	It enables easy availability of information with relation to any accounts, as the similar nature are recorded in a specific transactions of group.
12.	Recording transaction	The transactions debit and credit amount are recorded in two adjacent columns.	The transactions debit and credit amounts are recorded in two different sides of two different accounts.
13.	Appearance	Journal includes one debit column and one credit column.	Ledger includes two sides, the left side is known as the debit side and the right side is known as credit side.
14.	Importance	Computerization of accounting eliminates the importance of journal for recording routine transaction such as sales, purchases, etc.	Computerization of accounts cannot eliminate the importance of ledger. Ledger cannot be avoided as it is must.

2. Explain the features of Incomplete Records.

Ans :

Features

Following are the salient features of Incomplete records system,

1. Incomplete records system is suitable for sole trading concerns. Limited companies cannot use this systems due to legal requirements.
2. Only personal accounts are maintained in this system.
3. This system maintains one single cash book which comprises a mix-up of business and private transactions.

4. It does not have uniformity in maintaining the records. It may change from industry to industry as per the requirements of the firm.
5. In this system, systematic and scientific method of accounting/recording transactions are not accurate.
6. As the data is not recorded in subsidiary books and relevant information can only be stored in vouchers.
7. The determination of profit / loss is based on estimates. It does not show the true status of the firms, (i.e., Financial position of the firm).

3. What is journal?

Ans :

Meaning

A journal is known as a primary book of accounts or a book of original entry. With the increase in the size of business, the number of business transactions also increases. It is very difficult for a human-being to remember all those transactions. Therefore, to overcome this drawback, journal is prepared. Although, as stated above, the transactions can be recorded directly in the ledger. But such procedure will be cumbersome and confusing. Under this process, it will be very difficult to locate a transaction after several recordings. But in journal, the transactions can easily be located as it provides chronological record of transactions.

Definitions

- (i) **According to Carter says,** "The journal or daily record as originally used, is a book of prime entry in which transactions are copied in order of date from a memorandum or a waste book. The entries as they are copied, classified into debit and credit, so as to facilitate their being correctly posted afterwards in the ledger."
- (ii) **According to L.C. Cropper,** "A journal is a book employed to classify or sort out transactions in a form convenient for their subsequent entry in the ledger."
- (iii) **According to Roland,** "Journal means a day book, diary or a log book. It is called prime subsidiary book of double entry system."

4. Advantages of ledger.

Ans :

The main advantages of ledger are as follows:

1. Knowledge of Business Results

With the help of ledger the important information relating to business can easily be obtained as all the business transactions relating to an item are recorded in the form of separate accounts in the ledger in such a way as their effect on assets, liabilities and capital can easily be understood.

2. Knowledge of Incomes and Expenses

A separate account is opened for each item of income and expense. Thus, it enables to understand that what are the sources of income and where the amount is spent.

3. Helpful in Preparing Trial Balance

Ledger is also helpful in the preparation of trial balance. Without preparing the ledger, trial balance cannot be made.

5. Define trial balance.

Ans :

Meaning

Trial balance is a worksheet in which the balances of all ledgers are compiled into debit and credit columns. Under the double entry system, the total of debits must be equal to total of credits. This worksheet helps in evaluating whether or not the total debits for the period are equal to total number of credits generated for the same period.

Every businessman prepares the trial balance after journal and ledger. It is a tradition to prepare the trial balance before the preparation of the final accounts. It serves as a tool to detect errors. If the trial balance is balanced, it means there are no mathematical errors in the ledgers. However this does not mean that there are no errors in a company's accounting system. By preparing a trial balance on a regular basis makes it possible to quickly identify a specific accounting period where the imbalance took place and correct it quickly. Therefore many businessman choose to prepare a trial balance on monthly basis.

Definitions

- (i) **According to Carter**, "Trial Balance is a statement of debit and credit balances derived from the ledger, including cash and bank balances."
- (ii) **According to William Pickles**, "The statement prepared with the help of ledger balances, at the end of financial year or at any other date, to find out whether debit total agrees with credit total, is called a Trial Balance."
- (iii) **According to J. R. Battiboi**, "Trial Balance is a statement prepared with the help of debit and credit balances derived from the ledger, the objective of which is to check the arithmetical accuracy of the ledger."

6. Explain the advantages of trial balance.

Ans :

The trial balance has the following advantages:

1. It ensures that the transactions recorded in the books of accounts have identical debit and credit amount.
2. Balance of each ledger account has been computed correctly.
3. It helps in preparation of final accounts.
4. It makes the work of bookkeeping more active.
5. It summarises the business information.

7. What is Suspense Account?

Ans :

When a combination of the various errors mentioned above have been committed, the mismatch in the totals of the Trial Balance will be totally different for the amounts of the individual transactions and only through scrutiny and checking of the books of accounts will help in detecting the errors. Sometimes, when the Trial Balance disagrees and sufficient time is not available to scrutinize the books, the accountant will include 'Suspense A/c' in the Trial Balance to make it agree and proceed with the preparation of 'Profit and Loss A/c' and Balance Sheet. For instance, if the totals of the credits in a Trial Balance exceeds the debits by Rs. 2,550 then a suspense a/c with a debit balance of 2,550 will be included in the Trial Balance. At a later date, the books may be scrutinised to detect the errors and the rectification entries passed to clear the balance in the Suspense A/c.

8. Capital expenditure.*Ans :***Meaning**

It consists of expenditure the benefit of which is not fully consumed in one period but spread over several periods. It includes assets acquired for the purpose of earning and not for resale, improving and extending fixed assets, increasing the earning capacity of the business and raising capital for the business. Purchase of new plant, additions to the building, cost of removing the business to more spacious and better suited premises, brokerage and commission paid for procuring long term loans are few examples of such expenditure. Such expenses are taken to Balance Sheet and are determined by the fact whether:

- (i) The expenditure made is for the purpose of acquiring fixed assets and in placing the business in a position in which it can commence or continue operation;
- (ii) The expenditure results in some more or less long term benefit to the business;
- (iii) Expenditure increases the earning capacity of the business or reduces working expenses. Prima-facie it must be established whether the expenditure results in the acquisition of permanent asset and that the asset is to be used for the purpose of earning revenue. Suppose a permanent asset has been acquired for the business and that in addition to the cost of the asset, certain other expenditures were incurred on account of installation and erection etc., and travelling expenses for a trip abroad for the purchase of the asset. The cost of the asset is a capital expenditure, no doubt, but other expenditures are also capital as these are incurred direct in connection with the acquisition of a permanent asset.

9. What do you understand by Revenue expenditure?*Ans :***Meaning**

It consists of expenditure incurred in one period of account, the full benefit of which is consumed in that period. It includes purchasing assets required for resale at a profit or for being made into saleable goods, maintaining fixed assets in good working order, meeting the day-to-day expenses of carrying on business. Cost of goods, raw materials and stores, replacements, renewals, repairs, depreciation of the fixed assets, rent, rates and taxes, wages and salaries, carriage, insurance and other trade expenses are few examples of such expenditures. Such items appear in the Trading and Profit and Loss Account and may be determined from the test as to whether the expenditure made is incurred for the maintenance of the earning capacity or for the upkeep of fixed asset in an efficient condition.

Examples

1. Cost of purchases and carriage paid on
2. Cost of manufacture, Wages paid to labourers, Fuel etc.
3. Expenditure incurred in the normal course of business.
 - (a) **Office and Administration:** Salaries, Rent and Rates, Insurance, Postage, printing and Stationery etc.
 - (b) **Selling expenses:** Salaries of salesmen, advertisements etc.

10. Under what conditions, Revenue expenditure becomes capital expenditure.

Ans :

Following are some of the examples of revenue expenditure becoming capital expenditure:

1. Repairs

They are usually a revenue charge, but if we purchase a second hand plant and pay for immediate repairs necessary to make it efficient for our purpose, then such repairs become capital expenditure and must be added to the plant as part of its cost.

2. Wages

They are revenue item, but the wages paid to workmen to erect and fit some new machinery, the firm has bought, must be considered as an addition to the cost of the machinery. Similarly wages of workmen employed in the construction of any fixed asset are capital expenditure and must be treated as part of the cost of the asset.

3. Legal Expenses

They are revenue charge, but the legal expenses incurred in connection with the purchase of fixed asset must be treated as a part of the cost of the asset.

4. Transport Expenses

They are usually a revenue charge but payment made for transporting any plant and machinery is added on as part of the cost of plant and machinery.

5. Interest on Capital

Such interest, if paid, during the construction of works or buildings or plant may be capitalised.

6. Raw Materials and Stores

They are usually a revenue charge but if consumed in making of a fixed asset, must be treated as a part of the cost of the asset.

7. Carriage and Freight

Such expenses in connection with the acquisition of a fixed asset are capital expenditure.

11. What are the possible reasons for keeping incomplete records?

Ans :

The incompleteness of Accounting records could be due to the following reasons,

1. The business persons may not maintain proper accounts intentionally so as to avoid taxation.
2. Damage of account books due to flood or fire etc.
3. The business person may be unaware of the separate legal entity assumptions.
4. The business persons may not be aware of double entry accounting principles.

Choose the Correct Answers

1. The balance of cash book indicates The balance of cash book indicates. [a]
(a) Cash in hand
(b) Cash at bank
(c) Net profit
(d) Only the difference between creditor and debtor.
2. All the transactions relating to a particular account and collected at one place in a book is called _____. [b]
(a) Journal (b) Ledger account
(c) Single entry (d) Suspense account
3. Trial balance is prepared to find out _____. [c]
(a) Profit or loss (b) Financial position
(c) Arithmetical accuracy of accounts (d) None
4. Trial balance can be prepared on _____. [b]
(a) The end of accounting period (b) Any date
(c) Direction by the statutory provisions (d) None
5. The process of transferring the transactions relating to changes in a particular item at one place in the form of account is called _____. [b]
(a) Balancing (b) Posting
(c) Journalizing (d) None
6. Real account deals with _____. [d]
(a) Cash (b) Fixed assets
(c) Intangible assets (d) All
7. Ledger is prepared after preparing. [d]
(a) Income statement (b) Financial statement
(c) Balance sheet (d) Journal
8. The difference in the trail balance is known as _____. [d]
(a) Drawings (b) Loss
(c) Profit (d) Suspense account
9. The amount withdrawn for personal use. [d]
(a) Income for the business (b) Gain for the business
(c) Loss for the business (d) Drawings from the business
10. Ledger is prepared after preparing. [d]
(a) Income statement (b) Financial statement
(c) Balance sheet (d) Journal

Fill in the Blanks

1. A daily record in which all daily transactions are first recorded chronologically is referred to as _____.
2. The two aspects of each business transaction are depicted in terms of _____.
3. Trail balance is prepared as per the rules of _____.
4. _____ is a statement prepared with the debit and credit balance of ledger accounts.
5. Accounting has _____ branches.
6. LF stands for _____.
7. The fundamental principle of the double-entry system is that every _____ has a corresponding _____.
8. When a transaction is completely or partly omitted from the books of accounts such error is known as _____.
9. Preparation of _____ is the first stage in final accounts.
10. After trading account, the second stage of the preparation of final account is the preparation of _____.

ANSWERS

1. Journal book
2. Debit and credit.
3. Double entry system
4. Trial balance
5. Three
6. Ledger folio
7. Debit, Credit
8. Error of Omission
9. Trading account
10. Profit & Loss account

One Mark Question & Answers

1. Journal.

Ans :

A journal is known as a primary book of accounts or a book of original entry.

2. Ledger.

Ans :

Ledger is a book where the journalized transactions are being classified. Ledger is a set of accounts and includes all the accounts of business i.e., personal, nominal or real.

3. Trial Balance.

Ans :

Trial balance is a worksheet in which the balances of all ledgers are compiled into debit and credit columns. Under the double entry system, the total of debits must be equal to total of credits.

4. Error of Principle.

Ans :

Transactions are recorded as per generally accepted accounting principles. If any of these principles are violated or ignored, errors resulting from such violation are known as errors of principle.

5. Closing Stock.

Ans :

The unsold stock at the end of the year is known as closing stock.

6. Assets.

Ans :

Assets are property and possession of a business. Stock, land, buildings, books debts, cash, bills receivable are some examples of assets.

UNIT III

Valuation Models: Valuation of Assets, Tangible vs. Intangible Assets. Inventory Valuation: Methods of Inventory Valuation and Valuation of Goodwill, Methods of Valuation of Goodwill. Depreciation, Methods of Depreciation, their Impact on Measurement of Business Accounting.

3.1 VALUATION MODELS

3.1.1 Valuation of Assets

Q1. Define Asset. Explain the characteristics of asset.

Ans :

Meaning

According to the institute of chartered accountants of India, the term assets refers to "tangible objects or intangible rights owned by an enterprise and carrying probable future benefits".

Definitions

Some more definitions of assets are as,

- (i) **According to the Financial Accounting Standard Board, U.S.A,** "Assets are probable future economic benefits obtained or controlled by a particular equity as a result of past transactions or events".
- (ii) **According to Accounting Principles Board, Statement No. 4,** "Economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles including certain deferred charges".

"An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed). The beneficial interest which is legally or equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs".

In general, asset is that which entitles the future economic benefit. The things that come in to light when discussed about assets are fixed assets or long term tangible assets.

Assets are further classified into two categories. They are as follows,

(i) Tangible Assets

Tangible assets are those which are physical, materialistic and visual substances of a firm. For instance: Land, Building, Plant and machinery, Vehicles, Inventory' and so on.

According to the definition of IAS-16, tangible assets are meant for production / supply of goods and services or for usage by others for rent or for other administrative purposes for more than one period.

(ii) Intangible Assets

Intangible assets like physical substance or non-physical, non-materialistic substances and are not visible.

Example: Intellectual property such as trademarks, patents, copyrights, goodwill, franchises etc., are intangible assets.

Characteristics

Assets must have the following characteristics,

1. It represents a specific right to future benefits or service potentials.
2. The expired rights or services cannot be termed as assets.
3. It can be tangible or intangible.

4. The assets are the rights which are acquired by specific person or an entity over a period of time.
5. Asset can be economic resources of an organization which are recognized as per the rules of generally accepted accounting principles.
6. Services taken over by some other individuals or firms or by the government without compensation is not considered as an asset.
7. The economic benefits must be the consequence of past transactions.

Q2. Define fixed assets. Explain the nature of fixed assets.

Ans :

Meaning

Fixed Assets also referred to as PPE (Property, Plant, and Equipment), or tangible assets. These are purchased for continued and long-term use for earning profit in a business. This group includes land, building, machinery, furniture, tools, and certain wasting resources, e.g., timberland and minerals. They are written off against profits over their anticipated life by charging depreciation expenses (with exception of land). Accumulated depreciation is shown in the face of the balance sheet or in the notes. Fixed assets are also called Capital assets.

In an accounting term, fixed assets are defined as those tangible properties which are used in the operation of a business such as buildings, machinery, fixtures, furniture and equipment. It does not include items which are normally consumed in the course of business operation or production.

Fixed assets often comprise a significant portion of the total assets of an enterprise, and therefore, are important in the presentation of financial position. Furthermore, the determination of whether expenditure represents an asset or an expense can have a material effect on an enterprise's reported results of operations.

Definition

According to Accounting Standard 10, "Fixed asset is an asset held with the intention of

being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business".

Fair market value is the price that would be agreed in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown as net of accumulated depreciation, it is termed as net book value.

Nature

These assets are held with the intention of being used on continuous basis for the purpose of producing or providing goods or services and are not held for resale in the normal course of business.

Thus, the following are the characteristics of fixed assets:

1. They are acquired for relatively long period for carrying on business of the enterprise.
2. They are not intended for resale in the ordinary course of business.

Q3. Explain the various modes of valuation of fixed assets.

Ans :

While valuing the fixed assets, the following accounting concepts are important:

1. The fixed assets are meant for carrying on the operations of the business either by way of manufacturing the products or generating supporting services, e.g., for transporting employees or goods or products purchased or sold by the company.

They are not meant for resale and hence while valuing them the "going concern" concept of accounting is quite relevant. According to this concept, it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future.

Since the fixed assets are not meant for resale and hence it will be appropriate to value the assets at cost rather than their estimated realizable value in the event of the liquidation of the business.

2. A closely related accounting concept to the "Going Concern" concept is the "Cost Concept" of accounting. According to this concept, an asset is ordinarily entered in the accounting records at the price paid to acquire it and this cost is the basis for all accounting for the same. On account of this concept the fixed asset should be valued at cost and subsequent increase or decrease in their market values should not be taken into account. The only exception to the statement is the diminution in the value of the fixed asset on account of depreciation. Thus, the fixed assets are to be shown at cost less appropriate depreciation. The 'cost concept' has the advantage of bringing objectivity in accounting. In the absence of this concept the valuation of the fixed assets would have been influenced by the personal bias or judgment of the accountant causing distortions in the financial statements of the firm.

Q4. What are the differences between fixed assets and current assets.

Ans :

S.No.	Basis of Differences	Fixed Assets	Current Assets
1.	Valuation	Fixed assets are valued at cost less depreciation.	These assets are valued at cost or market price whichever is lower.
2.	Subject to Change	These assets are usually not subject to change.	These assets are usually subject to change.
3.	Pledge	These assets cannot be pledged.	These assets can be pledged.
4.	Fixed vs. Floating Charge	Fixed charge can be created on these assets.	Floating charge can be created on these assets.
5.	Nature of Profit on Sale	Profit on sale of these assets is of capital nature.	Profit on sale of these assets is of revenue nature.
6.	Revaluation Reserve in Case of Appreciation in the Value.	In case of appreciation in the value of such assets, revaluation reserve can be created.	In case of appreciation in the value of such assets, revaluation reserve cannot be created.
7.	Source of Finance	These assets are financed out of long-term funds.	These assets are mainly financed out of short-term funds.

Q5. How do you revalue fixed asset?

Ans :

Sometimes the historical costs of financial statements can be replaced by the fixed assets costs. These revalued amounts will form basis for the calculation of depreciation on these assets. The guidelines for the revaluation accounting are,

1. The book value of different categories of fixed assets can be determined based on different valuation criteria. The valuation methods include indexation with price indices and reference to current prices. The revalued fixed assets should be continuously assessed using appraisal by competent valuer method.

2. Net book value should be equal to net revalued amount. For which, firms need to restate the gross book value and accumulated depreciation along with the revalued fixed asset value.
3. Firm should revalue the whole class/category of assets in a systematic way.
4. If the net book value is higher than the recoverable amount of assets of a class then the revaluation of fixed assets of that class does not yield their net book value.
5. The rise in the net book value as a result of revaluation should be credited under revaluation reserves and it is not meant for allocation.
6. The increased value can be credited under profit and loss account if it offsets the previous decline in net book value due to revaluation. Similarly, the decline in the net book value as a result of revaluation should be debited under profit and loss account.

3.1.2 Tangible vs. Intangible Assets

Q6. Define tangible assets. Explain the characteristics of tangible assets.

Ans : (Nov.-20)

Meaning

Tangible assets are different from intangible assets which would include copyright, trademarks and goodwill of a firm. It is also different from natural resources such as timberland, coal deposits and oil reserves.

Tangible assets depreciate over the lifespan whereas intangible assets are amortized.

Tangible assets to be valued fall into two categories: physical and financial.

1. **Physical tangible assets** are those with true physical substance such as furniture, fixtures, equipment, and premises.
2. **Financial tangible assets** are those that involve a clear legal claim on future income or underlying assets, such as loans and investments.

Tangible assets can be defined as those assets that have a physical form such as buildings, machinery and land. Tangible assets would also include cash, accounts receivable property, inventory, plant and equipment of the firm. Tangible assets are accounted after deducting depreciation. Tangible assets are those whose value is dependent on particular physical characteristics. Tangible assets are also known as real assets.

Tangible assets are shown on the balance sheet and typically described as "Plant, Property and Equipment" or "Fixed Assets". The accounting elements are in three parts: the original cost of the property, the depreciation of amortization reserves, and the amount of "net plant." The original cost of property is self-explanatory, although one should be aware that the capitalization policy of companies may vary.

Characteristics

The following are some of the prominent features of the tangible fixed assets:

1. Tangible fixed assets are a valid ground for tax deductions as these assets are subject to heavy depreciation or amortization.
2. The monetary value of these assets is such that they do not get depleted within a time span of few years. According to most of the accounting standards, fixed assets should have a minimum life span of at least 12 months.
3. Tangible fixed assets have a comparatively high resale value.
4. A tangible fixed asset can be easily used as collateral to obtain secured loans.

Q7. Define Intangible assets. Explain the characteristics of intangible assets.

Ans : (Nov.-20)

Meaning

Intangible assets are identifiable non-monetary assets that cannot be seen, touched or physically measured, which are created through time and/or effort and that are identifiable as a separate asset. There are two primary forms of intangibles:

- (i) **Legal intangibles** such as trade secrets (e.g., customer lists), copyrights, patents, trademarks, and goodwill. Legal intangibles generate legal property rights defensible in a court of law.
- (ii) **Competitive intangibles** such as knowledge activities (know-how, knowledge), collaboration activities, leverage activities, and structural activities. Competitive intangibles, whilst legally non-ownable, directly impact effectiveness, productivity, wastage, and opportunity costs within an organization - and therefore costs, revenues, customer service, satisfaction, market value, and share price. Human capital is the primary source of competitive intangibles for organizations today.

Characteristics of Intangible Assets

1. Intangible assets are non-scarce.
2. Intangibles increase in value when used.
3. Intangibles have strong network effects.
4. Intangibles create future value. All intangibles are future oriented.
5. Intangible has no physical substance.
6. They convey a right or privilege.
7. They are relatively long-lived assets.
8. They are non-monetary assets.

Q8. Distinguish between tangible assets and Intangible Assets.

Ans :

Sl. No.	Basis of Difference	Tangible Assets	Intangible Assets
1)	Meaning	Assets that one can touch, hold or feel typically called fixed assets in accounting literature, tangible assets are the physical things that a business uses in the production of goods and services.	Intangible assets have no physical existence rather they represent legal rights or economic benefits, These assets are created through time and effort and that are identifiable as a separate asset,
2)	Classification	Tangible assets are classified into physical tangible assets and financial tangible assets.	Intangible assets are classified into legal intangibles and competitive intangibles assets.
3)	Valuation	The values of tangible assets are in three parts: the original cost of the property, the depreciation or amortization reserves, and the net amount.	Cost includes all costs of acquisition and expenditures necessary to make the intangible asset ready for its intended use. These costs are normally purchase price, legal fees, and other costs incurred in obtaining the asset.
4)	Accounting Standard	Accounting Standard 10 (AS 10) is for accounting for tangible assets.	Accounting Standard 26 (AS 26) is for accounting for intangible assets.
5)	Acceptance in Security	Lenders accept such assets as security for a loan given.	Lenders usually do not accept such assets as security for a loan given.
6)	Depreciation or Amortization	Tangible assets depreciate over the lifespan.	Intangible assets are amortized,

7)	Risk of Loss due to Fire	The assets may be lost due to fire.	These assets cannot be lost due to fire.
8)	Fixed vs. Current	Tangible assets can be fixed or current asset.	Intangible assets usually fall in the category of fixed assets.
9)	Risk of Loss due to Fire	These assets may be lost due to fire.	These assets cannot be lost due to fire,
10)	Example	Example of tangible assets are land, building, plant, and machinery, furniture and fittings, motor vans, etc.	Example of Intangible Assets are patents, trademarks, trade name, goodwill brand, copyrights, design, etc.

3.2 INVENTORY VALUATION

Q9. Define inventory state the objectives of inventory.

Ans. :

(Dec.-18)

Meaning

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

Inventory forms a significant portion of the total assets of many enterprises and a lot of working capital is invested in this item. Inventories generally constitute the second largest item after fixed assets in the financial statements, particularly of manufacturing concerns. This is why valuation of inventories has assumed significance in recent years.

The values attached to inventories can materially affect the operating results as shown by trading and profit and loss account and the financial position of a business, because closing inventory (stock in trade) is shown on the credit side of the trading account and this amount is also shown as current asset in the balance sheet. The closing inventory becomes the opening inventory in the next accounting period and shown on the debit side of trading account.

Thus, the valuation of inventories does affect the operating results not only of the current accounting period but also of the subsequent period. Inventory valuation is purely subjective depending upon the policies and the different bases of valuing inventories used by different business and even by different undertakings with in the same trade or industry.

According to Accounting Standards-2(AS-2), inventories mean tangible property held,

- (i) For sale.
- (ii) In the process of production for sale.
- (iii) For computing in the production of goods or services for sale.

Inventories are normally classified in the financial statements as current assets as under,

- (a) Raw materials and components
- (b) Work-in-progress
- (c) Finished goods
- (d) Stores and spares.

Objectives

The main objectives of inventory control are listed below :

1. No understocking

Understocking leads to materials running out of stock at some time or the other. Shortages of materials may arise at the time when they are urgently needed and production then be delayed. Delay or stoppage in production due to non-availability of materials is very costly as it may result in loss of profits. Material control system ensures that there is no shortage of materials.

2. No overstocking

Investment in materials must be kept as low as possible, considering the production requirements and the financial resources of the business. Overstocking of materials unnecessarily locks up capital and causes high storage costs, thus, adversely affecting the profits.

3. Minimum wastage

Proper storage conditions must be provided to different types of materials. Losses of materials may occur due to deterioration, obsolescence, theft, evaporation, etc. All efforts should be made to keep these losses at the minimum.

4. Economy in purchasing

The purchasing of material is a highly specialised function. By purchasing materials at the most favourable prices, the efficient purchaser is able to make a valuable contribution to the success of a business.

5. Proper quality of materials

While purchasing materials, due consideration should also be given to the quality. It is no use purchasing materials of inferior quality or of very superior quality. For each type of product there is a particular quality of materials which is needed and that quality alone should be purchased.

6. Information about materials

Not only that materials should be available as and when required, but also there should be a system to give complete and up-to-date accounting information about the stock of materials. Sometimes inadequate information about the availability of materials may cause new purchases be made of materials already in stock.

7. Material reports to management

The material control system should be so designed so as to serve the purpose of accurate and up - to - date reports to management about purchase, consumption and stocks of materials.

Q10. Explain the Elements of Inventory.

Ans :

1. Raw Material

It includes direct material used in the manufacture of a product. The purpose of holding raw material is to ensure uninterrupted production in the event of delaying delivery. The amount of raw materials to be kept by a firm depends on various factors such as speed with which raw materials are to be ordered and procured and uncertainty in the supply of these raw materials.

(i) Direct Material: Direct material is the primary classification for raw materials in manufacturing operations. It is directly related to the final product. It is only the material that, after manufacturing processes are applied, ships out to a distributor or the final customer. If, for e.g., company manufacture hammers, then steel would be its primary direct material.

(ii) Indirect Material: Indirect material is the class of materials in the manufacturing process that does not actually ship to the customer as part of the final product. For example, the gas used to heat the furnaces that melt the

steel in the manufacture of hammers, is an indirect material. Similarly, the water that cools the metal is also an indirect material.

2. Work-in-Progress

It includes partly finished goods and materials held between manufacturing stages. It can also be stated that those raw materials which are used in production process but are not finally converted into final product are work-in-progress.

3. Consumable

Consumables are products that consumers buy recurrently, i.e., items which "get used-up" or discarded. For example, consumable office supplies are such products as paper, pens, file folders, post-it notes, computer disks, and toner or ink cartridges. Not included capital goods such as computers, fax machines, and other business machines or office furniture.

4. Finished Goods

The goods ready for sale or distribution comes under this class. It helps to reduce the risk associated with stoppage in output on account of strikes, breakdowns, shortage of material, etc.

5. Stores and Spares

This category includes those products, which are accessories to the main products produced for the purpose of sale. For example, stores and spares items are bolts, nuts, clamps, screws, etc. These spare parts are usually bought from outside or some times they are manufactured in the company also.

Q11. Explain the Importance Inventory Valuation.

Ans : (Jan.-20)

The balance sheet of a concern must show true and fair view of the financial position of the concern. For this purpose asset including inventory should be properly valued to exhibit a true fair view. True profits cannot be calculated unless assets are properly valued. Only then, balance sheet will

exhibit a true and fair view of the financial affairs of the business. The following are some of the important reasons for emphasis of inventory valuation.

- (i) Sufficient inventory for production sale Process. All manufacturing and trading concerns, inventory represents a major current asset investment. Adequate inventory is essential for the production sale process of an enterprise an insufficient inventory hampers production and fails to generate sufficient sales. Inventory represents type of business insurance which assures a business unit that it will not have to close down due to shortage of saleable goods.
- (ii) Proper determination of profits. The proper determination of profit depends upon the proper valuation. If the ending inventory is values at a lower figure, profit is understood and if it is overvalued, profit is overstated. This shows that proper method of valuation of inventory should be followed.
- (iii) True financial positions. Overvaluation of inventory amounts to window dressing which in turn gives wrong idea about the liquid position of the company.

3.3 METHODS OF INVENTORY VALUATION

Q12. Explain various methods of Inventory Valuation.

(OR)

Discuss various methods of Inventory Valuation with their relative merits and demerits.

Ans : (Nov.-21, Jan.-20)

The methods of inventory valuation are divided into four types :

1. First In First Out (FIFO)
2. Last In First Out (LIFO)
3. Highest in, first out (HIFO)
4. Average Cost Method

1. First In First Out (FIFO)

The FIFO assumption of cost flow is recognised intuitively as being generally consistent with the physical flow of products and goods in most merchandising operations. This method follows the principle that goods received first are sold first. After the first lot or batch of goods purchased is exhausted, the next lot is taken up for sale. It does not suggest, however, that the same lot will be sold.

Sometimes, all items are tagged with their arrival date and sold in date order specially with stocks that deteriorate. The inventory is priced at latest stock.

Arguments in Favour of FIFO:

- The FIFO method depends on the assumption that it is a good inventory management to sell or use the oldest goods first and maintain a current inventory representing the most recent purchases. It has the advantage that management has little or no control over the selection of units in order to influence recorded profits.
- It also has the advantage of not being influenced by the arbitrary choices of customers.
- As a result, it provides a more consistent and systematic determination of inventory and cost of goods sold. It also permits better comparison among different firms in the same industry and among several years.
- Another benefit of FIFO is that it combines all elements of profit reported at the time of sale.
- Under FIFO, no separation can be made of gains and losses arising from price changes and income resulting from managerial decisions in the course of normal operations.
- With the FIFO method, the inventory is valued at costs that most closely represent the current cost. However, cost of goods sold is matched with costs that date back in time. If the prices of goods are rising rapidly, the cost of goods sold may be understated.

- If the sales price is fixed, then sale revenue may not produce enough income to cover the purchase of goods.
- The valuation of inventory in terms of current costs depend on the frequency of price changes and the stock turnover. In case stocks turn over rapidly, the inventory valuations will reflect current prices. But it is argued that the inventory valuations will hardly be identical with replacement costs under FIFO except accidentally or under unusual conditions of stable prices from the date of acquisition of the ending inventory to the date of the balance sheet.
- The objectives of matching current cost with current revenues is not achieved under the FIFO method. There are other limitations under the FIFO method.
- FIFO costing is improper if many lots of goods are purchased during the period at different prices. This method overstates profit especially with high inflation. It does not consider the cost of replacing used goods, a situation created by high inflation.
- The FIFO method is suitable where
 - (i) the size and cost of units are large
 - (ii) goods are easily identified as belonging to a particular purchased lot
 - (iii) not more than two or three different receipts of the goods are on hand at one time.

2. Last In First Out (LIFO)

Under LIFO, latest stocks of goods flow into costs of goods sold and oldest stocks are included in stocks of inventories. This method is based on the assumption that cost of goods sold is charged at prices which almost correspond to the replacement cost of the goods. The main objective in LIFO is the matching of current cost against current revenues, resulting in an operating income which excludes gain and loss from the holding of inventories.

In LIFO, a distinction is often made between natural LIFO where cost flows demonstrably reflect physical flows, and artificial LIFO where cost flows demonstrably contradict physical flows. In fact, there is no necessary connection between physical flows and inventory valuation and the relation of one to the other is simply a convenient assumption. The actual flow of goods will more commonly follow the FIFO concept.

Advantages

1. It is a cost method that prices goods sold in a systematic and realistic manner. It provides a better matching of current costs with current revenues.
2. It results in real income in time to rising prices by maintaining net income at a lower level than other costing methods.
3. In industries subject to sharp price fluctuations for goods, the method minimises unrealised inventory gains and losses and tends to stabilise reported operating profits. Income is reported only when it is available for distributions as dividends or for other purposes.
4. Probably the most important argument in favour of LIFO is its role in tax saving. It is generally considered a cheap form of tax avoidance by business firms. By valuing inventory at beginning-of-period price and calculating cost of sales at the prices of the period, the firm creates secret reserves which are not taxed. As long as prices and inventory levels do not decline, this benefit remains, and in this case the tax saving will be eliminated by higher tax rates.
5. LIFO produces an income statement which shows correct profit or losses and financial position. It correlates current cost and sales and income statements show the result of operation, excluding profits or losses due to changing price levels.

Disadvantages

1. The valuation of inventory for balance sheet purposes is out-of-date, as it reflects

prices of some past period. Inventory valuations do not reflect the current prices, and therefore, are useless in the context of current conditions.

2. The argument that LIFO should be used for matching current costs with current revenue, is not sound. The recent purchase costs are matched against the revenue of the current period. However, unless both purchases and sales occur regularly in even quantities, the revenue will not be matched with the current costs at the time of sale. When purchases are irregular and unrelated to the timing of sales, the matching is illogical and unsystematic particularly if prices and costs are changing rapidly.
3. The profit of a firm can be manipulated with the LIFO method in operation. By timing purchases, a company can cause higher or lower costs to flow into the income statement, thus increasing or decreasing reported net income at will.
4. Another limitation which also results from LIFO's lowering of the earnings figure is the effect it will have on existing bonus and profit sharing plans. Employees and managers who are interested in the growth of these plans may have difficulty in understanding a drop in benefits created wholly, or partially, by an accounting change.

3. Highest In First Out (HIFO)

Under this method, the highest priced materials are treated as being issued first. The closing inventory is kept at the lowest possible price. It is undervalued in times of rising prices and thus secret reserves are created. But the highest cost of materials is recovered first from production and closing inventory figure always remains at the minimum.

Advantages

Some of the advantages of HIFO are as follows,

1. It is beneficial when materials are in shortage.

2. It is suitable for valuing inventory in a fluctuating market.

Disadvantages

The following are some of the disadvantages of FIFO,

1. It is not accepted by accounting authorities as it violates basic accounting principles.
2. This method involves too many calculations.

4. Average Cost Method

When goods have been purchased from time to time and are mixed up on such a manner that individual units purchased cannot be identified, then an average of the prices at which the different lots were purchased is taken for the purposes of valuation of unsold stock. Liquid materials purchased at different timings and stored is the best example where average cost method can be applied. The average should be 'weighted average' by taking into consideration the quantity and cost. Weighted average prices is calculated by dividing the total cost of material by total quality. The method operates under the assumption that identity of the materials, is lost and their cost would reflect the average of the total supply.

The principle on which the average cost method is based is that all of the materials in store are so mixed up that an issue cannot be made from any particular lot of purchases and, therefore, it is proper if the materials are issued at the average cost of materials in store. Average may be of two types,

- (i) Simple average price
- (ii) Weighted average price.

- (i) **Simple Average Price:** "A price which is calculated by dividing the total of the price of the materials in the stock from which the material to be priced could be drawn by the number of the prices used in that total (C.I.M.A)".

Simple average price is calculated by dividing the total of unit purchase price of different lots in stock on the date of issue by the number of prices used in

the calculation and quantity of different lots is ignored. This method may lead to over recovery or under recovery of cost of materials from production because quantity purchased in each lot is ignored.

Advantages

Some of the advantages of simple average price method are as follows,

1. It is simple and easy to understand.
2. It can be applied when values of stock are not high.

Disadvantages

The following are some of the disadvantages of simple average price method,

1. It does not consider quantity of materials.
2. It does not show realistic product cost.

- (ii) **Weighted Average Price:** "A price which is calculated by dividing the total cost of materials in the stock from which the materials to be priced could be drawn by the total quantity of materials in that stock."

The weighted average price takes into account the price and quantity of the materials in store.

In periods of heavy fluctuations in the prices of materials, the average cost method gives better results because it tends to smooth out fluctuations in prices by taking the average of prices of various lots in stock.

Advantages

Some of the advantages of weighted average price method are as follows,

1. Issues and Inventory are not affected by changes in prices.
2. In this method, the closing stock is ascertained as per the accounting principles.

Disadvantages

The following are some of the disadvantages of weighted average price method,

1. The actual purchase price is not reflected by calculated issue price.
2. It involves heavy clerical work.

Q13. Discuss the meaning and accounting treatment of various kinds of material losses.

Ans :

1. Waste

Waste is the portion of basic raw material lost in processing, having no recoverable value. Waste may occur due to evaporation, breaking the bulk, loading and unloading, leakage, inefficient handling, fire, etc. It may be visible or invisible, for example, gases, dust, and smoke and unsaleable residues. The effect of waste is to increase the unit cost of production, since the total cost is spread over a smaller number of good units.

Accounting Treatment: The accounting treatment of waste depends upon whether the waste is normal or abnormal.

For normal waste arising from breakage, evaporation, deterioration, shrinkage in production, the total cost incurred is distributed over the good output. The treatment is based on the principle that normal losses should be borne by good output.

Abnormal wastage of material arising due to abnormal reasons, i.e. theft, fire, careless handling, etc., is not added to the cost of production but is transferred to costing profit and loss account. This is necessary to avoid any fluctuation in cost of production.

Control of Waste: In order to control waste in manufacturing industries, a waste report is prepared at regular intervals. The actual percentage of waste is compared with the standard percentage and remedial measures are taken to remove any abnormal waste.

2. Scrap

Scrap is defined as the incidental residue from certain types of manufacture usually of small amount

and low value recoverable without further processing. Example of scrap are available in operations like turning, boring, punching, shaving, moulding, etc.

There are three types of scraps, namely-

- (a) Legitimate scrap, i.e. scrap which is predetermined and arises due to the nature of operations like turning, boring, punching, etc.
- (b) Administrative scrap, i.e. scrap which arises due to administrative action such as change in the method of production,
- (c) Defective scrap, i.e. scrap which arises because of the use of inferior quality of material or bad workmanship or defective machine.

There is difference between waste and scrap. Waste cannot be realised whereas scrap can be realised. Scrap is always visible whereas waste may or may not be visible.

Accounting of Scrap

The usual methods for accounting of scrap are as follows:

- (i) The sale value of scrap is credited to profit and loss account as other income. The unit cost of production is, therefore, inclusive of cost of scrap. This method fails to secure effective control over scrap as detailed records are not kept and scraps are not identified to jobs or processes.
- (ii) From the sale proceeds of scrap selling and distribution costs are deducted and the net value is deducted from material cost or factory overhead. The effect of this method is to reduce material cost or overhead recovery rate. This method fails to secure effective control of scraps arising in processes or jobs. It is suitable in cases where several production orders are taken in hand and it is not possible to segregate the value of scrap for each order.

- (iii) The value realised from sale of scrap is credited to particular job, process or operation. This method has an advantage of identifying scrap with each operation, process or job.

Control over Scrap

Control over scrap is possible by:

- (i) Setting standards for scrap,
- (ii) Determining the responsibility for scrap,
- (iii) Keeping up proper records of scrap in the form of scrap reports.

3. Spoilage

Spoilage consists of goods that do not meet production standards and are either sold for their salvage value or discarded without further processing. Spoilage cost is the difference between costs incurred up to the point of rejection less the disposal or salvage value. When spoiled goods are discovered, they are taken out of production and no further work is performed on them.

Accounting

- (i) If spoilage is caused by an order's exacting specifications, the spoilage cost as reduced by the recovery or sales value of the spoiled units should be charged directly to that order.
- (ii) If some spoilage is normal in the manufacturing process, the cost of such spoilage will be borne by good units.
- (iii) In case of abnormal spoilage, cost of spoilage is transferred to costing profit and loss account.

Control

For effective cost control, normal spoilage rates should be established for each department and for each type or class of material. Weekly or monthly spoilage reports should be reviewed by the inspector. The actual spoilage is compared with the standard or normal spoilage and steps are taken to remove any abnormal spoilage.

4. Defectives

Goods that do not meet production standards and must be processed further in order to be saleable

as good units are known as defectives. Defective work can be corrected to meet specified standards with additional materials, labour and overhead. Defectives may arise due to substandard materials, poor workmanship, bad supervision and careless inspection.

The additional cost of rectifying the defectives is added to the total cost and the quantity of defectives rectified is added to the quantity of good output because defective units rectified can be sold as 'first' or 'seconds'. The main difference between spoilage and defectives is that spoilages are sold without further processing, whereas defectives are rectified by additional expenditure and sold as 'first' or 'seconds'.

Accounting

- (i) If the defective units are clearly identified with a numbered job order and the defects are peculiar to the job, the cost to complete the defective units can be charged to the job.
- (ii) If defective units occur irregularly, the cost of rectification is properly charged to factory overhead.
- (iii) If the defective production is due to abnormal reasons, the rectification cost is transferred to costing profit and loss account.

Control

On the receipt of defective work report, a decision is taken whether to rectify or not to rectify the work. All costs of rectification are collected against the rectification work order. Adequate steps should be taken to see that defective work remains within standard limits.

Q14. What are the factors do you consider while deciding the pricing methods of materials?

Ans : (July-18)

Following are the factors to be considered while deciding the pricing methods for materials. They are,

1. Nature of materials.
2. Method of stock valuation and stock turnover rate.

3. Efficiency of clerical staff and storage conditions.
4. Price fluctuations and costing system.
5. Nature and size of business.
6. Frequency of purchases and issues.
7. Management policy.
8. Purpose: contract, quotation, tender etc.
9. Percentage cost of raw materials to total cost of products.
10. Variation in cost.
11. Valuation of closing stock and level of stock-including EOQ.
12. Consideration to uniform costing, standard costing systems.

PROBLEMS

1. The following purchases and issue were made in a company :

Date	Particulars	Units	Rate
1-8-2006	Purchases	300	Rs. 15
6-8-2006	Issues	200	
10-8-2006	Purchases	400	Rs. 20
15-8-2006	Issues	450	
22-8-2006	Purchases	400	Rs. 25

What will be the value of stock on 22-8-2006 as per FIFO method ?

Sol :

(Nov.-21, Nov.-20)

Stores Ledger as per FIFO Method

Date	Particulars	Receipts			Issues			Balances		
		Units	Rate	Value	Units	Rate	Value	Units	Rate	Value
1/8/2006	Purchases	300	15	4500	–	–	–	300	15	4500
6/8/2006	Issues	–	–	–	200	15	3000	100	15	1500
10/8/2006	Purchases	400	20	8000	–	–	–	100	15	1500
								400	20	8000
15/8/2006	Issues	–	–	–	100	15	1500			
					350	20	7000	50	20	1000
22/8/2006	Purchases	400	25	10,000	–	–	–	50	20	1000
								400	25	10000
	Value of Closing Stock as on 22/8/06							450		11,000

2. The following purchases and issue were made in a company:

Date	Particulars	Units	Rate
1-8-2006	Purchases	300	Rs. 15
6-8-2006	Issues	200	
10-8-2008	Purchases	400	Rs. 20
15-8-2006	Issues	450	
22-8-2006	Purchases	400	Rs. 25

What will be the value of stock on 22-8-2006 as per LIFO method ?

Sol :

Stock Valuation based on LIFO Method

Date	Purchases			Issues			Balances		
	Qty.	Rate	Value	Qty.	Rate	Value	Qty.	Rate	Value
Aug 8 2006	300	15	4,500	–	–	–	300	15	4,500
6 Aug	–	–	–	200	15	3,000	100	15	1,500
10 Aug	400	20	8,000	–	–	–	100	15	1,500
							400	20	8,000
15 Aug	–	–	–	400	20	8000	50	15	750
				50	15	750			
22 Aug	400	25	10,000	–	–	–	50	15	750
							400	25	10,000
							450		10,750

3. Determine the values of stock as per books of AT Ltd., as at 31st March 2016 from the following information :
- The cost of stock as per physical verification as on 24 the March amounted to Rs. 1,00,000.
 - Purchases as per Purchase Book after stock taking till 31st March amounted to Rs. 1,00,000 and included the following :
Rs. 5,000 for goods received on 1st April
Rs. 10,000 for goods delivered on 1st April.
 - Sales as per Sales Book after stock-taking till 31st March amounted to Rs. 1,00,000 and included the following :
Rs. 5,000 for goods delivered till 23rd March.
Rs. 10,000 for goods delivered on 1st April.
 - Goods are sold by the trader at a profit of 25% on cost.
Also determine the cost of physical stock as on 31st March 2016.

Sol.:

(May-19)

Valuation of stock as at 31/3/2016

Particulars	Amount	Amount
Cost of stock as per physical verification as on 24/3/2016		1,00,000
(+) Costs of goods purchased after stock taking till 31 st March	95,000	95,000
		1,95,000
(-) Cost of goods sold after taking 31 st March	76,000	76,000
		1,19,000

Valuation of physical stock as at 31/3/2016

Particulars	Amount	Amount
Costs of stock as per physical verification as an 24/3/2016		1,00,000
(+) Costs of goods purchased and received after stock taking till 31 st March	85,000	85,000
		1,85,000
(-) Cost of goods sold and delivered after stock till 31 st March	68,000	68,000
		1,17,000

4. Balaji industries had an opening stock of 300 units materials values at Rs. 600 Receipts and Issues during August 2017 were as follows :

	Units	Value (Rs.)
August 2 received	200	440
August 4 issued	150	-
August 6 received	200	460
August 11 issued	150	-
August 19 issued	200	-
August 22 received	200	480
August 31 issued	250	-

Show the stores ledger using LIFO Method.

Sol.:

(Dec.-18)

LIFO Method

Date	Particulars	Receipts			Issues			Balance		
		Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
1/8/2017	To Opening stock							300	2	600
2/8/2017	To Purchase	200	2.20	440	-	-	-	300	2	600
								200	2.20	440
4/8/2017	To Issues	-	-	-	150	2.20	330	300	2	600
								50	2.20	110
6/8/2017	To Purchases	200	2.3	460	-	-	-	300	2	600
								50	2.20	110
								200	2.3	460
11/8/2017	To Issues				150	2.3	345	300	2	600
								50	2.20	110
								50	2.3	115
					50	2.3	115			
19/8/2017	To Issues				50	2.2	110	200	2	400
					100	2	200			
								200	2	400
22/8/2017	To Purchases	200	2.4	480				200	2.4	480
								150	2	300
31/8/2017	To Issues			50	2	100				
31/8/2017	To Closing Stock							150	2	300

5. The following transactions occurs in purchase and issue of materials.

Jan.-2 Purchased 4,000 units@ Rs. 4.00 per unit,

Jan.20 Purchased 500 units@ Rs. 5.00 per unit

Feb.-5 Issued 2,000 units

Feb.-10 Purchased 6,000 units@ Rs. 6.00 per unit

Feb.-12 Issued 4,000 units

Mar.-2 Issued 1,000 units

Mar.-15 Purchased 4,500 units@ rs. 5.50 per unit

Mar.-20 Issued 3,000 units

From the above, prepare stores ledger account in two ways : (i) by adopting LIFO method, and (ii) by adopting FIFO method of charging material issues. What would be the valuation of stock at the end of the period according to each of the methods ?

Sol.:

(July - 18)

Valuation of stock LIFO Method

Date	Particulars	Receipts			Issues			Balance		
		Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
Jan.-2	Purchases	4000	4	16,000	—	—	—	4000	4	16,000
Jan.-20	Purchases	500	5	2,500	—	—	—	4000	4	16,000
								500	5	2,500
Feb.-5	Issues	—	—	—	500	5	2,500	2500	4	10,000
					1500	4	6,000			
Feb.-10	Purchases	6000	6	36,000	—	—	—	2500	4	10,000
								6000	6	36,000
Feb.-12	Issues	—	—	—	4000	6	24,000	2500	4	10,000
								2000	6	12,000
March -2	Issues	—	—	—	1000	6	6,000	2500	4	10,000
								1000	6	6000
March -15	Purchases	4500	5.50	24,750	—	—	—	2500	4	10,000
								1000	6	6,000
								4500	5.50	24,750
March -20	Issues	—	—	—	3000	5.5	16,500	2500	4	10,000
								1000	6	6000
								1500	5.5	8,250
March 31	Closing Stock							<u>5000</u>		<u>24,250</u>

Valuation of stock FIFO Method

Date	Particulars	Receipts			Issues			Balance		
		Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
Jan.-2	Purchases	4000	4	16,000	—	—	—	4000	4	16,000
Jan.-20	Purchase	500	5	2,500	—	—	—	4000	4	16,000
								500	5	2,500
Feb.-5	Issues	—	—	—	2000	4	8,000	2000	4	8,000
								500	5	2,500
Feb.-10	Purchase	6000	6	36,000	—	—	—	2000	4	8,000
								500	5	2,500
								6000	6	36,000
Feb.-12	Issues	—	—	—	2000	4	8,000			
					500	5	2,500	4500	6	27,000
					1500	6	9,000			
March-2	Issues	—	—	—	1000	6	6,000	3,500	6	21,000
March-15	Purchases	4500	5.5	24,750	—	—	—	3500	6	21,000
								4500	5.5	24,750
March-20	Issues	—	—	—	3000	6	18000	500	6	21,000
								<u>4500</u>	5.5	<u>2,470</u>

$$\text{LIFO} = 10,000 + 6,000 + 8,250 = 24,250$$

$$\text{FIFO} = 3,000 + 24,750 = 27,750$$

6. The financial year of Mr. X ends on 31st March 1995 but the stock on hand was physically verified only on 7th April 1995. You are required to ascertain the value of closing stock as on 31st March 1995 from the following information
- (a) The stock as verified on 7th April 1995 was Rs. 1,54,000
 - (b) Sales have been entered in the Sales Day Book only after the dispatch of goods and sales returns only on receipt of the goods.
 - (c) Purchases have been entered in the Purchases Day Book on receipt of the purchase invoice irrespective of the receipt of the goods
 - (d) Sales as per Sales Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 68,800 of which goods of sale value Rs. 12,000 had not been delivered) at the verification
 - (e) Purchases as per Purchase Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 58,000 of which goods for purchases of Rs. 15,000 had not been received at the date of verification and goods for purchases Rs. 20,000 had been received prior 31st March 1995
 - (f) In respect of goods costing Rs. 50,000 received prior to 31st March 1995, invoices had not been received until the date of verification of stocks
 - (g) The gross profit is 25% on sales

Sol:

(Jan. - 18)

Statement showing the value stock 31/12/1995

Particulars	Amount	Amount
Stock as on 7-4-1995		1,54,000
(-) goods purchased and Received from 1/4/1995 – 7/4,1995	58,000	
Goods Received after 7/4/1995 15000		
Goods Received before 1/4/1995 20,000	35,000	23,000
(-) Goods Received prior to 31/3/1995 but invoices had not Received upto 7/4/1995		1,31,000 50,000
(+) Goods sold from 1/4/1995 to 7/4/1995	68,800	81,000
(-) Goods not dispatched till 3/4/1995	12,000	
	56,800	
(-) Gross profit $\left(56,800 \times \frac{25}{100} \right)$	14,200	42,600
		1,23,600

3.4 VALUATION OF GOODWILL

Q15. Define goodwill. Explain the factors effecting goodwill.

Ans : (Jan-20, Nov.-20, July-18)

Meaning

When a firm is reconstituted, goodwill is valued and shared by the existing partners. Goodwill is the present Value of a firm's anticipated excess earnings in future and the efforts had already made in the past. Goodwill really arises only if firm is able to earn higher profit than normal.

Goodwill is the value of the reputation of the firm which the business builds up due to its efficient service to its customers and quality of its products. It is a value of all favorable attributes relating to a business enterprise. It is not merely the past reputation but its continued existence in future that makes goodwill a valuable asset. It cannot be seen or touched. It is an intangible asset but not a fictitious asset.

In other words, goodwill is a thing which is not so easy to describe but in general words good-name, reputation, and wide business connection which helps the business to earn more profits than the profit could be earned by a newly started business. The monetary value of the advantage of earning more profits is known as goodwill. Goodwill is an attractive force, which brings in customers to old place of business. Goodwill is an intangible but valuable asset. In a profitable concern it is not a fictitious asset.

Definitions :

- (i) **According to J.O. Magee**, "The capacity of a business to earn profits in future is basically what is meant by the term goodwill".
- (ii) **According to Lord Lindley**, "The terms goodwill is generally used to denote benefit arising from connections and reputation".
- (iii) **According to Lord Eldon**, "Goodwill is nothing more than the probability, that the old customers will resort to the old place".
- (iv) **According to Lord Macnaghten**, "Goodwill is a thing very easy to describe, very difficult to define. It is the benefit and

advantage of the good name, reputation, and connections of a business. It is the attractive force, which brings in customers. It is one thing which distinguishes an old established business from a new business at its first start".

- (v) **According to Dr. Canning**, "Goodwill is the present value of a firm's anticipated excess earnings".

Thus, the valuation of goodwill is generally based on the calculation of a residual value. In basic terms, this approach requires the valuation of the net identifiable assets of the business (market-adjusted) and the valuation (market value) of the equity of the business.

A residual value may be derived by subtracting the value of the net identifiable assets of the business from the value of equity of the business. As a general rule, the calculation of a residual value will be the most appropriate method for deriving goodwill. However, other methods may be accepted if they are appropriate to the circumstances.

Factors

Goodwill relates to the profit earning capacity of the firm. Thus, the goodwill of a firm is affected by the following factors. The factors are:

1. Quality

If the firm enjoys good reputation for the quality of its products, there will be a ready sale and the value of goodwill, therefore, will be high.

2. Location

If the business is located in a prominent place, its value will be more.

3. Efficient Management

If the management is capable, the firm will earn more profits and that will raise the firm's value.

4. Competition

When there is no competition or competition is negligible, the value of those businesses will be high.

5. Advantage of Patents

Possession of trade marks, patents or copyrights will increase the firm's value.

6. Time

A business establishes reputation in course of time which is running for long period on profitable line.

7. Customers' Attitude

The type of customers which a firm has is important. If the firm has more customers, the value will be high.

8. Nature of business

A business having a stable demand is able to earn more profit and therefore, has more goodwill.

3.4.1 Methods of Valuation of Goodwill**Q16. Explain the Methods of Valuation of Goodwill.**

Ans :

(Nov.-20, Jan-20, July-18)

There are four methods of valuation of goodwill which are as follows :

1. Average Profit method
2. Super Profit method
3. Capitalization method
4. Annuity method

1. Average Profit Method

In this method, past profits of a number of years are taken into account. Such profits are added and the average profit is found out. The average profit is multiplied by a certain number of years to arrive at the value of goodwill.

The steps involved under this method are :

Step 1: Calculate total profits by adding each years profit and deducting loss, if any.

Step 2: Calculate the average profit by applying the following formula.

$$\text{Average profit} = \frac{\text{Total Profit}}{\text{No. of years}}$$

Step 3: Calculate the goodwill by applying the following formula.

Goodwill = Average Profit x No. of years' purchase

2. Super Profit method

The excess of average profit over normal profit is called super profit. The goodwill under the super profits method is calculated by multiplying the super profits by certain number of years purchase.

The steps involved under this method are :

Step 1: Calculate the average profit - it may be adjusted for partners remuneration.

Step 2: Calculate the normal profit on capital employed by applying the following formula. Normal Profit = Capital employed x Normal rate of return

Step 3: Calculate the super profit by applying the following formula.

$$\text{Super profit} = \text{Average Profit} - \text{Normal profit}$$

Step 4: Calculate the value of goodwill by multiplying the amount of super profit by the given number of years' purchase

$$\text{Goodwill} = \text{Super Profit} \times \text{No. of years of purchase}$$

3. Capitalization Method

According to this method, goodwill is equal to the difference of capital required and actual capital employed. If a firm earns more profit by investing lesser amount of capital as compared to other firms, it will have goodwill. This method is used in two ways :

(1) Capitalization of Average Profit Method

According to this method goodwill will be excess of the capitalized value of average profit over the actual capital employed. Following equations are used :

$$(i) \text{ Average profit} = \frac{\text{Total profits}}{\text{Number of years}}$$

$$(ii) \text{ Capitalized value of average profit} = \text{Average profit} \times \frac{100}{\text{Normal rate}}$$

$$(iii) \text{ Goodwill} = \text{Capital required} - \text{Capital employed}$$

(2) Capitalization of Super Profit Method

In this method, first of all we calculate the super profit, after this super profit is capitalized on the basis of normal rate of profit to get the amount of goodwill. Following equations are used :

$$(i) \text{ Average profit} = \frac{\text{Total profits}}{\text{Numbers of years}}$$

$$(ii) \text{ Normal profit} = \text{Capital employed} \times \frac{\text{Normal rate}}{100}$$

$$(iii) \text{ Super profit} = \text{Actual average profit} - \text{Normal profit}$$

$$(iv) \text{ Goodwill} = \text{Super profit} \times \frac{100}{\text{Normal rate}}$$

4. Annuity Method

According to this method, goodwill is equal to present or discounted value of average super profit of the firm. Therefore, under this method, the value of goodwill will be equal to the amount of liquid cash that is required to be paid immediately by the purchaser (or its beneficiary) in order to purchase the right to receive each year the amount of average super profit during the estimated number of years in the future. According to this method, goodwill is to be calculated as follows:

Value of goodwill = Average annual super profit x Annual rate or discounted rate per ` 1

$$\text{or } V = \frac{a}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

Here, V = Present value of annuity

a = Annual super profit

i = Rate of interest

n = Number of years

PROBLEMS ON VALUATION OF GOODWILL

7. The goodwill is to be valued at two years' purchase of last four years average profit. The profits were ₹ 40,000, ₹ 32,000, ₹ 15,000 and ₹ 13,000 respectively. Find out the value of goodwill.

Sol :

(July-18)

- (a) Calculation of average profit :

Years	₹
I year	40,000
II year	32,000
III year	15,000
IV year	13,000
	<u>1,00,000</u>

$$\text{Average profit} = \frac{\text{Total Profit}}{\text{No. of years}}$$

$$= \frac{1,00,000}{4} = 25,000$$

- (b) Calculation of Goodwill

$$\text{Goodwill} = \text{Average Profit} \times \text{two years purchase}$$

$$= 25,000 \times 2$$

$$= 50,000.$$

8. Three years' purchase of the last four years average profits is agreed as the value of goodwill. The profits and losses for the last four years are: I year 50,000, II year 80,000; III year 30,000(Loss); IV year 60,000. Calculate the amount of goodwill.

Sol :

- (a) Calculation of average profit :

I year	50,000
II year	80,000
IV year	60,000
	<u>1,90,000</u>
Profit of 3 years	1,90,000
III year loss	<u>(30,000)</u>
Total profit	<u>1,60,000</u>

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{No. of years}} = \frac{1,60,000}{4} = 40,000$$

(b) Calculation of goodwill

$$\text{Goodwill} = \text{Average Profit} \times \text{three years purchase}$$

$$= 40,000 \times 3$$

$$= 1,20,000$$

9. A firm's net profits during the last three years were ₹ 90,000, ₹ 1,00,000 and ₹ 1,10,000. The capital employed in the firm is 3,00,000. A normal return on the capital is 10%. Calculate the value of goodwill on the basis of two years' purchase of super profit.

Sol :

(July-18)

(a) Calculation of Average Profit

I year	90,000
II year	1,00,000
III year	1,10,000
Total Profit	<u>3,00,000</u>

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{No. of years}} = \frac{3,00,000}{3} = 1,00,000$$

(b) Calculation of Normal Profit

$$\text{Normal Profit} = \text{Capital employed} \times \text{Normal rate of return}$$

$$= 3,00,000 \times \frac{10}{100} = 30,000$$

(c) Calculation of Super Profit : = Average Profit - Normal Profit

$$= 1,00,000 - 30,000$$

$$= ₹ 70,000.$$

(d) Goodwill at two years' purchase of super profit :

$$\text{Goodwill} = \text{Super Profit} \times \text{No. of years of purchase}$$

$$= 70,000 \times 2 = 1,40,000$$

10. Venkatesh proposed to purchase the business of M/s. Greenrich Co. Ltd. Good will for this purpose is agreed to be valued at 3 years purchase of average profit. Calculate the amount of goodwill from the information given below :

(a) Profits for last 5 years

Years	Profit (₹)
2006	40,000
2007	45,000
2008	49,000
2009	47,000
2009	52,000

- (b) The profit of 2008 includes a non - recurring profits of ₹ 5,500. The profits of 2009 have been arrived after deducting an extraordinary loss on account of embezzlement for ₹ 4,300.
- (c) Venkatesh decided to insure company properties in future as these were not insured in the past. The insurance premium was estimated at ₹ 750 per annum.
- (d) Venkatesh has to leave his present employment where he is drawing ₹ 600 p.a. At the same time he intends to replace the supervisor of business who is being paid a salary of ₹ 700 per month.

Sol.:

Profit for 5 years = 40,000 + 45,000 + 49,000 + 47,000 + 52,000 = 2,33,000

Calculation of Adjusted Profit

Particulars	Amount (₹)
Profits for five years	2,33,000
Add : Extra ordinary Loss due to fire	4,300
	2,37,300
Less : Non - recurring profits	5,500
Total Adjusted Profits for Five years	2,31,800

$$\text{Average Profits} = \frac{2,31,800}{5} = ₹ 46,360$$

Calculation of Expected Average Profits

Particulars	Amount (₹)
Average Profits	46,360
Add : Expenses saved by way of salary to manager (700 × 12) (present salary of manager who is replaced)	8,400
	54,760
Less : Loss due to leaving the employment of company	600
	54,160
Less : Expenses to be paid in future insurance premium	750
Net Expected Average Profits	53,410

Good will = Net expected Average Profits × Number of years for which good will is calculated

$$\therefore \text{Good will} = 53,410 \times 3 = 1,60,230.$$

3.5 DEPRECIATION

Q17. Define depreciation. Explain the features of depreciation.

(OR)

Explain the concept of depreciation.

Ans : (Nov.-21, Jan-20, Dec.-18)

Meaning

The term depreciation is derived from the Latin words 'do' meaning down and 'pretium' meaning price. In common use it means putting down the value of an asset due to wear and tear, passage of time, obsolescence, etc.

Business is established for indefinite period. Fixed assets are constantly used in the business. The assets lose their value gradually due to their constant use. Loss in the value and utility of assets due to their constant use and expiry of time is termed as 'depreciation'.

It is very difficult to give a single definition of the term depreciation because under different situation this is handled differently and whatever seems to be correct in one situation may be improper in another. But even then some definitions are worth mentioning.

Definitions

- (i) **According to Malchman and Slavin**, "Depreciation refers to the process of estimating and recording the periodic charges to expense due to expiration of the usefulness of a capital asset".
- (ii) **According to R.N. Carter**, "Depreciation is the gradual and permanent decrease in the value of an asset from any cause".
- (iii) **According to J. R. Batilibo**, "Depreciation represents loss or diminution in the value of an asset consequent upon wear and tear, obsolescence, effluxion of time, or fall in the market value"
- (iv) **According to Spicer and Pegler**, depreciation may be defined as, "The measure of the exhaustion of the effective life of an asset from any cause during a given period".

Features

The features of depreciation are as follows:

1. Depreciation is loss in the value of assets.
2. Loss should be gradual and constant.
3. Depreciation is the exhaustion of the effective life of business.
4. Depreciation is the normal feature.
5. Maintenance of assets is not depreciation.
6. It is continuing decrease in the value of assets.
7. It is the allocation of cost of assets to the period of its life.

Q18. What are the causes of depreciation.

Ans :

The causes of depreciation are as follows:

1. Obsolescence

Sometimes new inventions throw away the existing machines and equipments as obsolete (useless) although the old machines and equipments are not completely useless. The firm will have to replace the old machine and equipment with the latest, up-to-date and newly invented machine and equipment. Loss due to the obsolescence of the old machine and equipment is known as 'obsolescence'.

2. Depletion / Exhaustion

The firm may possess certain mineral wealth such as coal, oil, iron ore, etc. The more one extract mineral wealth from these mines the more mines are depleted. Decrease in mineral wealth of the mines is termed as depletion. Loss of mineral wealth due to constant working of mines is also depreciation, but specifically known as 'depletion'. Suppose a particular mine has got 1,00,000 tonnes of coal during 1st year, coal worth 5,000 tonnes have been extracted. The loss of 5,000 tonnes of coal from mines is loss due to depletion. This is why; one charge depreciation on these mineral wealth according to depletion method.

3. Amortization

The word 'amortization' is used to show loss in the value of intangible assets. These assets are goodwill, patents and preliminary expenses, etc. These assets are written off over certain period.

4. Fluctuation

Increase and decrease in the market value of assets is known fluctuation. As one record the value of these assets on historical basis, he/she do not pass any entry for the fluctuations in the market value of assets. In case of permanent fall in the value of investments fluctuation may be recorded.

5. Permanent Fall in Price

Though fluctuations in the market value of fixed assets is not recorded in the books. Sometimes one have to account for this loss such as permanent fall in the value of investments.

6. By Accidents

Depreciation may also be due to the loss in the value of assets by accidents and damage.

7. By Constant Use

The loss in the value, efficiency, and utility of fixed assets due to its constant use is termed as depreciation.

8. By Expiry of Time

The effective life of assets goes on decreasing with the passage of time. If certain lease has been obtained for 20 years for ₹ 1,00,000, it

will lose its $\frac{1}{20}^{\text{th}}$, i.e., $\left(\frac{1}{20} \times 1,00,000\right) =$

5,000 value at the end of the first year and so on. At the end of 20th year it will become valueless. Depreciation in the value of assets in all the above cases is accounted for in the books of accounts.

Q19. Explain the importance of depreciation.

Ans :

The importance or need for providing depreciation arises for the following reasons:

1. For Determination of Net Profit or Net Loss

Loss in the value of assets is undoubtedly a business expense. It must be recorded and shown in the debit side of P/L A/c for the correct calculation of net profit or net loss. The ultimate objective of accounting is to determine the correct net income. This objective will not be achieved unless depreciation is not recorded in the books of accounts.

2. For Showing Assets at Fair and True Value in the Balance Sheet

If depreciation is not charged, the asset will be shown at value more than its actual value. The purpose of recording assets is to show them at their true value. Provision for depreciation reduces the value of assets with the amount of depreciation and assets are shown at their true and fair value.

3. Provision of Funds for Replacement of Assets

The assets acquired and used in the business will become useless after expiry of their estimated life or even before that, one will have to replace the obsolete assets with another fresh asset. The replacement will require funds. Proper method of depreciation will make the funds available for the purchase of fresh assets.

4. Ascertaining Accurate Cost of Production

Depreciation on factory plant and machinery is factory overhead. It will increase the cost of production and the price of the commodity will be fixed at higher rates. In the absence of provision for depreciation, the sales price of the commodity will be fixed at lower rates, because cost of production will also be lower due to ignorance of depreciation. Profit will thus, be reduced.

5. Distribution of Dividend Out of Profit Only

Depreciation is charged out of profit and loss account, so the profit after charging depreciation will be lesser. Shareholders will

get dividend out of this profit. If depreciation is not charged, the profit will be more and the excess dividend will be paid out of capital, which should have been paid out of profit.

6. **Avoiding Over Payment of Income Tax**

If depreciation is not charged, P/L A/c will show more profit. One will have to pay income tax on this profit. In this way, the payment of tax will be definitely more than what it should have actually been. The profit will reduce the amount of depreciation, so lesser or the actual income tax due will be paid. Provision for depreciation in this way avoids over payment of income tax.

Q20. Explain the need for depreciation.

Ans :

The need for charging a reasonable amount of depreciation over the estimated useful life of the asset arises for the following purposes:

1. **To ascertain the true income**

The basic need of depreciation is to ascertain the true income. If depreciation is ignored, the loss that is occurring in respect of fixed assets will be ignored. The loss will suddenly loom large when the asset becomes useless or valueless. From another angle, when goods are produced it involves use of fixed assets — the reduction in their value should be treated as an element of cost of production of goods. Therefore, depreciation should be debited to P & L A/c before profit is ascertained.

2. **To show the asset at its proper value**

In the absence of depreciation charge, the asset will be shown at its acquisition cost every year in the balance sheet. If depreciation is not allowed, the Balance Sheet would fail to show the true financial position. Therefore, depreciation must be accounted for in order to present the assets at their proper value.

3. **To maintain the capital invested:**

Depreciation helps to maintain the capital invested in the asset intact in the business so that it can be reinvested in the profit earning process.

4. **To retain fund for replacement**

The other need for depreciation is to retain out of profit funds for replacement of asset's. The amount debited in P & L A/c are retained in the business. These are available for replacement of the assets when its life is over.

5. **To allocate the cost of fixed asset to product**

The business firms, to find out the accurate cost of production, requires to allocate the cost of fixed asset to product.

6. **To compute tax liability**

In such a case the rate of depreciation is influenced by tax laws.

Q21. What are the objectives of depreciation?

Ans :

The following are the objectives of providing depreciation:

1. **Knowledge of True Profits**

When an asset is purchased, it is nothing more than payment in advance for an expense. For example, purchasing a building for ₹ 1,00,000 for business purposes will save rent in the future.

However, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for years.

Any paid rent would have been charged as an expense to determine the true profits made by the business during a particular period.

Therefore, the amount paid for the purchase of the building should be charged over the period for which the asset would be serviceable.

2. **True Financial Position**

The assets depreciate in their value on account of various factors.

To present a true state of affairs of the business, the assets should be shown in the balance sheet, at their proper values.

In case depreciation is not charged, the balance sheet will not indicate a true view of the state of affairs of the business.

3. Replacement of Assets

The business uses assets to earn revenue. On account of constant use or lapse of time and similar other causes, a stage may come when the assets need to be replaced. Providing depreciation retains a part of the business profits, which can purchase new assets.

4. Correct Cost of Production

Depreciation is a cost of production, and if depreciation is not charged, the cost of production so determined will not be correct.

Q22. What are the ingredients necessary for calculating depreciation ?

Ans : (Dec.-18)

The following are the ingredients necessary for calculating depreciation are :

(i) Date placed in service

If a new asset is placed in service immediately upon acquisition, its date placed in service is simple to establish. If an asset is added to a register that was already placed in service but originally excluded from the fixed asset register, determining the date placed in service will be more of a challenge, but important for your calculations.

(ii) Acquisition value

This is referring to an asset's value at the end of its useful life.

(iii) Salvage value

Fixed assets are typically recorded at historical cost. If an asset, such as a building, is of significant value, a more formal appraisal may be required to determine its value. For assets that have been excluded from the fixed asset register, you may first want to try researching the item's historical cost. If that information is unavailable, it is permissible to estimate the amount based on a similar asset's value.

(iv) Estimated useful life

The estimated useful life of an asset refers to the number of years that an asset can be used for its original intent.

- (v) **Depreciation method** : Using the straight-line method to calculate depreciation of fixed assets would consist of the following: $\text{Depreciation} = \frac{\text{Acquisition Value} - \text{Salvage Value}}{\text{Estimated Useful Life}}$. The asset is written off evenly over the course of its useful life, resulting in equal depreciation from year to year.

Q23. What is accumulated depreciation?

Ans : (Jan.-20)

Accumulated depreciation is the total depreciation for a fixed asset that has been charged to expense since that asset was acquired and made available for use. The intent behind doing so is to approximately match the revenue or other benefits generated by the asset to its cost over its useful life (known as the matching principle).

The amount of accumulated depreciation for an asset will increase over time, as depreciation continues to be charged against the asset. The original cost of the asset is known as its gross cost, while the original cost of the asset less the amount of accumulated depreciation and any impairment charges is known as its net cost or carrying amount.

The accumulated depreciation account is an asset account with a credit balance (also known as a contra asset account). When the asset is eventually retired or sold, the amount in the accumulated depreciation account relating to that asset is reversed, as is the original cost of the asset, thereby eliminating all record of the asset from the company's balance sheet. If this derecognition were not completed, a company would gradually build up a large amount of gross fixed asset cost and accumulated depreciation on its balance sheet.

3.5.1 Methods of Depreciation their Impact on Measurement of Business Accounting

3.5.1.1 Fixed or Equal Installment or Straight Line Method

Q24. Define Fixed or Equal Installment or Straight Line Method? Explain the advantages and disadvantages of straight line method.

Ans :

(Nov.-21, Jan-20, Nov.-20)

It is the simplest method of charging depreciation. In this, the depreciation is charged evenly every year throughout the effective life of the asset. The amount of depreciation is calculated by using the following formula:

$$\text{Depreciation} = \frac{\text{Original Cost of Assets} - \text{Estimated Scrap Value}}{\text{Life of Assets (Number of Accounting Periods)}}$$

For example, if an asset has been purchased for ₹ 1,00,000 and it will have scrap value of ₹ 10,000 at the end of the life after 10 years, the amount of the depreciation shall be calculated as follows:

$$\text{Depreciation} = \frac{\text{₹ } 1,00,000 - \text{₹ } 10,000}{10 \text{ years}} = \text{₹ } 9,000 \text{ per year}$$

Advantages of Straight Line Method

Following are the advantages of straight line method:

1. Simplicity

This is the simplest method of providing depreciation. This can be easily understood even by ordinary person. Calculation of depreciation according to this method is also very simple.

2. Assets can be completely Written-off

According to this method, assets can be written-off to zero. The depreciation is calculated on the original cost of the machine at the specified rate, so the value of asset is fully split over the useful life of asset.

3. Knowledge of Total Depreciation Charged

The amount of total depreciation charged can be easily known by multiplying the yearly amount of depreciation with number of years, machine has been used.

4. Suitable for Small Firms

Straight line method is the most suitable method for small firms. These firms use this method, because it is easy, simple and suitable to the size of the firms.

5. Suitable for Firms Having Large Number of Old and New Machines

The weakness of this method is removed, if the firm has both old and new machines. More maintenance charges on old machines and lesser on the new machines balance each other.

6. Useful for Assets Having Lesser Value

This method is the most suitable for charging depreciation on assets of lesser value such as furniture, fixture and patents.

Disadvantages of Straight Line Method

Following are the disadvantages of straight line method:

1. Undue Pressure on Final Years

The final years of the life of the asset have to bear more repairs and maintenance charges and also the same amount of depreciation, whereas initial years have to suffer lesser repair charges.

2. No Provision for Replacement

The amount charged as depreciation is retained in the business and used in the routine affairs. The firm has to bother for making arrangement of funds for the replacement of asset although depreciation has been charged every year.

3. Loss of Interest

The amount of depreciation charged every year is not invested outside the firm, so no interest is received. In certain methods of depreciation, the amount of depreciation is invested outside the business in securities and interest is received.

4. Illogical Method

It seems illogical to charge depreciation on the original cost of the asset every year when the balance of the asset is declining year after year.

5. Unsuitable for Assets having Long Life and More Value

This method is not suitable for those assets, which are subject to additions and extension from time to time, such as land and building and plant and machinery. It is not suitable for assets having more value.

3.5.1.2 Diminishing or Reducing or Written down Value Method

Q25. Define Diminishing or Reducing or Written down value method.

Ans :

(Nov.-21, Jan-20, Nov.-20, Jan-18)

Under the written down value method, depreciation, according to a fixed percentage calculated upon the "original cost (in the first year) and written down value, (in subsequent years) of an asset, is written-off during each accounting period over the expected useful life of the asset. Under this method, the rate of depreciation remains constant year after year whereas the amount of depreciation goes on decreasing.

How to Calculate Depreciation under WDV Method: The rate of depreciation is calculated as follows:

$$R = \left[1 - \sqrt[n]{\frac{S}{C}} \right] \times 100$$

Where,

R = Rate of Depreciation (in %),

n = Useful life of the asset (in years)

S = Scrap value at the end of useful life of the asset

C = Cost of the asset

For example, if a machine has been acquired for ₹ 1,00,000 and depreciation is charged @ 10% according to written down value method the depreciation to be charged will be made as under:

$$\text{1st year on ₹ 1,00,000 @ 10\% } \frac{10}{100} \times 1,00,000 = 10,000$$

$$\text{2nd year on ₹ 90,000 i.e. ₹ 1,00,000 - 10,000 = 90,000} \times \frac{10}{100} = 9,000$$

3rd year on ` 81,000 i.e. ` 90,000 – 9,000 = 81,000 $\times \frac{10}{100}$ = 8,100

4th year on ` 72,900 i.e. ` 81,000 – 8,100 = 72,900 $\times \frac{10}{100}$ = 7,290 and so on.

Q26. What are the advantages and disadvantages of Diminishing or Reducing or Written down value method.

Ans :

Advantages

Following are the advantages of written down value method:

1. Easy Calculation

Calculation of depreciation is easier as compared to other methods of calculating depreciation except straight line method. Depreciation is calculated every year on the opening balance of asset. Depreciation on additions is separately calculated.

2. Balanced Effect on the Profit and Loss Account of Different Years

In the initial years depreciation is more and the maintenance charges are lesser. In the final years, depreciation is lesser but repairs and maintenance charges are more. So every year bears the charges almost the same as regards depreciation and maintenance.

3. Approved Method by Income Tax Authorities: The method is approved by income tax authorities.

4. Logical Method: It seems logical even to layman that the value of asset goes on diminishing year after year, so the depreciation should also be charged on the reducing balances. .

5. Suitable for Assets having Long Life: This method is suitable for those assets, which have long life. It is also suitable for those assets where additions and extensions are common feature, such as land, building and plant and machinery.

Disadvantages

Following are the disadvantages of written down value method:

1. Value of Asset Cannot be Reduced to Zero: It is very difficult to determine a rate by which the value of asset could be written down to zero.

2. Loss of Interest: The amount charged as depreciation is not invested outside the business so no interest is received. In certain methods, the amount is invested outside the business in securities and interest is received.

3. No Fund for Replacement: Though depreciation is charged every year but the amount charged is retained in the business and used in routine business operations. At the time of replacing assets, firm has to bother for making arrangement of funds, although it has charged depreciation every year.

4. Higher Rate of Depreciation: The rate of depreciation in this method is higher, because it will require longer period to write off the asset, if the rate is lower and the assets may become useless earlier.

5. Unequal Burden on Profit and Loss Account: The amount of depreciation goes on declining year after year, whereas the asset is used equally by every year.

Q27. Distinguish between straight line method and written down value method.

Ans :

(Imp.)

S.No.	Nature	Straight Line Method	Written Down Value Method
1)	Basic of Calculation	Depreciation is calculated at a fixed percentage on the original cost.	Depreciation is calculated at a fixed percentage on original cost (in first year) and on written down value (in subsequent years).
2)	Amount of Depreciation	The amount of depreciation remains constant.	The amount of depreciation goes on decreasing.
3)	Total Charge (i.e., depreciation plus repairs and renewals)	Total charge in later years is more as compared to that in earlier years since the amount of repairs and renewals goes on increasing as the asset grows older, whereas the amount of depreciation remains constant year after year.	Total charge almost remains uniform year after year, since in earlier years the amount of depreciation is more and the amount of repairs and renewals is less whereas in latter years, the amount of depreciation is less and the amount of repairs & renewals is more.
4)	Book Value/Zero-Level	The book value of the asset becomes zero or equal to its scrap value.	The book value of the asset does not become zero.
5)	Suitability	This method is suitable for those assets in relation to which (a) repair charges are less (b) the possibility of obsolescence is less.	This method is suitable for those assets in relation to which (a) the amount of repairs & renewals goes on increasing as the asset grows older and (b) the possibilities of obsolescence are more.
6)	Calculation-Easy or difficult	It is easy to calculate the rate of depreciation.	It is difficult to calculate the rate of depreciation,
7)	Effect on profit and loss account	The initial years of the life of the asset bear lesser amount as depreciation and repairs but final years bear the same amount of depreciation but more repairs and maintenance charges.	Every year bears almost the same charges, Depreciation goes on declining, whereas repairs and maintenance charges go on increasing,

3.5.1.3 Sum of Year Digits Method

Q28. Define Sum of Year Digits Method.

Ans :

It is variation of the "Reducing Balance Method". In this case, the annual depreciation is calculated by multiplying the original cost of the asset less its estimated scrap value by the fraction represented by:

$$\frac{\text{The number of years (Including the present year) of remaining life of the asset}}{\text{Total of all digits of the life of the asset (in years)}}$$

For example, the estimated life of an asset is 10 years and the total of all the digits from 1 to 10 is 55 i.e., $10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1$, or by the formula:

$$\frac{n(n+1)}{2} = \frac{10 \times 11}{2} = 55$$

The depreciation to be written off in the first year will be 10/55 of the cost of the asset less estimated scrap value and the depreciation for the second year will be 9/55 of the cost of the asset less estimated scrap value and so on.

This method is prevalent in USA, and is permitted under the Federal Tax Laws, but this method is not yet in vogue in India and its advantages are the same as those of the Reducing Balance Method.

3.5.1.4 Sinking Fund Method / Depreciation Fund Method

Q29. Define Sinking Fund Method / Depreciation Fund Method. Explain the steps involved in Sinking Fund Method.

Ans :

Meaning

Sinking fund is created to provide a definite amount at a certain future date for a specific purpose of 'replacement of the asset at the end of its useful life. The working of this method may be summarized here as follows:

1. A sinking fund described as depreciation fund is established for the purpose of accumulating sufficient funds to replace the asset at the end of its useful life.
2. An amount equal to the annual depreciation of the asset is charged against the profits every year and accumulated in the form of depreciation fund.
3. An equivalent amount of cash (or in the multiples of a specific denomination say ` 10 or ` 100 if so required) is withdrawn from the business and is invested-outside the business in securities which are readily convertible into cash.
4. At the time of replacement of the asset, the investments made are realized and the available money is used in replacing the asset concerned.

One of the objectives of providing depreciation is to provide for the replacement of the asset at the end of the useful life of the asset. In all the methods discussed earlier, the amount of

depreciation is charged to profit and loss account and this amount is automatically remain invested in the business. At the time of the replacement of the asset, it may not be possible to mobilize the adequate resources, unless the amount of accumulated depreciation is invested in the liquid current assets. In order to ensure that the necessary amount is available for replacement, the amount charged by way of depreciation is invested in certain interest bearing securities. The amount of interest received is also invested in the securities and such amount is not use for the day-to-day operations. At the end of the useful life of the assets, when replacement is required, the securities are disposed off and the sales proceeds are used for purchase of new asset.

Steps Involved in the working of Sinking Fund Method

- Step 1:** Calculate the amount of depreciation to be provided for with the help of Sinking Fund Table.
- Step 2:** Set aside the amount of depreciation at the end of each year.
- Step 3:** Purchase the investments at the end of each year (except last year).
- Step 4:** Receive the interest on investments at the due dates.
- Step 5:** Repeat Step 2 for each year, Repeat Step 3 for each year except last year, Repeat Step 4 for each year.
- Step 6:** Realize the investments in the year of replacement of asset.
- Step 7:** Transfer profit/loss on sale of investments to Depreciation Fund Account.
- Step 8:** Transfer the balance left in Depreciation Fund Account to Respective Asset Account.

Q30. What are the advantages and disadvantages of Sinking Fund Method.

Ans :

Advantages of Sinking Fund Method

Following are the advantages of sinking fund method:

1. The primary advantage of this method is that a fund is created during the working life of an asset, which is equal to the depreciated value (cost price minus scrap value) of the same at the end of its effective life. Since the amount of depreciation is kept aside and invested in readily marketable securities, they are easily saleable; the process being utilized for the purpose of replacement of asset, i.e., ready cash is made available.
2. Another advantage is that one can know at any time the original value of the asset since it is always shown in the balance sheet.
3. One can also know the exact amount written-off in any year by comparing the depreciation fund account for different years.
4. This method is also useful if the asset is to be replaced when it becomes a scrap.

Disadvantages of Sinking Fund Method

Following are the disadvantages of sinking fund method:

1. One cannot know whether the investment will be sold for a price which will be sufficient to replace the asset or not.
2. The amount which is invested in securities is withdrawn for the business and, as such, working capital is reduced.

3.5.1.5 Annuity Method

Q31. What do you understand by Annuity Method?

Ans :

Meaning

The amount invested in an asset has an opportunity cost, i.e., if that amount had been invested in some other form it would have earned some interest. The fixed installment and the diminishing balance methods ignore such cost. Normally, depreciation does not take such loss of interest into account. But in some cases it is considered desirable to include it.

For example, when some property is taken on lease we have to pay a lumpsum amount at the initial stage and then a nominal amount as rent

every year. The amount paid at the initial stage is a sort of advance payment of rent. It is treated as the cost of lease and written-off during the lease period by way of providing depreciation.

In such a situation the loss of interest on advance payment must also be treated as a part of the cost of using the asset. The method by which the interest is also included in the amount of depreciation is known as annuity method. This method is usually employed for providing depreciation on leasehold property. But it can also be used for other fixed assets provided it is decided to account for the loss of interest on the amount invested in the asset.

As the depreciation is to be inclusive of interest, the amount of depreciation charged every year is higher than what it would have been under any other method. Although the amount of interest varies from year to year (it goes on decreasing), the installment of depreciation is uniform.

The straight line method and written down value method of charging depreciation ignores the interest factor. The annuity method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of the asset Thus, according to this method, such opportunity cost of finance, for the value of the asset, is considered at the acceptable rate. The interest is calculated on the book value of the asset at the beginning of the year. The amount of depreciation is uniform and the amount of interest is determined based on the annuity tables. This method is also known as Compound Interest Method of Depreciation.

Computation of Depreciation

Under Annuity Method, such an amount is charged by way of depreciation which takes into account not only the cost of the asset but also interest thereon at a given rate. A fixed amount of depreciation is computed with the help of an Annuity Table which provides the amount to write-off' 1 over a given period and at a given rate of interest.

Amount of depreciation = [(Original cost - scrap value) x (Value of annuity for a given period at a given rate of interest)] + Interest on scrap value (if any) for a year at a given rate of interest.

Note: Value of Annuity for a given period at a given rate of interest is ascertained with the help of following formula:

$$\text{Value of Annuity} = \frac{r(1+r)^n}{(1+r)^n - 1}$$

Q32. What are the advantages and disadvantages of Annuity Method?

Ans :

Advantages

Following are the advantages of annuity method :

1. It is to some extent scientific, since it recognizes that the purchase of an asset is an investment in the business and charges interest on such investment.
2. The depreciation, under this method, not only provides for recovery of invested capital but also arranges for collecting interest on uncovered capital, i.e., depreciation includes a part of capital plus interest on uncovered capital.

Disadvantages

Following are the disadvantages of annuity method:

1. This method is not suitable where additions to assets are made from year to year since calculation on the same is very difficult and complicated.
2. The total consolidated cost of repairs and depreciation of an asset may not remain uniform from year to year.

The asset is shown in the balance sheet at a figure which is higher than its actual cost.

Q33. Explain the impact of depreciation methods on measurement of business accounting.

Ans :

(Nov.-20)

The impact of depreciation methods on measurement of business accounting are as follows,

1. Impact of Straight Line Method

Under straight line method, a fixed proportion of original cost of long-term fixed

asset is written off each year. The calculation of depreciation under this method may put less impact on the business accounts of companies. Because the depreciation is always calculated on the original cost of the asset till its useful life. This type of depreciation method is used to calculate depreciation for assets like furniture, fixtures, office equipment, patents and short leases etc.

2. Impact of Diminishing Balance Method

Under diminishing balance method, assets of companies never becomes zero. This method act as a tax shield for companies. It tends to equalise the burden on profit and loss account in respect of depreciation and repairs. Usually, companies adopt this method to calculate depreciation on assets like plant and machinery. Thus, it puts more impact on the business accounts of companies.

3. Impact of Annuity Method

Under Annuity method, depreciation is calculated with the help of annuity tables. This method is best suitable for those assets which requires high amount of capital. The asset account is debited with interest which is credited to profit and loss account including the amount of depreciation which remains fixed year after year. Thus, annuity method puts the same impact on profit and loss account of the company every year.

4. Impact of Depreciation Fund Method

Under this method, depreciation amount is fixed and remains the same year after year and it is charged to profit and loss account through the creation of depreciation account. Depreciation fund method also provides various provisions for the replacement of asset at the end of its useful life. If the organization is capable in investing some amount of funds outside the business then the normal financial functioning would be disabled because of the withdrawals of funds from regular business operations.

5. Impact of Sum of Years Digits Method

Sum of years digits method is very less useful in current business organizations. The

problem involved with this method that it artificially reduces the reported profit of a business over a time period. In addition, this method had a indirect impact on business cash flows which will directly effect the business accounts.

6. Impact of Revaluation Method

The impact of revaluation method on business account is very positive. It gives a chance or option to business for carrying the fixed asset at its revalued amount. However, this option is only useful for the business under International Financial Reporting Standards (IFRS).

7. Impact of Insurance Policy Method

Insurance policy method is effective method of depreciation. However, under this method premium is calculated which is called as depreciation of company's asset. Company may purchase a insurance policy for an amount equal to replacement cost of asset. For this, insurance company will get agree to pay a lumsum amount in return for some premium paid for insuring asset. The impact of this method on business account is that, a definite amount is received on maturity of policy. However, profit and loss account of company will get overloaded with repairs and depreciation.

8. Impact of Depletion Method

The depletion method of depreciation is used to calculate depreciation for natural resources like coal, oil, timber, metal, salt etc. It is periodic charge for the use of natural resources. Every organization uses any of the natural resources as such the wear and tear of natural resources results in depletion. As a result depletion method impact on all those business accounts where natural resources are utilized for business purpose.

9. Impact of Machine Hour Rate Method

Machine hour rate method is used to calculate the depreciation on asset based on hours instead of years. This method divide the actual cost of fixed assets with total life of assets in hours. This method only applicable to machines. Therefore, the accounting books may get effected based on the usage of machines in working hours.

Q34. Distinguish between amortization and depletion.

Ans :

(Jan.-20)

S.No.	Nature	Amortization	Depletion
1.	Meaning	Decrement and allocation of cost of an intangible asset throughout its useful life.	Decrement in the net value of a nature resource after it has been extracted and utilized.
2.	Asset type	Intangible assets like debts, loans and agreements.	Tangible natural resources like timber, coal, oil, material reserves etc.
3.	Industry usage	Any industry that deals with intangible resources like loaning and business related organizations.	Industries which deal with usage of natural resources like mining industries, oil fields etc.
4.	Basis of charge	Term of life and usage of the asset in terms of time in years or months.	Based on assessment and utilization and exhaustion of natural resources.

Q35. Distinguish between depreciation, amortization and depletion.*Ans :***(May.-22)****1. Depreciation**

It is to spread or allocate the cost of a tangible fixed asset over its estimated economic useful life. In other words, it may be seen as a reduction in the cost of a fixed asset due to normal usage, wear and tear, new technology, and other related reasons.

Example – A company charging 10% depreciation on all their buildings, 25% depreciation on laptops, etc.

2. Amortization

Prorating cost of an "Intangible Asset" over the period during which benefits of this asset are estimated to last is called Amortization. The concept of amortization is also used with leases & debt repayment.

Amortization is for Intangible assets whereas depreciation is for tangible fixed assets. Examples of intangible assets are copyrights, patents, software, goodwill, etc.

3. Depletion

When dealing with a natural resource also referred as a mineral asset the concept of depreciation or amortization cannot be applied. "Depletion" is a form of a systematic reduction in the value of a natural resource based on the rate at which it is being used.

For example – A coal mine has 10 Million tonnes of coal and the coal extraction is happening at the rate of 1 Million tonnes per year. In this case, depletion rate would be 10% p.a. since at this rate of extraction the coal mine is being depleted at 10% per year.

PROBLEMS

- 11. An asset has been purchased for ` 1,00,000 and it will have scrap value of ` 10,000 at the end of the life after 10 years, the amount of the depreciation shall be calculated as follows.**

Sol :

$$\text{Depreciation} = \frac{\text{Rs. } 1,00,000 - \text{Rs. } 10,000}{10 \text{ years}} = \text{Rs. } 9,000 \text{ per year}$$

- 12. A company purchased a machine worth of ` 1,00,000 on 01.04.2004 and establishment expenses incurred was ` 10,000. The life of the Machine is 5 years Show that Machinery Account for 4 years using Straight Line method.**

Sol :

$$\text{Depreciation} = \frac{\text{Investment} + \text{Establishment expenses} - \text{Scrap value}}{\text{Life of the Asset}}$$

$$\text{Depreciation} = \frac{1,00,000 + 10,000}{5} = \text{Rs. } 22,000.$$

Dr			Machinery A/c			Cr		
Date	Particulars	Amount	Date	Particulars	Amount			
2004	To Bank A/c (Purchase)	1,00,000	2005	By Depreciation A/c	22,000			
Apr 1	To Bank A/c	10,000	Mar 31	By Balance c/d	88,000			
		1,10,000			1,10,000			
2005	To Balance b/d	88,000	2006	By Depreciation A/c	22,000			
Apr 1		88,000	Mar 31	By Balance c/d	66,000			
		66,000			88,000			
2006	To Balance b/d	66,000	2007	By Depreciation A/c	22,000			
Apr 1		66,000	Mar 31	By Balance c/d	44,000			
		44,000			66,000			
2007	To Balance b/d	44,000	2008	By Depreciation A/c	22,000			
Apr 1		44,000	Mar 31	By Balance c/d	22,000			
		22,000			44,000			
2008	To Balance b/d	22,000						
Apr 1								

13. Y Ltd Co. purchased a machine costing Rs. 3,00,000 on 1st Jan. 2005. The depreciation is to be charged at 20% p.a. on Diminishing Balance method.

Write up Machinery A/c for first four years.

Sol :

Dr.			Machinery A/c			Cr.		
Date	Particulars	Rs.	Date	Particulars	Rs.			
2005	To Bank	3,00,000	2005	By Depreciation	60,000			
Jan. 1		3,00,000	Dec. 31	By Balance c/d	2,40,000			
		2,40,000			3,00,000			
2006	To Balance	2,40,000	2006	By Depreciation	48,000			
Jan. 1		2,40,000	Dec. 31	By Balance c/d	1,92,000			
		1,92,000			2,40,000			

2007			2007		
Jan. 1	To Balance b/d	1,92,000	Dec. 31	By Depreciation	38,400
			Dec. 31	By Balance c/d	1,53,600
		1,92,000			1,92,000
2008			2008		
Jan. 1	To Balance b/d	1,53,600	Dec. 31	By Depreciation	30,720
			Dec. 31	By Bal. c/d	1,22,880
		1,53,600			1,53,600

14. M/s Ram Ltd. purchased a Plant costing ` 2,50,000 on 1st July, 2005 and labor charges were ` 20,000. Depreciation is charged at 10%. Using Written-down Value Method, prepare Plant Account for 4 Years.

Sol.:

Dr.			Plant A/c			Cr.		
Date	Particulars	Amount (`)	Date	Particulars	Amount (`)			
2005	To Bank A/c (Purchase)	2,50,000	2006	By Depreciation A/c	20,250			
July 1	To Bank A/c (Labor Cost)	20,000	Mar 31	(2,70,000 x 10% x 9/12)				
				By Balance c/d	2,49,750			
		2,70,000			2,70,000			
2006			2007	By Depreciation A/c	24,975			
Apr 1	To Balance b/d	2,49,750	Mar 31	By Balance c/d	2,24,775			
		2,49,750			2,49,750			
2007			2008	By Depreciation A/c	22,478			
Apr 1	To Balance b/d	2,24,775	Mar 31	By Balance c/d	2,02,297			
		2,24,775			2,24,775			
2008			2009	By Depreciation A/c	20,230			
Apr 1	To Balance b/d	2,02,297	Mar 31	By Balance c/d	1,82,067			
		2,02,297			2,02,297			
2009								
Apr 1	To Balance b/d	1,82,067						

15. A lease is purchased on 1st January, 1990 for 4 years at a cost of ₹ 20,000. It is proposed to depreciate the lease by the annuity method charging 5 percent interest. A reference to the annuity table shows that to depreciate Re. 1 by annuity method over 4 years charging 5% interest, one must write off a sum of ₹ 0.282012 [To write off ₹ 20,000 one has to write off every year ₹ 5,640.24 i.e., $0.282012 \times 20,000$].

Show the least account for four years and also the relevant entries in the profit and loss account.

Sol.:

Dr.				Lesae Account				Cr.			
Date	Particular	L.F.	Amount	Date	Particular	L.F.	Amount				
1990 Jan. 1	To Bank Account		20,000.00	1990 Dec. 31	By Dep. A/c		5,640.24				
Dec. 31	To Interest A/c (5% on ₹ 20,000)		1,000.00	Dec. 31	By Balance c/d		15,359.76				
			21,000.00				21,000.00				
1991 Jan. 1	To Balance b/d		15,359.76	1991 Dec. 31	By Dep. A/c		5,640.24				
Dec. 31	To Interest A/c (5% on ₹ 15,359.76)		767.99	Dec. 31	By Balance c/d		10,487.51				
			16,127.75				16,127.75				
1992 Jan. 1	To Balance b/d		10,487.75	1992 Dec. 31	By Dep. A/c		5,640.24				
Dec. 31	To Interest A/c		524.38	Dec. 31	By Balance c/d		5,371.65				
			11,011.89				11,011.89				
1993 Jan. 1	To Balance b/d		5,371.65	1993 Dec. 31	By Dep. A/c		5,640.24				
Dec. 31	To Interest A/c		268.59				5,640.24				
			5,640.24								

Profit & Loss Account

Date	Particular	J.F.	Amount	Date	Particular	J.F.	Amount
1990 Dec. 1	To Dep. A/c		5,640.24	1990 Dec. 31	By Interest A/c		1,000.00
1991 Dec. 1	To Dep. A/c		5,640.24	1991 Dec. 31	By Interest A/c		767.99
1992 Dec. 1	To Dep. A/c		5,640.24	1992 Dec. 31	By Interest A/c		524.38
1993 Dec. 1	To Dep. A/c		5,640.24	1993 Dec. 31	By Interest A/c		268.59

16. On January 1st, 2009 an asset was purchased for Rs. 1,50,000/-. What would be its book value after three years, if it was depreciated by straight line and written down value methods at the rate of 10% p.a.?

Sol.:

(Nov.-20)

(i) Straight Line Method

Machinery A/c

Date	Particulars	Amt	Date	Particulars	Amt
Jan. 1 st 2009	To Bank A/c	1,50,000	Dec. 31 2009	By Dep. A/c	15,000
			Dec. 31	By Balance c/d	1,35,000
		1,50,000			1,50,000
Jan. 1 st 2010	To Balance b/d	1,35,000	Dec. 31 2010	By Dep. A/c	15,000
			Dec. 31	By Balance c/d	1,20,000
		1,35,000			1,35,000
Jan. 1 st 2011	To Balance b/d	1,20,000	Dec. 31 2011	By Dep.	15,000
			Dec. 31	By Balance c/d	1,05,000
		1,20,000			1,20,000
Jan. 1 st 2012	To Balance b/d	1,05,000			

(ii) Written down value method

Dr.

Machinery A/c

Cr.

Date	Particulars	Amt	Date	Particulars	Amt
Jan. 1 st 2009	To Bank A/c	1,50,000	Dec. 31 2009	By Dep. A/c	15,000
			Dec. 31	By Balance c/d	1,35,000
		1,50,000			1,50,000
Jan. 1 st 2010	To Balance b/d	1,35,000	Dec. 31 2010	By Dep. A/c	13,500
			Dec. 31	By Balance c/d	1,21,500
		1,35,000			1,35,000
Jan. 1 st 2011	To Balance b/d	1,21,500	Dec. 31 2011	By Dep. A/c	12,150
			Dec. 31	By Balance c/d	1,09,350
		1,21,500			1,21,500
Jan. 1 st 2012	To Balance b/d	1,09,350			

17. India Ltd. charges depreciation on plant and machinery under Reducing balance Sheet @15% Per Annum. On 1.4.2014 the balance in Ledger stood at Rs. 4,60,000. The following particulars are given to plant and machinery during three four years ended 31.3.2018

- (i) 1.9.2014 : A machine purchased for Rs. 20,000 (Installation Expenses Rs. 1,000) on 1.5.2012 was fully destroyed in an accident
- (ii) 1.7.2015 : Purchased a new machine costing Rs. 50,000 (Installation Expenses Rs. 2,500). A sum of Rs. 30,000 was paid on the same date and balance was paid in May 2,000
- (iii) 31.8.2016: Plant purchased on 1.4.2013 for Rs. 30,000 (Installation Expenses Rs. 1,500) was disposed off Rs. 36,000.
- (iv) 1.11.2017: Some old machineries (Book value on 1.4.2014 at Rs. 10,000) were sold for Rs. 4,000

Show the plant and machinery Accounts as would appear in books of the company for the four year ended 31.3.2018 assuming depreciation is charged proportionately even if the asset is sold (or) destroyed.

Sol.:

(Dec.-18)

Dr.			Machinery A/c		Cr
Date	Particulars	Amount	Date	Particulars	Amount
1/4/2004	To Balance b/d	4,60,000	1/9/2014	By Profit Loss (WN -I)	14,434
			31/3/2015	By Depreciation A/c	962
			31/3/2015	By Depreciation A/c	66,691
			31/3/2015	By Balance c/d	3,77,913
		4,60,000			4,60,000
1/4/2005	To Balance c/d	3,77,913	31/3/2006	By Depreciation A/c	62,593
1/7/2005	To Bank	32,500	31/3/2006	By Depreciation A/c	3,67,820
1/7/2005	To Creditors	20,000			
		4,30,413			4,30,413
1/4/2016	To Balance b/d	3,67,820	31/8/2017	By Bank (sales)	36,000
31/8/2016	To P & L A/c (WN-III)	17,864	31/3/2017	By Depreciation(WN-III)	1,209
			31/3/2017	By Depreciation	52,271
				By Balance c/d	2,96,204
		3,85,684			3,85,684
1/4/2017	To Balance b/d	2,96,204	1/11/2017	By Bank	4,000
			1/11/2017	By Depreciation	537
			1/11/2017	By P & L a/c (less)	1,604
			31/3/2017	By Depreciation	43,509
			31/3/2017	By Balance c/d	2,46,554
		2,96,204			2,96,204

(i) Calculation of Loss on Accidents

Particulars	Amount
Cost on 1-5-2012	21,000
(-) Depreciation for 11 months	2,887
	18,113
(-) Depreciation for 1 year	2,717
	15,396
(-) Depreciation for 5 months	962
	14,434

(ii) Calculation of Profit & Loss 31/8/2016

Particulars	Amount
Cost on 1-4-2013	31,500
(-) Depreciation 2013 – 14	4,725
	26,775
(-) Depreciation 2014 – 15	4,016
	22,759
(-) Depreciation 2015 – 16	3,414
	19,345
(-) Depreciation 2016 – 17	1,209
	18,136
(-) Sales	36,000
Profit	17,864

(iii) Calculation of Profit & Loss on Sale of Machinery 1/11/2017

Particulars	Amount
Cost on 1-4-2014	10,000
(-) Depreciation 2014 – 15	1,500
	8,500
(-) Depreciation 2015 – 16	1,275
	7,225
(-) Depreciation 2016 – 17	1,084
	6,141
(-) Depreciation 7 months	537
	5,604
(-) Sale	4,000
Loss on sale of Machinery	1,604

18. Aswin purchased a machine for Rs. 2,50,000 with an expected life of 10 years, on 1st April, 2010 and spent Rs. 20,000 towards transportation and installation. He followed straight line method for providing depreciation for 2 years and found unsuitable. On 1st April, 2012, he switched over to Diminishing balance method and continued up to 31st March, 2015. Prepare Machinery Accounts for the entire period and ascertain the book value on 1st April, 2015.

Sol.:

(July-18)

Dr. Machinery A/c			Cr		
Date	Particulars	Amount	Date	Particulars	Amount
1/4/2010	To Bank A/c (2,50,000 + 20,000)	2,70,000	31/3/2000	By Depreciation (2,70,000 × 10%)	27,000
			31/3/2011	By Balance c/d	2,43,000
		2,70,000			2,70,000
1/4/2011	To Balance b/d	2,43,000	31/3/2012	By Depreciation	27,000
			31/3/2012	By Balance c/d	2,16,000
		2,43,000			2,43,000
1/4/2012	To Balance b/d	2,16,000	31/3/2013	By Depreciation A/c $\left(2,16,000 \times \frac{10}{100}\right)$	21,600
			31/3/2013	By Balance c/d	1,94,400
		2,16,000			2,16,000
1/4/2013	To Balance b/d	1,94,400	31/3/2014	By Depreciation A/c (1,94,400 × 10%)	19,440
			31/3/2014	By Balance c/d	1,74,960
		1,94,400			1,94,400
1/4/2014	To Balance b/d	1,74,960	31/3/2015	By Depreciation A/c (1,74,960 × 10%)	17,496
			31/3/2015	By Balance c/d	
		1,74,960			1,74,960

$$\text{Calculation of Depreciation} = \frac{2,70,000 - 0}{10} = 27,000$$

As Rate of Depreciation is not given. Hence we are assuming Rate of Depreciation = 10%

19. A firm purchase a leasehold for a period of five years for Rs. 10,000 on 1.1.1995, it decides to write off the lease by Annuity Method presuming the rate of interest at 5% p.a. The annuity table shows that the annual amount necessary to write off Re 1 at 5% p.a. 0.230976. You are required to prepare the lease hold property account for five years and shows the net amount to be charged to the Profit & Loss account for these five years.

Sol.:

(Jan.-18)

Dr.

Leasehold Property

Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1/1/95	To Bank A/c	10,000	31/12/95	By Depreciation A/c	2306.76
31/12/95	To Interest A/c	500	31/12/95	By Balance c/d	8190.24
		10,500			10,500
1/1/96	To Balance b/d	8193.24	31/12/96	By Depreciation A/c	2309.76
31/12/96	To Interest A/c	409.51	31/12/96	By Balance c/d	6289.99
		8599.75			8599.75
1/1/97	To Balance b/d	6289.99	31/12/97	By Depreciation A/c	2309.76
31/12/97	To Interest A/c	314.49	31/12/97	By Balance c/d	4294.72
		6604.48			6604.48
1/1/98	To Balance b/d	4294.72	31/12/98	By Depreciation	2309.76
31/12/98	To Interest A/c	214.73	31/12/98	By Balance c/d	2199.69
		4590.45			4590.45
1/1/99	To Balance b/d	2199.69	31/12/99	By Depreciation A/c	2309.76
31/12/99	To Interest A/c	110.07			
		2309.76			2309.76

Statement showing the amount chargeable to P & L A/c

Year	Depreciation	Interest	Net charge against profits
1995	2309.76	500.00	1809.76
1996	2309.76	409.51	1900.25
1997	2309.76	314.46	1995.27
1998	2309.76	214.73	2095.03
1999	2309.76	110.07	2019.69
	11,548.80	1548.8	10,000

20. A company had bought machinery for Rs. 20,00,000 including a boiler worth Rs. 2,00,000. The machinery account had been credited for depreciation on the Reducing Instalment System for the past four years at the rate of 10% p.a. In the beginning of the fifth year, the boiler became useless on account of damage to some of its vital parts and the damaged boiler is sold for Rs. 40,000. You are required to write up the machinery account for five years.

Sol :

(Nov.-22)

Dr. Machinery A/c				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)
1 st year	To Bank A/c		20,00,000	1 st year	By Depreciation A/c		2,00,000
				1 st year	By Balance c/d		18,00,000
			20,00,000				20,00,000
2 nd year	To Balance b/d		18,00,000	2 nd year	By Depreciation A/c		1,80,000
					By Balance c/d		16,20,000
			18,00,000				18,00,000
3 rd year	To Balance b/d		16,20,000	3 rd year	By Depreciation A/c		1,62,000
					By Balance c/d		14,58,000
			16,20,000				16,20,000
4 th year	To Balance b/d		14,58,000	4 th year	By Depreciation A/c		1,45,800
					By Balance c/d		13,12,200
			14,58,000				14,58,000
5 th year	To Balance b/d		13,12,200	5 th year	By Bank A/c		40,000
					By profit & loss A/c		12,72,200
			13,12,200				13,12,200

Calculation of profit / loss on sale of boiler:

	(₹)
Original cost in the 1 st year	20,00,000
(-) Depreciation for first year @ 10% p.a.	2,00,000
Written down value in the 2 nd year	18,00,000
(-) Depreciation for second year @ 10% p.a.	(1,80,000)
Written down value in the 3 rd year	16,20,000
(-) Depreciation for third year @ 10% p.a.	(1,62,000)
Written down value in the 4 th year	14,58,000
(-) Depreciation for fourth year @ 10% p.a.	(1,45,800)
Written down value in the 5 th year	13,12,200
(-) Sale value	(40,000)
Loss on sale of boiler	12,72,200

Exercise Problems

1. On 1st Jan. 2008, Y Ltd. purchased machinery for Rs. 1,20,000 and on 30 June 2009, it acquired additional machinery at a cost of Rs. 20,000. On 31st Mar. 2010 one of the original machines which had cost Rs. 5,000 was found to have become obsolete and was sold as scrap for Rs. 500. It was replaced by a new machine costing Rs. 8,000. Depreciation is provided at rate of 15% on W.D.V. method. Accounts are closed on 31st December every year. Prepare Machinery A/c for 3 years.

[Ans : Loss Rs. 2,977 Bal. Rs. 93,450]

2. A transport Co. purchases 5 Trucks at Rs. 2,00,000 each on 1 April 2002, The company writes off depreciation @ 20% p.a. on original cost and accounts are closed on 31st December every year. On 1st Oct. 2004, one of the trucks is involved in an accident and is completely destroyed. Insurance Company pays Rs. 90,000 in full settlement of the claim. On the same day the Co. purchased an old truck for Rs. 1,00,000 and spent Rs. 20,000 on its overhauling. Prepare Truck A/c for 3 years.

[Ans : Loss Rs. 10,000 Bal Rs. 4,74,000]

3. A company purchased on 1st Jan. 2004 a secondhand plant for Rs. 30,000 and immediately spent Rs. 20,000 in overhauling it. On July 1 2004 additional machinery costing Rs. 25,000 was purchased. On July 1, 2006 the plant purchased on Jan. 1, 2004 became obsolete and was sold for Rs. 10,000. On that date new machinery was purchased at a cost of Rs. 60,000. Depreciation was provided annually on 31st Dec. at the rate of 10% p.a. on original cost of the Assets. In 2007, however, the Co. changed this method of providing depreciation and adopted the method of writing off 15% on diminishing value. Prepare Machinery A/c from 2004 to 2009.

[Ans : Loss Rs. 27,500 Bal. 46,520]

Short Question and Answers

1. Define goodwill.

Ans :

Meaning

When a firm is reconstituted, goodwill is valued and shared by the existing partners. Goodwill is the present Value of a firm's anticipated excess earnings in future and the efforts had already made in the past. Goodwill really arises only if firm is able to earn higher profit than normal.

Goodwill is the value of the reputation of the firm which the business builds up due to its efficient service to its customers and quality of its products. It is a value of all favorable attributes relating to a business enterprise. It is not merely the past reputation but its continued existence in future that makes goodwill a valuable asset. It cannot be seen or touched. It is an intangible asset but not a fictitious asset.

In other words, goodwill is a thing which is not so easy to describe but in general words good-name, reputation, and wide business connection which helps the business to earn more profits than the profit could be earned by a newly started business. The monetary value of the advantage of earning more profits is known as goodwill. Goodwill is an attractive force, which brings in customers to old place of business. Goodwill is an intangible but valuable asset. In a profitable concern it is not a fictitious asset.

Definitions :

- (i) **According to J.O. Magee**, "The capacity of a business to earn profits in future is basically what is meant by the term goodwill".
- (ii) **According to Lord Lindley**, "The terms goodwill is generally used to denote benefit arising from connections and reputation".
- (iii) **According to Lord Eldon**, "Goodwill is nothing more than the probability, that the old customers will resort to the old place".
- (iv) **According to Lord Macnaghten**, "Goodwill is a thing very easy to describe,

very difficult to define. It is the benefit and advantage of the good name, reputation, and connections of a business. It is the attractive force, which brings in customers. It is one thing which distinguishes an old established business from a new business at its first start".

- (v) **According to Dr. Canning**, "Goodwill is the present value of a firm's anticipated excess earnings".

2. Define depreciation.

Ans :

Meaning

The term depreciation is derived from the Latin words 'do' meaning down and 'pretium' meaning price. In common use it means putting down the value of an asset due to wear and tear, passage of time, obsolescence, etc.

Business is established for indefinite period. Fixed assets are constantly used in the business. The assets lose their value gradually due to their constant use. Loss in the value and utility of assets due to their constant use and expiry of time is termed as 'depreciation'.

It is very difficult to give a single definition of the term depreciation because under different situation this is handled differently and whatever seems to be correct in one situation may be improper in another. But even then some definitions are worth mentioning.

Definitions

- (i) **According to Malchman and Slavin**, "Depreciation refers to the process of estimating and recording the periodic charges to expense due to expiration of the usefulness of a capital asset".
- (ii) **According to R.N. Carter**, "Depreciation is the gradual and permanent decrease in the value of an asset from any cause".
- (iii) **According to J. R. Batliboi**, "Depreciation represents loss or diminution in the value of

an asset consequent upon wear and tear, obsolescence, effluxion of time, or fall in the market value"

- (iv) **According to Spicer and Pegler**, depreciation may be defined as, "The measure of the exhaustion of the effective life of an asset from any cause during a given period".

3. Define inventory.

Ans :

Meaning

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

Inventory forms a significant portion of the total assets of many enterprises and a lot of working capital is invested in this item. Inventories generally constitute the second largest item after fixed assets in the financial statements, particularly of manufacturing concerns. This is why valuation of inventories has assumed significance in recent years.

The values attached to inventories can materially affect the operating results as shown by trading and profit and loss account and the financial position of a business, because closing inventory (stock in trade) is shown on the credit side of the trading account and this amount is also shown as current asset in the balance sheet. The closing inventory becomes the opening inventory in the next accounting period and shown on the debit side of trading account.

Thus, the valuation of inventories does affect the operating results not only of the current accounting period but also of the subsequent period. Inventory valuation is purely subjective depending upon the policies and the different bases of valuing inventories used by different business and even by different undertakings with in the same trade or industry.

4. First In First Out.

Ans :

The FIFO assumption of cost flow is recognised intuitively as being generally consistent with the physical flow of products and goods in most merchandising operations. This method follows the principle that goods received first are sold first. After the first lot or batch of goods purchased is exhausted, the next lot is taken up for sale. It does not suggest, however, that the same lot will be sold.

Sometimes, all items are tagged with their arrival date and sold in date order specially with stocks that deteriorate. The inventory is priced at latest stock.

5. Last In First Out.

Ans :

Under LIFO, latest stocks of goods flow into costs of goods sold and oldest stocks are included in stocks of inventories. This method is based on the assumption that cost of goods sold is charged at prices which almost correspond to the replacement cost of the goods. The main objective in LIFO is the matching of current cost against current revenues, resulting in an operating income which excludes gain and loss from the holding of inventories.

In LIFO, a distinction is often made between natural LIFO where cost flows demonstrably reflect physical flows, and artificial LIFO where cost flows demonstrably contradict physical flows. In fact, there is no necessary connection between physical flows and inventory valuation and the relation of one to the other is simply a convenient assumption. The actual flow of goods will more commonly follow the FIFO concept.

6. Written down value method.

Ans : (Nov.-21, Jan-20, Nov.-20, Jan-18)

Under the written down value method, depreciation, according to a fixed percentage calculated upon the "original cost (in the first year) and written down value, (in subsequent years) of an asset, is written-off during each accounting period over the expected useful life of the asset. Under this method, the rate of depreciation remains constant year after year whereas the amount of depreciation goes on decreasing.

How to Calculate Depreciation under WDV Method: The rate of depreciation is calculated as follows:

$$R = \left[1 - \sqrt[n]{\frac{S}{C}} \right] \times 100$$

Where,

R = Rate of Depreciation (in %),

n = Useful life of the asset (in years)

S = Scrap value at the end of useful life of the asset

C = Cost of the asset

7. What are the objectives of depreciation?

Ans :

The following are the objectives of providing depreciation:

1. Knowledge of True Profits

When an asset is purchased, it is nothing more than payment in advance for an expense. For example, purchasing a building for \$100,000 for business purposes will save rent in the future.

However, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for years.

Any paid rent would have been charged as an expense to determine the true profits made by the business during a particular period.

Therefore, the amount paid for the purchase of the building should be charged over the period for which the asset would be serviceable.

2. True Financial Position

The assets depreciate in their value on account of various factors.

To present a true state of affairs of the business, the assets should be shown in the balance sheet, at their proper values.

In case depreciation is not charged, the balance sheet will not indicate a true view of the state of affairs of the business.

3. Replacement of Assets

The business uses assets to earn revenue. On account of constant use or lapse of time and similar other causes, a stage may come when the assets need to be replaced. Providing depreciation retains a part of the business profits, which can purchase new assets.

4. Correct Cost of Production

Depreciation is a cost of production, and if depreciation is not charged, the cost of production so determined will not be correct.

8. Define Asset.

Ans :

Meaning

According to the institute of chartered accountants of India, the term assets refers to "tangible objects or intangible rights owned by an enterprise and carrying probable future benefits".

Definitions

Some more definitions of assets are as,

(i) **According to the Financial Accounting Standard Board, U.S.A,** "Assets are probable future economic benefits obtained or controlled by a particular equity as a result of past transactions or events".

(ii) **According to Accounting Principles Board, Statement No. 4,** "Economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles including certain deferred charges".

"An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed). The beneficial interest which is legally or equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs".

9. Characteristics of Tangible Assets.

Ans :

The following are some of the prominent features of the tangible fixed assets:

1. Tangible fixed assets are a valid ground for tax deductions as these assets are subject to heavy depreciation or amortization.
2. The monetary value of these assets is such that they do not get depleted within a time span of few years. According to most of the accounting standards, fixed assets should have a minimum life span of at least 12 months.
3. Tangible fixed assets have a comparatively high resale value.
4. A tangible fixed asset can be easily used as collateral to obtain secured loans.

10. Objectives of Inventory.

Ans :

The main objectives of inventory control are listed below :

1. No understocking

Understocking leads to materials running out of stock at some time or the other. Shortages of materials may arise at the time when they are urgently needed and production then be delayed. Delay or stoppage in production due to non-availability of materials is very costly as it may result in loss of profits. Material control system ensures that there is no shortage of materials.

2. No overstocking

Investment in materials must be kept as low as possible, considering the production requirements and the financial resources of the business. Overstocking of materials unnecessarily locks up capital and causes high storage costs, thus, adversely affecting the profits.

3. Minimum wastage

Proper storage conditions must be provided to different types of materials. Losses of materials may occur due to deterioration, obsolescence, theft, evaporation, etc. All efforts should be made to keep these losses at the minimum.

4. Economy in purchasing

The purchasing of material is a highly specialised function. By purchasing materials at the most favourable prices, the efficient purchaser is able to make a valuable contribution to the success of a business.

Choose the Correct Answers

1. The main objective of depreciation is _____. [b]
(a) To show the previous profit (b) To calculate net profit
(c) To reduce tax (d) To satisfy the tax department
2. Depreciation is generated due to _____. [c]
(a) Increase in the value of liability (b) Decrease in capital
(c) Wear and tear (d) Decrease in the value of assets
3. What is the purpose of making a provision for depreciation in the accounts? [a]
(a) To charge the cost of fixed assets against profits
(b) To show the current market value of fixed asset
(c) To make cash available to replace fixed assets
(d) To make a provision for repairs
4. According to straight line method of providing depreciation, the depreciation [a]
(a) Remains constant (b) Increase each year.
(c) Decrease each year (d) None of them.
5. Total amount of depreciation of an asset cannot exceed its [a]
(a) Depreciable value (b) Scrap value
(c) Market value (d) None of these
6. What does FIFO mean? [d]
(a) Finished stock In Finished stock out (b) Fabrications Inward Fabrications Outward
(c) Final Input Final Output (d) First In First Out
7. Regardless of how long it takes to produce and sell inventory, inventory is always considered to be a? [a]
(a) Current asset (b) Current liability
(c) Long-term asset (d) Stockholder's equity

8. The latest cost of inventories is changed to production but the old prices are changed to inventories on hand? [b]
- (a) Average (b) LIFO
(c) FIFO (d) Perpetual
9. An increase in inventories indicates that? [a]
- (a) More merchandise was purchased then the amount sold to customer
(b) Less merchandise was purchased then sold to the customer
(c) Not all purchases were cash
(d) Cash payments were more than purchases on account
10. Which type of inventory system is updated inventory system? [d]
- (a) Periodic inventory system (b) Contingency inventory system
(c) LIFO (d) Perpetual inventory system

Fill in the Blanks

1. _____ are probable future economic benefits obtained or controlled by a particular equity as a result of past transactions or events.
2. _____ is the primary classification for raw materials in manufacturing operations.
3. _____ consists of goods that do not meet production standards and are either sold for their salvage value or discarded without further processing.
4. Goods that do not meet production standards and must be processed further in order to be saleable as good units are known as _____.
5. The excess of average profit over normal profit is called _____.
6. _____ is the gradual and permanent decrease in the value of an asset from any cause.
7. _____ is created to provide a definite amount at a certain future date for a specific purpose of 'replacement of the asset at the end of its useful life.
8. _____ depreciation is the total depreciation for a fixed asset that has been charged to expense since that asset was acquired and made available for use.
9. The word _____ is used to show loss in the value of intangible assets.
10. Increase and decrease in the market value of assets is known _____.

ANSWERS

1. Assets
2. Direct material
3. Spoilage
4. Defectives
5. Super profit
6. Depreciation
7. Sinking fund
8. Accumulated
9. Amortization
10. Fluctuation

One Mark Question & Answers

1. Tangible Assets.

Ans :

Tangible assets are those which are physical, materialistic and visual substances of a firm. For instance: Land, Building, Plant and machinery, Vehicles, Inventory' and so on.

2. Intangible assets.

Ans :

Intangible assets are identifiable non-monetary assets that cannot be seen, touched or physically measured, which are created through time and/or effort and that are identifiable as a separate asset.

3. Highest In First Out.

Ans :

The highest priced materials are treated as being issued first. The closing inventory is kept at the lowest possible price.

4. Goodwill.

Ans :

The capacity of a business to earn profits in future is basically what is meant by the term goodwill.

5. Annuity Method.

Ans :

According to this method, goodwill is equal to present or discounted value of average super profit of the firm.

UNIT IV

Financial Statement Analysis-I

Statement of Changes in Working Capital, Funds from Operations, Paid Cost and Unpaid Costs. Distinction between Cash Profits and Book Profits, Preparation and Analysis of Cash Flow Statement and Funds Flow Statement, Horizontal Analysis and Vertical Analysis of Company.

4.1 FINANCIAL STATEMENT ANALYSIS

Q1. Define financial statement analysis.

Ans :

Meaning

Financial analysis is also referred as financial statements analysis. The term 'financial analysis', also known as an 'analysis and interpretation of financial statements', refers to the process of determining financial strengths and weakness of firm by establishing strategic relationship between the items of balance sheet, profit and loss account and other operative data.

Definition

(i) **According to Myers,** "Financial statements analysis is largely a study of relationship among the various financial factors in a business as disclosed by single set-of statements, and study of the trend of these factors as shown in a series of statement".

Analysis of financial statements is the systematic numerical calculation of the relationship between one fact with the other to measure the profitability, operational, efficiency, solvency and the growth potential of the business.

(ii) **According to Hampton,** "Analysis of financial statement i & the process of determining the significant operating and financial characteristics of a firm from accounting data.

Q2. Explain the various Stages of Financial Statement Analysis.

Ans :

The following are the stages of financial statement analysis.

1. Established Relationship

A relationship is established among financial statements with the help of tools and techniques of analysis such as ratios, trends, common size, funds flow, etc.

2. Re-arrangement

Whatever information is available must be re-arranged' with a view to derive the maximum information from the analysis of financial statements. Re-arrangement depends upon the purpose of analysis.

3. Comparison

It is also required to collect data in such a form whereby comparison is done easily. For this purpose data of some more years is required.

4. Analysis and Interpretation

Data is analyzed as per purpose and then interpreted. Interpretation should be precise.

5. Conclusion

The conclusions drawn from interpretation are presented to the management in the form of reports.

Q3. Explain the objectives of financial statement analysis.*Ans :*

The objectives/importance of financial statement analysis is as follows:

1. Measuring Short-term Solvency

Whether the firm is in a position to pay its short term liabilities or not, this can be judged by analyzing its financial statements. If the information is positive, the creditors would like to lend and financially the firm is considered as solvent.

2. Measuring Long-term Solvency

Whether the firm is in a position to meet its long term obligations or not, this can again be studied from the analysis of financial statements. Long term liabilities mean debentures and other secured loans. Both the debenture holders and lenders of money are interested to have interest and safety of return of their investment in the form of loans given to the business.

3. Measuring Operating Efficiency

Whether the business is running at a profit or loss can be made clear only from the analysis of financial statements. If there is any loss, corrective steps may be taken to wipe off losses, if any, or minimize it in order to make it a viable business.

4. Measuring Profitability

Financial statement analysis is used to ascertain its earning capacity as well as prediction relating to its future earnings. This sort of information can be inferred from the financial analysis, which may be used by the investors, in general, and financial institutions, in particular. Thus, analysis of financial statements helps in measuring profitability of the business.

5. Comparison of Inter-firm Position

The analysis of financial statements makes it possible for an analyst to compare inter-firm

position and draw necessary conclusions relating to financial soundness etc.

6. Forecasting, Budgeting and Deciding Future Line of Action

Analysis of financial statement predicts the growth potential of the business. Comparison of actual performance with the desired performance shows our shortcomings. The analysis provides sufficient information regarding the profitability, performance and financial soundness of the business. On the basis of these informations one can make effective forecasting, budgeting, and planning.

7. Indicating Trend of Achievements

Financial statement of the previous years can be compared and the trend regarding various expenses, purchases, sales, gross profit and net profit can be ascertained, cost of goods sold, values of assets and liabilities can be compared and the future prospectus of the business can be indicated.

8. Assessing Growth Potential of the Business

The trend and dynamic analysis of the business provides us sufficient information indicating the growth potential of the business. If the trend predicts gloomy picture, effective measures can be applied as remedial (corrective) measures. If cost of production is rising without corresponding increase in sales price, efforts should be made to reduce cost production.

9. Simplified, Systematic and Intelligible Presentation of Facts

Analysis of financial statements is an effective tool for simplifying, systematizing and summarizing the monotonous figures. An average person can draw conclusion from these ratios. The facts can be made more attractive by graphs and diagrams, which can be easily understood.

Q4. Explain the limitations of financial statement analysis.*Ans :*

The limitations of financial statement analysis are as follows:

1. Absence of Standard Universally Accepted Terminology

Accounting is not an exact science. It does not have standard universally accepted terminology. Different meanings are given to a particular term. There are different methods of providing depreciation; interest may be charged on different rates, etc.

2. Ignoring Qualitative Aspects

Financial analysis does not measure the qualitative aspects of the business. It is the quantitative measurement of performance. It means that analysis of financial statement measures only the one sided performance of the business.

3. Misleading Result in Absence of Absolute Data

Result shown by financial analysis may be misleading in the absence of absolute data.

4. Ignoring Price Level Changes

The comparability of ratios suffers if the prices of the commodities in two different years are not the same. Change in price affects the cost of production, sales and also the value of assets. It means that the ratio will not be meaningful for comparison if the prices of commodities are different.

5. Suffering from Limitations of Financial Statements

Financial statement suffers from variety of weaknesses. Balance sheet is prepared on historical record of the value of assets. It is just possible that assets may not have the same value. Financial statements are prepared according to certain conventions at a point of time, whereas the investor is concerned with the present and the future of the company. Certain assets and liabilities are not disclosed.

Financial statements suffer from these weaknesses, so analysis based upon these statements can not be said to be always reliable.

6. Financial Statements are Affected by Window Dressing

The management displays rosy picture of the enterprise through financial statements. Sometimes material information is concealed. Financial statements sometimes contain false information. In order to show excellent profit, sales may be exaggerated, stock may be over valued and certain purchases may not be shown.

7. Financial Statements are Affected by the Personal Ability and Bias of Analyst

The figures of financial statements do not speak themselves. This information are analyzed and interpreted by shrewd analyst, who may have their own views, reflected in the analysis. In many situations the accountant has to choose between alternatives available, e.g., choice between straight line and diminishing balance method of depreciation and choice between LIFO and FIFO method of the valuation of stock, etc.

8. Financial Analysis is Only a Tool, not the Final Remedy

Analysis of statement is a tool to measure the profitability, efficiency and financial soundness of the business. It should be noted that personal judgment of the analyst are most important in financial analysis. One should not rely on single ratio. Accountant should not be biased in the calculations of ratios. It should not be calculated to prove the personal contention.

9. Financial Analysis Spots the Symptoms but does not Arrive at Diagnosis

Financial analysis shows the trend of the affairs of the business. It may spot symptoms of financial unsoundness and operational inefficiency but that cannot be accepted. A final decision in this regard will require further investigation and thorough diagnosis.

Q5. Explain the users of financial statement analysis.*Ans :*

The following points explain the importance and usefulness of financial statement analysis and interpretation to various parties,

1. Proprietor/Owners of Organization

The financial statements give the complete details of the funds which are being utilized and invested

by the owners for carrying out the business. The owner can find out whether the funds are being properly utilized or not by analyzing the financial statements.

2. Creditors/Finances of Business

The financial statements are very useful to the creditors for the purpose of analyzing or verifying the financial position of the organization before granting loan or credit to the companies.

3. Investors of Business

The investors usually need information about the business in which they are going to invest their money so as to decide whether they can invest or not. Thus, financial statements help the investors to make wise decisions.

4. Employees of organization

The information provided through financial statements is also useful to the employees of the organization. They are interested to know financial position with respect to bonus and other benefits i.e., whether they are getting correct percent of bonus or not.

5. Government Agencies

The financial statements of the organization help the government in framing taxation policies.

6. Researchers

The financial statements are very useful to the researchers who are greatly interested in doing research study for analyzing the financial position of a particular organization.

7. Managers of Organization

The financial statements are also useful to managers in making appraisals of the performance of organization and its employees. It allows the managers to compare the budgeted performance with the actual performance on the basis of which managers can take necessary measures to bring improvement in the performances.

Q6. Explain different types of financial statement analysis.*Ans :*

The different types of financial statement analysis are as follows,

- I. According to materials used
- II. According to modus operandi of analysis
- III. According to the objectives of analysis.

I. According to Materials Used

Based on material used it can be further divided into external and internal.

1. External Analysis

This is effected by those who do not have access to the detailed accounting records of the company. This group contains investors, creditors, government and the public depends almost entirely on published financial statements. With the recent changes in the Government regulations requiring business concerns to make available detailed information to the public through audited accounts, the position of the external analyst has been considerably improved.

2. Internal Analysis

This is effected by those who have access to the books of accounts and other informations relating to the business concern. Any financial analysis is conducted with reference to a part of the whole unit. This type of analysis is meant for management purpose. It is conducted by employees of the business units.

II. According to Modus Operandi of Analysis

Based on this, the analysis can be divided into horizontal and vertical.

1. Horizontal Analysis

When financial statements for a certain number of years are examined and analyzed, then the analysis is called as horizontal analysis. It is also known as "dynamic analysis". This is based on the data spread over a period of years rather than on one date or period of time as a whole.

2. Vertical Analysis

This refers to analysis of ratios developed for one date or for one accounting period. This is also known as 'static analysis'. But vertical analysis does not facilitate a proper analysis and interpretation of figures in perspective and also comparisons over a period of years. As such, this type of analysis is not resorted by the financial analysts.

III. According to the Objectives of Analysis

On the basis of objectives, the analysis is basically divided into long-term and short-term analysis.

1. Long-term Analysis

Long term analysis basically aims at helping the decision makers in taking long term decisions. Long terms plans usually deals with the aspects relating to growth, development, expansion, diversification, innovation and so on. For this purpose, the analyst needs to carefully examine/study the long term financial stability of business/firm by taking into consideration its solvency, liquidity, profitability and earning capacity.

2. Short Term Analysis

Short term analysis basically aims at helping the decision makers in taking

short term decisions. It carefully studies/ examines the short solvency, liquidity profitability and earning capacity of the firm. Short term analysis gives a clear picture about the capability of business/ firm in meeting up short term requirements. This analysis significantly takes into consideration the current assets and current liabilities in order to ascertain the short term financial position of business firm.

4.2 STATEMENT OF CHANGES IN WORKING CAPITAL

Q7. Define working capital. What are the factors determining working capital?

Ans :

Meaning

Working Capital refers to the cash a business requires for day-to-day operations, (or) more specifically, for financing the conversion of raw materials into finished goods, which the company sells for payment. Among the most important items of working capital are levels of inventory, debtors and creditors. These items are looked at for signs of a company's efficiency and financial strength.

Definition

- (i) **According to Shubin**, "Working capital the amount of funds necessary to cover the cost of operating the enterprise".
- (ii) **According to Gerstenberg**, "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as **for example**, from cash to inventories, inventories to receivables, receivables into cash".
- (iii) **According to Hoagland**, "Working capital is descriptive of that capital which is not fixed. But, the more common use of working capital is to consider it as the difference between the book value of the current assets and the current liabilities".

Factors**(a) Nature (or) character of business**

The Working Capital requirements of a firm basically depend upon the nature of its business. Public utility undertaking like Electricity, Water Supply and Railways need very limited Working Capital because they offer cash sales only and supply services, not products, and as such no funds are tied up in inventories and receivables. The trading and financial firms require less investment in fixed assets but have to invest large amounts in current assets like inventories, receivables and cash; as such they need large amount of Working Capital.

(b) Size of business / Scale of operations

The Working Capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations. Greater the size of a business unit, larger will be the requirements of Working Capital. In some cases even a smaller concern may need more Working Capital due to high overhead charges, inefficient use of available resources and other economic disadvantages of small size.

(c) Production policy

In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of Working Capital, in such cases depend upon the production policy. The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak season. If the policy is to keep production steady by accumulating inventories it will require higher Working Capital.

(d) Manufacturing process/length of production cycle

In manufacturing business, the requirements of Working Capital increase in direct proportion to length of manufacturing process. Longer the process period of

manufacture, larger is the amount of Working Capital required. The longer the manufacturing time, the raw materials and other supplies have to be carried for a longer period in the process with progressive increment of labour and service costs before the finished product is finally obtained. Therefore, if there are alternative processes of production, the process with the shortest production period should be chosen.

(e) Seasonal variations

In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process them during the entire year. A huge amount is, thus, blocked in the form of material inventories during such season, which gives rise to more Working Capital requirements. During the busy season, a firm required larger Working Capital than in the slack season.

Q8. What are the advantages and disadvantages of working capital?

Ans :

Advantages

The main advantages of maintaining adequate amount of working capital are as follows:

1. Cash Discount

If a proper cash balance is maintained, the business can avail the advantage of cash discount by paying cash for the purchase of raw materials and merchandise. It will result in reducing the cost of production.

2. Creates a Feeling of Security and Confidence

The proprietor or officials or management of a concern are quite carefree, if they have proper working capital arrangements because they need not worry for the payment of business expenditure or creditors. Adequate working capital creates a sense of security, confidence and loyalty, not only throughout the business itself, but also among its customers, creditors and business associates.

3. 'Must' for Maintaining Solvency and Continuing Production

In order to maintain the solvency of the business, it is but essential that the sufficient amount of fund is available to make all the payments in time as and when they are due. Without ample working capital, production will suffer, particularly in the era of cut throat competition, and a business can never flourish in the absence of adequate working capital.

4. Sound Goodwill and Debt Capacity

It is common experience of all prudent businessmen that promptness of payment in business creates goodwill and increases the debt of the capacity of the business. A firm can raise funds from the market, purchase goods on credit and borrow short-term funds from bank, etc. If the investor and borrowers are confident that they will get their due interest and payment of principal in time.

5. Easy Loans from the Banks

An adequate working capital i.e. excess of current assets over current liabilities helps the company to borrow unsecured loans from the bank because the excess provides a good security to the unsecured loans, Banks favour in granting seasonal loans, if business has a good credit standing and trade reputation.

6. Distribution of Dividend

If company is short of working capital, it cannot distribute the good dividend to its shareholders inspite of sufficient profits. Profits are to be retained in the business to make up the deficiency of working capital. On the other contrary, if working capital is sufficient, ample dividend can be declared and distributed. It increases the market value of shares.

7. Exploitation of Good Opportunity

In case of adequacy of capital in a concern, good opportunities can be exploited e.g., company may make off-season purchases resulting in substantial savings or it can fetch big supply orders resulting in good profits.

8. Meeting Unseen Contingency

Depression shoots the demand of working capital because stock piling of finished goods become necessary. Certain other unseen contingencies e.g., financial crisis due to heavy losses, business oscillations, etc. can easily be overcome, if company maintains adequate working capital.

9. High Morale

The provision of adequate working capital improves the morale of the executive because they have an environment of certainty, security and confidence, which is a great psychological, factor in improving the overall efficiency of the business and of the person who is at the helm of affairs in the company.

10. Increased Production Efficiency

A continuous supply of raw material, research programme, innovations and technical development and expansion programmes can successfully be carried out if adequate working capital is maintained in the business. It will increase the production efficiency, which will, in turn increase the efficiency and morale of the employees and lower costs and create image among the community.

11. Regular Supply of Raw Materials

Sufficient working capital ensures regular supply of raw materials and continuous production.

12. Regular Payment of Salaries, Wages and Other Day-to-Day Commitments

A company which has ample working capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastage's and costs and enhances production and profits.

Disadvantages

The disadvantages suffered by a company with excessive working capital are as follows :

1. Heavy Investment in Fixed Assets

A concern may invest heavily in their fixed asset which is not justified by actual sales. This may create situation of over capitalization.

2. Reckless Purchase of Materials

Inventory is purchased recklessly which results in dormant slow moving and obsolete inventory. At the same time it may increase the cost due to mishandling, waste, theft, etc.

3. Speculative Tendencies

Speculative tendencies may increase and if profit is increased dividend distribution will also increase. This will hamper the image of a concern in future when speculative loss may start.

4. Liberal Credit

Due to liberal credit, size of accounts receivables will also increase. Liberal credit facility can increase bad debts and wrong practices will start, regarding delay in payments.

5. Carelessness

Excessive working capital will lead to carelessness about costs which will adversely affect the profitability.

Q9. Write about the statement of changes in working capital.

Ans :

Statement of Changes in Working Capital

This involves two aspects namely,

1. Determination of working capital at the commencement and at the end of the period covered by the funds flow statement.
2. Ascertainment of increase or decrease in working capital.

1. Determination of Working Capital

Working capital is ascertained by deducting the total of current liabilities from the total of current assets.

$$\text{Working capital} = \text{Current Assets} - \text{Current Liabilities}$$

2. Increase or Decrease in Working Capital

Increase or decrease in working capital over a period is ascertained by preparing schedule of changes in working capital.

Schedule of Changes in Working Capital

(1) Particulars	(2) Previous year (₹)	(3) Current year (₹)	(4) Increase in W.C (₹)	(5) Decrease in W.C (₹)
A. Current Assets				
(a) Inventories	xxx	xxx		
(b) Sundry Debtors	xxx	xxx		
(c) Cash Balance	xxx	xxx		
(d) Bank Balance	xxx	xxx		
(e) Bills Receivable	xxx	xxx		
(f) Prepaid Expenses	xxx	xxx		
(g) Accrued Incomes	xxx	xxx		
(h) Short-term Loans and Advances	xxx	xxx		
(i) Marketable Investments (Short-term)	xxx	xxx		
Total Current Assets (A)	<u>xxx</u>	<u>xxx</u>		
B. Current Liabilities				
(a) Sundry Creditors	xxx	xxx		
(b) Bills Payable	xxx	xxx		
(c) Outstanding Expenses	xxx	xxx		
(d) Bank Overdraft	xxx	xxx		
(e) Unclaimed Dividend	xxx	xxx		
(f) Unaccrued Incomes	xxx	xxx		
(g) Short-term Loans and Advances	xxx	xxx		
(h) Provision for Doubtful Debt	xxx	xxx		
(i) Provision for Discount on Debtors	xxx	xxx		
Total Current Liabilities (B)	<u>xxx</u>	<u>xxx</u>		
C. Working Capital (A - B)	xxx	xxx		
D. Increase in Working Capital (or) Decrease in Working Capital	xxx	xxx		
	xxx	xxx	xxx	xxx

Q10. How can the Net increase in working capital be computed ?

Ans :

(July-2018)

Step 1 :

Enter the amounts of current assets for previous year in previous year column.

Step 2 :

Enter the amounts of current assets for current year in current year column

Step 3 :

If current assets is increasing working capital also increasing. If current assets decreases working capital also decreases.

Step 4 :

Enter the amount of current liabilities for previous year in previous year column.

Step 5 :

Enter the amount of current liabilities for current year in current year column.

Step 6 :

If current liabilities increases working capital decreases. If current liabilities decrease working capital increases.

PROBLEMS

- From the following details prepare a statement showing changes in working capital during 2012.

Balance sheet of Rohit as on 31st December

Liabilities	2011 Rs.	2012 Rs.	Assets	2011Rs.	2012 Rs.
Share capital	5,00,000	6,00,000	Fixed assets	10,00,000	11,20,000
			Less :	3,70,000	4,60,000
			Depreciation	6,30,000	6,60,000
Reserve	1,50,000	1,80,000			
Profit and Loss A/c	40,000	65,000	Stock	2,40,000	3,70,000
Debentures	3,00,000	2,50,000	Book Debts	2,50,000	2,30,000
Creditors for goods	1,70,000	1,60,000	Cash in hand	80,000	65,000
			Preliminary		
Provision for tax	60,000	80,000	expenses	20,000	15,000
	12,20,000	13,35,000		12,20,000	13,35,000

Sol :

The first step is to prepare the schedule of changes in working capital

Schedule of changes in working capital

Particulars	2011 Rs.	2012 Rs.	Increase in working capital Rs.	Decrease in working capital Rs.
Current Asset :				
Stock	2,40,000	3,70,000	1,30,000	---
Book debts	2,50,000	2,30,000	--	20,000
Cash in hand	80,000	60,000	--	20,000
Total (A)	5,70,000	6,60,000	1,30,000	40,000
Current Liability				
Creditors for goods	1,70,000	1,60,000	10,000	--
Total (B)	1,70,000	1,60,000		
Working capital (A-B)	4,00,000	5,00,000	1,40,000	40,000
Increase in working capital	1,00,000	--	--	1,00,000
	5,00,000	5,00,000	1,40,000	1,40,000

4.3 FUNDS FROM OPERATIONS

Q11. Draw the proforma of funds from operations.

Ans :

Funds generated from business operations (to be shown under sources) or the funds lost in business operations (to be shown under applications) should be ascertained by deducting from or adding back to the figure of net profit. The items which are not in form of a trading charge should also be added back to net profit. And the items which are not in form of normal business income or profit should be deducted from net profit. Those items which do not result in a change in any current liability or asset should be deducted from net profit.

Funds generated from business operations (or funds lost in business operations) can be calculated as follows,

Funds from Operations

Particulars	Amount (₹)
Profit and Loss Account (Closing Balance)	xxx
Add: Non-Fund or Non-Operating items (Debited to P & L A/c)	
(i) Depreciation written off	xxx
(ii) Preliminary expenses written off	xxx
(iii) Goodwill written off	xxx
(iv) Discount on issue of shares or debentures written off	xxx

(v) Transfer to general reserve	xxx
(vi) Transfer to sinking funds	xxx
(vii) Transfer to dividend equalization reserve	xxx
(viii) Loss on sale of fixed assets or investments (other than temporary investments)	xxx
Less: Non-Fund or Non-Operating Items (Credited to P&LA/c)	
(i) Dividend received on investments (other than temporary investments) credited to Profit & Loss Account	xxx
(ii) Excess of provision for taxation written back	xxx
(iii) Profit on sale of fixed assets or investments (other than temporary investments)	xxx
(iv) Funds generated from business operations (or funds lost in business operations)	xxx

PROBLEMS ON FUNDS FROM OPERATIONS

2. The profit and loss a/c of XYZ Ltd., for the year ending 2007 is presented below,

Particulars	Amount (₹)	Amount (₹)
Sales		1,00,000
Less		
Materials consumed	2,000	
Manufacturing expenses	3,000	
Administration and selling expenses	1,000	
Depreciation	500	
Amortisation of Patent	200	
Preliminary expenses	200	
Loss on sale of furniture	300	7,200
Operating profit		92,800
Add : Dividend received		1,200
		94,000
Less : Income tax		1,000
Net profit		93,000

You are required to compute the funds from operation for the year 2007.

*Sol :***Calculation of Funds from Operations**

Particulars	Amount (₹)	Amount (₹)
Net profit as per profit and loss account		93,000
Non-fund and Non-operating items debited to P & L a/c		
Add:		
a. Loss on sale of furniture	300	
b. Depreciation written off	500	
c. Amortisation of intangible assets	400	
[Patents and preliminary expenses]		1,200
		94,200
Less : Non-fund and Non-operating items credited to P & L a/c		
a. Dividends received		1,200
Funds from operations		93,000

3. Extracts from the balance sheets prepare funds flow statements.

Particulars	31 st Dec 06 (₹)	31 st Dec 07 (₹)
Balance of profit and loss a/c	1,00,000	1,50,000
Additional Information,		[in ₹]
a. Depreciation charged on assets		10,000
b. Preliminary expenses written off		5,000
c. Amounts transferred to dividend equalization fund		15,000
d. A plant having a value of ₹ 60,000 was sold for		65,000
e. Interim dividend paid ₹ 10,000		

*Sol.:***Calculation of Funds from Operations**

Particulars	Amount (₹)	Amount (₹)
Net profit [Closing balance of P & L a/c given in B/S]		1,50,000
Add :		
Non-fund and non-operating items debited to P & L a/c		
Depreciation charged on assets	10,000	
Preliminary expenses written off	5,000	
Dividend equalizations fund	15,000	
Interim dividend	10,000	40,000
		1,90,000
Less :		
Non-fund and non-operating items credited to P & L a/c		
Profit on the sale of plant	5,000	
Opening balance of P & L a/c [given in B/S]	1,00,000	1,05,000
Funds from operation		85,000

4. Following are the extracts from the balance sheet of a company as on 31 st Dec. 2008 and 31 st Dec. 2009. You are required to calculate funds from operations:

Particulars	As on 31st December	
	2008	2009
Profit and Loss Account	30,000	40,000
General Reserve	20,000	25,000
Goodwill	10,000	5,000
Preliminary Expenses	6,000	4,000
Provision for Depreciation	10,000	12,000

*Sol :***Funds from Operation**

Particulars		
Net profit (as given)		40,000
Add : Non-fund or non-operating items which have been debited to P/L A/c		
Transfer to general Reserve	5,000	
Goodwill written off	5,000	
Preliminary expenses written off	2,000	
Provision for depreciation	2,000	14,000
		54,000
Less : Non-fund or non-operating items which have been credit to P/L A/c:		
Balance as on 31st Dec. 2005	30,000	30,000
Funds from Operations		24,000

5. From the following balance sheets for the years 2004 and 2005; find out funds from operations.

Particulars	2004 (Rs.)	2005 (Rs.)
General reserve	10,000	12,500
Goodwill	5,000	2,500
Provision for depreciation on plant	5,000	6,000
Preliminary expenses	3,000	2,000
Profit and loss appropriation A/c	15,000	20,000

*Sol :***Funds from Operations**

Particulars	Rs.
Profit and loss appropriation account as on December 31, 2005	20,000
Add : Items not decreasing funds :	
Transfer to general reserve	2,500
Goodwill written off	2,500
Provision for depreciation on Plant	1,000
Preliminary expenses written off	1,000
	27,000
Less : Profit and loss appropriation account balance as on December 31, 2004	15,000
Funds from operations	12,000

The funds from operations can also be found by preparing adjusted profit and loss account as given below :

Adjusted Profit and Loss Account

Particulars	Rs.	Particulars	Rs.
To Transfer to general reserve	2,500	By Balance b/d	15,000
To Goodwill written off	2,500	By Funds from operations	12,000
		(balancing figure)	
To Preliminary expenses written off	1,000		
To Provision for depreciation	1,000		
To Balance c/d	20,000		
	27,000		27,000

4.4 PAID COST AND UNPAID COSTS

Q12. Write in detail about paid cost and unpaid cost or paid expenses and unpaid expenses.

Ans :

(Jan-18)

Paid Costs/Expenses

Paid costs/expenses are also called prepaid expenses or expenses paid in advance. The expenses that are paid in advance for the events that are to be held in next year during the present accounting period are called prepaid expenses.

Example

Rent that has to be paid for next year has been paid in advance in this year. The prepaid expenses should not be considered under profit and loss account and are required to carry forward for next year and are debited to expenses account.

1. These expenses should be debited in trial balance.
2. They should be deducted from the respective expense in profit and loss account.
3. They should be represented under assets in Balance sheet.

Dr.

Profit and Loss Account

Cr.

Particulars	Amount (₹)	Particular	Amount (₹)
Rent	xxx		
Less: Prepaid rent	xxx		

Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
		Prepaid rent	xxx

Effect of Prepaid Expenses on Cash from Operations

The effect of prepaid expenses on cash from operations is analogous to the effect of debtors. The prepaid expenses are not considered in profit and loss account and in the calculation of net profit as they are related to next year. Unlike outstanding expenses, prepaid expenses have a significant effect on cash from operations as they decrease the cash from operation without affecting the net profit.

$$\text{Net profit} = \text{Gross profit} - \text{Expenses} - \text{Prepaid expenses}$$

Unpaid Costs/Expenses

Unpaid expenses are also called outstanding expenses. The expenses that are due or unpaid during that accounting period are called outstanding expenses. These expenses include outstanding rent, salaries, interest etc., These expenses cannot be entered in the records till their realization. But for ascertaining the true picture of profit/loss incurred in a particular accounting period one should represent these expenses in the final accounts.

1. These expenses should be debited to the profit and loss account
2. They should be stated under liabilities in balance sheet.

Dr		Profit and Loss Account		Cr	
Particulars	Amount (₹)	Particular	Amount (₹)		
To rent (trial balance amount)	xxx				
Add: Outstanding rent (adjustment amount)	xxx				

Balance Sheet

Liabilities	Amount (₹)	Assets	Amount (₹)
Outstanding rent	xxx		

Effect of Unpaid Expenses on Cash from Operations

The effect of outstanding or unpaid expenses in cash from operations is analogous to the effect of creditors. There exists a direct relationship between unpaid expenses and cash from operations i.e., the increase in the outstanding expenses results in a corresponding increase in the cash from operations and vice-versa. Net profit can be calculated after adding all the expenses and income to the gross profit. But there exists an inverse relation between outstanding expenses and net profit.

4.5 DISTINCTION BETWEEN CASH PROFITS AND BOOK PROFITS

Q13. What are the difference between cash profits and book profits.

(OR)

Distinguish between cash profits and book profits.

(OR)

Explain the differences between cash profit and book profit.

Ans :

(Jan-18)

S.No.	Basis	Cash Profits	Book Profits
1.	Meaning	Cash profits refers to the actual surplus generated or earned by the firm.	Book profits refers to the profit which is recorded in the accounting books of firm.
2.	Components	Cash profits consist of components like cash in hand, demand deposits and other cash transactions.	Book profits consist of components like depreciation and other non-cash items.
3.	Maintenances of Account	Under this, accounts are maintained on cash basis i.e., only those transactions are recorded in which cash is generated by sale of goods.	Under this, accounts are maintained on accrual basis i.e., when sale is made and cash is not received then the transactions have to be recorded in income statement.
4.	Example	Electricity manufacturing firms are the example of firms which earns book profits.	Sole trading and partnership firms are the examples of firms which earn cash profits directly.
5.	Linkage or Relationship	Adjustments made in cash profits results in book profits.	After the adjustments of cash profits, book profits are disclosed.

4.6 PREPARATION AND ANALYSIS OF CASH FLOW STATEMENT

Q14. Define Cash Flow Statement. What are the Advantages and Disadvantages of Cash Flow Statements.

(OR)

Describe the Advantages and Disadvantages of Cash Flow Statements.

(OR)

What are the Limitations of Cash Flow Statements?

(OR)

What is Cash Flow Statement?

(OR)

What information can be Obtained from Cash Flow.

Ans :

(Nov.-22, Jan.-20, Dec.-18, Jan-18)

Cash plays a very important role in the entire economic life of a business. A firm needs cash to make payments to its suppliers, to incur day-to-day expenses and to pay salaries, wages, interest and dividends, etc. In fact, what blood is to a human body, cash is to a business enterprise. It is very essential for a business to maintain an adequate balance of cash. But many a times, a concern operates profitably and yet it becomes very difficult to pay taxes and dividends. This may be because (i) although huge profits have been earned yet cash may not have been received or (ii) even if cash has been received; it may have drained out (used) for some other purposes. This movement of cash is of vital importance to the management.

A statement of changes in the financial position of firm on cash basis is called a cash flow statement. Such a statement enumerates net effects of the various business transactions on cash and takes into account receipts and disbursements of cash. A cash flow statement summarizes the causes of changes in cash position of a business enterprise between dates of two balance sheets.

Cash flow statement is a statement of changes of financial position in business due to inflow or outflow of cash and their statement is required for short-range business premises.

Advantages

A cash flow statement is useful for short-term planning. A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts maturing in the near future, expenses of the business, etc.

A cash flow analysis is an important financial tool for the management. Its chief advantages are as follows:

1. Helps in Efficient Cash Management

Cash flow statement helps in evaluating financial policies and cash position, cash is the basis for all operations and hence a projected cash flow statement will enable the management to plan and coordinate the financial operations properly.

2. Helps in Internal Financial Management

Cash flow statement provides information about funds, which will be available from operations. This will help the management in determining policies regarding internal financial management, for example, possibility of repayment of long-term debt, dividend policies, planning replacement of plant and machinery, etc.

3. Disclose the Movements of Cash

Cash flow statement discloses the complete story of cash movement. The increase or decrease in cash and the reason therefore can be known. It discloses the reasons for low cash balance in spite of heavy operating profits or for heavy cash balance in spite of

low profits. However, comparison of original forecast with the actual results highlights the trends of movement of cash, which may otherwise go undetected.

4. Discloses Success or Failure of Cash Planning

The extent of success or failure of cash planning can be known by comparing the projected cash flow statement with the actual cash flow statement and necessary remedial measures can be taken.

5. Helpful in Declaring Dividends etc

Cash flow statement is very helpful in declaring dividends etc. This statement can supply information regarding availability of cash. If cash is available, dividend can be paid. Thus, it helps to understand the liquidity. It must be paid within 42 days.

Disadvantages

The disadvantages of cash flow statement are as follows:

1. Ignores Basic Principle of Accounting

As cash flow statement is based on cash basis of accounting, it ignores the basic accounting concept of accrual basis.

2. Not Suitable for Judging Profitability

Cash flow statement is not suitable for judging the profitability of a firm, as non-cash charges are ignored while calculating cash flows from operating activities.

3. Cannot be Equated with Income Statement

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 does not necessarily mean net income of the business.

4. May not Represent Real Liquid Position

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.

Q15. Write the procedure for preparing cash flow statement.

(OR)

Discuss briefly the major classification of cash flow as per AS-3 (Revised).

(OR)

Explain how cash flow statements are prepared.

(OR)

How are cash flows classified as per AS-3.

Ans :

(Nov.-20, May-19, Dec.-18, July-18)

The Institute of Chartered Accountants of India has issued in 1997 the Accounting Standard AS-3 (revised) relating to cash flow statement which has superseded AS-3 issued earlier. As per recent proposed format issued by the SEBI (Securities Exchange Board of India) it is mandatory for each company to give a copy of its cash flow statement along with a copy of its final accounts.

The cash flow statement can be classified into following activities:

1. Operating activities,
2. Investing activities, and
3. Financing activities.

1. Operating activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from principal revenue producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

Examples

- (i) Cash receipts from the sale of goods and the rendering of services;
- (ii) Cash receipts from royalties, fees, commissions and other revenue;
- (iii) Cash payments to suppliers for goods and services;
- (iv) Cash payments to and on behalf of employees;
- (v) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- (vi) Cash payments of refunds of income taxes unless they can be specifically identified with financing and investing activities; and
- (vii) Cash receipts and payments relating to future contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing on trading purpose.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or selling securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate, to the main revenue producing activity of that enterprise.

2. Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples

- (i) Cash payment to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets;
- (ii) Cash receipts from disposal of fixed assets (including intangibles);
- (iii) Cash payments to acquire shares, warrants, or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (iv) Cash receipts from disposal of shares, warrant, or debt instrument of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- (v) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- (vi) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- (vii) Cash payments for future contracts, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the payment are classifieds financing activities; and
- (viii) Cash receipts for future contract, forward contracts, option contracts, and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

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

3. Financing Activities

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

Examples

- (i) Cash proceeds from issuing shares or other similar instruments;
- (ii) Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and
- (iii) Cash repayments of amounts borrowed.

Q16. Explain the format of cash flow statement as per Accounting Standard - 3 (AS-3).

Ans :

The formats of cash flow statement given by Accounting Standard No-3 is shown below,

Format of Cash Flow Statement as per AS-3 (Direct Method)

Particulars	Amount (₹)	Amount (₹)
Cash Flows from Operating Activities:		
Cash receipts from customers	xxx	
Cash paid to suppliers and employees	(xxx)	
Cash generated from operations	xxx	
Income taxes paid	(xxx)	
Cash flow before extraordinary item	xxx	
Proceeds from earthquake disaster settlement	xxx	
Net cash from operating activities (A)	xxx	xxx
Cash Flows from Investing Activities:		
Purchase of fixed assets	(xxx)	
Proceeds from sale of equipment	xxx	
Interest receivedxxx		
Dividend received	xxx	
Net cash from investing activities (B)	xxx	xxx
Cash Flows from Financing Activities:		
Proceeds from issue of share capital	xxx	
Proceeds from long-term borrowings	xxx	
Repayment of long-term borrowings	(xxx)	
Interest paid	(xxx)	
Dividend paid	(xxx)	
Net cash used in financing activities (C)	(xxx)	(xxx)
Net increase in cash and cash equivalents (A + B + C)		xxx
Add: Cash and cash equivalents at the beginning of the period		xxx
Cash and cash equivalents at the end of the period		xxx

Revised Format of Cash Flow Statement as per AS-3 (Indirect Method)

Particulars	Amount (₹)	Amount (₹)
Cash Flows from Operating Activities		
Net profit before taxation (excluding extraordinary profit/loss)	xxx	
Add: Depreciation	xxx	
Goodwill written off	xxx	
Preliminary expenses written off	xxx	
Interest expenses (for long-term loan/debentures)	xxx	
Loss on sale of assets, long-term investments	xxx	
Proposed dividends	xxx	
	xxx	
Less: Profit on sale of investment, assets etc	xxx	
Interest income (from long-term investments)	xxx	
Dividend income (from long-term investments)	xxx	
Operating profit/Cash Generated from Operations Before Working Capital Charges	xxx	
Decrease in Debtors/ (Increase in Debtors)	xxx	
Decrease in Stocks/ (Increase in Stocks)	xxx	
Decrease in Bills Receivable/ (Increase in Bills Receivable)	xxx	
Decrease in Prepaid Expenses/ (Increase in Prepaid Expenses)	xxx	
Increase in Creditors/ (Decrease in Creditors)	xxx	
Increase in Bills Payable/ (Decrease in Bills Payable)	xxx	
Increase in Outstanding Expenses/ (Decrease in Outstanding	xxx	
Cash Generated from Operations	xxx	
Less: Income taxes paid	xxx	
Net Cash from Operating Activities (A)	xxx	
Cash Flows from Investing Activities		
Purchase of Fixed Assets	xxx	
Purchase of Investments	xxx	
Proceeds from Sale of Fixed Assets	xxx	
Proceeds from Sale of Investments	xxx	
Interest Received	xxx	
Dividend Received	xxx	xxx
Net Cash from Investing Activities (B)		xxx

Cash Flows from Financing Activities		
Proceeds from Issue of Share Capital	xxx	
Proceeds from Long-term Loans	xxx	
Proceeds from Issue of Debentures	xxx	
Redemption of Preference Shares	xxx	
Redemption of Debentures	xxx	
Interest paid	xxx	
Repayment of Long-term Loans/Borrowing	(xxx)	
Dividends paid	(xxx)	
Interim dividends paid	(xxx)	
Net Cash from Financing Activities (C)		xxx
Net Increase in Cash and Cash Equivalents (A + B + C)		xxx
Add: Cash and Cash Equivalents at the Beginning of the Period		xxx
Cash and Cash Equivalents at the End of the Period		xxx
Note: The values in brackets indicate deductions i.e, (-) sign.		

PROBLEMS

6. How will the following transaction be shown in the statement of cash flows:
- Acquisition of the assets of another company by issuance of shares for Rs. 1,60,000.
 - Conversion of 10,000 preference shares of Rs. 100 each to 50,000 equity shares at a premium of Rs. 10 per share.
 - Entering into finance lease for a new plant with a value of Rs.2,30,000 ?

Sol.:

- Statement is not shown in cash flow statement because there is no flow of cash.
- Statement is not shown in cash flow statement because there is no flow of cash.
- It is a non cash transaction so this transaction is not considered in cash flow statement.

7. Following are the balance sheets of a Vijay & son :

Liabilities	1-1-05	31-12-05	Assets	1-1-05	31-12-05
Creditors	36,000	41,000	Cash	4,000	3,600
Loan from Partner	-	20,000	Debtor	35,000	38,400
Loan from Bank	30,000	25,000	Stock	25,000	22,000
Capital	1,48,000	1,49,000	Land	20,000	30,000
			Building	50,000	55,000
			Machinery	80,000	86,000
	2,14,000	2,35,000		2,14,000	2,35,000

During the year Rs. 26,000 paid as dividend. The provision made for depreciation against machinery as on 1.1.05 was Rs. 27,000 and on 31.12.05 Rs. 36,000. Prepare a Cashflow Statement.

Sol :

Machinery Account

Particulars	Rs	Particulars	Rs
To Balance b/d	80,000	By Prov. for depreciation	36,000
To Prov. for depreciation	27,000	By Balance c/d	86,000
To Bank (purchase)	15,000		
	1,22,000		1,22,000

Cash flow statement for the year ended 31-12-2005

Particular	Rs.	Rs.
1. Cash flows from operating activities		
Net profit before tax	27,000	
Adjustment for dep.	9,000	
Increase in current liabilities	36,000	
Increase in debtor	5,000	
Decrease in stock	(3,400)	
	3,000	
Net cash from operating activities		40,600
2. Cash flows from investing activities		
Purchase of land	(10,000)	
Purchase of building	(5,000)	
Purchase of machinery	(15,000)	
Net cash from investing activities		(30,000)
3. Cash flows from financing activities		
Loan	20,000	
Repayment of bank loan	(5,000)	
Payment of Dividends	(26,000)	
Net cash from financing activities		(11,000)
Net Cash Flow from all activities (A + B + C)		(400)
Add : opening cash balance		4,000
Closing cash balance		3,600

Working notes

Particulars	Amount
Net profit before tax.	
Capital (1.1.05)	1,48,000
Capital (31.12.05)	1,49,000
Diff.	1,000
Add. Dividends	26,000
	27,000

8. The summarized balance sheet of Bhadresh Ltd. as on 31.12.05 and 31.12.2006 are as follows :

Liabilities	2005	2006	Assets	2005	2006
Share capital	4,50,000	4,50,000	Fixed asset	4,00,000	3,20,000
General Reserve	3,00,000	3,10,000	Investment	50,000	60,000
P & I a/c	56,000	68,000	Stock	2,40,000	2,10,000
Creditors	1,68,000	1,34,000	Debtor	2,10,000	4,55,000
Tax provision	75,000	10,000	Bank	1,49,000	1,97,000
Mortgage loan	-	2,70,000			
	10,49,000	12,42,000		10,49,000	12,42,000

Additional Details :

- Investment costing Rs.8,000 were sold for Rs. 8,500
- Tax provision made during the year was Rs. 9,000
- During the year part of fixed assets costing Rs 10,000 was sold for Rs 12,000 and the profit was included in P & L A/c. You are required to prepare cash flow statement for 2006.

Sol :

Cash flow statement for the year ended 31.12.2006

Particulars	Rs	Rs
1. Cash flows from operating activities :		
Net profit before tax (Rs. 28,500 in case Profit on sale on Investment & Fixed Asset not considered)	31,000	
Adjustment for :		
Depreciation	70,000	
Profit on sale of investment	(500)	
Profit on sale of Fixed assets	(2,000)	

Decrease in stock	30,000	
Decrease in creditor	(34,000)	
Increase in debtor	(2,45,000)	
Income tax paid	(74,000)	
Net cash from operating activities		(2,24,500)
2. Cash flows from investing activities :		
Investment purchased	(18,000)	
Sale of investment	8,500	
Sale of Fixed assets	12,000	
Net cash from investing activities		2,500
3. Cash flows from financing activities :		
Mortgage loan taken		2,70,000
Net Cash Flow from all activities (A + B + C)		48,000
Add : opening cash balance		1,49,000
Closing cash balance		1,97,000

Fixed Assets A/c

Particulars	Rs	Particulars	Rs
To Balance b/d	4,00,000	By Bank a/c	12,000
To Profit and Loss a/c	2,000	By Dep.	70,000
		By Balance c/d	3,20,000
	4,02,000		4,02,000

Provision for tax A/c

Particulars	Rs	Particulars	Rs
To Bank (tax paid)	74,000	By Balance b/d	75,000
To Balance c/d	10,000	By P & L A/c (provision)	9,000
	84,000		84,000

Investment A/c

Particulars	Rs	Particulars	Rs
To Balance b/d	50,000	By Bank (sale)	8,500
To P & L A/c	500	By Balance c/d	60,000
To Bank (purchase)	18,000		
	68,500		68,500

Adjusted P & L A/c

Particulars	Rs	Particulars	Rs
To Provision for tax	9,000	By Balance b/d	56,000
To Provision for G.R.	10,000	By Profit on sale of Inv.	500
To Balance c/d	68,000	By Profit on sale of F.A.	2,000
		By Adjusted Profit	28,500
	<u>87,000</u>		<u>87,000</u>

9. The summarized balance sheet of Jay Ltd as on 31.12.06 and 31.12.2007 are as follows:

Liabilities	2005	2006	Assets	2005	2006
Share capital	1,00,000	1,00,000	Building	46,800	45,000
General Reserve	38,400	42,000	Plant and Machinery	38,280	42,030
Creditors	9,750	6,380	Goodwill	13,000	13,000
Tax provision	19,000	21,000	Investment	10,000	11,250
Prov. for doubtful debt	1,000	1,200	Stock	30,000	28,000
			Debtor	22,070	22,300
			Cash	8,000	9,000
	<u>1,68,150</u>	<u>1,70,580</u>		<u>1,68,150</u>	<u>1,70,580</u>

After taking the following information in to account, prepare a cash flow statement for the year ending 31.12.2007

1. The profit for 2006-2007 was Rs. 8,600 against this had been charged Dep. Rs.3,050 and increase in provision for doubtful debt Rs.200
2. Income tax Rs.18,000 was paid during the year charged against the provision and in addition Rs. 20,000 was charged against profit and carried to the provision.
3. An interim dividend of Rs. 5,000 was paid in January 2007
4. Additional plant was purchased in September 2006 for Rs. 5,000
5. Investments (cost Rs.5,000) were sold 2007 for Rs. 4800 and on 1st march 2007 another investment was made for Rs.6,250

*Sol/ :***Cash flow statement for the year ended 31.12.2007**

Particulars	Rs	Rs
1. Cash flows from operating activities :		
Net profit before tax	28,800	
Adjustment for :		
Depreciation	3,050	
Increase in provision for d/d	200	
Decrease in stock	2,000	
Decrease in creditor	(3,370)	
Increase in debtor	(230)	
Income tax paid	(18,000)	12,450
Net cash from operating activities		
2. Cash flows from investing activities :		
Investment purchased	(6,250)	
Sale of investment	4,800	
Plant purchased	(5,000)	(6,450)
Net cash from investing activities		
3. Cash flows from financing activities		
Payment of interim dividend		(5,000)
Net increase in cash equivalents		1,000
Add : opening cash balance		8,000
Closing cash balance		9,000

Adjusted profit and loss A/c

Particulars	Rs	Particulars	Rs
To Provision for tax	20,000	By profit	28,800
To General reserve	3,600		
To Loss on sale of Invest	200		
To Interim dividend	5,000		
	28,000		28,000

Provision for tax A/c

Particulars	Rs	Particulars	Rs
To Bank (tax paid)	18,000	By Balance b/d	19,000
To Balance c/d	21,000	By P & L A/c. (provision)	20,000
	39,000		39,000

10. Balance Sheets of M/s Sanjay Enterprises on 1/1/1992 and 31/12/1992 were as follows :

Liabilities	1.1.92 Rs.	31.12.92 Rs.	Assets	1.1.92 Rs.	31.12.92 Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Loan from Ram	25,000	–	Debtors	30,000	50,000
Loan from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery less prov. For Depreciation	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provision for depreciation against the machinery as on 1.1.1992 was Rs. 25,000 and on 31.12.1992 was Rs. 40,000. You are required to prepare cash flow statement.

Sol :

(Nov.-21, Jan.-18)

Working notes

(i) Calculation of Drawings

Capital Account			
Dr			Cr
Particulars	`	Particulars	`
Drawings (Balancing Figure)	17,000	Balance b/d	1,25,000
Balance c/d	1,53,000	Profit and Loss Account	15,000
	1,70,000		1,70,000

(ii) Dr Machinery Account Cr

Particulars	₹	Particulars	₹
Balance b/d (80,000 + 25,000)	1,05,000	Cash (Sale)	5,000
		Provision for Depreciation	3,000
		Profit and Loss Account (Loss on Sale)	2,000
		Balance c/d (55,000 + 40,000)	95,000
	1,05,000		1,05,000

(iii) Calculation of depreciation shown in statement of Profit and Loss Account

Dr Provision for Depreciation Account Cr

Particulars	₹	Particulars	₹
Machinery Account	3,000	Balance b/d	25,000
Balance c/d	40,000	Statement of P/L Account	18,000
	43,000		43,000

M/s Anand and Sons
Cash Flow Statement [AS-3 (Revised)]
For the year ending 31 December 2017

Particulars	₹	₹
A) Cash Flows from Operating Activities		
Net Profit	45,000	
Adjustments for :		
Depreciation	18,000	
Loss on sale of machinery	2,000	
Operating profit before working capital changes	65,000	
Decrease in Stock	10,000	
Increase in Debtors	(20,000)	
Increase in Creditors	4,000	
Net cash generated from operations		59,000
B) Cash Flows from Investing Activities		
Purchase of Land	(10,000)	
Purchase of Building	(25,000)	
Sale of Machinery	5,000	
Net cash used in investing activities		(30,000)

C) Cash Flows from financing activities		
Loan from Bank	(10,000)	
Payment of Mrs. A's Loan	(25,000)	
Drawings	(17,000)	
Net Cash used in financing activities		(32,000)
Net decrease in cash and cash equivalents (A + B + C)		(3,000)
Cash and cash equivalent at the beginning		10,000
Cash and cash equivalents at the end		7,000

4.7 FUNDS FLOW STATEMENT

Q17. Define Funds Flow Statement. Explain the Importance of Funds Flow Statement.

(OR)

What is Funds Flow Statement?

(OR)

What is Funds Flow in Accounting

Ans :

(Nov.-22, Jan-20)

Meaning

The funds flow statement consists of two terms 'Fund' and 'Flow'. Fund may be interpreted as cash or working capital or all financial resources. Flow means change.

Funds flow statement is a method by which one studies the changes in the financial position of a business enterprise between beginning and ending financial statements dates. It is a statement showing sources and uses of funds for a period of time.

Definitions

- (i) **According to Foulke**, "A statement of sources and application of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates".
- (ii) **According to Anthony**, "The funds flow statement describes the sources from which additional funds were derived and the use to which these sources were put".

I.C.W.A. in glossary of Management Accounting terms defines funds flow statement as, "A statement either prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of the statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilization and application of the same".

The statement, which is prepared to show the inflow (sources) and outflow (uses) of fund, is termed as 'Fund Flow Statement'. This statement is also termed as:

1. Statement of sources and application of funds.
2. Funds statement.
3. Statement of change in financial position.

4. Statement of inflow and outflow of funds.
5. Statement of sources and uses of funds.

Thus, funds flow statement is a statement which indicates various means by which the funds have been obtained during a certain period and the way to which these funds have been used during that period. The term 'funds' used here means working capital, i.e., the excess of current assets over current liabilities.

The importance or advantages of funds flow statement are as follows:

1. Helps in the Analysis of Financial Operations

The financial statements reveal the net effect of various transactions on the operational and financial position of a concern. The balance sheet gives a static view of the resources of a business and the uses to which these resources have been put at a certain point of time. But it does not disclose the causes for changes in the assets and liabilities between two different points of time. The funds flow statement explains causes for such changes and also the effect of these changes on the liquidity position of the company.

2. Throws Light on Many Confusing Questions of General Interest

It throws light on many confusing questions of general interest which otherwise may be difficult to be answered, such as:

- i) Why were the net current assets lesser in spite of higher profits and vice-versa?
- ii) Why more dividends could not be declared in spite of available profits?
- iii) How was it possible to distribute more dividends than the present earnings?
- iv) What happened to the net profit? Where did they go?
- v) What happened to the proceeds of sale of fixed assets or issue of shares, debentures, etc.?
- vi) What are the sources of the repayment of debt?

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

3. Helps in the Formation of a Realistic Dividend Policy

Sometimes a firm has sufficient profits available for distribution as dividend but yet it may not be advisable to distribute dividend for lack of liquid or cash resources. In such cases, a funds flow statement helps in the formation of a realistic dividend policy.

4. Helps in the Proper Allocation of Resources

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

5. Acts as a Future Guide

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

6. Helps in Appraising the Use of Working Capital

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

7. Helps Knowing the Overall Credit Worthiness of a Firm

The financial institutions and banks such as State Financial Institutions, Industrial Development Corporation, Industrial Finance Corporation of India, Industrial Development Bank of India, etc. all ask for funds flow statement constructed for a number of years

before granting loans in order to know the creditworthiness and paying capacity of the firm. Hence, a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

Q18. Explain the parties involved in funds flow statement.

Ans :

Funds flow statement is now serving as a device and guide not only to the management but to financial analysts, credit granting institutions, shareholders and other prospective investors. Generally the following parties are deeply interested in this statement:

1. Management

Funds flow statement has now become a valuable document for the management. It is employed by the management in establishing and reviewing budgets particularly cash budgets. It also helps management in evaluating alternative financial plans and assessing long-range forecasts of cash requirements and variability. Management is also interested in assessing the extent to which working capital has effectively been put to use and to facilitate their policy decisions, budgetary control, dividends, investment in stocks and capital expenditures.

2. Banks and Financial Institutions

Bank and financial institutions are also having interest in fund flow statement because it conveys meaningful information about the risk involved in granting credit to the business concerns. They are interested to know the concern's performance in using the funds and its capacity to generate funds. This information may be obtained from funds flow statement only.

3. Shareholders and other Investors

Depending upon their status, these parties are interested to assess the amount of funds available for payment of dividends and for interest in their investments in the business. They are also interested in the ability of the management in making effective use of working capital. All these facts can be obtained from funds flow statement and hence these parties are also interested in it.

4. Debenture Holders

Debenture holders too are long-term creditors of the firm. Their stake is similar to financial institutions. They would get back their money after several years, dependant of the maturity period of the debentures. Debenture holders look for redemption and projected fund flow statement shows the position of availability of funds when the debentures fall due for repayment. To continue to hold the debentures till such time or not, funds flow statement is useful for them to take a suitable decision.

5. Trade Creditors

They are the suppliers of goods and services and look for short-term liquidity for payment. Liquidity of the firm and operating profits assure the repayment schedule. Statement of working capital position indicates how the firm is liquid to meet the promised payment schedule to view their credit policy.

Q19. Explain the purpose of funds flow statement.

Ans :

Need/Purpose of Funds Flow Statement

Funds flow statement/analysis or statement of changes in the financial position of a firm serves the following purposes,

- (i) It helps the investors to determine the most significant factors which are responsible for facilitating changes in financial position.
- (ii) It helps to identify internal factors (i.e. internal operations) and external sources through which changes has been made.
- (iii) It helps to focus on the factors that are responsible for estimating the differences in equity , assets and liabilities.
- (iv) It is useful to emphasize the changes which took place in the investment assets.
- (v) It also depicts the changes which have beer made while collecting funds for investing in business.

Q20. "Is a Funds flow statement a better substitute for an income statement". Comment.

Ans :

(Nov.-21)

A Funds Flow Statement is neither a substitute of Income Statement nor a Balance Sheet.

We know that a Profit and Loss Account presents the results of the operation, i.e. the profit or loss of a firm, i.e. it does not exhibit the changes of financial position and, at the same time, it does not indicate the inflows and outflows of funds for a particular period although it gives some valuable information about performance of a firm.

A Balance Sheet, on the other hand, presents the financial position of a firm at a particular date. Since Balance Sheet is prepared at a particular date, it is a static one, but a funds flow statement is dynamic in nature.

A funds flow statement presents various information about the financial resources of a firm, i.e. the various sources of funds and the application for the same and exhibits also the changes in assets and liabilities by which the analyst can understand the reasons therefor, which is not done by a Balance Sheet.

Moreover, Balance Sheet is the final outcome of all financial transactions at a particular date. But a funds flow statement is a Post-balance Sheet activity which is done by an analyst. It also supplies information relating to various sources of funds and their applications.

From the above discussions it becomes clear that an Income Statement reveals the results of the operation for a particular period in the form of profit or loss, i.e. how much has been earned by a firm and how the same has been incurred.

Funds Flow Statement, on the other hand, expresses the requirement of financial resources in order to operate the business activities, i.e. what are the possible sources from which funds can be raised and the application for the same.

Q21. Explain the preparation of funds flow statement.

Ans :

The funds flow statement is prepared to reflect the changes in the financial position of an organization during a particular period. As such, balance sheets at the beginning and end of the particular period are the basic documents which are needed for preparation of funds flow statement. Additional information available should also be considered, while preparing. Consider only those transactions which affect the flow of funds in the funds flow statement. Funds from operations has to be separately calculated and shown as an individual item in the statement.

Format of Funds Flow Statement

The format of the funds flow statement or statement of sources and application of funds is as follows,

Statement of Sources and Applications of Funds for the Year Ended

Source	Amount (₹)	Applications	Amount (₹)
Issue of share capital	xxxx	Redemption of redeemable	xxx
Issue of debentures	xxxx	Preference shares	xxxx
Long-term loans raised	xxxx	Redemption of debentures	xxxx
Sale of long-term investments	xxxx	Repayment of long term loans	xxxx
Sale of fixed assets	xxxx	Purchase of fixed assets	xxxx
Receipts from partly paid share called up	xxxx	Purchase of long term investments	xxxx
Funds from operations	xxxx	Funds lost in operations	xxxx
Non-trading income	xxxx	Non-trading expenses	xxxx
Decrease in working capital	xxxx	Payment of dividend	xxxx
		Payment of tax	xxxx
		Increase in working capital	xxxx
	xxxx		xxxx

Q22. Explain the various Sources and Applications of Funds Flow Statements.

Ans :

(Imp.)

A) Sources of Funds

Sources of funds are those elements from which funds can be generated for the business. They are,

1. Funds from Operations/Trading Profits

Profits obtained from various business operations act as a main source of funds. Sales are the major source of cash inflows while expenses and cost of goods sold are considered as major cash outflows of a business. Business transactions are said to be efficient, if the sources of funds (obtained from cash sales) exceeds the outflow for expenses and cost of goods sold. However, while preparing the funds flow statement, firms need to consider only the operational expenses whereas, the non-operational expenses such as loss on sale of machinery or payment of dividends needn't be considered as they are not related to the trading operations of the business.

2. Issue of Share Capital

When the amount of share capital increases during the year, it means capital is raised through the issue of shares, etc. So issue of shares is regarded as a source of funds as it helps in increasing the inflows of funds. But sometimes when shares are issued for converting debentures into shares, against the purchase of asset, etc., then it is not considered as a source of funds.

3. Nontrading Receipts

Any non-trading receipts which increases the funds of the business like dividend received, rent received, refund of tax, etc., are regarded as a sources of funds. Such incomes should not be considered while preparing the funds from operations.

4. Decrease in Working Capital

A release of funds from working capital indicates that current working capital has decreased from the working capital of previous year and it must be treated as a source of funds.

5. Sale of Fixed Assets and Long-term Investments

The sale of any fixed or non-current asset may create funds in the business, so it is regarded as a source of funds. But the exchange of one fixed asset with another fixed asset doesn't constitute the source of funds.

6. Issue of Debentures and Raising of Loans

When debentures are issued and long term loans are raised, it contributes to the inflow of funds of the business. If the loan is raised for some other reason other than a current asset such as purchase of land and building then it is not considered as inflow of funds.

B) Application / Uses of Funds

Application of funds are those activities in which sources of funds are utilized. They are,

1. Funds Lost in Operations

Firms may suffer loss in a particular year from its trading operations, then such losses constitutes the outflow of funds and are recorded as application of funds.

2. Redemption of Preference Share Capital

When any preference shares are redeemed it means a net amount is paid to the shareholder. It implies an outflow of funds, but if any shares are redeemed in exchange of other shares or debentures then it is not considered as an outflow of funds.

3. Repayment of Loans and Redemption of Debentures

When firm repay its loan, funds go out of the business. Hence, it is an outflow of funds and recorded as application of funds.

4. Purchase of Fixed Asset

Usually, when fixed asset is purchased the business has to incur expenses and it is regarded as outflow of funds. But when fixed asset is purchased in exchange of issue of shares or some other fixed asset then there is no outflow of funds as it only involves exchanges rather than the deployment of fund. Hence, it is an application of funds.

5. Payments of Dividends and Tax

When the actual payment of dividend and tax is made, then it is regarded as an application of fund. If only dividends are declared but not paid and provision of taxes is made then it doesn't constitutes the application of funds.

6. Non-trading Payment

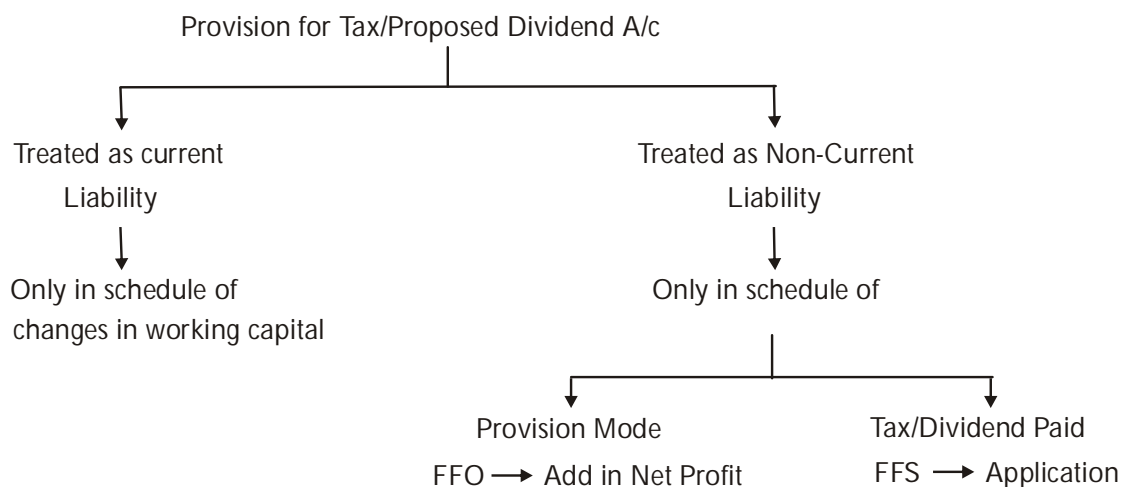
When a firm makes payment towards the realization of non-trading operations like drawings, loss of cash, etc., then it is regarded as an application of funds.

Q23. Explain the treatment of various adjustment in funds flow statement.

Ans :

1. Provision for Taxation and Proposed Dividend

The adjustment of proposed dividend and provision for taxation is similar. They can be treated as current liability or as non-current liability. If treated as current liability, then the amounts given in balance sheet will appear in schedule of changes in working capital only. No treatment will be done for the amount given in adjustment, if treated as non-current liability, an account should be prepared.



Provision for Tax/Proposed Dividend A/c

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Cash A/c	—	By Balance b/d (prev. year)	—
To Balance c/d (Current Year)	—	By Profit and Loss A/c (provision made)	—

2. Tax Payable/Dividend Payable

Always treat it as current liability and therefore it will appear in schedule of changes in working capital only.

3. Hidden Information in Assets Account

Prepare the asset account to find out the hidden information as follows:

Dr.	Asset A/c		Cr.
Particulars	Rs.	Particulars	Rs.
To Balance b/d		By Cash A/c (Sale)	
To Profit and Loss A/c (Profit)		By Depreciation A/c	
To Cash A/c (Balance figure)		By Profit and Loss A/c (Loss)	
		By Balance c/d	

If the balance of accumulated depreciation is also given, then prepare account of accumulated depreciation first and then prepare the account of fixed asset.

Dr.		Accumulated Depreciation A/c		Cr.	
Particulars		Rs.	Particulars		Rs.
To Fixed Asset A/c			By Balance b/d		
(A. Depreciation on Asset Sold)			By Profit and Loss A/c		
To Balance c/d			(Current Year Depreciation)		

Dr.		Fixed Asset A/c		Cr.	
Particulars		Rs.	Particulars		Rs.
To Balance c/d			By Cash A/c (Sale Amount)		
To Cash A/c (Purchase)			By Accumulated Depreciation A/c		
			By Profit and Loss A/c		
			By Balance c/d		

Here, in the fixed asset account, the amount of loss will be added in profit in FFO and the amount of sale will be shown in sources of Fund in FFS and the amount of purchase in FFS as Application of Funds.

4. Interim Dividend

Interim dividend is the dividend paid in between of the year. It is to be added in net profit while calculating Fund From Operations and also to show in Applications of Funds.

Q24. What are the Difference between Funds Flow and Cash Flow Statement.

(OR)

Explain the differences Funds Flow and Cash Flow Statement.

(OR)

Distinguish between differences Funds Flow and Cash Flow Statement.

(OR)

How does the statement of cash flow differ from the funds flow statement.

(OR)

What are the differences between funds flow statement and cash flow statement.

Ans :

(May-22, Jan-20, May-19, July-18)

S.No.	Basis of Difference	Funds Flow Statement	Cash Flow Statement
1)	Object	Its object is to help in providing information relating to firm's ability to meet its long term liabilities.	Its object is to provide the firm's ability to meet its short term liabilities.
2)	Dependence	Funds flow statement can be prepared if cash flow statement is there. is there. Thus, it is dependent.	Cash flow statement is prepared only when schedule of changes in working capital along with funds flow statement
3)	Nature of Statement	It deals with the changes in working capital.	It deals with the changes in cash position only.

4)	Opening Balance	There is no such balance.	There is always cash opening balance, or it is prepared with the opening balance of cash in hand.
5)	Difference of Sides	Difference of both the sides of funds flow statement is either the increase or decrease in working capital.	Difference of both the sides of cash flow statement is the closing balance of cash.
6)	Additional Statement	Whenever funds flow statement is prepared an additional statement in the name of schedule showing changes in working capital is also prepared.	No additional statement is prepared when cash flow statement is prepared.
7)	Planning	Fund flow is helpful in long term planning.	Cash flow is useful in short term planning.
8)	Period	It is prepared for longer period.	It is prepared for shorter period,

PROBLEMS

11. Balance sheet of ABC Ltd., for two years is given below :

Liabilities	31.12.2014	31.12.2015
Share Capital	200000	260000
P&L Account	39690	41220
Reserves	50000	50000
Sundry creditors	39500	41135
Bills payable	33780	11525
Bank over draft	59510	—
Provision for taxation	40000	50000
	462480	453880

Assets	31.12.2014	31.12.2015
Goodwill	—	20000
Land and Building	112450	116200
Plant and Machinery	148000	144250
Stocks	111040	97370
Sundry Debtors	85175	72625
Bills receivable	2315	735
Cash	2500	2700
	461480	453880

Additional information:

1. During the year ending 31.12.2015, an interim dividend of Rs.2600 was paid.
2. Income tax paid during the year amounted to Rs.25000
3. The net profit for the year before tax was Rs. 62530

You are required to prepare statement of changes on working capital, treating provision for taxation. as a current liability.

Sol :

(Nov.-2020)

Statement of Working Capital

Particulars	31-12-2014	31-12-2015	Effect on Working Capital	
			Increase	Decrease
Current Assets				
Stock	1,11,040	97,370	–	13,670
Sundry debts	85,175	72,625	–	12,550
Bills receivable	2,315	735	–	1,580
Cash	2,500	2,700	200	–
Total Current Assets (A)	2,01,030	1,73,430		
Current Liabilities				
Sundry creditors	39,500	41,135	–	1,635
Bills payable	33,780	11,525	22,255	–
BOD	59,510	–	59,510	–
Provision for taxation	40,000	50,000	–	10,000
Total current Liabilities (B)	1,72,790	1,02,660		
Working Capital (A – B)	28,240	70,770		
Increase in Working Capital	42,530			42,530
	70,770	70,770	81,965	81,965

12. From the following information relation to A Limited, prepare

- (a) Statement of changes in the requirements of working capital
- (b) Funds Flow statement and
- (c) Cash flow statement

Liabilities (Rs.000)	2013	2014	Assets (Rs.000)	2013	2014
Share capital	300	400	Cash	30	90
Reserves	100	50	Receivables	105	150
Retained Earnings	30	60	Inventories	50	195
Payables	45	135	Fixed Assets	190	210
	475	645		475	645

Additional Information:

The company purchased the worth of Rs. 40000 Furniture, Rs. 10000 Loose

Tools by issue of share capital

A Piece to fixed asset, book value of which is Rs 10000/- depreciation on it is

Rs. 3000/-, sold for Rs. 5000/-

Tax paid during the year Rs. 43000

Dividend paid during the year Rs. 26000

Sol.:

(Jan.-2020)

(a) Preparation of Statement of Changes in the Requirements of Working Capital**Statement of Changes in Working Capital**

Particulars	2013 (₹)	2014 (₹)	Increase in W.C. (₹)	Decrease in W.C. (₹)
Current Assets:				
Cash	30,000	90,000	60,000	
Receivables	1,05,000	1,50,000	45,000	
Inventories	1,50,000	1,95,000	45,000	
Total [A]	2,85,000	4,35,000		
Current Liabilities:				
Payables	45,000	1,35,000		90,000
Total [B]	45,000	1,35,000		
Working Capital [A - B]	2,40,000	3,00,000		
Increase in working capital	60,000			60,000
	3,00,000	3,00,000	1,50,000	1,50,000

(b) Preparation of Funds Flow Statement**Funds Flow Statement**

Sources	Amount (₹)	Applications	Amount (₹)
Sale of Fixed Assets	5,000	Tax paid	43,000
Funds from operations	1,54,000	Dividend paid	26,000
		Increase in working capital	60,000
		Purchase of Fixed Assets	30,000
	1,59,000		1,59,000

Dr.		Fixed Assets A/c		Cr.	
Particulars		Amount	Particulars	Amount	
		(₹)		(₹)	
To Balance b/d		1,90,000	By Bank (sales)	5,000	
To Bank (Purchase) (balancing figure a/c)		30,000	By Depreciation A/c	3,000	
			By Adjusted P&L A/c		
			(Loss on Sale)	2,000	
			By Balance c/d	2,10,000	
		2,20,000		2,20,000	

Dr.		Share Capital A/c		Cr.	
Particulars		Amount	Particulars	Amount	
		(₹)		(₹)	
To Balance c/d		4,00,000	By Balance b/d	3,00,000	
			By Furniture (purchases) A/c	40,000	
			By Vehicle (purchases) A/c	50,000	
			By Loose tools (purchases) A/c	10,000	
		4,00,000		4,00,000	

Dr. Machinery A/c Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Share capital (purchase) A/c	40,000	By Adjusted P&L A/c (Depreciation balancing figure)	40,000
	40,000		40,000

Dr. Vehicle A/c Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Share capital (purchase) A/c	50,000	By Adjusted P&L A/c (Depreciation) (Balancing figure)	50,000
	50,000		50,000

Dr. Loose Tools A/c Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Share capital (purchase) A/c	10,000	By Adjusted P & L A/c (Depreciation) (Balance Figure)	10,000
	10,000		10,000

Dr. Adjusted Profit and Loss A/c Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Depreciation on sold fixed assets	3,000	By Balance b/d	30,000
To Depreciation on Furniture	40,000	By General Reserve	50,000
To Depreciation on vehicle	50,000	By Funds from Operations	1,54,000
To Depreciation on Loose Tools	10,000	(Balancing Figure)	
To Loss on Sale of fixed assets	2,000		
To Dividend paid	26,000		
To Tax paid	43,000		
To Balance c/d	60,000		
	2,34,000		2,34,000

(c) Preparation of Cash Flow Statement

Cash Flow Statement

Particulars	Amount (₹)	Amount (₹)
Cash Flows from Operating Activities		
Net profit (60,000 - 30,000)		30,000
Add: Non operating expenses (debited to profit and loss A/c)		
Depreciation on sold fixed assets	3,000	
Depreciation on Furniture	40,000	
Depreciation on Vehicle	50,000	
Depreciation on Loose Tools	10,000	
Dividend Paid	26,000	
Tax Paid	43,000	
General Reserve	(50,000)	
Loss on sale of fixed assets	2,000	1,24,000
Operating profit before working capital changes		1,54,000
Add: Decrease in current assets or increase in current liabilities:		
Increase in payables		90,000
Less: Increase in current assets or decrease in current liabilities:		2,44,000
Increase in inventories	45,000	
Increase in receivables	45,000	90,000
Operating profit after working capital changes		1,54,000
Less: Tax paid		(43,000)
Net Cash from Operating Activities (A)		1,11,000
Cash Flows from Investing Activities:		
Purchase of Fixed Assets	(30,000)	
Sale of Fixed Assets	5,000	(25,000)
Net Cash used in Investing Activities (B)		(25,000)
Cash Flows from Financing Activities		
Dividend paid		(26,000)
Net Cash used in Financing Activities (C)		(26,000)
Net Increase in Cash and Cash Equivalents (A + B + C)		60,000
Cash and Cash Equivalents at the beginning		30,000
Cash and Cash Equivalents at the End		90,000

13. Ramco Cements presents the following information and you are required to calculate Funds From Operation.

Dr.		Profit and Loss Account		Cr.
Particulars	Amount	Particulars	Amount	
To Operation Expenses	100000	By Gross Profit b/d	215000	
To Depreciation	40000	By Gain on sale of plant	5000	
To Loss on sale of building	10000			
To Advertisement suspense a/c	5000			
To Discount Allowed	500			
To Discount on issue of shares	500			
To Goodwill written off	12000			
To Net Profit c/d	52000			
	220000		220000	

Sol :

(Jan.-20)

Calculation of Funds from Operations for Ramco Cements

Particulars	Amount (₹)	Amount (₹)
Profit and Loss A/c (given)		52,000
Add: Non-fund and Non-operating items (Debited to P&L a/c):		
Depreciation	40,000	
Loss on Sale of Building	10,000	
Advertisement written off	5,000	
Discount written off	500	
Goodwill written off	12,000	67,500
		1,19,500
Less: Non-fund and Non-operating items		
(Credited to P&L a/c):		
Gain on sale of plant	5,000	5,000
Funds from operations		1,14,500

Dr.

Adjusted Profit and Loss Account

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Depreciation	40,000	By Opening balance	
To Loss on Sale of building	10,000	By Gain on sale of plant	5,000
To Advertisement suspense	5,000	By Funds from operations	1,14,500
To Discount written off	500	(Balanceing Figure)	
To Goodwill written off	12,000		
To Closing balance	52,000		
	1,19,500		1,19,500

14. The Balance Sheets of National Company as on 31st December, 2017 and 2018 has been presented below :

Liabilities (Rs.)	2017	2018	Assets (Rs.000)	2017	2018
Share Capital	5,00,000	7,00,000	Buildings	80,000	1,20,000
Profit and Loss Account	1,00,000	1,60,000	Machinery	5,00,000	8,00,000
General Reserve	50,000	70,000	Stock	1,00,000	75,000
Sundry Reserve	1,53,000	1,90,000	Debtors	1,50,000	1,60,000
Bills Payable	40,000	50,000	Cash	20,000	20,000
Expenses outstanding	4,000	3,000			
Outstanding telephone Charges	3,000	2,000			
	8,50,000	11,75,000		8,50,000	11,75,000

From the above, prepare the statement of changes in the requirements of working capital.

Sol.:

(Jan.-20)

Statement of Changes in the requirements of Working Capital

Particulars	2017 (₹)	2018 (₹)	Changes in Working Capital	
			Increase (₹)	Decrease (₹)
Current Assets:				
Stock	1,00,000	75,000	-	25,000
Debtors	1,50,000	1,60,000	10,000	
Cash	20,000	20,000		
Total (A)	2,70,000	2,55,000		

Current Liabilities:				
Sundry Creditors	1,53,000	1,90,000	-	37,000
Bills Payable	40,000	50,000	-	10,000
Expenses Outstanding	4,000	3,000	1,000	-
Outstanding Telephone charges	3,000	2,000	1,000	—
Total (B)	2,00,000	2,45,000		
Working Capital (A-B)	70,000	10,000		
Decrease in working capital		60,000	60,000	
	70,000	70,000	72,000	72,000

15. The following information and the balance sheet relate to Shyam sons Ltd.

Particulars	Year 1 Rs.	Year 2 Rs.
Assets		
Cash	10,000	15,000
Receivables	20,000	25,000
Inventory	20,000	35,000
Plant and machinery at cost	85,000	85,000
Less : Accumulated depreciation	(15,000)	(10,000)
	1,20,000	1,20,000
Liabilities and Capital		
Sundry creditors	8,000	10,000
Outstanding expenses	7,000	10,000
Debenture payable	10,000	5,000
Long terms loans	5,000	25,000
Capital	50,000	50,000
Retained earnings	40,000	50,000
	1,20,000	1,50,000

Net profit for the period after charging Rs. 5,000 on account of depreciation was Rs. 20,000. A piece of equipment costing Rs. 25,000 on which depreciation accumulated in the amount of Rs. 10,000 was sold for Rs. 10,000. Dividend paid during the year amounted to Rs. 10,000.

Prepare a source and use of funds statement.

Sol :

(May-19)

Statement showing changes in working capital

Particulars	Year 1	Year 2	Increase	Decrease
Current Assets				
Cash	10,000	15,000	5,000	–
Receivables	20,000	25,000	5,000	–
Inventory	20,000	35,000	15,000	–
Total (A)	50,000	75,000		
Current liabilities				
Sundry creditors	8,000	10,000	–	2,000
Outstanding expenses	7,000	10,000	–	3,000
Total (B)	15,000	20,000		
Working capital (A – B)	35,000	55,000		
Increase in working capital	20,000	–	–	20,000
	55,000	55,000	25,000	25,000

Fundsflow statement

Sources	Amount	Applications	Amount
Net profit	20,000	Purchase of plant and machinery	25,000
(–) Loss on sale of plant	5,000		
(+) Depreciation	5,000		
	30,000		
Sale of plant and machinery	10,000		
Long term loan	20,000		
	60,000		60,000

16. From the following data of national Ltd. for the year 2015 and 2016, Prepare a cashflow statement :

Particulars	2015 Rs.	2016 Rs.
Cash	2,000	2,500
Accounts receivable	2,400	2,700
Inventories	3,100	3,200
Other current assets	800	700
Fixed assets	5,000	5,800
Accumulated depreciation	2,100	2,500
Accounts payable	2,000	2,100
Long term debt	1,400	1,300
Equity capital	5,000	5,300
Retained earning	2,800	3,700

The following additional information is also available

- (a) Fixed assets costing Rs. 1200 were purchased for cash.
- (b) Fixed assets (Original cost of Rs. 400 accumulated depreciation Rs. 150 were sold for Rs. 200).
- (c) Depreciation for the year 2016 amounted to Rs. 550 and duly debited to profit & loss account.
- (d) Dividend paid amounted to Rs. 300 in 2016.
- (e) Reported income for 2016 was Rs. 2,400.

Sol :

(Dec.-18)

Note :

With the above information we can prepare only funds flow statement not a cash flow statement.

Statement of changes in working capital

Particulars	2015	2016	Increase	Decrease
Current Assets				
Cash	2,000	2,500	500	–
Accounts receivable	2,400	2,700	300	–
Inventories	3,100	3,200	100	–
Other current assets	800	700	–	100
Total (A)	8,300	9,100		
Current Liabilities				
Accounts payable	2,000	2,100	–	100
Total (B)	2,000	2,100		
Working capital (A – B)	6,300	7,000		
Increase in working capital	700	–	–	700
	7,000	7,000	900	900

Funds from Operations

Particulars	Amount	Particulars	Amount
To Fixed Assets A/c	50	By Balance b/d	2,800
To Accumulated Depreciation	550	By Funds from Operation	1,800
To Dividend	300		
To Balance c/d	3,700		
	4,600		4,600

Fundsflow Statement

Sources	Amount	Applications	Amount
Funds from Operation	1,800	Dividend paid	300
Issue of equity capital	300	Purchase of fixed assets	1,200
sale of fixed asset	200	Repayment of long term	100
		Increase in working capital	700
	2,300		2,300

Working Notes :

Dr.	Fixed Assets A/c		Cr
Particulars	Amount	Particulars	Amount
To Balance b/d	5,000	By Cash A/c	200
To Cash	1,200	By Accumulated Depreciation	1,500
		By P & L A/c (Loss)	50
		By Balance b/d	5,800
	6,200		6,200

17. From the following abridge balance sheets of Hansraj as on 31st March, 2015 and 2016, you are required to prepare a schedule of changes in working capital and a fund flow statement :

Liabilities	31.3.2015	31.3.2016	Assets	31.3.2015	31.3.2016
Share capital	Rs.3,00,000	Rs.4,50,000	Fixed Assets	Rs.5,00,000	Rs.6,00,000
Long term borrowings	1,10,000	1,30,000	Less (Accumulated Depreciation)	50,000	60,000
Short term borrowings	80,000	70,000	Net value of Assets	4,50,000	5,40,000
Current liabilities	40,000	30,000	Current Assets	50,000	1,00,000
			P & L Account	30,000	40,000
	5,30,000	6,80,000		5,30,000	6,80,000

Sol.:

(July-18)

Statement showing changes in working capital

Particulars	2015	2016	Working Capital - I	
			Increase	Decrease
Current Assets				
Current Assets	50,000	1,00,000	50,000	—
Total (A)	50,000	1,00,000		

Current liabilities				
Short term borrowings	80,000	70,000	10,000	–
Current liabilities	40,00	30,000	10,000	–
Total (B)	1,20,000	1,00,000		
Working capital (A – B)	(70,000)	–		
Increase in working capital	70,000	–	–	70,000
	–	–	70,000	70,000

Dr.	Fixed Assets A/c		Cr
Particulars	Amount	Particulars	Amount
To Balance b/d	5,00,000	By Balance c/d	6,00,000
To Purchase	1,00,000		
	6,00,000		6,00,000

Dr.	Funds flow Statement		Cr
Sources	Amount	Applications	Amount
Issue of share capital	1,50,000	Purchase of fixed assets	1,00,000
Long term loans raised	20,000	Increase in working capital	70,000
	1,70,000		1,70,000

4.8 HORIZONTAL ANALYSIS AND VERTICAL ANALYSIS OF COMPANY

Q25. Define

- Horizontal Analysis
- Vertical Analysis

Ans.:

(a) Horizontal Analysis

Horizontal analysis of financial statements involves comparison of a financial ratio, a benchmark, or a line item over a number of accounting periods. This method of analysis is also known as trend analysis. Horizontal analysis allows the assessment of relative changes in different items over time. It also indicates the behavior of revenues, expenses, and other line items of financial statements over the course of time.

Accounting periods can be two or more than two periods. Accounting period can be a month, a quarter or a year. It will depend on the analyst's discretion when choosing an appropriate number of accounting periods. During the investment appraisal, the number of accounting periods for analysis is based on the time horizon under consideration.

Horizontal analysis of financial statements can be performed on any of the item in the income statement, balance sheet and statement of cash flows. For example, this analysis can be performed on revenues, cost of sales, expenses, assets, cash, equity and liabilities. It can also be performed on ratios such as earnings per share (EPS), price earning ratio, dividend payout, and other similar ratio.

(b) Vertical Analysis

Vertical analysis of financial statements is a technique in which the relationship between items in the same financial statement is identified by expressing all amounts as a percentage a total amount. This method compares different items to a single item in the same accounting period. The financial statements prepared by using this technique are known as common size financial statements.

Q26. What are the difference between horizontal and vertical analysis.

(OR)

Explain the differences between horizontal analysis and vertical analysis.

Ans :

(May-19)

S.No.	Basis	Horizontal Analysis	Vertical Analysis
1.	Need	Comparative Financial statement is needed to prepare horizontal analysis.	Financial statements of one accounting period are needed to prepare vertical analysis.
2.	Items	It includes same items of different periods	It includes different items of same period.
3.	Calculation	In this analysis, both absolute and percentage changes are computed.	In this analysis, only percentage change is computed.
4.	Application	It is applicable to time series analysis.	It is applicable to cross-section analysis.

Exercise Problems

1. Following are the Balance Sheets of X Co. Ltd. as on 31st March, 2005 and 2006 :

Liabilities	2005 Rs.	2006 Rs.	Assets	2005 Rs.	2006 Rs.
Pref. Share capital	--	2,00,000	Goodwill	20,000	30,000
Eq. share capital	4,20,000	5,20,000	Buildings	6,00,000	5,80,000
General Reserve	1,00,000	1,10,000	Machinery	3,00,000	3,38,000
Creditors	4,40,000	2,68,000	Stock	2,00,000	1,48,000
Profit and Loss a/c	61,000	71,200	Debtors	1,40,400	1,08,000
14% Debentures	2,00,000	--	Cash/Bank	20,600	37,200
Unclaimed dividend	--	--			
	12,81,000	12,41,200		12,81,000	12,41,200

Information:

- (i) Dividend paid in cash Rs. 50,000 during the year.
- (ii) Assets acquired for Rs. 1,00,000 payable in equity shares; stock Rs. 50,000, Machine Rs. 40,000 and good will.
- (iii) Machine purchased for cash Rs. 12,000
- (iv) Provision for tax during the year Rs. 66,000.
- (v) debenture-holders accept preference shares in settlement of their claims.
- (vi) Depreciation on building Rs. 20,000.

Prepare Funds Flow Statement and Schedule of Changes in Working Capital.

[Ans : Net increase in working capital Rs. 92,200; Funds from operations Rs. 1,06,200; Depreciation on machinery Rs. 14,000]

2. From the particulars of X Co. Ltd., prepare funds flow statement and schedule of changes in working capital :

Liabilities	31-3-09 Rs.	31-3-08 Rs.	Assets	31-3-09 Rs.	31-3-08 Rs.
Equity share Capital	7,00,000	5,00,000	Fixed Assets	12,40,000	10,20,000
14% Debentures	6,00,000	7,00,000	Investments	1,60,000	60,000
Profit and Loss a/c	5,40,000	2,20,000	Debtors (All good)	1,50,000	80,000
Creditors	2,00,000	1,00,000	Other Current Assets	6,00,000	4,00,000
Proposed dividend	50,000	20,000	Discount on Issue of Debentures	10,000	20,000
Provision for Doubtful Debts	30,000	20,000		21,60,000	15,80,000

The following additional information is given :

- (i) Tax provided during the year, Rs. 30,000
- (ii) some investments were sold for Rs. 1,00,000 at a profit of 25% on cost.
- (iii) An interim dividend @ 15% was paid on equity shares. New equity shares were issued on 31st March, 2009.
- (iv) Provision for depreciation stood at Rs. 3,00,000 on 1st April, 2008 and at Rs. 3,80,000 on 31st March, 2009. A fixed asset costing Rs. 1,40,000 (Book value, Rs. 80,000) was sold for Rs. 50,000.

[Ans : Increase in Working Capital Rs. 1,70,000; Total Source Rs. 9,95,000; Total uses Rs. 8,25,000]

3. From the following Balance Sheets of Twenty First Century Ltd. and additional information prepare a Cashflow Statement as per AS 3 (Revised)

Liabilities	31-3-2004 Rs.	31-3-2005 Rs.
Equity Share Capital	12,00,000	15,00,000
General Reserve	3,00,000	3,50,000
Profit and Loss A/c	1,00,000	1,50,000
9% Debentures	6,00,000	4,00,000
Creditors	4,90,000	5,60,000
Proposed Dividends	1,20,000	1,80,000
Provision for Taxation	1,00,000	1,30,000
	29,10,000	32,70,000
Assets		
Building	8,00,000	7,60,000
Machinery	5,00,000	7,20,000
Short - Term Investments	3,00,000	4,50,000
Inventories	4,00,000	4,70,000
Debtors	6,70,000	5,30,000
Cash at Bank	2,20,000	3,30,000
Prepaid Expenses	20,000	10,000
	29,10,000	32,70,000

Additional Information :

- (i) Debentures were redeemed at a premium of 10% on 1st April, 2004.
- (ii) Income tax paid during the year amounted to Rs. 1,40,000.
- (iii) A machine which appeared at a W.D.V. of Rs.80,000 was sold for Rs. 1, 30,000 and a new machine costing Rs. 3,60,000 was acquired during the year.

[Ans: Net cash flow from operating activities : Rs. 5,66,000]

Net cash used in investing activities : Rs. (3,80,000)

Net increase in cash and cash equivalents: Rs.1,10,000]

4. From the summary cash account of N. Ltd. prepare cashflow statement for the year ended 31st March 2008 in accordance with AS 3 (Revised) using the direct method and indirect method. The company does not have any equivalents.

Summary Cash Account
for the year ended 31-03-2008

(Rs.'000)

	Rs.		Rs.
Balance on 1-4-2007	50	Payment to suppliers	2,000
Issue of equity shares	300	Purchase of fixed assets	200
Receipts from customers	2,800	Overhead expenses	200
Sale of fixed assets	100	Wages and salaries	100
		Taxation	250
		Dividend	50
		Repayment of bank loan	300
		Balance on 31-03-2008	150
	3,250		3,250

[Ans : Net cash from operating activities in Rs. (000) Rs. 250

Net cash used in investing activities Rs. (100)

Net increase in cash : Rs. 100]

5. From the following Balance Sheet of Ahmed Ltd. prepare a Cashflow Statement

Liabilities	31-03-04 Rs.	31-03-05 Rs.
12% Preference Share Capital	--	90,000
Equity Share Capital	7,20,000	8,10,000
General Reserve	36,000	45,000
Profit and Loss Account	18,000	21,600
15% Debentures	1,08,000	1,17,000
S. Creditors	2,16,000	1,98,000
Bank overdraft	2,25,000	1,22,400
Provision for Taxation	54,000	75,600
Proposed Dividend	90,000	1,04,000
	14,67,000	15,84,000

Assets		
Fixed Assets	7,38,000	7,20,000
Less : Provision for Depreciation	(1,98,000)	(2,70,000)
	5,40,000	4,50,000
Stock	5,40,000	6,30,000
Debtors	3,60,000	4,32,000
Prepaid Expenses	5,400	9,000
Cash and Bank	21,600	63,000
	14,67,000	15,84,000

Interest paid on debentures - Rs. 16,200

Prepare Cashflow Statement

[Ans : Cash from Operating Activities - Rs. 43,200

Cash from Investing Activities - Rs. 18,000

Cash used in Financing Activities - Rs. 82,800

Net Increase in Cash and Cash equivalent - Rs. 1,44,000]

Short Question & Answers

1. What is Funds Flow Statement

Ans :

Meaning

The funds flow statement consists of two terms 'Fund' and 'Flow'. Fund may be interpreted as cash or working capital or all financial resources. Flow means change.

Funds flow statement is a method by which one studies the changes in the financial position of a business enterprise between beginning and ending financial statements dates. It is a statement showing sources and uses of funds for a period of time.

Definitions

- (i) **According to Foulke**, "A statement of sources and application of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates".
- (ii) **According to Anthony**, "The funds flow statement describes the sources from which additional funds were derived and the use to which these sources were put".

I.C.W.A. in glossary of Management Accounting terms defines funds flow statement as, "A statement either prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of the statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilization and application of the same".

2. Distinguish between differences Funds Flow and Cash Flow Statement.

Ans :

S.No.	Basis of Difference	Funds Flow Statement	Cash Flow Statement
1)	Object	Its object is to help in providing information relating to firm's ability to meet its long term liabilities.	Its object is to provide the firm's ability to meet its short term liabilities.
2)	Dependence	Funds flow statement can be prepared if cash flow statement is there. is there. Thus, it is dependent.	Cash flow statement is prepared only when schedule of changes in working capital along with funds flow statement
3)	Nature of Statement	It deals with the changes in working capital.	It deals with the changes in cash position only.
4)	Opening Balance	There is no such balance.	There is always cash opening balance, or it is prepared with the opening balance of cash in hand.

5)	Difference of Sides	Difference of both the sides of funds flow statement is either the increase or decrease in working capital.	Difference of both the sides of cash flow statement is the closing balance of cash.
6)	Additional Statement	Whenever funds flow statement is prepared an additional statement in the name of schedule showing changes in working capital is also prepared.	No additional statement is prepared when cash flow statement is prepared.

3. What information can be Obtained from Cash Flow?

Ans :

Cash plays a very important role in the entire economic life of a business. A firm needs cash to make payments to its suppliers, to incur day-to-day expenses and to pay salaries, wages, interest and dividends, etc. In fact, what blood is to a human body, cash is to a business enterprise. It is very essential for a business to maintain an adequate balance of cash. But many a times, a concern operates profitably and yet it becomes very difficult to pay taxes and dividends. This may be because (i) although huge profits have been earned yet cash may not have been received or (ii) even if cash has been received; it may have drained out (used) for some other purposes. This movement of cash is of vital importance to the management.

A statement of changes in the financial position of firm on cash basis is called a cash flow statement. Such a statement enumerates net effects of the various business transactions on cash and takes into account receipts and disbursements of cash. A cash flow statement summarizes the causes of changes in cash position of a business enterprise between dates of two balance sheets.

Cash flow statement is a statement of changes of financial position in business due to inflow or outflow of cash and their statement is required for short-range business premises.

4. How are cash flows classified as per AS-3.

Ans :

The cash flow statement can be classified into following activities:

1. Operating activities,
2. Investing activities, and
3. Financing activities.

1. Operating activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from principal revenue producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

2. Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

3. Financing Activities

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

5. Explain the differences between horizontal analysis and vertical analysis.

Ans :

S.No.	Basis	Horizontal Analysis	Vertical Analysis
1.	Need	Comparative Financial statement is needed to prepare horizontal analysis.	Financial statements of one accounting period are needed to prepare vertical analysis.
2.	Items	It includes same items of different periods	It includes different items of same period.
3.	Calculation	In this analysis, both absolute and percentage changes are computed.	In this analysis, only percentage change is computed.
4.	Application	It is applicable to time series analysis.	It is applicable to cross-section analysis.

6. How can the Net increase in working capital be computed ?

Ans :

Step 1 : Enter the amounts of current assets for previous year in previous year column.

Step 2 : Enter the amounts of current assets for current year in current year column

Step 3 :

If current assets is increasing working capital also increasing. If current assets decreases working capital also decreases.

Step 4 : Enter the amount of current liabilities for previous year in previous year column.

Step 5 : Enter the amount of current liabilities for current year in current year column.

Step 6 :

If current liabilities increases working capital decreases. If current liabilities decrease working capital increases.

7. Paid Costs.

Ans :

Paid costs/expenses are also called prepaid expenses or expenses paid in advance. The expenses that are paid in advance for the events that are to be held in next year during the present accounting period are called prepaid expenses.

Example

Rent that has to be paid for next year has been paid in advance in this year. The prepaid expenses should not be considered under profit and loss account and are required to carry forward for next year and are debited to expenses account.

8. Unpaid Costs/Expenses

Ans :

Unpaid expenses are also called outstanding expenses. The expenses that are due or unpaid during that accounting period are called outstanding expenses. These expenses include outstanding rent, salaries, interest etc., These expenses cannot be entered in the records till their realization. But for ascertaining the true picture of profit/loss incurred in a particular accounting period one should represent these expenses in the final accounts.

1. These expenses should be debited to the profit and loss account
2. They should be stated under liabilities in balance sheet.

9. Define financial statement analysis.

Ans :

Meaning

Financial analysis is also referred as financial statements analysis. The term 'financial analysis', also known as an 'analysis and interpretation of financial statements', refers to the process of determining financial strengths and weakness of firm by establishing strategic relationship between the items of balance sheet, profit and loss account and other operative data.

Definition

- (i) **According to Myers**, "Financial statements analysis is largely a study of relationship among the various financial factors in a business as disclosed by single set-of statements, and study of the trend of these factors as shown in a series of statement".

Analysis of financial statements is the systematic numerical calculation of the relationship between one fact with the other to measure the profitability, operational, efficiency, solvency and the growth potential of the business.

- (ii) **According to Hampton**, "Analysis of financial statement i & the process of determining the significant operating and financial characteristics of a firm from accounting data.

10. Limitations of Financial Statement Analysis.

Ans :

The limitations of financial statement analysis are as follows:

1. Absence of Standard Universally Accepted Terminology

Accounting is not an exact science. It does not have standard universally accepted terminology. Different meanings are given to a particular term. There are different methods of providing depreciation; interest may be charged on different rates, etc.

2. Ignoring Qualitative Aspects

Financial analysis does not measure the qualitative aspects of the business. It is the quantitative measurement of performance. It means that analysis of financial statement measures only the one sided performance of the business.

3. Misleading Result in Absence of Absolute Data

Result shown by financial analysis may be misleading in the absence of absolute data.

4. Ignoring Price Level Changes

The comparability of ratios suffers if the prices of the commodities in two different years are not the same. Change in price affects the cost of production, sales and also the value of assets. It means that the ratio will not be meaningful for comparison if the prices of commodities are different.

Choose the Correct Answers

1. _____ is a legal measure to reduce the tax liability. [b]
(a) Tax avoidance (b) Tax planning
(c) Tax evasion (d) Tax income.
2. Parties who are interested in knowing the financial position of a business are, [d]
(a) Owners (b) Employees
(c) Financial institutions (d) All the above
3. The net cash flow are classified into operating, financing and investing activities in _____. [a]
(a) Cash flow statement (b) Funds flow statement
(c) Balance sheet (d) None
4. Cash flows from _____ activities result from the major revenue producing activities of a firm [c]
(a) Financing (b) Investing
(c) Operating (d) Both (a) and (b)
5. As per Accounting Standard-3, Cash Flow is classified into [d]
(a) Operating activities and investing activities
(b) Investing activities and financing activities
(c) Operating activities and financing activities
(d) Operating activities, financing activities and investing activities
6. Cash Flow Statement is also known as [c]
(a) Statement of Changes in Financial Position on Cash basis
(b) Statement accounting for variation in cash
(c) Both a and b
(d) None of the above.
7. The objectives of Cash Flow Statement are [d]
i) Analysis of cash position
ii) Short-term cash planning
iii) Evaluation of liquidity
iv) Comparison of operating Performance
(a) Both i and ii (b) Both i and iii
(c) Both ii and iv (d) i, ii, iii, iv

8. Cash Flow Statement is based upon [a]
(a) Cash basis of accounting
(b) Accrual basis of accounting
(c) Credit basis of accounting
(d) None of the above
9. Which of the following statements are true? [d]
i) Cash flow reveals only the inflow of cash
ii) Cash flow reveals only the outflow of cash
iii) Cash flow is a substitute for income statement
iv) Cash flow statement is not a replacement of funds flow statement.
(a) Only i (b) Only ii
(c) Both ii and iii (d) Only iv
10. The statement of cash flows does not include cash inflows and outflows for which of the following activities? [d]
(a) Financing activities (b) Investing activities
(c) Operating activities (d) Revenue activities

Fill in the blanks

1. _____ reveals the effects of transactions involving the changes in cash or cash equivalents.
2. Cash flow statement is useful for _____
3. Cash flows are _____ and _____ of cash and cash equivalents.
4. Income from investments is a cash flow from _____ activities.
5. If the taxable incomes are not completely revalued to the income tax department then such act is known as _____
6. Cash flow statement (based on AS-3) indicates change in _____
7. Buy back of shares comes under _____
8. Cash payments to supplies for goods and services is an example of _____
9. _____ refers to the cash a business requires for day-to-day operations, (or) specifically.
10. Working capital = _____

ANSWERS

1. Cash flow statement
2. Short-term financial analysis
3. Inflows and outflows
4. Investing
5. Tax evasion
6. Cash and cash equivalents
7. Financing activity
8. Operating activity
9. Working Capital
10. Current Assets -Current Liabilities

One Mark Question & Answers

1. Horizontal Analysis

Ans :

When financial statements for a certain number of years are examined and analyzed, then the analysis is called as horizontal analysis. It is also known as "dynamic analysis".

2. Vertical Analysis

Ans :

This refers to analysis of ratios developed for one date or for one accounting period. This is also known as 'static analysis'.

3. Funds Flow Statement.

Ans :

Funds flow statement is a method by which one studies the changes in the financial position of a business enterprise between beginning and ending financial statements dates.

4. Funds Lost in Operations

Ans :

Firms may suffer loss in a particular year from its trading operations, then such losses constitutes the outflow of funds and are recorded as application of funds.

5. Unpaid Costs

Ans :

Unpaid expenses are also called outstanding expenses. The expenses that are due or unpaid during that accounting period are called outstanding expenses.

UNIT V

Financial Statement Analysis-II: Analysis and Interpretation of Financial Statements, Liquidity, Leverage, Solvency and Profitability Ratios, Valuation Ratios, Du Pont Chart, Accounting Standards Issued by ICAI, Focus on INDAS, International Financial Reporting Standards (IFRS).

5.1 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

Q1. What are the Tools and Techniques of Financial Analysis ?

Ans :

Important tools or techniques of financial statement analysis are as follows.

1. Comparative Statement
2. Comparative Income Statement
3. Comparative Balance Sheet
4. Common Size Statements.
5. Trend Analysis.
6. Average Analysis.
7. Statement of Changes in Working Capital.
8. Fund Flow Analysis.
9. Cash Flow Analysis.
10. Ratio Analysis.
11. Cost Volume Profit Analysis

A brief explanation of the tools or techniques of financial statement analysis presented below.

1. Comparative Statements

Comparative statements deal with the comparison of different items of the Profit and Loss Account and Balance Sheets of two or more periods. Separate comparative statements are prepared for Profit and Loss Account as Comparative Income Statement and for Balance Sheets.

As a rule, any financial statement can be presented in the form of comparative statement such as comparative balance sheet, comparative profit and loss account, comparative cost of production statement, comparative statement of working capital and the like.

2. Comparative Income Statement

Three important information are obtained from the Comparative Income Statement. They are Gross Profit, Operating Profit and Net Profit. The changes or the improvement in the profitability of the business concern is find out over a period of time. If the changes or improvement is not satisfactory, the management can find out the reasons for it and some corrective action can be taken.

3. Comparative Balance Sheet

The financial condition of the business concern can be find out by preparing comparative balance sheet. The various items of Balance sheet for two different periods are used. The assets are classified as current assets and fixed assets for comparison. Likewise, the liabilities are classified as current liabilities, long term liabilities and shareholders' net worth. The term shareholders' net worth includes Equity Share Capital, Preference Share Capital, Reserves and Surplus and the like.

4. Common Size Statements

A vertical presentation of financial information is followed for preparing common-size statements. Besides, the rupee value of financial statement contents are not taken into consideration. But, only percentage is

considered for preparing common size statement.

The total assets or total liabilities or sales is taken as 100 and the balance items are compared to the total assets, total liabilities or sales in terms of percentage. Thus, a common size statement shows the relation of each component to the whole. Separate common size statement is prepared for profit and loss account as Common Size Income Statement and for balance sheet as Common Size Balance Sheet.

5. Trend Analysis

The ratios of different items for various periods are found out and then compared under this analysis. The analysis of the ratios over a period of years gives an idea of whether the business concern is trending upward or downward. This analysis is otherwise called as Pyramid Method.

6. Average Analysis

Whenever, the trend ratios are calculated for a business concern, such ratios are compared with industry average. These both trends can be presented on the graph paper also in the shape of curves. This presentation of facts in the shape of pictures makes the analysis and comparison more comprehensive and impressive.

7. Statement of Changes in Working Capital

The extent of increase or decrease of working capital is identified by preparing the statement of changes in working capital. The amount of net working capital is calculated by subtracting the sum of current liabilities from the sum of current assets. It does not detail the reasons for changes in working capital.

8. Fund Flow Analysis

Fund flow analysis deals with detailed sources and application of funds of the business concern for a specific period. It indicates where funds come from and how they are used during the period under review. It highlights the changes in the financial structure of the company.

9. Cash Flow Analysis

Cash flow analysis is based on the movement of cash and bank balances. In other words, the movement of cash instead of movement of working capital would be considered in the cash flow analysis. There are two types of cash flows. They are actual cash flows and notional cash flows.

10. Ratio Analysis

Ratio analysis is an attempt of developing meaningful relationship between individual items (or group of items) in the balance sheet or profit and loss account. Ratio analysis is not only useful to internal parties of business concern but also useful to external parties. Ratio analysis highlights the liquidity, solvency, profitability and capital gearing.

11. Cost Volume Profit Analysis

This analysis discloses the prevailing relationship among sales, cost and profit. The cost is divided into two. They are fixed cost and variable cost. There is a constant relationship between sales and variable cost. Cost analysis enables the management for better profit planning.

5.1.1 Comparative Statement

Q2. What do you mean by comparative statement analysis? Write about comparative size balance sheet and comparative size income statement.

Ans :

Comparative Statement Analysis

As the very term signifies, comparative financial statements are statements of the financial position of a business which are formulated to focus on the elements contained therein and provide the necessary time perspective to it. Normally, it is the balance sheet and profit and loss account which alone are prepared in a comparative form, since it is these two statements which are considered as important financial statements. Moreover, it is through these two statements the financial position and the operational results of any business can be determined.

Comparative financial statements are designed to disclose the following,

- (i) Absolute data
- (ii) Increase or decrease in absolute data
- (iii) Increase or decrease in absolute data in terms of percentage.

Comparative financial statements are very useful to the financial analyst since they contain figures drawn from single statement and also provide necessary information for the study of financial and operating results over a period of time. They only point out the direction or the trend of the movement concerning to financial position and operating results of the business concern.

Comparisons will become effective only if the data compared truly reflect the constancy in the application of generally accepted accounting principles from date to date or period to period.

The analyst should also keep in mind the price level changes that have taken place between the dates of different transactions and that of preparation of financial statements. Where there is a substantial price fluctuation, the analyst must exercise great caution while interpreting the values.

Comparative Size Balance Sheet

Normally any increase or decrease in the value of various assets and liabilities as well as in proprietor's equity or capital, resulting from the operational activities of the business can be easily observed by means of comparison of the balance sheet at the beginning and end of the accounting period. To facilitate comparison, a simple device known as "comparative balance sheet" may be employed. Such method often yields valuable information relating to progress of the business concern.

While the single balance sheet represents balance of accounts drawn at the end of an accounting period, the comparative balance sheet represents not merely the balance of accounts drawn on two different dates, but also the extent of their increase or decrease between these two dates. The single balance sheet focuses on the financial status of the concern as on a particular date, the comparative balance sheet focuses on the changes that have taken place in one accounting period. The changes are the direct outcome of operational activities, conversion of assets, liability and capital form into others as well as various interactions among assets, liability and capital.

The proforma of comparative balance sheet consists of two columns for the date of the original balance sheet, third column for disclosing increase and decrease in various items. A fourth column showing the percentage of increase and decrease.

Comparative Size Balance Sheet

Particulars	Previous Year	Current Year	Increase/Decrease	Percentage Change
Assets :				
Liabilities :				

Step 1:

Draw a comparative balance sheet format with the current period listed first and the period listed first and the previous period listed next. Add fourth column as Increase/Decrease and fifth column as percentage change.

Step 2:

For each item on the balance sheet, calculate the difference between the current and previous period and enter this figure in the fourth column (Increase/Decrease).

Step 3:

Calculate the percent change (increase or decrease) using the percentage formula,

$$\text{Percent Change (Rate)} = \frac{\text{Amount of Change, Step 3 (Portion)}}{\text{Previous period amount (Base)}}$$

Step 4:

Enter the percent change (rounded to the nearest tenth percent) in the Percentage change column.

Comparative Size Income Statement

The comparative income statement shows the operational results of the business for number of accounting periods so that changes in absolute figures from one period to another may be stated in terms of money and percentages.

The comparative income statement also like the comparative balance sheet and provides the same type of particulars such as the account balances, increase or decrease in such balances and the percentage of increase or decrease.

Comparative Size Income Statement

Particulars	Previous Year	Current Year	Increase/Decrease	Percentage Change

Percentage change is calculated by the following formula,

$$\text{Percentage change} = \frac{\text{Absolute Change}}{\text{Amount of Previous Year}} \times 100$$

PROBLEMS

- From the following information, prepare a comparative income statement and comment on the profitability.

Particulars	31.3.2009 (₹)	31.3.2010 (₹)
Net Sales	1,570	1,800
Cost of Goods sold	900	1,000
Administration expenses	140	144
Selling and Distribution expenses	160	180
Interest paid	50	60
Income Tax	140	160

Sol :

Comparative Income Statement

Particulars	31-3-2009 (₹)	31-3-2010 (₹)	Absolute Change	Percentage Change
Net Sales	1,570	1,800	230	14.65%
Less: Cost of Goods Sold	900	1,000	100	11.11%
Gross Profit (A)	670	800	130	19.40%
Less: Operating Expenses:				
Administration expenses	140	144	4	2.85%
Selling and distribution expenses	160	180	20	12.5%
Total Operating Expenses (B)	300	324	24	8%
Profit Before Interest and Tax (A-B) (Gross profit - operating expenses)	370	476	106	28.65%
Less: Interest paid	50	60	10	20%
Profit Before Tax	320	416	96	30%
Less: Income Tax	140	160	20	14.29%
Profit After Tax	1801	2561	76	42.22%

Comments

1. Increase in gross profit is more than the increase in net sales by nearly 5%
 2. There is marginal increase in operating expenses i.e., 8%
 3. The profitability of the concern has increased in 2010 compared to 2009 by 42.22%
 4. Hence, profitability condition of the concern is good.
2. From the following information, prepare a comparative income statement and comment on the profitability.

	31.3.2009 (₹)	31.3.2010 (₹)
Net Sales	1,570	1,800
Cost of Goods sold	900	1,000
Administration expenses	140	144
Selling and Distribution expenses	160	180
Interest paid	50	60
Income Tax	140	160

Sol.:

Comparative Income Statement

Particulars	31-3-2009 (₹)	31-3-2010 (₹)	Absolute Change	Percentage Change
Net Sales	1,570	1,800	230	14.65%
Less: Cost of Goods Sold	900	1,000	100	11.11%
Gross Profit (A)	670	800	130	19.40%
Less: Operating Expenses:				
Administration expenses	140	144	4	2.85%
Selling and distribution expenses	160	180	20	12.5%
Total Operating Expenses (B)	300	324	24	8%
Profit Before Interest and Tax(A-B) (Gross profit - operating expenses)	370	476	106	28.65%
Less: Interest paid	50	60	10	20%
Profit Before Tax	320	416	96	30%
Less: Income Tax	140	160	20	14.29%
Profit After Tax	180	256	76	42.22%

Comments

1. Increase in gross profit is more than the increase in net sales by nearly 5%
 2. There is marginal increase in operating expenses i.e., 8%
 3. The profitability of the concern has increased in 2010 compared to 2009 by 42.22%
 4. Hence, profitability condition of the concern is good.
3. The comparative Balance sheet of Kowranth Ltd. are given below Balance sheet as on 31.12.2016 and 2017

Liabilities	2016	2017	Assets	2016	2017
Equity share capital	800	1,200	Cash	236	20
Capital Reserve	120	220	Debtors	418	380
General Reserve	444	418	Stock	320	260
Sinking funds	80	100	Others	64	26
6% Debentures	400	650	Investments	540	340
Current liabilities					
Sundry creditors	510	234	Fixed Assets		
Others	14	20	Furniture less Depri	18	36
			Building Less Depri	620	1,572
			Land	40	60
			Others Assets	112	148
	2,368	2,842		2,368	2,842

Sol :

(Dec.-18)

**Comparative Balance Sheet of Kowranth Ltd., as on 31st December-2016 and
31st December-2017**

Particulars	2016	2017	Absolute Change	Percentage Change
Current Assets :				
Cash	2,36,000	20,000	- 2,16,000	- 91.53%
Debtors	4,18,000	3,80,000	- 38,000	- 9.09% 1
Stock	3,20,000	2,60,000	- 60,000	- 18.75%
Investments	5,40,000	3,40,000	- 2,00,000	- 37.04%
Others	64,000	26,000	- 38,000	- 59.38%
Total Current Assets (A)	15,78,000	10,26,000	- 5,52,000	- 34.98%
Fixed Assets :				
Furniture less Depri	18,000	36,000	18,000	100%
Building less Depri	6,20,000	15,72,000	9,52,000	153.55%
Land	40,000	60,000	20,000	50%
Other Assets	1,12,000	1,48,000	36,000	32.14%
Total Fixed Assets (B)	7,90,000	18,16,000	10,26,000	129.87%
Total Assets (A+B)	23,68,000	28,42,000	4,74,000	20.02%
Liabilities :				
Equity Share Capital	8,00,000	12,00,000	4,00,000	50%
Capital Reserve	1,20,000	2,20,000	1,00,000	83.33%
General Reserve	4,44,000	4,18,000	- 26,000	- 5.86%
Sinking Fund	80,000	1,00,000	20,000	25%
6% Debentures	4,00,000	6,50,000	2,50,000	62.5%
Total Liabilities (A)	18,44,000	25,88,000	7,44,000	40.35%
Current Liabilities:				
Sundry Creditors	5,10,000	2,34,000	- 2,76,000	- 54.12%
Others	14,000	20,000	6,000	42.86%
Total Current Liabilities (B)	5,24,000	2,54,000	- 2,70,000	- 51.53%
Total Liabilities (A+B)	23,68,000	28,42,000	4,74,000	20.02%

5.1.2 Common size statements

Q3. What do you mean by common-size analysis? Write about common-size balance sheet and common- size income statement.

Ans :

Common-Size Statements

Common size statement represents all figures in percentages because of which it is also called as 'percentage statement'. As common size statement shows every financial element in percentages, it get easy for the firm to measure its financial status, size, capacity and liquidity. Thus, it provides significant information about the financial performance and financial stability of the firm.

The common size statements are also known as "component percentage" or " 100 percent statement". Each statement is reduced to the total of 100 and each individual item contained there in is expressed as a percentage to the total 100. Thus, each percentage in the statement shows the relationship of individual item to its representative total.

Common size statement consist of two different statements i.e., common size income statement and common size balance sheet.

Computation of Common-Size Statement

- (i) The total assets, total liabilities, capital and total net sales are taken as 100.
- (ii) The ratio that each item bears to the total is ascertained by dividing the individual amounts by the total amount as contained in the statement. For instance, if selling and distribution expenses amount to ` 3 lakhs out of a net sales of ` 30 lakhs for a company in 1999, then the ratio that this item bears to the total can be calculated as follows:

$$= \frac{\text{Selling and distribution expenses}}{\text{Net sales}} \times 100$$

This ratio of 10% denotes that the selling and distribution expenses of the company are 10% of the net sales for 1999. In other words, the amount to ` 10 for every ` 100 worth of net sales.

Common-Size Balance Sheet

The common-size balance sheet represents the relation of each asset item to total assets and each liability and capital item to total liabilities and capital respectively. As these percentages indicate the relationship to balance sheet totals, variations from year to year do not necessarily indicate changes in money amounts. The ratios expressed in the common- size balance sheet would reflect a change in the individual item, total or both.

The common-size balance sheet percentages facilitate a horizontal comparison from year to year and a study of the trends of relationships. They do not throw light on the trends of the individual items from year to year. The usefulness of the common-size balance sheet can be improved by establishing norms of percentages for each item to the relative total. The formula for calculating percentages of individual asset or liability is as follows,

$$\text{Percentage} = \frac{\text{Asset}}{\text{Total Asset}} \times 100 \text{ (or)}$$

$$\text{Percentage} = \frac{\text{Liability}}{\text{Total Liability}} \times 100$$

Common-Size Income Statement

Common-size income statement show the percentage of net sales that has been absorbed by each individual item representing cost or expense, in the income statement. The comparison of the common-size income statement ratios is significant as they indicate whether a larger or smaller amount of net sales figure is used in meeting a particular cost or expenses.

Q4. List out the advantages and disadvantages to common-size statement.

Ans :

The preparation of common-size statement includes both advantages and disadvantages,

Advantages

The advantages of common-size statement are as follows,

1. In terms of percentages, the relative importance of each item is shown in common size statements.
2. In common size income statement, the proportion of sales used in cost of sales, operating expenses, interest and tax is ascertained by converting each item in terms of percentage of sales.
3. The common size balance sheet helps the analyst to determine the percentage of total assets which is shared between fixed and current assets and percentage of total liabilities which is payable to owners and outsiders.
4. It gives an overview of capital structure i.e., portion of own capital and debt capital in total capital structure.
5. It helps in inter-company comparison even comparison of firms with different sizes is also possible in common-size statement.
6. Both short term and long term financial position of an enterprise can be ascertained.

Disadvantages

The disadvantages of common-size statement are as follows,

1. In this statement, relative importance of each item is shown but there is no comparison between years.
2. Time value of money is not considered in common size statement.
3. This analysis is not beneficial in making important decisions.
4. It is not useful in segment wise analysis.
5. The comparison of common size statements of two or more years does not exhibits significant disclosure.

PROBLEMS

4. The Balance Sheet of S & Co. and K & Co. are given as follows:

Balance Sheets as on Dec. 31st, 2009

Liabilities	S & Co. (₹)	K & Co. (₹)	Assets	S & Co. (₹)	K & Co. (₹)
Preference Share Capital	1,20,000	1,60,000	Land and Building	80,000	1,23,000
Equity Share Capital	1,50,000	4,00,000	Plant and Machinery	3,34,000	6,00,000
Reserves and Surplus	14,000	18,000	Temporary Investment	1,000	40,000
Long Term Loans	1,15,000	1,30,000	Inventories	10,000	25,000
Bills Payable	2,000	–	Book-Debts	4,000	8,000
Sundry Creditors	12,000	4,000	Prepaid Expenses	1,000	2,000
Outstanding Expenses	15,000	6,000	Cash and Bank Balances	8,000	10,000
Proposed Dividend	10,000	90,000			
	4,38,000	8,08,000		4,38,000	8,08,000

Compare the financial position of two companies with the help of Comparative Balance Sheet

Sol.:

Comparative Balance Sheet of S & Co. and K & Co.

for the year ending 31st December 2009.

Particulars	S & Co. (₹) (1)	K & Co. (₹) (2)	Absolute Change(₹) (3)	Percentage Change (4) = 3 ÷ 1
Assets:				
Fixed Assets:				
Land and Buildings	80,000	1,23,000	43,000	54%
Plant and Machinery	3,34,000	6,00,000	2,66,000	80%
Total (A)	4,14,000	7,23,000	3,09,000	75%
Current Assets:				
Investment (Temporary)	1,000	40,000	39,000	3,900%
Book Debts	4,000	8,000	4,000	100%
Prepaid Expenses	1,000	2,000	1,000	100%
Cash and Bank Balances	8,000	10,000	2,000	25%
Inventories	10,000	25,000	15,000	150%
Total (B)	24,000	85,000	61,000	254%
Total Assets (A+B)	4,38,000	8,08,000	3,70,000	84%

Liabilities:				
Equity Share Capital	1,50,000	4,00,000	2,50,000	167%
Preference Share Capital	1,20,000	1,60,000	40,000	33%
Reserves and Surplus	14,000	18,000	4,000	28%
Long Term Loans	1,15,000	1,30,000	15,000	13%
Total (A)	3,99,000	7,08,000	3,09,000	77%
Current Liabilities:				
Bills Payable	2,000	-	-2,000	-100%
Sundry Creditors	12,000	4,000	-8,000	-67%
Outstanding Expenses	15,000	6,000	-9,000	-60%
Proposed Dividend	10,000	90,000	80,000	800%
Total (B)	39,000	1,00,000	61,000	156%
Total Liabilities (A+B)	4,38,000	8,08,000	3,70,000	84%

Interpretation

- Both current assets and current liabilities in K & Co. are more than those in S & Co. It indicates that working capital of K & Co. is also more than S & Co. Hence liquidity position of K & Co. is comparatively good than S & Co.
 - Share capital, reserves and surplus and long term loans amount seems to be utilized by both the companies through payment of dividend and purchasing fixed assets.
 - Reserves and surplus need to be improve in both companies.
 - Above all, financial position of K & Co. and S & Co. is satisfactory.
5. From the following information prepare common size income statement for the years ended 31st December 2008 and 2009.

Particulars	31 st December (₹ in '000)	31 st December (₹ in '000)
Sales	1,000	1,400
Miscellaneous income	40	30
	1,040	1,430
Expenses :		
Cost of sales	650	1,020
Office expenses	40	50
Selling expenses	60	90
Interest	50	60
	800	1,220
	240	210
Net Profit	1,040	1,430

Sol.:

Common Size Income Statement
For the Years Ending 31 December 2008 and 31 December 2009

Particulars	2008		2009	
	Amount (` in '000)	Percentage (%)	Amount (` in '000)	Percentage (%)
Sales	1,000	100	1,400	100
Less : Cost of sales	650	65	1020	72.86
Gross Profit (A)	350	35	380	27.14
Operating Expenses :				
Office expenses	40	4	50	3.57
Selling expenses	60	6	90	6.43
Total Operating Expenses (B)	100	10	140	10
Operating Profit (A – B)	250	25	240	17.14
Add : Miscellaneous income	40	4	30	2.14
Total Income	290	29	270	19.28
Less : Non- operating expenses:				
Interest	50	5	60	4.29
Net Profit	240	24	210	15

Interpretations

- Both sales and gross profit have increased in absolute figures but percentage of gross profit has decreased in year 2009.
- The increase in cost of sales has reduced profitability from 35 percent to 27.14 percent
- Percentage of operating expenses remains same in both the years.
- The absolute figure as well as percentage of net profit have decreased in 2009 compare to 2008

5.2 RATIO ANALYSIS

Q5. What is Ratio Analysis? State the objectives of ratio analysis.

*Ans.:***(Imp.)****Definition**

- (i) According to Myers,** "Ratio analysis is a study of relationship among the various financial factors in a business".

Thus, ratio analysis measures the profitability, efficiency and financial soundness of the business.

Ratio analysis is to present the figure of financial statement in simple and intangible form. Ratio analysis is to present the figure of financial statement in simple and intangible form. Ratio analysis, in this way, is the process of establishing meaningful relationship between two figures and set of financial statement.

Objectives

The objectives of ratio analysis are as follows :

1. **Measuring the Profitability:** The profitability of the business can be measured by calculating gross profit, net profit, expenses ratio and other.
2. **Judging the Operational Efficiency of Business:** The operational efficiency of the business can be ascertained by calculating operating ratio.
3. **Assessing the Solvency of the Business:** It can be ascertained whether the firm is solvent or not by calculating solvency ratio. Solvency ratios show relationship between total liabilities and total assets. If total assets are lesser than the total liabilities it shows unsound position of the business.
4. **Measuring Short and Long-Term Financial Position of the Company:** Ratio analysis helps in knowing the short term and long term financial position of the business by calculating various ratios. Current and liquid ratio indicates short-term financial position, whereas debt equity ratio, fixed asset ratio and proprietary ratio shows long-term financial positions.
5. **Facilitating Comparative Analysis of the Performance:** Every firm has to compare its present performance with the previous and discover the plus and minus points. These points can be located by the calculation of different ratio. Comparison with the performance of other competitive firms can also be made.

Q6. Explain the nature of ratio analysis.

Ans :

In financial analysis, ratio is used as an index of yardstick for evaluating the financial position and performance of the firm. It is a technique of analysis and interpretation of financial statements. Ratio analysis helps in making decisions as it helps in establishing relationship between various ratios and interpret thereon. Ratio analysis helps analysts to make quantitative judgement about the financial position and performance of the firm. Ratio analysis involves following steps:

1. Relevant data selection from the financial statements related to the objectives of the analysis.
2. Calculation of required ratios from the data and presenting them either in pure ratio form or in percentage.
3. Comparison of derived different ratios with :
 - (i) The ratio of the same concern over a period of years to know upward or downward trend or static position to help in estimating the future, or
 - (ii) The ratios of another firm in same line, or
 - (iii) The ratios of projected financial statements, or
 - (iv) The ratios of industry average, or
 - (v) The predetermined standards, or
 - (vi) The ratios between the departments of the same concern assessing either the financial position or the profitability or both.

Q7. What are the Guidelines (or) Precautions for use of Ratios?

Ans :

The calculation of ratios may not be difficult task but their use is not easy. The information on which these are based, the constraints of financial statements, objective for using them, the calibre of the analyst, etc. are important factors which influence the use of ratios. Following guidelines or factors may be kept in mind while interpreting various ratios.

1. Accuracy of Financial Statements

The ratios are calculated from the data available in financial statements. The reliability of ratios is linked to the accuracy of information in these statements. Before calculating ratios one should see whether proper concepts and conventions have been used for preparing financial statements or not. These statements should also be properly audited by competent auditors. The precautions will establish the reliability of data given in financial statements.

2. Objective or Purpose of Analysis

The type of ratios to be calculated will depend upon the purpose for which these are required. If the purpose is to study current financial position then ratios relating to current assets and current liabilities will be studied. The purpose of 'user' is also important for the analysis of ratios. A creditor, a banker, an investor, a shareholder, all have different objects for studying ratios. The purpose or object for which ratios are required to be studied should always be kept in mind for studying various ratios. Different objects may require the study of different ratios.

3. Selection of Ratios

Another precaution in ratio analysis is the proper selection of appropriate ratios. The ratios should match the purpose for which these are required. Calculation of large number of ratios without determining their need in the present context may confuse the things instead of solving them. Only those ratios should be selected which can throw proper light on the matter to be discussed.

4. Use of Standards

The ratios will give an indication of financial position only when discussed with reference to certain standards. Unless otherwise these ratios are compared with certain standards one will not be able to reach at conclusions. These standards may be rule of thumb as in case of current ratio (2:1) and acid-test ratio (1 : 1), may be industry standards, may be budgeted or projected ratios, etc. The comparison of calculated ratios with the standards will help the analyst in forming his opinion about financial situation of the concern.

5. Calibre of the Analyst

The ratios are only the tools of analysis and their interpretation will depend upon the calibre and competence of the analyst. He should be familiar with various financial statements and the significance of changes, etc. A wrong interpretation may create havoc for the concern since wrong conclusions may lead to wrong decisions. The utility of ratios is linked to the expertise of the analyst.

6. Ratios Provide Only a Base

The ratios are only guidelines for the analyst. He should not base his decisions entirely on them. He should study any other relevant information, situation in the concern, general economic environment, etc. before reaching final conclusions. The study of ratios in isolation may not always prove useful. A businessman will not afford a single wrong decision because it may have far-reaching consequences. The interpreter should use the ratios as guide and may try to solicit any other relevant information which helps in reaching a correct decision.

Q8. Explain about Rational and Utility of Ratio Analysis.

Ans :

Importance of Ratio Analysis to Various Users

Ratio analysis plays a significant role in ascertaining the financial performance of a concern. The following are the various users of ratio analysis.

(i) Management

Ratio analysis-helps a management to reap many managerial uses from it. They are,

- a) Ratio analysis helps a management assess the financial position of the firm and making necessary decisions from the information available in the financial statement.
- b) It facilitates in financial forecasting' and financial planning.
- c) It helps in communicating the financial strength and weakness of a firm in a more easy and understandable form.
- d) It helps in the coordination of activities which is the most important functions of business management.
- e) It facilitates in effective control of the business by revealing the loop holes in it;
- f) Ratio analysis also serves many other purposes to the management by becoming an essential part in budgetary control and standard costing.

(ii) Investors/Shareholders

Ratio analysis helps an investors or a shareholder to assess the financial position of the concern in which he is going to invest. It warns him in making up his mind whether the present financial position of the concern warrants him for further investment or not. The calculation of various ratios help him to do this.

(iii) Creditors/Suppliers

Ratio analysis helps the creditors or suppliers who extend short-term credit to the concern, to know whether the financial position of the concern warrants their payment at a specified time or not.

(iv) Employees

Ratio analysis also helps the employees who are interested in knowing the financial position of the concern. Various profitability ratios facilitate them to know for the increase of their wages and other benefits.

(v) Government

- Ratio analysis aid the government in assessing the financial health of different industries and prepare its future policies.
- With all the utilities to various users, ratio analysis Serves as a powerful tool for ascertaining the financial position of a concern.

Q9. Explain the advantages of ratio analysis.

Ans : (Nov.-21)

Ratio analysis is an important tool for analyzing the company's financial performance. The following are the important advantages of the accounting ratios.

1. Analyzing Financial Statements

Ratio analysis is an important technique of financial statement analysis. Accounting ratios are useful for understanding the financial position of the company. Different users such as investors, management bankers and creditors use the ratio to analyze the financial situation of the company for their decision making purpose.

2. Judging Efficiency

Accounting ratios are important for judging the company's efficiency in terms of its operations and management. They help to judge how well the company has been able to utilize its assets and earn profits.

3. Locating Weakness

Accounting ratios can also be used in locating weakness of the company's operations even though its overall performance may be quite good. Management can then pay attention to the weakness and take remedial measures to overcome them.

4. Formulating Plans

Although accounting ratios are used to analyze the company's past financial performance, they can also be used to establish future trends of its financial performance. As a result, they help formulate the company's future plans.

5. Comparing Performance

It is essential for a company to know how well it is performing over the years and as compared to the other firms of the similar nature. Besides, it is also important to know how well its different divisions are performing among themselves in different years. Ratio analysis facilitates such comparison.

Q10. What are the Limitations of Ratio Analysis.

Ans : (Nov.-21, Imp.)

Though ratio analysis is a powerful tool for analyzing the financial position of a firm, it suffers from the following limitations.

- i) As ratios are calculated based on the historical data or past performance, they may not necessarily provide the correct information that is useful in decision-making.
- ii) As there are no particular standards or rules of thumb for all the ratios, it is difficult to interpret accurate results.
- iii) In order to draw correct interpretations, a single ratio may not be helpful. For this purpose, a number of ratios are to be

calculated which is likely to confuse the financial analyst than to help him in making any meaningful conclusions.

- iv) Changes in the accounting procedures by the firms may mislead the ratio analysis. For example, a change in the methods of valuating inventory from FIFO to LIFO increases the cost of sales and decreases the value of closing stock. This results in unfavourable stock turnover ratio and gross profit ratio.
- v) In inflationary conditions, the accounting data of several years cannot be compared and therefore analysis based on such data is not accurate.
- vi) As ratio analysis is purely quantitative in nature, other aspects such as managerial efficiency, employee performance cannot be interpreted.
- vii) Comparison of ratios of one firm to the other in an industry is not possible due to their differences in sizes, accounting procedures etc.
- viii) As changes in price is not considered while calculating ratios, this may adversely affect the interpretation.

In spite of these limitations, ratio analysis is considered as the powerful tool for analyzing the financial statements.

5.3 CLASSIFICATION OF RATIOS

5.3.1 Liquidity Ratios

Q11. What is liquidity ratio. Explain various types of liquidity ratios.

(OR)

Explain about liquidity ratios

Ans :

Liquidity refers to the ability of a concern to meet its current obligations as and when these become due. Liquidity ratios are calculated to measure short-term financial soundness of the business. The short-term obligations are met by realizing amounts from current, floating or circulating assets. The current assets should either

be liquid or near liquidity. These should be convertible into cash for paying obligations of short-term nature. The sufficiency or insufficiency of current assets should be assessed by comparing them with short-term (current) liabilities. If current assets can pay off current liabilities, then liquidity position will be satisfactory.

On the other hand, if current liabilities may not be easily met out of current assets then liquidity position will be bad. The bankers, suppliers of goods and other short-term creditors are interested in the liquidity of the concern. They will extend credit only if they are sure that current assets are enough to pay out the obligations. To measure the liquidity of a firm, the following ratios can be calculated:

1. Current Ratio (or) Working Capital Ratio
2. Quick or Acid Test (or) Liquid Ratio
3. Absolute Liquid Ratio (or) Cash Position Ratio

Note

The ideal current ratio is 2:1 The ideal quick ratio is 1:1 The ideal cash ratio is 0.5:1

1. Current Ratio

Meaning

This ratio establishes a relationship between current assets and current liabilities.

Objective

The objective of computing this ratio is to measure the ability of the firm to meet its short-term obligations and to reflect the short-term financial strength/solvency of a firm. In other words, the objective is to measure the safety margin available for short-term creditors.

Components

There are two components of this ratio which are as under:

- (i) **Current Assets:** Current assets mean the assets which are held for their conversion into cash within a year and include the following:

Cash Balance	Bank Balance
Marketable Securities	Debtors (less Provision)
Bills Receivable (less Provisions)	Stock of all types, viz., Raw Materials.
Prepaid Expenses	Work-in-progress. Finished Goods.
Incomes accrued but not due	Short-term Loans and Advances
Advance Payment of tax	(Debit Balances)
Tax reduced at source (Debit Balance)	Incomes due but not received

Note: The 'provision of bad and doubtful debts/bills' is deducted from the total amount of trade debtors/bills receivable in order to ascertain the realizable value of trade debtors/bills receivable.

- (ii) **Current Liabilities:** Current Liabilities are those obligations which are payable within a short period of generally one year and include the following:

Creditors for Goods Creditors for Expenses

Creditors for goods	Creditors for expenses
Bills Payable	Bank Overdraft
Short-term Loans and Advances	Income received-in-advance
Provision for Tax	Unclaimed dividend

Short-term Loans and Advances Income received-in-advance Provision for Tax Unclaimed dividend

Computation: This ratio is computed by dividing the current assets by the current liabilities. This ratio is usually expressed as a pure ratio **for example**, 2:1. In the form of a formula, this ratio may be expressed as under:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Interpretation of Current Ratio: A relatively high current ratio is an indication that the firm is liquid and has the ability to pay its current obligations in time as and when they become due.

On the other hand, a relatively low current ratio represents that the liquidity position of the firm is not good and the firm shall not be able to pay its current liabilities in time without facing difficulties.

A ratio equal or near to the rule of thumb of 2:1, i.e., current assets double the current liabilities is considered to be satisfactory.

The idea of having doubled the current assets as compared to current liabilities is to provide for delays and losses in the realization of current assets.

However, the rule of 2:1 should not be blindly followed while making interpretation of the ratio, because firms having less than 2:1 ratio may be having a better liquidity than even firms having more than 2:1 ratio.

This is so because the current ratio measures only the quantity of current assets and not quality of current assets.

A high current ratio may not be favorable due to the following reasons:

- i) There may be slow moving stocks. The stocks will pile up due to poor sale.
- ii) The figures of debtors may go up because debt collection is not satisfactory.
- iii) The cash or bank balances may be lying idle because of insufficient investment opportunities.

On the other hand, a low current ratio may be due to the following reasons:

- i) There may not be sufficient funds to pay off liabilities.
- ii) The business may be trading beyond its capacity. The resources may not warrant the activities.

2. Quick Ratio**Meaning**

This ratio establishes a relationship between quick assets and current liabilities.

Objective

The objective of computing this ratio is to measure the ability of the firm to meet its short-term obligations as and when due without relying upon the realization of stock.

Components

There are two components of this ratio which are as under:

- (i) **Quick Assets:** Which mean those current assets which can be converted into cash immediately or at a short notice without a loss of value and include the following:
 - a) Cash Balances
 - b) Bank Balances
 - c) Marketable Securities Debtors
 - d) Bills Receivable
 - e) Short-term Loans and
 - f) Advances
- (ii) **Current Liabilities:** (as explained earlier in Current Ratio)

Computation: This ratio is computed by dividing the quick assets by the current liabilities. This ratio is usually expressed as a pure ratio, e.g., 1:1. In the form of a formula, this ratio may be expressed as under:

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

Interpretation: It indicates rupees of quick assets available for each rupee of current liability.

Traditionally, a quick ratio of 1:1 is considered to be a satisfactory ratio.

However, this traditional rule should not be used blindly since a firm having a quick ratio of more than 1, may not be meeting its short-term obligations in time if its current assets consist of doubtful and slow paying debtors while a firm having a quick ratio of less than 1, may be meeting its short-term obligations in time because of its very efficient inventory management.

3. Absolute Liquid Ratio

Meaning

Although receivables, debtors and bills receivable are generally more liquid than inventories, yet there may be doubts regarding their realization into cash immediately or in time.

Objective

The objective of computing this ratio is to calculate it (absolute liquid ratio) together with current ratio and acid test ratio so as to exclude even receivables from the current assets and find out the absolute liquid assets.

Components

There are two components of this ratio which are as under:

- (i) **Absolute liquid assets:** Absolute liquid assets include cash in hand and at bank and marketable securities or temporary investments.
- (ii) **Current liabilities:** As explained in current ratio.

Computation

This ratio is computed by dividing absolute liquid assets by current liabilities. The acceptable norm for this ratio is 50% or 0.5:1 or 1:2, i.e. Re. 1 worth absolute liquid assets are considered adequate to pay `2 worth current liabilities in time as all the creditors are not expected to demand cash at the same time and then cash may also be realized from debtors and inventories.

In the form of formula this ratio may be expressed as under:

$\text{Absolute Liquid Ratio} = \frac{\text{Absolute Liquid Assets}}{\text{Current Liabilities}}$

5.3.2 Leverage Ratios

Q12. Explain different types of leverage ratios.

Ans :

Leverage Ratios

It is defined as the funds that are borrowed from other's (other than stockholders) to purchase the assets for business purposes. Leverage ratios represent the ability of the firm to utilize the funds of other people for purchasing assets. High leverage ratio facilitates the firm with high returns through,

- (i) Purchasing more assets without an additional investment from stockholders/investors.
- (ii) More productivity and increased sales.
- (iii) Increased income.
- (iv) High returns for stakeholders.

Types

Most of the firms (borrowers) are willing to maintain high leverage ratios as it can help the firm to widen their functional areas without any additional investments, whereas the lenders do not prefer high leverage for safety purposes. Thus, it is necessary for a firm to maintain a perfect capital structure through balancing the above conditions. The important ratios under leverage ratios are,

1. Debt Ratio

Debt ratio represents a total picture of firm's debt or borrowings as a percentage of total funds.

$$\text{Debt ratio} = \frac{\text{Total debt}}{\text{Total assets}}$$

Interpretation

Higher the debt ratio, higher will be the borrowings and vice versa.

2. Equity Multiplier Ratio

This ratio represents the debt position of a firm and also the contribution from either assets or equity to meet the firm's debt.

Components

- (i) Total assets
- (ii) Owner's equity.

$$\text{Equity multiplier} = \frac{\text{Total assets}}{\text{Owner's equity}}$$

Interpretation

The standard equity multiplier is 2. That means the finance for one half of book value of assets can be acquired through debt. If the ratio is more than 2, it represents that the debt of the firm can be met more from assets when compared to equity and vice versa.

3. Current Liabilities to Total Debt Ratio

This ratio represents the percentage of current liabilities in total debt which depicts the current ability of a firm to meet the debt.

$$\text{Current liabilities to total debt ratio} = \frac{\text{Current liabilities}}{\text{Total debt}}$$

Interpretation

The high ratio shows that the firm can quickly repay the debt and vice versa

5.3.3 Solvency Ratios

Q13. What is Solvency? Explain various types of Solvency Ratios.

(OR)

What is Solvency? Define and explain two of the ratios used for Solvency.

(OR)

Discuss briefly the various types of Solvency Ratios.

Ans :

(May-19, July-18)

Solvency

The term solvency refers to the ability of a firm to meet its debt. A firm is said to be solvent when its assets are greater than its liabilities. It is under insolvent position when a firm has more liabilities than its assets i.e.,

if Assets > Liabilities, a firm is solvent.

If Liabilities > Assets, a firm is insolvent.

For measuring the solvency of a firm, there are different ratios. They are,

- (i) Debt - equity ratio
- (ii) Interest coverage ratio.

Types of Solvency/Capital Structure Ratios

Solvency ratios are also called capital structure ratios or average ratios. Capital structure ratios are used in evaluating the long term financial position of the firm. It gives the relationship between long term debentures, preference share and equity share capital, also taking reserves and surplus into consideration.

The solvency capital structure ratios include,

- 1. Capital gearing ratio
- 2. Debt equity ratio
- 3. Total investment to long-term liabilities
- 4. Ratio of fixed assets to funded debt
- 5. Ratio of current liabilities to proprietors funds
- 6. Ratio of reserves to equity capital.

1. Capital Gearing Ratio

The ratio of equity share capital and reserves and surpluses to preference share capital and other fixed interest bearing loans is called capital gearing ratio.

$$\begin{aligned}\text{Capital Gearing Ratio} &= \frac{\text{Equity share capital} + \text{Reserves \& surplus}}{\text{Preference capital} + \text{Long-term debt bearing fixed interest}} \\ &\quad (\text{or}) \\ &= \frac{\text{Fixed income bearing funds}}{\text{Equity shareholders funds}} \\ &\quad (\text{or}) \\ &= \frac{\text{Fixed income bearing funds}}{\text{Total capital employed}}\end{aligned}$$

If numerator exceeds denominator the firm is said to be low geared, otherwise it is highly geared.

2. Debt-equity Ratio

It is the ratio of external equities or outsiders funds to the shareholders funds or internal funds.

$$\begin{aligned}&= \frac{\text{Long - term Debt}}{\text{Shareholder's Funds/Equity}} \\ &\quad (\text{or}) \\ &= \frac{\text{Outsiders funds}}{\text{Shareholders funds/ Equity}} \\ &\quad (\text{or}) \\ &= \frac{\text{External equities}}{\text{Internal equities}}\end{aligned}$$

3. Total Investment of Long-term Liabilities

It is the ratio of the total long term funds to long-term liabilities.

$$= \frac{\text{Shareholders fund} + \text{Long-term liabilities}}{\text{Long-term liabilities}}$$

4. Ratio of Fixed Assets to Funded Debts

It is the ratio of fixed assets to the funded debt which is essential for the long creditors.

$$= \frac{\text{Fixed assets}}{\text{Funded debts}}$$

5. Ratio of Current Liabilities to Proprietor's Funds

The ratio of current liabilities to the proprietor's funds i.e., the short-term borrowings to the long-term funds raised by proprietors.

$$= \frac{\text{Current liabilities}}{\text{Proprietors funds}}$$

6. Ratio of Reserves to Equity Capital

It gives the profits that firm retains for future growth. It is the ratio of reserves to the equity share capital.

$$= \frac{\text{Reserves}}{\text{Equity share capital}} \times 100$$

5.3.4 Profitability Ratios**Q14. Explain different types of profitability ratios.**

Ans :

The primary objective of a business undertaking is to earn profits. Profit earning is considered essential for the survival of the business. A business needs profits not only for its existence but also for expansion and diversification. "Profits are thus, a useful measure of overall efficiency of a business. Profits to the management are the test of efficiency and a measurement of control; to owners, a measure of worth of their investment; to the creditors, the margin of safety; to employees, a source of fringe benefits; to government, a measure of tax-paying capacity and the basis of legislative action; to customers, a hint to demand for better quality and price cuts; to an enterprise, less cumbersome source of finance for growth and existence and finally to the country, profits are an index of economic progress. Profitability ratios are calculated to measure the overall efficiency of the business." Generally, profitability ratios are calculated either in relation to sales or in relation to investment. To measure the profitability of a firm, the following ratios can be calculated:

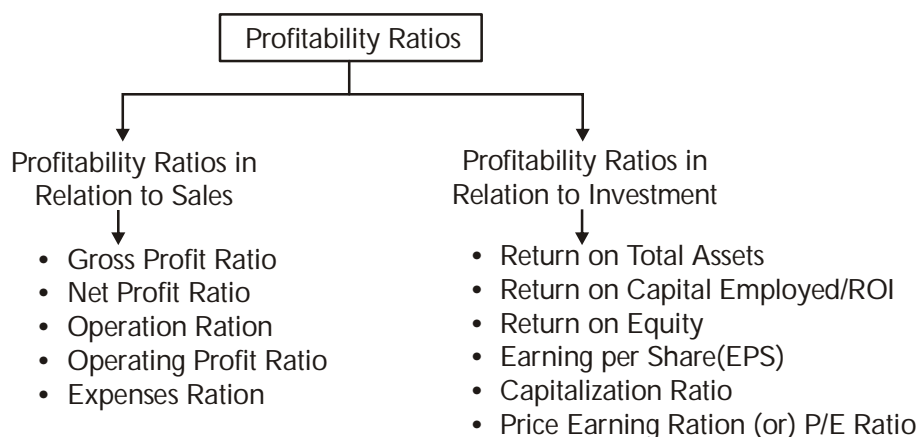


Fig.: Classification of Profitability Ratios

A) Profitability Ratios in Relation to Sales**(i) Gross Profit Ratio****Meaning**

This ratio measures the relationship between gross profit and net sales.

Objective

Gross profit ratio is calculated to know:

1. Whether the business is in a position to meet operating expenses or not, and
2. How much the share holders can get after meeting such expenses?

Components

There are two components of this ratio which are as under:

1. Gross profit
2. Net Sales

Cost of Goods Sold is calculated as under:

Particulars	
A: Opening Stock	xxx
B: Add: Net Purchases	xxx
C: Add: Direct Expenses (for example carriage inward)	xxx
D: Less: Closing Stock	xxx
Cost of Goods Sold (A + B + C – D)	xxx

Computation

This ratio is computed by dividing the gross profit by the net sales. It is expressed as percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Gross Profit = Net Sales - Cost of Good Sold

Net Sales = Gross Sales - Sales Return

Gross profit is higher because of the following factors:

1. When sale price is higher.
2. Cost of sales remains constant.
3. If there is an increase in the volume of sales.
4. If closing stock is valued at a higher price.

Interpretation

This ratio indicates:

- (a) An average gross margin earned on a sales of ` 100,
- (b) The limit beyond which the fall in sales prices will definitely result in losses, and,
- (c) What portion of sales is left to cover operating expenses, (other than the cost of goods sold) and non-operating expenses (for example, interest on borrowed funds), to pay dividend and to create reserves. Higher the ratio, the more efficient the production and/or purchase management.

(ii) Net Profit Ratio

Meaning

This ratio measures the relationship between net profit and net sales.

Objective

The main objective of computing this ratio is to determine the overall profitability due to various factors such as operational efficiency, trading on equity, etc.

Components

There are two components of this ratio which are as under:

1. Net Profit
2. Net Sales

Computation

This ratio is computed by dividing the net profit by the net sales. It is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

Note : The figure of net profit may be taken either before tax or after tax.

Interpretation

This ratio indicates,

- (a) An average net margin earned on a sale of ` 100
- (b) What portion of sales is left to pay dividend and to create reserves, and
- (c) Firm's capacity to withstand adverse economic conditions when selling price is declining, cost of production is rising and the demand for the product is falling. Higher the ratio, greater is the capacity of the firm to withstand adverse economic conditions and vice versa.

(iii) Operating Ratio**Meaning**

This ratio measures the relationship between operation cost and net sales.

Objective

The main objective of computing this ratio is to determine the operational efficiency with which production and/or purchases and selling operations are carried on.

Components

There are two components of this ratio which are as under:

1. Operating cost which comprises:

- i) Cost of goods sold, and
- ii) Other operation expenses.

For example, administrative expenses, selling and distribution expenses, interest on short-term loans, discount allowed and bad debts.

2. Net sales = Gross Sales - Sales Returns.

Computation

This ratio is computed by dividing the operating cost by the net sales. This ratio is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100$$

$$\begin{aligned} \text{Operating Cost} &= \text{Cost of Good Sold} + \text{Operating Expenses} \\ &= \frac{\text{Cost of good Sold} + \text{Operating Expenses}}{\text{Net Sales}} \times 100 \end{aligned}$$

Interpretation

This ratio indicates an average operating cost incurred on a sale of goods worth ` 100. Lower the ratio, greater is the operating profit to cover the non-operating expenses, to pay dividend and to create reserves and vice versa.

(iv) Operating Profit Ratio**Meaning**

This ratio measures the relationship between operating profits and net sales.

Objective

The main objective of computing this ratio is to determine the operational efficiency of the management. Components: There are two components of this ratio which are as under:

1. **Operating Profit:** It is the excess of gross profit over other operating expenses. (For example, office and administrative expenses, selling and distribution expenses, discount, bad debts, interest on short-term debts).

2. Net Sales: It means gross sales (both cash and credit minus sales returns).

Computation

This ratio is computed by dividing the operating profit by the net sales. It is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$$

$$\text{Operating Profit} = \text{Net Sales} - \text{Operating Cost}$$

(or)

$$= \text{Net Sales} - (\text{Cost of Goods Sold} + \text{Administrative and Office Expenses} + \text{Selling and Distributive Expenses})$$

$$\text{Net Sales} = \text{Gross Sales} - \text{Sales Return}$$

Alternatively

Operating Profit can also be calculated as

$$\text{Operating Profit} = \text{Net Profit} + \text{Non-operating Expenses} - \text{Non-operating income.}$$

This ratio can also be calculated as:

$$\text{Operating Profit Ratio} = 100 - \text{Operating Ratio.}$$

Interpretation

This ratio indicates:

- i) An average operating margin earned on a sale of ` 100, and
- ii) What portion of sales is left to cover non-operating expenses, to pay dividend and to create reserves.

(v) Expenses Ratio

Meaning

Expenses ratios indicate the relationship of various expenses to net sales.

Objective

The objective of computing this ratio is to provide information about increase or decrease in expenses. Lower expense ratio is considered better for the business.

Computation

This can be calculated by using the following formula:

$$\text{Expense Ratio} = \frac{\text{Amount of Expenses}}{\text{Net Sales}} \times 100$$

One can also calculate separate expense ratios, such as ratio of administrative expenses to net sales, ratio of selling and distribution expenses to sales, financial expenses to sales etc. The above ratios can be calculated as below:

$$\text{For Administrative Expenses to Net Sales Ratio} = \frac{\text{Administrative and Office Expenses}}{\text{Net Sales}} \times 100$$

$$\text{For Selling \& Distribution Expenses to Net Sales Ratio} = \frac{\text{Selling and Distribution Expenses}}{\text{Net Sales}} \times 100$$

$$\text{For Financial Expenses to Net Sales Ratio} = \frac{\text{Financial Expenses and Interest}}{\text{Net Sales}} \times 100$$

Interpretation

The expense ratio indicates about efficiency of the business.

B) Profitability Ratio in Relation to Investment

(i) Return on Total Assets

Meaning

This ratio measures a relationship between net profit before interest and tax, and total assets.

Objective

The objective of computing this ratio is to find out how efficiently the total assets have been used by the management.

Components

There are two components of this ratio which are as under:

1. Net Profit before interest and tax.
2. Total assets (excluding fictitious assets,

For example, preliminary expenses.

Computation

This ratio is computed by dividing the net profit before interest and tax by total assets. This ratio is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Return on Total Assets} = \frac{\text{Net Profit Interest and Tax}}{\text{Total Assets}} \times 100$$

Interpretation

This ratio indicates the firm's ability of generating profit per rupee of total assets. Higher the ratio, the more efficient the management and utilization of total assets.

(ii) Return on Capital Employed/Return on Investment

Meaning

This ratio measures a relationship between net profit before interest and tax and capital employed.

Objective

The objective of computing this ratio is to find out how efficiently the long-term funds supplied by the creditors and shareholders have been used.

Components

There are two components of this ratio which are as under:

1. Net profit before interest and tax.
2. Capital employed which refers to long-term funds supplied by the long-term creditors and shareholders. It comprises the long-term debt and shareholders' funds.

Computation

This ratio is computed by dividing the net profit before interest and tax by capital employed. It is expressed as a percentage. In the form of formula, this ratio may be expressed as under:

$$\text{Return on Capital Employed} = \frac{\text{Net Profit before Interest and Tax}}{\text{Capital Employed}} \times 100$$

Note: Generally return on capital employed is taken as return on investments.

The term 'capital employed' refers to the total of investments made in a business and can be defined in a number of ways. The three most widely used definitions of this term are:

- i) **Gross Capital Employed:** The term 'gross capital employed' usually comprises the total assets, fixed as well as current assets used in a business.

$$\text{Gross Capital Employed} = \text{Fixed Assets} + \text{Current Assets}$$

- ii) **Net Capital Employed:** The term 'net capital employed' comprises the total assets used in a business less its current liabilities.

$$\text{Net Capital Employed} = \text{Total Assets} - \text{Current Liabilities}$$

- iii) **Proprietors' Net Capital Employed:** Proprietors' net capital employed means shareholders' funds or investments in the business. This term is the same as return on shareholders' investment.

$$\text{Proprietors' Net Capital Employed} = \text{Fixed Assets} + \text{Current Assets} - \text{Outside Liabilities} \\ \text{(both long-term and short-term)}$$

Interpretation

This ratio indicates the firm's ability of generating profit per rupee of capital employed. Higher the ratio, the more efficient the management and utilization of capital employed.

iii) Return on Equity or Return on Equity Shareholders' Funds

Meaning

This ratio measures a relationship between net profit after interest, tax, and preference dividend, and equity shareholders' funds.

Objective

The objective of computing this ratio is to find out how efficiently the funds supplied by the equity shareholders have been used.

Components

There are two components of this ratio, which are as under:

1. Net profit after interest, tax and preference dividend (including participating dividend, if any, due to participating preference shareholders).
2. **Equity shareholders' funds**

Computation

This ratio is computed by dividing the net profit after interest, tax and preference dividend by shareholders' funds. It is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Return on Equity Shareholder's Funds} = \frac{\text{Net Profit after interest, tax and preference dividend}}{\text{Equity Shareholder's Funds}} \times 100$$

$$\text{Equity Shareholder Fund} = \text{Equity Share Capital} + \text{Preference Share Capital} + \text{Reserve and Surplus} - \text{Fictitious Assets (if any)}$$

Interpretation

This ratio indicates the firm's ability of generating profit per rupee of equity shareholders' funds. Higher the ratio, the more efficient the management and utilization of equity shareholders' funds.)

(iv) Earning Per Share (EPS)**Meaning**

This ratio measures the earnings available to an equity shareholder on a per share basis.

Objective

The objective of computing this ratio is to measure the profitability of the firm on per equity share basis.

Components

There are two components of this ratio which are as under:

- 1) Net profit after interest, tax and preference dividend;
- 2) Number of equity shares

Computation

This ratio is computed by dividing the net profit after interest, tax and preference dividend by the number of equity shares. It is expressed as an absolute figure. In the form of a formula, this ratio may be expressed as under:

$\text{Earning Per Share} = \frac{\text{Net Profit after interest, tax and preference dividend}}{\text{Number of Equity Shares}} \times 100$
--

Interpretation

In general, higher the figure, better it is and vice versa. While interpreting this ratio, it must be seen whether there is any increase in equity shareholders' funds as a result of retained earnings without any change in numbers of outstanding shares.

For example, in the case of a company which, is following a practice of ploughing.

(v) Capitalization Ratio**Meaning**

This ratio measures the relationship between market price and earnings per share.

Computation

This ratio is calculated as given below:

$$\text{Capitalization Ratio} = \frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

If market price is taken along with dividend received, this is known as **Dividend Yield Ratio**.

Only change is that in place of earnings per share, dividend per share is written. In a formula, it is:

$$\text{Dividend Yield Ratio} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

vi) Price Earning Ratio or P/E Ratio (Earning Yield Ratio)**Meaning**

This ratio measures the relationship between market price per equity share and earnings per share.

Objective

The objective of computing this ratio is to make an estimate of appreciation in the value of a share of a company and is widely used by investors to decide whether or not to buy shares in a particular company.

Computation

The ratio is calculated as:

$$\text{Price earnings ratio} = \frac{\text{Market price per equity share}}{\text{Earnings per share}}$$

$$\text{Earning Yield Ratio} = \frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

Interpretation

Generally, higher the price-earning ratio, the better it is. If the P/E ratio falls, the management should look into the causes that have resulted into the fall of this ratio.

5.3.5 Valuation Ratios**Q15. What are Valuation Ratios?**

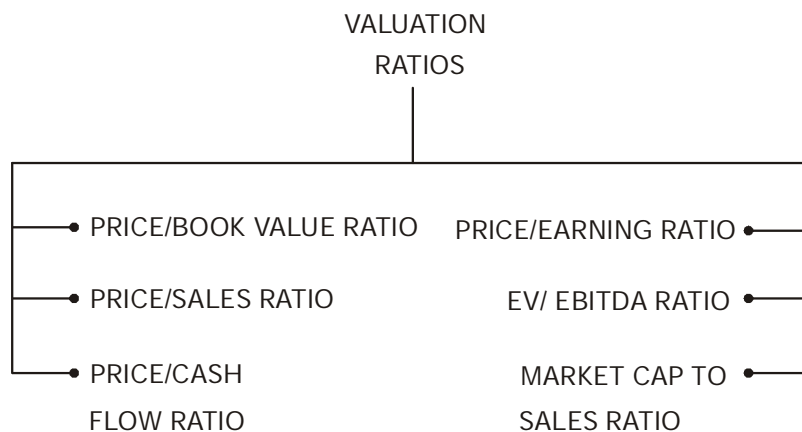
Ans :

Valuation Ratios

Lastly, we will discuss valuation ratios that measure a company's financial strength to its market value.

What are Valuation Ratios?

Valuation ratios measure the quantity of an asset or flow (e.g., earnings) associated with ownership of a specified claim (e.g., a share or ownership of the enterprise). It compares the stock price of the company with either the profitability of the company or the overall value of the company.



1. Price/Earnings Ratio (P/E)

$$\text{P/E Ratio} = \frac{\text{Price per share}}{\text{Earnings per share}}$$

The P/E ratio expresses the relationship between the price per share and the amount of earnings attributable to a single share. In other words, the P/E ratio tells us how much an investor in common stock pays per rupee of earnings.

2. Price/Sales Ratio (P/S)

$$\text{P/S Ratio} = \frac{\text{Price per share}}{\text{Sales per share}}$$

This ratio compares a company's stock price to its revenue. This ratio is also known as a Sales Multiple or Revenue Multiple. A low P/s ratio implies that the stock is undervalued while a high ratio indicates that the stock is overvalued. P/s ratio is sometimes used as a comparative price metric when a company does not have positive net income.

3. Price/Cash Flow Ratio (P/CF)

$$\text{P/CF Ratio} = \frac{\text{Price per share}}{\text{Cash flow per share}}$$

This ratio compares a company's stock price per share to operating cash flow per share. It is usually considered a better measure than P/E ratio since cash flows cannot be manipulated as earnings (which includes depreciation, amortization and other non-cash expenditure). Hence, it works well for the companies that have large non-cash expenditures.

4. Price/Book Value Ratio (P/BV)

$$\text{P/BV Ratio} = \frac{\text{Price per share}}{\text{Book value per share}}$$

This ratio is often interpreted as an indicator of market judgment about the relationship between a company's required rate of return and its actual rate of return. Assuming that book values reflect the fair values of the assets, a price to book ratio of one can be interpreted as an indicator that the company's

future returns are expected to be exactly equal to the returns required by the market. An asset's book value is equal to its carrying value on the balance sheet, and companies calculate it netting the asset against its accumulated depreciation.

5. Enterprise Multiple (EV/EBITDA):

$$\text{Enterprise Multiple} = \frac{\text{Enterprise Value}}{\text{EBITDA}}$$

EV/ EBITDA or Enterprise Multiple is used to determine the value of a company. It looks at a firm in the way a potential acquirer would buy considering the company's debt. It is a better valuation metric since it remains unaffected by changing capital structures and offers fairer comparisons of companies with capital structures that differ. It removes the effect of the company's non-cash expenses on its value.

A high EV/EBITDA ratio means that the company is overvalued and a low ratio means a company is undervalued. A company with a low enterprise multiple can be considered as a good takeover candidate.

6. Market Cap to Sales Ratio:

$$\text{Market Cap to Sales Ratio} = \frac{\text{Market Price of a share} \times \text{Total no. of outstanding shares}}{\text{Total Sales}}$$

This ratio determines how much price is one willing to pay for every rupee of sales generated by the company. It is an important ratio as it combines two very important aspects namely sales and the market price of the share. It is useful for valuing a company's actual price.

Q16. What are the main ratios on which ROI depends upon?

Ans :

(Nov.-22)

S.No.	Metric	Definition	Formula
1.	Costs	Total amount of money spent on a new and improved software process	$\sum_{i=1}^n \text{Cost}_i$
2.	Benefits	Total amount of money gained from a new and improved software process	$\sum_{i=1}^n \text{Benefit}_i$
3.	B/CR	Ratio of benefits to costs	$\frac{\text{Benefits}}{\text{Costs}}$
4.	ROI	Ratio of adjusted benefits to costs	$\frac{\text{Benefits} - \text{Costs}}{\text{Costs}} \times 100\%$
5.	NPV	Discounted cash flows	$\sum_{i=1}^{\text{Years}} \frac{\text{Benefits}_i}{(1 + \text{Discount Rate})^{\text{Years}}} - \text{Costs}_0$
6.	BEP	Point when benefits meet or exceed cost	$\frac{\text{Costs}}{\text{Old Costs/New Costs}-1}$

PROBLEMS

6. Calculate :

(i) Current Assets

(ii) Current Liability

(iii) Stock turnover ratio from the following formation :

Current Ratio	:	2.5
Working Capital	:	Rs. 60,000
Opening Stock	:	Rs. 29,000
Closing Stock	:	Rs. 31,000
Sales	:	Rs. 3,20,000
Gross profit ratio	:	25% on sales.

Sol :

(Oct.-21)

$$(i) \quad \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5$$

$$\text{Current Assets} = 2.5 \times \text{Current Liabilities}$$

$$\text{Working Capital} = 60,000 \text{ (Given)}$$

Let Current Liabilities be x

$$\text{Current Assets} - \text{Current Liabilities}$$

$$2.5x - x = 60,000$$

$$x = \frac{60,000}{1.5} = 40,000 \text{ (Current Liabilities)}$$

$$\begin{aligned} \text{Current Assets} &= 2.5 \times 40,000 \\ &= 1,00,000 \end{aligned}$$

Inventory Turnover

$$\text{Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Cost of goods sold} = \text{Total Sales} - \text{Gross profit}$$

$$\text{Gross profit} = 25\% \text{ on sales}$$

$$3,20,000 \times \frac{25}{100} = 80,000$$

$$\begin{aligned} \text{Cost of goods sold} &= 3,20,000 - 80,000 \\ &= 2,40,000 \end{aligned}$$

Average

$$\text{Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$= \frac{29,000 + 31,000}{2} = 30,000$$

$$\text{Inventory turnover ratio} = \frac{2,40,000}{30,000} = 8 \text{ times}$$

7. From the balance sheet given below, calculate:

i) Working capital,

ii) Current Ratio,

iii) Acid test Ratio

iv) Debt Equity Ratio,

v) Assets Proprietorship Ratio

BALANCE SHEET OF ABC COMPANY LTD.,

as on 31st December 2006

Liabilities	Amount	Assets	Amount
Shareholders fund:		Fixed assets	1,80,000
Equity share capital:	1,50,000	Current assets:	
12% Preference share capital:	30,000	Cash in Hand:	2,000
Reserves and surplus:	24,000	Cash at bank:	4,000
	2,04,000	Sundry Debtors:	10,000
15% Debentures	48,000	Stores:	12,000
Bank overdraft:	12,000	Stock-in-Trade:	32,000
	60,000		
Sundry creditors:	16,000	Preliminary expenses	48,000
Proposed dividend:	2,000		
Provision for taxation:	10,000		
Discount on issue of Debenture	4,000		
	2,92,000		2,92,000

Sol.:

(Oct.-2020)

(i) $\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$

$$= 60,000 - 40,000$$

$$= 20,000$$

(ii) $\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$

$$\text{CA} = \text{Cash} + \text{Bank} + \text{Debtors} + \text{Stores} + \text{Stock in trade}$$

$$= 2,000 + 4,000 + 10,000 + 12,000 + 32,000$$

$$= 60,000$$

$$\begin{aligned}
 \text{CL} &= \text{Creditors} + \text{Proposed Dividend} + \text{Provision for Taxation} + \text{Bank Overdraft} \\
 &= 16,000 + 2,000 + 10,000 + 12,000 \\
 &= 40,000
 \end{aligned}$$

$$\text{Current Ratio} = 1.5 : 1 = \frac{60,000}{40,000} = 1.5$$

$$(iii) \quad \text{Acid - test ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned}
 \text{Quick Assets} &= \text{Current Assets} - \text{Stock} + \text{Stores} \\
 &= 60,000 - (32,000 + 12,000) \\
 &= 16,000
 \end{aligned}$$

$$= \frac{16,000}{28,000} = 0.57 : 1$$

$$(iv) \quad \text{Debt-equity ratio} = \frac{\text{Debt}}{\text{Equity}}$$

$$\begin{aligned}
 \text{Debt} &= \text{Debentures} \\
 &= 48,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Equity} &= \text{Shareholders fund} = 2,04,000 - \text{Preliminary expenses} \\
 &= 2,04,000 - 52,000 = 1,52,000
 \end{aligned}$$

$$= \frac{48,000}{1,52,000} = 0.135$$

$$(v) \quad \text{Assets proprietorship ratio} = \frac{\text{Fixed Assets}}{\text{Proprietors Funds}}$$

$$= \frac{1,80,000}{1,52,000} = 1.184$$

8. Following is the summarized Balance Sheet of ABC Company as on 31-12-2015

Liabilities	Amount	Assets	Amount
Equity share capital	250000	Goodwill	20000
6% preference capital	150000	Buildings	250000
General Reserve	20000	Machinery	175000
Profit and loss Account	15000	Furniture	10000
5% Debentures	100000	Stock	90000
Sundry creditors	28000	Sundry debtors	21000
Bills payable	12000	Cash at Bank	5000
Preliminary expenses	4000		
	5,75,000		5,75,000

Other Information :

Total Sales Rs. 4 Lakhs. 20 percent of which is made on credit. Gross Profit and Net Profit (after tax) for the year ended amounted to Rs. 80000 and 20000 respectively.

Calculate and interpret the following ratios :

- a) Current Ratio
- b) Liquid Ratio
- c) Proprietary fund ratio
- d) Fixed Assets to proprietary fund ratio
- e) Debt-equity ratio
- f) Capital gearing ratio
- g) Gross Profit ratio
- h) Net Profit Ratio
- i) Stock turnover Ratio
- j) Debtors turnover ratio
- k) Return on proprietors fund
- l) Turnover to fixed assets ratio

Sol :

(Jan.-20)

(a) Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{\text{Stock} + \text{Sundry debtors} + \text{Cash at bank}}{\text{Sundry Creditors} + \text{Bills payable}}$$

$$= \frac{90,000 + 21,000 + 5,000}{28,000 + 12,000}$$

$$= \frac{1,16,000}{40,000}$$

$$= 2.9:1.$$

(b) Liquid Ratio

$$\text{Liquid Ratio} = \frac{\text{Liquid/Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Liquid Assets} &= \text{Current Assets} - \text{Stock} \\ &= 1,16,000 - 90,000 = 26,000\end{aligned}$$

$$\text{Liquid Ratio} = \frac{26,000}{40,000}$$

$$= 0.65:1$$

(c) Proprietary Fund Ratio

$$\text{Proprietary Fund Ratio} = \frac{\text{Proprietor's Fund}}{\text{Total Assets}}$$

$$\begin{aligned} \text{Proprietor's Fund} &= \text{Equity share capital} + \text{Preference share capital} + \text{General reserve} \\ &\quad + \text{P \& L A/c} - (\text{Goodwill} + \text{Preliminary Expenses}) \\ &= 2,50,000 + 1,50,000 + 20,000 + 15,000 - (20,000 + 4,000) \\ &= 4,35,000 - 24,000 \\ &= 4,11,000 \end{aligned}$$

$$\begin{aligned} \text{Total assets} &= \text{Total Fixed Assets} + \text{Total current assets} \\ &= 4,35,000 + 1,16,000 = 5,51,000 \end{aligned}$$

$$\begin{aligned} \text{Proprietary Fund Ratio} &= \frac{4,11,000}{5,51,000} \\ &= 0.75 : 1 \end{aligned}$$

(d) Fixed Assets to Proprietary Fund Ratio

$$\text{Fixed Assets Proprietorship Ratio} = \frac{\text{Fixed Assets}}{\text{Proprietor's Equity}}$$

$$\begin{aligned} &= \frac{4,35,000}{4,11,000} \\ &= 1.06 : 1 \end{aligned}$$

(e) Debt-Equity Ratio

$$\text{Debt-Equity Ratio} = \frac{\text{Total Debt}}{\text{Proprietor's Equity}}$$

$$= \frac{(5\% \text{ Debentures} + \text{Current Liabilities})}{4,11,000}$$

$$= \frac{1,00,000 + 40,000}{4,11,000}$$

$$= \frac{1,40,000}{4,11,000}$$

$$= 0.34 : 1$$

(f) Capital Gearing Ratio

$$\text{Capital Gearing Ratio} = \frac{\text{Equity Share Capital}}{\text{Preference Share Capital} + \text{Debentures}}$$

$$= \frac{2,50,000}{1,50,000 + 1,00,000} = \frac{2,50,000}{2,50,000} = 1 : 1$$

(g) Gross Profit Ratio

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

$$\begin{aligned} &= \frac{80,000}{4,00,000} \times 100 \\ &= 20\% \end{aligned}$$

(h) Net Profit Ratio

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

$$\begin{aligned} &= \frac{20,000}{4,00,000} \times 100 \\ &= 5\% \end{aligned}$$

(i) Stock Turnover Ratio

$$\text{Stock-Turn over Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$\begin{aligned} \text{Cost of goods sold} &= \text{Sales} - \text{Gross Profit} \\ &= 4,00,000 - 80,000 \\ &= 3,20,000 \end{aligned}$$

$$\begin{aligned} \text{Stock-Turnover Ratio} &= \frac{3,20,000}{90,000} \\ &= 3.6 \text{ times} \end{aligned}$$

(j) Debtors Tunover Ratio

$$\text{Debtors Tunover Ratio} = \frac{\text{Credit Sales}}{\text{Debtors}}$$

$$\begin{aligned} &= \frac{80,000}{21,000} \\ &= 3.81 \end{aligned}$$

(k) Return on Proprietors Fund

$$\text{Return on Proprietors Fund} = \frac{\text{Net Profit (After Tax)}}{\text{Proprietor's Fund}}$$

$$\begin{aligned} &= \frac{20,000}{4,11,000} \\ &= 0.05 : 1 \end{aligned}$$

(I) Turnover to Fixed Assets Ratio

$$\text{Turnover to Fixed Assets Ratio} = \frac{\text{Turnover}}{\text{Fixed Assets}}$$

$$= \frac{4,00,000}{4,35,000}$$

$$= 0.92 : 1$$

9. From the following information, prepare the Balance Sheet of PQR Company Limited as on 31 -03.2012, with as many details as possible

- a) Paid up capital Rs. 50 lakhs
- b) Plant and Machinery Rs. 125 Lakhs
- c) Total Annual Sales Rs. 500 lakhs
- d) Gross profit margin 25 percent
- e) Annual Credit sales 80 percent of net sales
- f) Current ratio 2 Inventory turnover ratio 4
- g) Fixed assets turnover ratio 2
- h) Sales returns 20 percent of sales
- i) Average collection period 73 days
- j) Bank credit to trade credit 2
- k) cash to inventory 1 : 15
- i) Total debt to current liabilities 3

*Sol :***(Jan.-20)****Balance sheet of PQR Company Ltd. as on 31-03-2012**

Liabilities	Amount (₹) (in lakhs)	Assets	Amount (₹) (in lakhs)
Share Capital (Given)	50	Fixed Assets	200
Reserves and Surplus	78	Inventories	75
Long-term borrowings	144	Trade Receivables	64
Short-term borrowings	48	Cash and cash equivalents	5
Trade payables	24		
	344		344

Working Notes :**1. Calculation of Net Sales**

Net Sales = Sales – Sales Return (20% of sales)

Sales Return = 500 * 20% = 100

$$\text{Net Sales} = 500 - 100 = 400 \text{ Lakhs}$$

$$\text{Credit Sales} = 80\% \text{ of Net Sales}$$

$$= 80\% \times 400$$

$$= 320 \text{ Lakhs}$$

$$\text{Gross Profit} = 25\% \text{ of Net Sales}$$

$$= 25\% \times 400$$

$$= 100 \text{ Lakhs}$$

2. Calculation of Cost of Goods Sold/Sales

$$\text{Cost of Goods Sold} = \text{Net Sales} - \text{Gross Profit}$$

$$= 400 - 100$$

$$= 300 \text{ Lakhs}$$

3. Calculation of Inventory/Stock

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$4 = \frac{300}{\text{Average Stock}}$$

$$\text{Average stock} = \frac{300}{4}$$

$$\text{Average stock} = 75 \text{ Lakhs}$$

4. Calculation of Receivables

$$\text{Receivables} = \frac{\text{Credit Sales}}{\text{Receivables Turnover}}$$

$$= \frac{320}{5} = 64$$

Calculation of Receivables Turnover

$$\text{Receivables Turnover} = \frac{\text{No. of Working Days}}{\text{Average Collection Period}}$$

$$= \frac{365}{73} = 5 \text{ times}$$

5. Calculation of Cash

$$\text{Cash} = 1:15 \text{ of inventory}$$

$$\text{Inventory} = 75 \text{ lakhs}$$

$$= 75 \times \frac{1}{15} = 5 \text{ lakhs}$$

6. Calculation of Total Current Assets

$$\begin{aligned}\text{Current Assets} &= \text{Cash} + \text{Receivables} + \text{Inventories} \\ &= 5 + 64 + 75 \\ &= 144 \text{ lakhs}\end{aligned}$$

7. Calculation of Current Liabilities

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$2 = \frac{144}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Current Liabilities} &= \frac{144}{2} \\ &= 72 \text{ lakhs}\end{aligned}$$

Current liabilities being 72 lakhs out of which $\frac{2}{3}$ rd is for bank credit and $\frac{1}{3}$ rd for trade credit i.e., $72 \text{ lakhs} \times \frac{2}{3} = 48 \text{ lakhs}$ (short term borrowings) and $72 \text{ lakhs} \times \frac{1}{3} = 24 \text{ lakhs}$ (Trade payables)

8. Calculation of Total Debts

$$\begin{aligned}\text{Total debts} &= \text{Current liabilities} \times 3 \\ &= 72 \times 3 = 216\end{aligned}$$

9. Calculation of Fixed Assets Turnover

Given fixed assets turnover as 2% per annum

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Fixed Assets}}$$

$$2 = \frac{400}{\text{Fixed Assets}}$$

$$\text{Fixed Assets} = \frac{400}{2} = 200 \text{ lakhs}$$

10. Calculation of Other Fixed Assets

$$\begin{aligned}\text{Other Fixed Assets} &= \text{Total Fixed Assets} - \text{Plant and Machinery} \\ &= 200 - 125 \\ &= 75 \text{ Lakhs}\end{aligned}$$

11. Calculation of Total Assets

$$\begin{aligned}\text{Total Assets} &= \text{Fixed Assets} + \text{Current Assets} \\ &= 200 + 144 \\ &= 344 \text{ Lakhs}\end{aligned}$$

12. Calculation of Net Worth

$$\begin{aligned}
 \text{Net Worth} &= \text{Total Assets} - \text{Total Debts} \\
 &= 344 - 216 \\
 &= 128 \text{ Lakhs}
 \end{aligned}$$

13. Calculation of Reserves and Surplus

$$\begin{aligned}
 \text{Reserves and Surplus} &= \text{Net worth} - \text{Paid Up Capital} \\
 &= 128 - 50 \\
 &= 78 \text{ Lakhs}
 \end{aligned}$$

14. Calculation of Long-Term Debt

$$\begin{aligned}
 \text{Long-Term Debt} &= \text{Total debt} - \text{Current liabilities} \\
 &= 216 - 72 \\
 &= 144 \text{ Lakhs}
 \end{aligned}$$

10. The National Bank Limited has been approached by two customers for a short term loan of Rs. 50,000. The following summarized financial information is available from the latest financial statements :

Particulars	Granny foods Rs.	Home foods Rs.
Net sales	9,10,000	7,50,000
Gross profit margin	3,82,200	2,92,500
Interest expenses	20,000	8,200
Income tax	75,000	50,000
Profit after tax	82,000	56,250
Inventories	90,000	65,200
Debtors	70,000	56,000
Cash	6,000	18,000
Current liabilities	1,82,600	1,16,000
Long term liabilities	1,60,000	1,30,000
Shareholders equity	1,80,000	1,40,000

The bank intends to accept one of the two loan requests. Which customer's loan request should be accepted ? Why ?

Sol :

(May-19)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

(i) Granny foods

Current Assets

$$\text{Inventories} - 90,000$$

$$\begin{aligned}
 \text{Debtors} &= 70,000 \\
 \text{Cash} &= 6,000 \\
 \text{Total} &= 1,66,000 \\
 \text{Current liabilities} &= 1,82,600 \\
 \text{Current Ratio} &= \frac{1,66,000}{1,82,600} = 0.91 : 1
 \end{aligned}$$

(ii) Home foods

$$\begin{aligned}
 \text{Current Assets} &= 65,200 + 56,000 + 18,000 \\
 &= 1,39,200 \\
 \text{Current liabilities} &= 1,16,000 \\
 &= \frac{1,39,200}{1,16,000} = 1.2 : 1
 \end{aligned}$$

(b) Quick Ratio

$$\begin{aligned}
 &= \frac{\text{Quick Assets}}{\text{Current liabilities}} \\
 \text{Quick Assets} &= \text{Current Assets} - \text{Inventory Assets} \\
 \text{Granny foods} &= 1,66,000 - 90,000 = 76,000 \\
 \text{Quick Ratio} &= \frac{76,000}{1,82,600} = 0.42 : 1 \\
 \text{Home foods} &= 1,39,200 - 65,200 = 74,000 \\
 \text{Quick Ratio} &= \frac{74,000}{1,16,000} = 0.64 : 1
 \end{aligned}$$

Interpretation :

The liquidity position of Home foods is better than Granny foods.

11. A five year comparative analysis of Low Light Company's current ratio and quick ratio follows :

Particulars	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Current ratio	1.19	1.85	2.50	3.40	4.02
Acid test ratio	1.15	1.02	0.98	0.72	0.50

- (i) What has been happening on the liquidity of Low Light Company over the five years presented ?
- (ii) Considering both ratios what does the trend indicate about, what has happened to the makeup of Low Light's current assets over the five year period ?

Sol.:

(May-19)

I.

- (a) The current ratio over the five year indicates that the liquidity of low light company consistently increased.
- (b) The quick ratio over the five year indicates that the liquidity of low light company consistently decreased.

II.

- (a) Current ratio of low light company increases from 1.19 in 2005 to 1.02 in 2009 which indicates that current assets of low light company increased to a large extent
- (b) Acid test ratio of low light company decreases from 1.15 in 2005 to 0.50 in 2009. Which indicates assets of the company are locked up in stock over five years.

12. With the help of the following Ratio regarding Narmadha Text, draw the Trading Profit and Loss A/c and balance Sheet of the company for the year 2017

- (a) Current Ratio : 2.5
- (b) Liquidity Ratio : 1.5
- (c) Net working capital : Rs. 3,00,000
- (d) Stock Turnover Ratio : 6 times (cost of sales / Closing stock)
- (e) Gross Profit Ratio : 20%
- (f) Fixed assets Turnover Ratio (on cost of sales) : 2 times
- (g) Debt Collection Period : 2 Months
- (h) Fixed Assets to Shareholder's Net worth : 0.80
- (i) Reserves and Surplus to Capital : 0.5

Sol.:

(Dec.-18)

Working Notes (WN)**1. Calculation of Current Assets and Current Liabilities**

$$\text{Let Current Liabilities be } x \text{ CR} = \frac{\text{CA}}{\text{CL}}$$

$$2.5 = \frac{\text{CA}}{x}$$

$$\text{CA} = 2.5 x$$

Net Working Capital = Current Assets – Current Liabilities

$$3,00,000 = 2.5 x - x$$

$$x = \frac{3,00,000}{1.5} = 2,00,000$$

$$\therefore \text{Current Liabilities} = ₹ 2,00,000$$

$$\text{Current Assets (C.A.)} = 2.5 \times 2,00,000$$

$$\text{C.A} = ₹ 5,00,000$$

2. Calculation of Stock

$$\text{Liquidity Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = 1.5$$

$$\begin{aligned}\text{Quick Assets} &= 1.5 \times \text{Current Liabilities} \\ &= 1.5 \times 2,00,000 = 3,00,000\end{aligned}$$

$$\begin{aligned}\text{Stock} &= \text{Current Assets} - \text{Quick Assets} \\ &= 5,00,000 - 30,000 = ₹ 2,00,000\end{aligned}$$

3. Calculation of Cost of Goods Sold

$$\text{Stock turnover ratio} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Closing Stock}}$$

$$= \frac{\text{COGS}}{2,00,000} = 6.$$

$$\text{COGS} = 2,00,000 \times 6$$

$$\text{COGS} = ₹ 12,00,000$$

4. Calculation of Sales

If ₹ 100 = sales then gross profit = ₹ 20, and cost of goods sold = ₹ 80(100 – 20).

If cost of goods sold = ₹ 12,00,000, then sales will be.

$$\frac{12,00,000}{80} \times 100 = ₹ 15,00,000.$$

5. Calculation of Fixed Assets

$$\text{Fixed asset turnover ratio} = \frac{\text{COGS}}{\text{Fixed Assets (F.A.)}}$$

$$2 = \frac{12,00,000}{\text{Fixed Assets (F.A.)}}$$

$$\text{F.A.} = \frac{12,00,000}{2}$$

$$\text{F.A.} = ₹ 6,00,000.$$

6. Calculation of Debtors

Debt collection period = 2 months

$$\text{Debt collection ratio} = \frac{\text{Debtors}}{\text{Credit Sales}}$$

$$12 \text{ Debtors} = 15,00,000 \times 2$$

$$\text{Debtors} = \frac{15,00,000 \times 2}{12}$$

$$= \frac{30,00,000}{12}$$

$$\text{Debtors} = ₹ 2,50,000.$$

7. Calculation of Shareholders Net Worth

Fixed assets to shareholders net worth = 0.80

$$\text{Fixed assets to net worth ratio} = \frac{\text{Fixed Assets}}{\text{Shareholders Net Worth}}$$

$$0.80 = \frac{6,00,000}{\text{Shareholders Net Worth}}$$

$$\begin{aligned} \text{Shareholders's net worth} &= \frac{6,00,000}{0.80} \\ &= ₹ 7,50,000. \end{aligned}$$

8. Calculation of reserve and Surplus

Reserves and Surplus to Capital = 0.5

Let the share capital be 'S', then reserves will be 0.5S

Shareholders net worth = Share Capital + Reserves and Surplus

$$7,50,000 = 1S + 0.5S$$

$$7,50,000 = 1.5S$$

$$\text{Share capital (S)} = \frac{7,50,000}{1.5} = 5,00,000$$

If share capital = 5,00,000 then,

reserve and Surplus = $0.5 \times 5,00,000 = ₹ 2,50,000.$

9. Calculation of Cash

Particulars	Amount(₹)	Amount(₹)
Total Current Assets		5,00,000
Less : Stock	2,00,000	
Debtor	2,50,000	4,50,000
Cash		50,000

Liabilities	Amount(₹)	Assets	Amount(₹)
Shares Capital	5,00,000	Fixed Assets	6,00,000
Reserves and Surplus	2,50,000	Debtors	2,50,000
Current Liabilities	2,00,000	Stock	2,00,000
Long-term Loan (b/f)	1,50,000	Cash	50,000
	11,00,000		11,00,000

13. The following financial statement is summarized from the books of Akhilesh Ltd.
as 31st March, 2016 :

Liabilities	Amount(Rs.)	Assets	Amount(RS.)
Liabilities	15,00,000	Fixed Assets	16,50,000
Reserves & Surplus	6,00,000	Stock in trade	9,10,000
Debentures	5,00,000	Book Debts	12,40,000
Bank overdraft	2,00,000	Short term investments	1,60,000
Sundry creditors	12,00,000	Cash	40,000
	40,00,000		40,00,000

Additional information :

Annual sales : Rs. 74,40,000 and Gross profit : Rs. 7,44,000

Bank overdraft is payable on demand

You are required to calculate the following ratios for year and comment on the financial position as revealed by these ratios :

- a) Debt equity ratio b) Current ratio c) Proprietary ratio
d) Gross profit ratio e) Debtor-Turnover ratio, and f) Stock-Turnover ration

Sol :

(July -18)

(a) Debt Equity Ratio

$$\begin{aligned}
 &= \frac{\text{Longterm debts}}{\text{Shareholders funds}} \\
 &= \frac{5,00,000}{15,00,000 + 6,00,000} = \frac{5,00,000}{21,00,000} = 0.23 : 1
 \end{aligned}$$

Comment

The Ratio is 0.23:1 more use of equity funds debts in the business

(b) Current Ratio

$$\begin{aligned}
 &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\
 &= \frac{9,10,000 + 12,40,000 + 1,60,000 + 40,000}{2,00,000 + 12,00,000} \\
 &= \frac{23,50,000}{14,00,000} = 1.678 : 1
 \end{aligned}$$

Comment

The Ratio is 1.678 : 1 there is greater margin of safety for creditors.

(c) Proprietary Ratio

$$= \frac{\text{Proprietary funds}}{\text{Total assets}}$$

$$= \frac{21,00,000}{40,00,000} = 0.525 : 1$$

Comment

The Ratio is 0.525 : 1 more than standard Ratio 0.5 : 1. Hence it is satisfactory

(d) Gross profit Ratio

$$= \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

$$= \frac{7,44,000}{74,40,000} \times 100 = 10\%$$

Comment

The last year profit is not mentioned. It is difficult to determine position.

(e) Debtor Turnover Ratio

$$= \frac{\text{Net Credit Sales}}{\text{Average Debtors}}$$

$$= \frac{74,40,000}{12,40,000} = 6$$

Assume total sales are credit.

Comment

As the Ratio is 6 it is low the collection period is long and hence there is delay in payment of debtors.

(f) Stock Turnover Ratio

$$= \frac{\text{Cost of goods sold}}{\text{Average Inventory}}$$

$$\text{COGS} = \boxed{\text{Sales} - \text{Gross profit}}$$

$$= 74,40,000 - 7,40,000$$

$$= 66,96,000$$

$$= \frac{66,96,000}{9,10,000} = 7.34$$

Comment

Ratio 7.34 is Normal

14. A Company sells goods on cash as well as credit (though not on deferred installment terms). The following particulars are extracted from their books of accounts for the calendar year 2020.

Particulars	Rs.
Total gross sales	20,00,000
Sales return	4,00,000
Total debtors for sales on 31-12-2020	1,40,000
Bills receivable on 31-12-2020	1,80,000
Provision for doubtful debts 31-12-2020	40,000
Total creditors	20,000

Calculate the average collection period.

Sol.:

(Nov.-22)

$$\text{Debtors Turn over Ratio} = \frac{\text{Net credit sales}}{\text{Average Trade debtors}}$$

$$\begin{aligned} \text{Net credit sales} &= \text{Gross credit} - \text{Sales return} \\ &= 20,00,000 - 4,00,000 = 16,00,000 \end{aligned}$$

$$\begin{aligned} \text{Average Trade debtors} &= \frac{1,40,000 + 1,80,000}{2} \\ &= 1,60,000 \end{aligned}$$

$$= \frac{16,00,000}{1,60,000} = 10$$

$$\text{Average collection period} = \frac{365 \text{ days}}{\text{Debtor Turn over Ratio}} = \frac{365}{10} = 36.5 \text{ days}$$

5.4 DU POINT CHART

Q17. Explain Du Point analysis with Chart.

(OR)

What is Du Point Chart analysis? Draw the Du Point and its significance.

(OR)

Draw Du Point Chart by providing required data.

Ans.:

(Nov.-21, Jan.-20, Dec.18)

Du-Point control chart has been designed by an American company, namely Du-Point for the control of management system. This system is used for comparing the standard ratios of a company with the present ratios so as to determine the performance of the system.

Du-Point chart comprises two elements which are,

1. Net profit
2. Capital employed.

1. Net profit

Net profit is related to the operating expenses of an organization, hence, every firm must reduce such expenses in order to, increase profit margins. Profitability can be obtained by dividing earnings by sales. However, earning is obtained by deducting the cost of sales from sales, where, the cost of sales is the sum of cost of goods sold, office and administrative expenses and selling and distribution expenses.

$$\text{Mathematically, percentage of profitability, } = \frac{\text{Earnings}}{\text{Sales}}$$

$$\text{Earnings} = \text{Sales} - \text{Cost of sales (or)}$$

$$= \text{Sales} - [\text{Cost of goods sold} + \text{Office and administrative expenses} + \text{Selling and distribution expenses}]$$

2. Capital Employed

Current assets and net fixed assets constitutes the components of capital employed. Examples of current assets include debtors, stock, cash-in-hand, cash-at-bank, bills receivables, prepaid expenses and so on. Whereas, net fixed asset is obtained by deducting depreciation from the total amount of fixed assets. Thus, the ratio is Return On Investment (ROI),

$$\text{R.O.I} = \frac{\text{Profit margin/Net profit}}{\text{Capital employed}} \times 100$$

Du-Point control chart is depicted in the following figure,

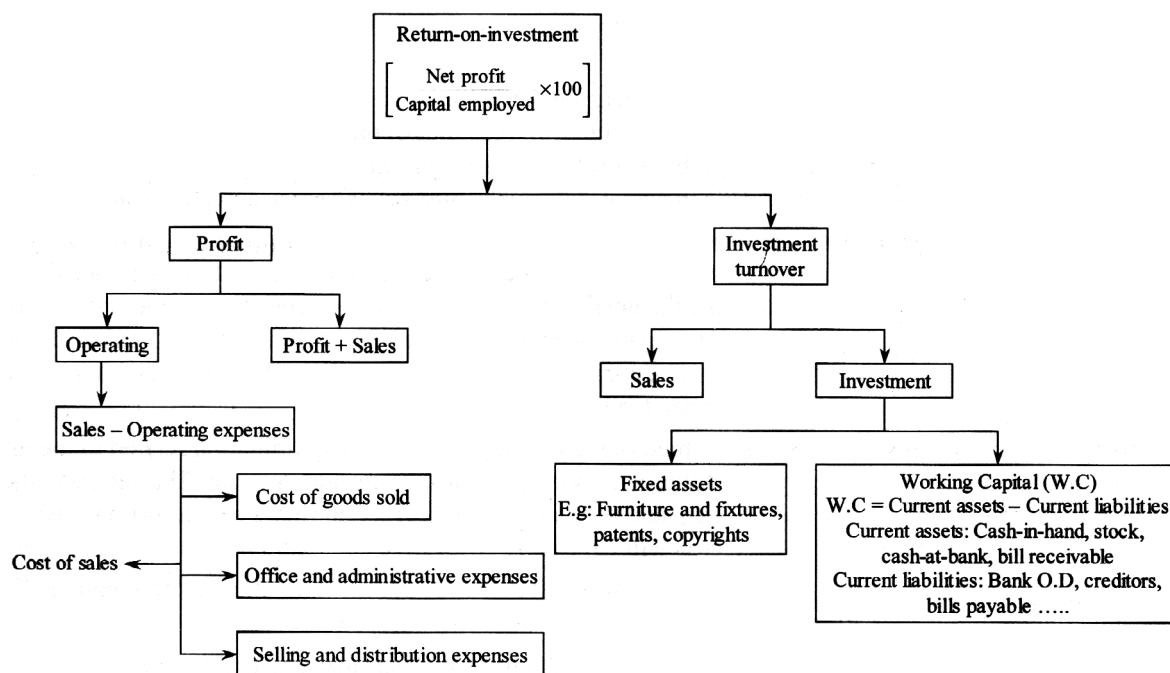


Fig.: Du-Point Chart

Through ROI, efficiency of various business operations can be determined as it enables the firm to assess whether the fixed assets have been used profitably or not. Firms must maintain optimal efficiency by improving the relationship between sales and costs (such that, costs can be reduced to a great extent by increasing the sales turnover of a firm). Thus, profits can be increased either by controlling cost or by increasing sales. The investment turnover can be increased by restricting its investment in fixed assets and working capital without affecting the sales.

Hence, management needs to take corrective actions for improving the financial performance of weaker areas. Performance of a firm can be judged accurately by inter-firm comparisons. While performing such comparisons, certain ratios are used as standard ratios (of performance) such as, ROI, assets turnover and profit margins.

5.5 ACCOUNTING STANDARDS ISSUED BY ICAI

Q18. Define accounting standards. Explain the characteristics of accounting standards.

Ans :

Accounting Standards are defined as the policy documents issued by a recognized expert accounting body relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.

According to Kohler, "Accounting standard, a mode of conduct imposed on accountant by custom, law, or professional body".

Characteristics

The characteristics of accounting standards are as follows:

1. Accounting standards determine the norm of accounting policy and transactions.
2. Accounting standards determine the most suitable method from the available methods for solving one or more accounting problems.
3. Accounting standards determine those limitations in which Accountant perform his work.
4. Accounting standards provide the information to different parties using the financial statements.
5. Accounting standards provide uniformity in accounting work. It removes the effect from adopting different policies and transactions.

Q19. What are the objectives setting up accounting standards for business units.

Ans :

(July-18)

The summarized objectives of Accounting Standards are as follows,

1. To homogenize the accounting methods, procedures, treatments and policies globally.
2. To formulate same principles for creation and presentation of the financial statements throughout the world.
3. To create benchmarks for assessing the quality of earnings and reporting globally.
4. To make sure that the financial statement users receive good information.
5. To achieve global levels in financial accounting, reporting and analysis.

Q20. Enlist some of the Accounting Standards issued by ICAI by focusing on the importance of standards to give a general view on financial accounting practices.

OR

Explain any two Accounting Standard issued by ICAI.

(OR)

Mention any five Accounting Standard. Explain the significance of Accounting Standard.

(OR)

Bring out a general view on financial accounting practices issued by ICAI.

Ans :

(Nov.-21, Nov.-20, July-18)

The following are the various Accounting standards issued by ICAI.

Number	Title of Standard	Date of Issue	Description
AS-1	Disclosure of accounting policies	1-4-1991	It deals with disclosure of accounting policies which mainly aims at providing clear information of financial statements through standard of accounting
AS-2	Valuation of inventories	1-4-1991	It deals with valuation of inventories wherein the actual to be recorded in value of inventory financial statements is ascertained.
AS-3	Cashflow statements	1-4-1991	It lays down rules and regulations for preparation and reporting of cash flow statements.
AS-4	Contingencies and events occurring after the balance sheet date	1-4-1995	It deals with provisions relating to contingencies and events occurring after the date of balance sheet.
AS-5	Net profit or loss for the period, prior period, items and changes in accounting policies	1-4-1996	It specify the classification and disclosure of some in in P & L statement so that there is uniformity items in preparing and presenting the statements by all the enterprises.
AS-6	Accounting for depreciation	1-4-1995	It deals with the depreciation of assets which assigned systematically to each accounting period through out the useful life of the asset.
AS-7	Accounting for construction contracts	1-4-1991	It deals with construction contracts where in it specify the criteria for accounting of revenue and costs in relation to construction contracts.
AS-8	Accounting for R & D Projects	1-4-1991	It prescribes accounting for R & D contracts. It specify the basis for selecting and changing accounting policies along with the accounting treatment and disclosure of changes in accounting policies, accounting estimates and corrections of errors.
AS-9	Revenue recognition	1-4-1991	It deals with revenue recognition and is applicable when accounting for revenue is emerging from sale of goods, rendering services and use by others of the entity's
AS-10	Property, Plant and Equipment (PPE)	1-4-1991	assets generating interest, royalties or dividends It deals with Property, Plant and Equipment (PPE) generally known as fixed assets.

AS-11	Accounting for effects of changes in foreign exchange rates	1-4-1995	It deals with 'effects of changes in foreign exchange rates'. It determine how to treat transactions relating to foreign currencies and foreign activities.
AS-12	Accounting for government grants	1-4-1994	It is concerned with 'Accounting for Government Grants'. The assistance provided by government in the form of cash to a business entity is referred to as Government Grants.
AS-13	Accounting for investments	1-4-1995	It deals with 'Accounting for investment'. when the assets are held for earning income through interest, dividend and rentals to achieve benefits, it is referred to as 'Investment'
AS-14	Accounting for amalgamations	1-4-1995	It deals with accounting for amalgamations and the resolution of any resultant reserves or goodwill.
AS-15	Accounting for employee retirement benefits	1-4-1995	It deals with the accounting treatment of employee benefits such as PF, defined contribution schemes employee contribution.
AS-16	Accounting for borrowing costs	1-4-2000	It prescribe accounting treatment for borrowing costs. Borrowing costs are direct costs associated with the acquisition, construction and production using long term fixed assets.
AS-17	Segment Reporting	1-4-2001	It deals with the criteria for reporting the financial information regarding different products and services and various location of the firm
AS-18	Related Parity Disclosures	1-4-2001	It deals with "Related party disclosure". Disclosure of related transaction is necessary to ensure proper understanding of financial position and financial performance of a business enterprise.
AS-19	Accounting for leases	1-4-2001	It deals with the details of account policies and disclosure requirements for both lessor and lessee for operational and financial lease.
AS-20	Earning per share	1-4-2001	It prescribes the guidelines for determining and presentation of earnings per share to enhance either the comparative analysis of firms performance over a period of time or with different firms.
AS-21	Consolidated Financial Statements	1-4-2001	It deals with the determination of accounting procedures for the preparation and presentation of consolidated financial statements.
AS-22	Accounting for taxes on Income	1-4-2002	It specifies the accounting treatment for taxes on income It suggest that the tax on income should be determined based on the principle of accrual concept.
AS-23	Accounting for investments in associates in consolidated financial statements	1-4-2002	It deals with the accounting treatment of investments in associates.
AS-24	Discontinuing operations	1-4-2002	It deals with 'Discontinuing operations' with a main aim to set rules for disclosure of information regarding discontinuing operations.

AS-25	Interim Financial Reporting	1-4-2002	It prescribe principles for preparation and presentation of the interim financial reports including condensed financial statement along with recent changes.
AS-26	Intangible assets	1-4-2003	It determines accounting policy for the treatment of intangible assets.
AS-27	Financial reporting of interests in joint ventures	1-4-2002	It prescribes the principles for accounting of investments in joint ventures and presentation of investments in joint venture assets, liabilities, income and expenses in financial statements of investors.
AS-28	Impairment of Asset	1-4-2004	It establishes procedure for the recognition of impaired assets and accounting treatment of the loss.
AS-29	Provisions, contingent liabilities and contingent assets.	1-4-2004	It prescribe the accounting treatment for provisions, contingent liabilities and assets.
AS-30	Accounting for recognition of financial instruments.	1-4-2003	It is issued for the recognition and measurement of the financial instruments including fixed assets, fixed liabilities etc.
AS-31	Norms for reporting of financial instruments	1-4-2011	It prescribes the principles for reporting and presenting the financial instruments.
AS-32	Disclosure of financial instruments.	1-4-2011	It prescribes the disclosure requirements for accounting financial instruments. It helps the users of financial statements to evaluate the importance of financial institutions in the success of a firm.

Q21. Explain Accounting Standard 6 (Revised) related to Depreciation Accounting.

Sol :

(Jan.-18)

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time or obsolescence through technology and market changes.

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

Depreciable assets are assets which

- (i) They are expected to be used during more than one accounting period; and
- (ii) They have a limited useful life; and
- (iii) They are held by an enterprise for use in the production or supply or for administrative purposes.

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

Useful life is the period over which a depreciable asset is expected to be used by the enterprise.

The useful life of a depreciable asset is shorter than its physical life

5.6 FOCUS ON INDAS

Q22. What are Indian Accounting Standards? Explain the scope of Indian Accounting Standards.

Ans :

Ind-AS or Indian Accounting Standards govern the accounting and recording of financial transactions as well as the presentation of statements such as profit and loss account and balance sheet of a company. For long, there has been a heated debate about Indian companies moving to the globally accepted International Financial Reporting Standards (Indian Accounting) for their accounts.

But firms have resisted this shift, stating that this will lead too many changes in the capture and reporting of their numbers. Ind-AS has been evolved as a compromise formula that tries to harmonize Indian accounting rules with the Indian Accounting.

Scope

The Accounting Standard Board (ASB) has given a general description of the scope of accounting standards.

1. Attempts will be made to issue those accounting standards which are in accordance with the provisions of the applicable laws, usages, business environment and customs of the country. If a specific accounting standard is not in conformance with law because of the subsequent changes in the law, then the provision of the said law will be in effect and the financial statements must be made in accordance with such law.
2. In our country, the local regulations which regulate the preparation and presentation of financial statements cannot be over ridden by the accounting standards. Inspite of that the institute will decide the amount of subject to be revealed in the financial statements and the corresponding reports of auditor. These disclosures through proper notes explain how some specific items are to be treated. These descriptive or explanatory notes must not be considered as serious comments on the financial statements but should be used only for a better understanding.
3. Accounting standards are designed for material items only. If there is any limitation related to the use of a particular standard, then the institute will inform about it from time to time. The institute also mentions the date from which a specific standard comes into effect and the class of enterprises to which it will apply. Nevertheless, the standards will have no retrospective application, until it is mentioned.
4. To gain uniformity in the presentation of financial statements, the institute attempts to convince the government, proper authorities, business and industrial community to embrace there standards.
5. While designing the accounting standards, the aim is to focus on basic matters. The attempt is to confine accounting standards to essentials and not to make them complicated. This is to ensure that they could be used properly nationwide.
6. ASB designed standards consist of paragraphs in plain type and bold italic which have equal authority. The paragraphs which are in bold italic type signify the main principles.

Q23. Explain the benefits of Indian Accounting Standards?

Ans :

Indian Accounting Standards address this challenge by providing a high quality, internationally recognized set of accounting standards that bring transparency, accountability and efficiency to financial markets around the world.

Indian Accounting Standards bring transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.

Indian Accounting Standards strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Our Standards provide information that is needed to hold management to account. As a source of globally comparable information, Indian Accounting Standards are also of vital importance to regulators around the world.

Indian Accounting Standards contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language lowers the cost of capital and reduces international reporting costs.

Lowered cost of capital - Increased insight into financial results and adherence to high-quality financial standards, as specified by Ind-AS, can benefit both companies and their investors with reduced cost of capital.

Q24. Explain the developments of Indian Accounting Standards.

Ans :

1. First Step Towards IFRSs

The Institute of Chartered Accountants of India (ICAI) is the association that sets accounting standards. In 2006, it decided to follow the International Financial Reporting Standards (IFRSs) which are released by International Accounting Standards Board (IASB). This step was taken to strengthen acceptability and transparency of financial data provided by corporates of India through their financial statements. The Indian Government accepted this move towards IFRS.

The government of India carried out a detailed analysis of IFRS requirements and discussed the matter with different stakeholders. Finally, the government decided that it will adopt IFRSs issued by the IASB. Therefore, at the time of designing IFRS converged Indian Accounting Standards (Ind AS), it was considered that these standards are in accordance with the IFRSs and departures were made wherever needed. These changes were made by considering different factors i.e., different terminology related changes were made in order to make them consistent with the terminology used in law and it also made changes by considering the country's economic environment which is different from the economic environment from the economic environment assumed to be in existence by IFRS.

2. Government of India - Commitment to IFRS Converged Ind AS

At the beginning, it was expected that Ind AS would be implemented from the year 2011. However, the Ministry of Corporate Affairs (MCA) planned to delay implementation date of Ind AS as few issues including tax issues were still needed to be resolved.

In July 2014, Shri Arun Jaitley who was the finance minister at that time, in his budget speech announced the importance of converging the prevailing accounting standards with the IFRS by setting new Indian AS by the Indian organizations.

By considering the above announcement, the government took different steps in order to encourage the implementation of IFRS - converged Ind AS. Further, the MCA released companies (Indian Accounting Standards) Rules, 2015 on February 16, 2015 by covering redesigned road map for implementation of Ind AS for all companies except banking, insurance, non-banking financial companies and Ind AS. According to this notification, Ind AS converged with IFRS will be implemented on voluntary basis from 1st April, 2015 and compulsory from 1st April, 2016. After this, in 2016, MCA has declared road map for NBFC by declaring implementation date for Ind AS. In the same way, various road maps for implementation of Ind AS, were issued by banking and insurance regulatory authority for banking and insurance companies.

Q25. Explain the applicability of Ind As ?*Ans :***(Imp.)**

Ind ASs are applicable to different class of entities as under:

1st April 2016: Mandatory Basis

- (a) Companies listed/in process of listing on Stock Exchanges in India or Outside India having net worth > INR 5 Billion
- (b) Unlisted Companies having net worth > INR 5 Billion
- (c) Parent, Subsidiary, Associate and JV of Above

1st April 2017: Mandatory Basis

- (a) All companies which are listed / or in process of listing inside or outside India on Stock Exchanges not covered in Phase I (other than companies listed on SME Exchanges)
- (b) Unlisted companies having net worth INR 2.5 Billion or more but less than INR 5 billion
- (c) Parent, Subsidiary, Associate and JV of above

Mandatory Basis (Postponed date not yet decided)

- Scheduled commercial banks (excluding RRBs)
- Holding, subsidiary, joint venture or associate companies of scheduled commercial banks

Mandatory Basis - (Postponed date not yet decided)

- All India Term lending refinancing institutions (i.e. exim Bank, NABARD, NHB and SIDBI) as RBI notification of deferring Ind AS for banks does not cover All India term lending refinancing institutions. RBI clarification needs

Mandatory Basis - 1st April 2018

- NBFCs having a net worth of ₹ 500 crore or more.
- Holding, subsidiary, joint venture or associate companies of the above, other than those companies already covered under the corporate road map announced by MCA

1st April 2019 : Mandatory Basis

- NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having a net worth less than ₹ 500 crore.
- NBFCs that are unlisted companies, having a net worth of ₹ 250 crore or more but less than ₹ 500 crore.
- Holding, subsidiary, joint venture or associate companies of companies covered above, other than those companies already covered under the corporate road map announced by MCA.

1st April 2020 : Mandatory Basis

- Insurers/insurance companies
- Holding, subsidiary, joint venture or associate companies of the above, other than those companies already covered under the corporate road map announced by MCA

Companies listed on SME exchange not required to apply Ind AS

Once Ind ASs are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements.

Q26. List out various Indian Accounting Standards.

Ans :

S.No.	Ind AS No.	Name of Indian Accounting Standard
1.	Ind AS 1	Presentation of Financial Statements
2.	Ind AS 2	Inventories
3.	Ind AS 7	Statement of Cash Flows
4.	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
5.	Ind AS 10	Events occurring after Reporting Period
6.	Ind AS 11	Construction Contracts (Omitted by the Companies (Indian Accounting Standards) Amendment Rules, 2018)
7.	Ind AS 12	Income Taxes
8.	Ind AS 16	Property, Plant and Equipment
9.	Ind AS 19	Employee Benefits
10.	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
11.	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
12.	Ind AS 23	Borrowing Costs
13.	Ind AS 24	Related Party Disclosures
14.	Ind AS 27	Separate Financial Statements
15.	Ind AS 28	Investments in Associates and Joint Ventures
16.	Ind AS 29	Financial Reporting in Hyper inflationary Economies
17.	Ind AS 32	Financial Instruments: Presentation
18.	Ind AS 33	Earnings per Share
19.	Ind AS 34	Interim Financial Reporting
20.	Ind AS 36	Impairment of Assets
21.	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
22.	Ind AS 38	Intangible Assets
23.	Ind AS 40	Investment Property
24.	Ind AS 41	Agriculture
25.	Ind AS 101	First time adoption of Ind AS
26.	Ind AS 102	Share Based Payment

27.	Ind AS 103	Business Combination
28.	Ind AS 104	Insurance Contracts
29.	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
30.	Ind AS 106	Exploration for and Evaluation of Mineral Resources
31.	Ind AS 107	Financial Instruments: Disclosures
32.	Ind AS 108	Operating Segments
33.	Ind AS 109	Financial Instruments
34.	Ind AS 110	Consolidated Financial Statements
35.	Ind AS 111	Joint Arrangements
36.	Ind AS 112	Disclosure of Interests in Other Entities
37.	Ind AS 113	Fair Value Measurement
38.	Ind AS 114	Regulatory Deferral Accounts
39.	Ind AS 115	Revenue from Contracts with Customers (Applicable from April 2018)
40.	Ind AS 116	Leases (Applicable from April 2019)

5.7 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Q27. Explain the concept of International Financial Reporting Standards (IFRS).

(OR)

What are International Financial Reporting Standards (IFRS)? Explain.

Ans . **(Nov.-20)**

The International Accounting Standards Board (IASB). It was founded on 1st April 2001. It is London based and mainly responsible for the development of International Financial Reporting Standards (IFRS). The accounting standards set by the International Accounting Standards Committee (IASC) are called as the international accounting standards composition. The IASB comprises of 14 board members which are appointed by the (IASCF) i.e., International Accounting Standard Committee Foundation. These accounting standards are set by each country's accounting standards board which finally becomes GAAP for each particular country.

The main objective of international accounting standards is to provide guidance relating to the accounting treatment having impact on financial systems. These international accounting standards are mandatory and cannot be divided at the time of audit. Otherwise, the members of ICAI (Institute of Chartered Account of India) will examine and make adequate disclosures in their audit reports, so that the financial statements users should become aware of it.

International Financial Reporting Standards (IFRS) Are formulated by international accounting standards board.

This board comprises of accountants and other interested parties from different countries.

U.S does not follow IFRS but there is pressure on SEC to do so.

US-GAAP Objectives

1. The main objective of US-GAAP is to prepare, present and report the financial instruments in such a way that it should be useful to the potential investors and creditors in making investments.
2. The financial information should provide details of economic resources and changes in them.

Fundamental Qualities of Financial Statements

1. The financial information provided must reflect measurable and comparable financial statements between different companies.
2. The financial information should help creditors to make decisions for future.
3. It should be neutral timely available and more importantly reliable to the potential investors.

Assumptions of US-GAAP

1. The business units of partnerships and sole-proprietorship is separate from legal entities.
2. It also implies the going concern concept as the business prolongs for a long time.
3. It also assumes that the business operations can be separated into months, Quarter's and year's requiring for the comparison between past and present events.

American Institute of Certified Public Accountants (AICPA)

Rule 203 of AICPA code of professional ethics states that no departures can be regarded as GAAP unless the member can demonstrate that due to unusual circumstances the financial statements would be misleading. Such departures are rare and if they do exist, the report must describe the reasons for making it. In 1959 AICAP established Accounting Principles Board (APB) to make overall conceptual framework.

Q28. Prepare a comparative statement showing differences between IAS, Indian GAAP and US GAAP.

Ans :

(Imp.)

The comparative statement between IAS, GAAP and US GAAP are as follows.

S.No.	Point of Difference	IAS	Indian GAAP	US GAAP
1.	Financial statement contents	Balance sheet, profit and lost statement, cash flow statement end the statement of changes In shareholder's equity an the basic financial statements required by IAS.	The companies under Indian GAAP must present balance sheet, profit and loss account for two years along with appropriate accounting policies. Besides this all the listed companies and companies with more than ` 500 million turnover needs to present cash flow statement.	The basic financial statements required by US GAAP companies include the balance sheet, profit and loss account, cash flow statement, a statement of changes in shareholder's equity and also a statement of comprehensive income.
2.	Cash and cash equivalents	Cash and cash equivalents comprises of overdrafts and short-term maturities respectively.	Besides overdraft and short term maturities it also includes the bank borrowings when they are the part of cash.	Similar to IAS, cash includes overdrafts, and cash equivalents include short-term maturities.

3.	Miscellaneous expenditure	Does not permit deferral expenses.	Indian GAAP disallows the deferral of expenses with direct advertising costs can preliminary expenses from 1-April-2004.	US GAAP is similar to IAS with the only difference that be deferred over a particular period of time.
4.	Related party transactions definition	It is ascertained by the direct or indirect control and the important effect of one party, party over the other, or similar control of both parties.	Similar to IAS	Similar to IAS.
5.	Volume-based rebates/sales incentives	No particular guidance for volume-based incentives.	No particular guidance for volume-based incentives.	It provides particular/specific guidance as when to identify the liability for volume-based incentives/free services, the ways to measure cost and the way to apportion the cost in financial statement.
6.	Correction of fundamental errors	IAS either restates the comparatives or adds the influence/effect in the present year income statement with the format of comparatives in the notes.	Includes the effect in the present year income statement with adequate disclosure.	It restates the comparatives.
7.	Changes in accounting estimates	The changes in accounting estimates is recorded in the current year's income statement.	Same as IAS.	Same as IAS.
8.	Contingencies	IAS discloses the hidden losses and possible profits.	It is same as IAS with the only difference that the contingent profits are neither identified nor disclosed in the financial statements.	It is same as IAS.
9.	Provisions	It reports those provisions which are related/linked with the current obligations from past events, if in case the resource's outflow is possible and can be estimated.	It is similar to IAS with the only difference is it does not allow discounting.	It is same as IAS and has rules for particular situations, such as employee termination costs, environmental liabilities, loss contingencies and so on.
10.	Earnings per share EPS(diluted)	IAS uses weighted average potential dilutive shares as the denominator for diluted EPS. It also uses the 'treasury stock' method for share options and warrants.	Same as IAS.	Same as IAS.

Exercise Problems

1. If a company merchandise inventory is ₹ 1,20,000; total current liabilities are ₹ 80,000; Acid Test Ratio is 2 : 1, what is current ratio ?

[Ans: Current ratio = 3.5 times]

2. If Apple Company Ltd.'s Current Ratio is 55 : 1, Quick Ratio is 4 to 1; Inventory is ₹ 30,000 what are the current liabilities ?

[Ans: Current liabilities ₹ 20,000]

3. You are given the following information about two companies

	Company A	Company B
Cash	180	140
Debtors	1,420	3,200
Inventory	1,800	5,400
Bills Payable	270	1,000
Creditors	500	4,000
Accrued Expenses	150	125
Tax Payable	750	1,000

Calculate liquidity ratios for the two companies and give your interpretation of the liquidity position of the companies, as revealed by the ratios.

[Ans : Current ratio Company A : 2.03 : 1; Company B : 1.43 : 1]

Quick ratio Company A : 0.95 : 1; Company B : 0.54 : 1]

4. From the following balance sheet and information, calculate ratios for (a) testing liquidity and (b) solvency.

Balance sheet as on 31.3.2008

(₹ in '000)

Liabilities		Assets	
Equity	20	Good will	12
Capital Reserves	4	Fixed Assets	28
8% Loan on Mortgage	16	Stocks	6
Trade Creditors	8	Debtors	6
Taxation :		Cash	6

Current	2		
Future	2		
<u>Profit and Loss A/c</u>			
Profit for 2008 after tax and			
Interest on fixed deposits 12,000			
Less : Transfer to dividend 2,000			
Reserves 4,000	6		
	60		60

[Ans : Current ratio 1.67, Quick ratio 1.17, Long term debt Equity ratio 1 : 2, Total debt Equity ratio 7 : 8]

5. If net income of Simco Led. is ` 1,22,600. (after tax at 50%); its fixed interest charges on Debenture amount to ` 4,800. Calculate the Interest Coverage Ratio.

[Ans : Interest coverage ratio 51.08]

6. Calculate and comment on the rate of return on total assets from the following data of two companies:

	Gama Ltd	Lama Ltd
Sales	x x x	` 2,52,75,000
Total Assets	` 42,50,000	x x x
Net profit on sales	6%	4%
Turnover of Assets	6 times	6 times
Gross Margin	` 20,68,000	12%

[Ans : Rate of return on total assets, Gama Ltd 36%, Lama Ltd 24%]

Short Question and Answers

1. What is Du Point Chart analysis? Draw the Du Point and its significance.

Ans :

Du-Point control chart has been designed by an American company, namely Du-Point for the control of management system. This system is used for comparing the standard ratios of a company with the present ratios so as to determine the performance of the system.

Du-Point chart comprises two elements which are:

- i) Net profit
- ii) Capital employed.

(i) Net profit

Net profit is related to the operating expenses of an organization, hence, every firm must reduce such expenses in order to, increase profit margins. Profitability can be obtained by dividing earnings by sales. However, earning is obtained by deducting the cost of sales from sales, where, the cost of sales is the sum of cost of goods sold, office and administrative expenses and selling and distribution expenses.

Mathematically, percentage of profitability, $= \frac{\text{Earnings}}{\text{Sales}}$

Earnings = Sales - Cost of sales (or)

= Sales - [Cost of goods sold + Office and administrative expenses + Selling and distribution expenses]

(ii) Capital Employed

Current assets and net fixed assets constitutes the components of capital employed. Examples of current assets include debtors, stock, cash-in-hand, cash-at-bank, bills receivables, prepaid expenses and so on. Whereas, net fixed asset is obtained by deducting depreciation from the total amount of fixed assets. Thus, the ratio is Return On Investment (ROI),

$$\text{R.O.I} = \frac{\text{Profit margin/Net profit}}{\text{Capital employed}} \times 100$$

Du-Point control chart is depicted in the following figure,

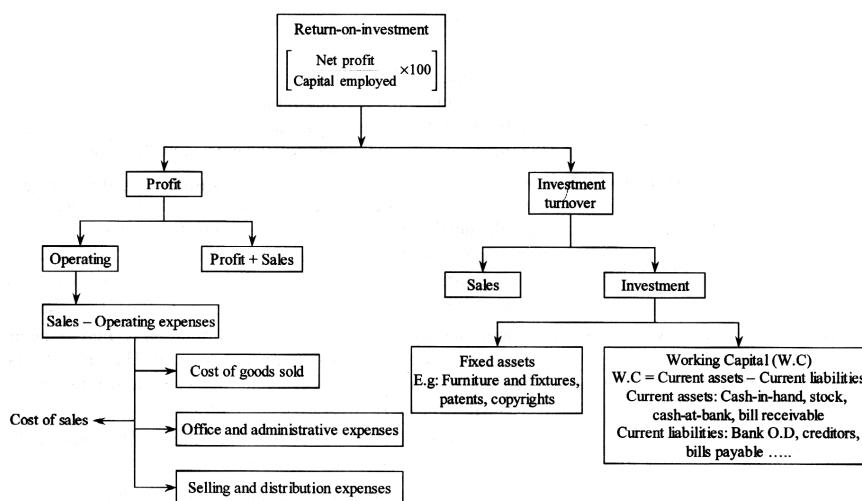


Fig.: Du-Point Chart

Through ROI, efficiency of various business operations can be determined as it enables the firm to assess whether the fixed assets have been used profitably or not. Firms must maintain optimal efficiency by improving the relationship between sales and costs (such that, costs can be reduced to a great extent by increasing the sales turnover of a firm). Thus, profits can be increased either by controlling cost or by increasing sales. The investment turnover can be increased by restricting its investment in fixed assets and working capital without affecting the sales.

Hence, management needs to take corrective actions for improving the financial performance of weaker areas. Performance of a firm can be judged accurately by inter-firm comparisons. While performing such comparisons, certain ratios are used as standard ratios (of performance) such as, ROI, assets turnover and profit margins.

2. Operating Profit Ratio.

Ans :

Meaning

This ratio measures the relationship between operating profits and net sales.

Objective

The main objective of computing this ratio is to determine the operational efficiency of the management. Components: There are two components of this ratio which are as under:

- (i) **Operating Profit:** It is the excess of gross profit over other operating expenses. (For example, office and administrative expenses, selling and distribution expenses, discount, bad debts, interest on short-term debts).
- (ii) **Net Sales:** It means gross sales (both cash and credit minus sales returns).

Computation

This ratio is computed by dividing the operating profit by the net sales. It is expressed as a percentage. In the form of a formula, this ratio may be expressed as under:

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$$

$$\text{Operating Profit} = \text{Net Sales} - \text{Operating Cost}$$

(or)

$$= \text{Net Sales} - (\text{Cost of Goods Sold} + \text{Administrative and Office Expenses} + \text{Selling and Distributive Expenses})$$

$$\text{Net Sales} = \text{Gross Sales} - \text{Sales Return}$$

Alternatively

Operating Profit can also be calculated as

$$\text{Operating Profit} = \text{Net Profit} + \text{Non-operating Expenses} - \text{Non-operating income.}$$

This ratio can also be calculated as:

$$\text{Operating Profit Ratio} = 100 - \text{Operating Ratio.}$$

Interpretation

This ratio indicates:

- i) An average operating margin earned on a sale of ` 100, and
- ii) What portion of sales is left to cover non-operating expenses, to pay dividend and to create reserves.

3. Trend Analysis.

Ans :

The ratios of different items for various periods are find out and then compared under this analysis. The analysis of the ratios over a period of years gives an idea of whether the business concern is trending upward or downward. This analysis is otherwise called as Pyramid Method.

4. Comparative Income Statement.

Ans :

Three important information are obtained from the Comparative Income Statement. They are Gross Profit, Operating Profit and Net Profit. The changes or the improvement in the profitability of the business concern is find out over a period of time. If the changes or improvement is not satisfactory, the management can find out the reasons for it and some corrective action can be taken.

5. What is Ratio Analysis?

Ans :

Definition

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

Thus, ratio analysis measures the profitability, efficiency and financial soundness of the business.

Ratio analysis is to present the figure of financial statement in simple and intangible form. Ratio analysis is to present the figure of financial statement in simple and intangible form. Ratio analysis, in this way, is the process of establishing meaningful relationship between two figures and set of financial statement.

6. Objectives of ratio analysis.

Ans :

- 1. Measuring the Profitability:** The profitability of the business can be measured by calculating gross profit, net profit, expenses ratio and other.
- 2. Judging the Operational Efficiency of Business:** The operational efficiency of the business can be ascertained by calculating operating ratio.
- 3. Assessing the Solvency of the Business:** It can be ascertained whether the firm is solvent or not by calculating solvency ratio. Solvency ratios show relationship between total liabilities and total assets. If total assets are lesser than the total liabilities it shows unsound position of the business.
- 4. Measuring Short and Long-Term Financial Position of the Company:** Ratio analysis helps in knowing the short term and long term financial position of the business by calculating various ratios. Current and liquid ratio indicates short-term financial position, whereas debt equity ratio, fixed asset ratio and proprietary ratio shows long-term financial positions.
- 5. Facilitating Comparative Analysis of the Performance:** Every firm has to compare its present performance with the previous and discover the plus and minus points. These points can be located by the calculation of different ratio. Comparison with the performance of other competitive firms can also be made.

7. Advantages of ratio analysis.

Ans :

The following are the important advantages of the accounting ratios.

1. Analyzing Financial Statements

Ratio analysis is an important technique of financial statement analysis. Accounting ratios are useful for understanding the financial position of the company. Different users such as

investors, management bankers and creditors use the ratio to analyze the financial situation of the company for their decision making purpose.

2. Judging Efficiency

Accounting ratios are important for judging the company's efficiency in terms of its operations and management. They help to judge how well the company has been able to utilize its assets and earn profits.

3. Locating Weakness

Accounting ratios can also be used in locating weakness of the company's operations even though its overall performance may be quite good. Management can then pay attention to the weakness and take remedial measures to overcome them.

4. Formulating Plans

Although accounting ratios are used to analyze the company's past financial performance, they can also be used to establish future trends of its financial performance. As a result, they help formulate the company's future plans.

8. Limitations of Ratio Analysis.

Ans :

- i) As ratios are calculated based on the historical data or past performance, they may not necessarily provide the correct information that is useful in decision-making.
- ii) As there are no particular standards or rules of thumb for all the ratios, it is difficult to interpret accurate results.
- iii) In order to draw correct interpretations, a single ratio may not be helpful. For this purpose, a number of ratios are to be calculated which is likely to confuse the financial analyst than to help him in making any meaningful conclusions.

9. What are Indian Accounting Standards? Explain the scope of Indian Accounting Standards.

Ans :

Ind-AS or Indian Accounting Standards govern the accounting and recording of financial transactions as well as the presentation of statements such as profit and loss account and balance sheet of a company. For long, there has been a heated debate about Indian companies moving to the globally accepted International Financial Reporting Standards (Indian Accounting) for their accounts.

But firms have resisted this shift, stating that this will lead too many changes in the capture and reporting of their numbers. Ind-AS has been evolved as a compromise formula that tries to harmonize Indian accounting rules with the Indian Accounting.

10. What are International Financial Reporting Standards?

Ans :

The International Accounting Standards Board (IASB). It was founded on 1st April 2001. It is London based and mainly responsible for the development of International Financial Reporting Standards (IFRS). The accounting standards set by the International Accounting Standards Committee (IASC) are called as the international accounting standards composition. The IASB comprises of 14 board members which are appointed by the (IASCF) i.e., International Accounting Standard Committee Foundation. These accounting standards are set by each country's accounting standards board which finally becomes GAAP for each particular country.

Choose the Correct Answers

1. Profitability ratios are based on _____. [c]
(a) Sales (b) Investment
(c) Both (a) and (b) (d) Purchases.
2. According to modus operandi, analysis are divided into _____. [d]
(a) Horizontal analysis (b) Vertical analysis
(c) Internal analysis (d) Both (a) and (b)
3. Following are the methods used in analyzing financial statements are _____. [d]
(a) Trend ratios (b) Ratio analysis
(c) Comparative analysis (d) All the above.
4. Ratio analysis is useful to _____. [b]
(a) Management (b) Both (a) and (c)
(c) Government (d) Students.
5. The ratio which measures the relationship between operating cost and net sales is_____, [a]
(a) Operating ratio (b) Gross profit ratio
(c) Net profit ratio (d) Operating profit ratio.
6. Dividend coverage ratio = [c]
(a) $\frac{\text{PBIT}}{\text{Interest}}$ (b) $\frac{\text{PAT}}{\text{Interest}}$
(c) $\frac{\text{PAT}}{\text{Dividend}}$ (d) $\frac{\text{PBIT}}{\text{Dividend}}$
7. The ratio which establishes relationship between net sales and working capital. [a]
(a) Working capital turnover ratio (b) Debtors turnover ratio
(c) Stock turnover ratio (d) None.
8. Return on investment can be calculated by using. [d]
(a) Return on total asset (b) Return on shareholder's fund
(c) Return on capital employed (d) All the above.
9. Standard or Thumb rule of a current ratio is _____. [b]
(a) 1:1 (b) 2:1
(c) 2:4 (d) 1:3
10. The statement which shows the percentage of net sales that are absorbed by each individual item representing cost or expense is _____. [d]
(a) Common size balance sheet (b) Comparative income statement
(c) Trend ratios (d) Common size income statement.

Fill in the Blanks

1. _____ is a collection of data which is organized according to the logical and consistent accounting procedures.
2. _____ is a major tool used for analyzing the financial statements.
3. _____ ratio facilitates to identify whether the company has enough capability to meet its short term obligations/requirements.
4. Capital turnover ratio = _____
5. The ratio which measures the relationship between gross profit and net sales is _____.
6. EBIT Means _____.
7. The items of the financial statements are presented as percentage of a particular item in _____.
8. Leverage ratios are also known as _____.
9. The ratio which measures the profitability of the firm on per equity share basis is _____.
10. Ratio analysis suffers from lack of _____.

ANSWERS

1. Financial statements
2. Ratio analysis
3. Liquidity
4. $\frac{\text{Net sales}}{\text{Total capital employed}}$
5. Gross profit ratio
6. Earning before interest and tax
7. Common size statements
8. Capital structure ratios
9. Earning per share
10. Consistency.

One Mark Question & Answers

1. Common-Size Statements.

Ans :

Common size statement represents all figures in percentages because of which it is also called as 'percentage statement'.

2. Liquidity ratios.

Ans :

Liquidity refers to the ability of a concern to meet its current obligations as and when these become due. Liquidity ratios are calculated to measure short-term financial soundness of the business.

3. Current Ratio.

Ans :

This ratio establishes a relationship between current assets and current liabilities.

4. What is Solvency?

Ans :

The term solvency refers to the ability of a firm to meet its debt. A firm is said to be solvent when its assets are greater than its liabilities. It is under insolvent position when a firm has more liabilities than its assets i.e.,

if Assets > Liabilities, a firm is solvent.

If Liabilities > Assets, a firm is insolvent.

5. Du Point Chart.

Ans :

Du-Point control chart has been designed by an American company, namely Du-Point for the control of management system.

Internal Assessment (Mid Examinations)

In CIE, for theory subjects, during a semester, there shall be two mid-term examinations. Each MidTerm examination consists of two parts i) **Part – A** for 10 marks, ii) **Part – B** for 15 marks with a total duration of 2 hours as follows:

1. Mid-Term Examination for 25 marks:

- (a) Part - A: Objective/quiz paper/Short Note for 10 marks.
- (b) Part - B: Descriptive paper for 15 marks.

Student shall have to earn 40%, i.e. 10 marks out of 25 marks from average of two mid-term examinations (I Mid-Term & II Mid-Term).

The remaining 15 marks of Continuous Internal Assessment (out of 40) are distributed as:

2. Assignment for 5 marks. (Average of 2 Assignments each for 5 marks)
3. PPT/Poster Presentation/ Case Study/Video presentation/Survey/Field Study/Group discussion /Role Play on a topic in the concerned subject for 5+5 = 10 marks before II MidTerm Examination.
 - The objective/quiz paper is set with multiple choice, fill-in the blanks, match the following type of questions and short notes for a total of 10 marks. The descriptive paper shall contain 5 full questions out of which, the student has to answer 3 questions, each carrying 5 marks. The student has to get minimum of 40% (on 25 marks allocated for Mid-Term examinations) on average of two Mid-Term examinations.
 - While the first mid-term examination shall be conducted on 50% of the syllabus, the second mid-term examination shall be conducted on the remaining 50% of the syllabus.
 - Five (5) marks are allocated for assignments (as specified by the subject teacher concerned). The first assignment should be submitted before the conduct of the first mid-term examination, and the second assignment should be submitted before the conduct of the second mid-term examination.
 - The average of the two assignments shall be taken as the final marks for assignment (for 5 marks). PPT/Poster Presentation/ Case Study/ Video presentation/ Survey/ Field Study/ Group discussion / Role Play on a topic in the concerned subject for 5+5 = 10 marks before II Mid-Term Examination.

UNIT - I

Part - A

Multiple Choice Questions

1. Accounting provides data or information on _____. [d]
 - (a) Income and cost for the managers
 - (b) Financial conditions of the institutions
 - (c) Company's tax liability for a particular year
 - (d) All the above

2. In India, the accounting standard board was set up in the year _____. [b]
(a) 1972 (b) 1977
(c) 1956 (d) 1932
3. A concept that a business enterprise will not be sold or liquidated in the near future is known as _____. [a]
(a) Going concern (b) Economic entity
(c) Monetary unit (d) None of the above

Fill in the Blanks

4. _____ accounting has been developed in order to overcome the limitations of Financial Accounting with regard to the historical costs. **(Inflation)**
5. _____ accounting is the application of professional information in such a way as to assist the management in the formation of policies. **(Management)**
6. Assets = _____ + _____. **(Liabilities + Capital)**

Short Notes

7. Define Accounting. **(Unit-I, SAQ - 2)**
8. Limitations of Accounting **(Unit-I, SAQ - 4)**
9. Objectives of Accounting. **(Unit-I, SAQ - 6)**
10. What are Accounting Principles? **(Unit-I, SAQ - 8)**

Part - B

1. "Accounting is a service activity its function is to provide qualitative information". Comment. **(Unit-I, Q.No. 1)**
2. Explain briefly about Advantages and Limitations of Accounting. **(Unit-I, Q.No. 3)**
3. Explain in detail the various accounting concepts. **(Unit-I, Q.No. 12)**
4. Explain in detail the various accounting conventions. **(Unit-I, Q.No. 13)**
5. What are generally accepted accounting principles (GAAP) issued by ICAI? **(Unit-I, Q.No. 16)**

UNIT - II**Part - A****Multiple Choice Questions**

1. Trial balance is prepared to find out _____. [c]
(a) Profit or loss (b) Financial position
(c) Arithmetical accuracy of accounts (d) None
2. Real account deals with _____. [d]
(a) Cash (b) Fixed assets
(c) Intangible assets (d) All

3. The amount withdrawn for personal use. [d]
(a) Income for the business (b) Gain for the business
(c) Loss for the business (d) Drawings from the business

Fill in the Blanks

4. The two aspects of each business transaction are depicted in terms of _____. (Debit and credit)
5. Accounting has _____ branches. (Three)
6. Preparation of _____ is the first stage in final accounts. (Trading account)

Short Notes

7. Explain the features of Incomplete Records. (Unit-II, SAQ - 2)
8. Define trial balance. (Unit-II, SAQ - 5)
9. Explain the advantages of trial balance. (Unit-II, SAQ - 6)
10. What is Suspense Account? (Unit-II, SAQ - 7)

Part - B

1. What is journal ? Explain the objectives of journal. (Unit-II, Q.No. 2)
2. What are the objectives of preparing trial balance? (Unit-II, Q.No. 13)
3. How can you validate the balances entered in either column of a trial balance? (Unit-II, Q.No. 22)
4. Describe the limitations of single entry system of accounting. (Unit-II, Q.No. 50)
5. Discuss the accounting treatment as per the statement of affairs method. (Unit-II, Q.No. 55)

UNIT - III**Part - A****Multiple Choice Questions**

1. According to straight line method of providing depreciation, the depreciation [a]
(a) Remains constant (b) Increase each year.
(c) Decrease each year (d) None of them.
2. Regardless of how long it takes to produce and sell inventory, inventory is always considered to be a? [a]
(a) Current asset (b) Current liability
(c) Long-term asset (d) Stockholder's equity
3. The latest cost of inventories is changed to production but the old prices are changed to inventories on hand? [b]
(a) Average (b) LIFO
(c) FIFO (d) Perpetual

Fill in the Blanks

4. The excess of average profit over normal profit is called _____. (Super profit)
5. The word _____ is used to show loss in the value of intangible assets. (Amortization)
6. Increase and decrease in the market value of assets is known _____. (Fluctuation)

Short Notes

7. Define inventory. (Unit-III, SAQ - 3)
8. First In First Out. (Unit-III, SAQ - 4)
9. Last In First Out. (Unit-III, SAQ - 5)
10. Written down value method. (Unit-III, SAQ - 6)

Part - B

1. Define tangible assets. Explain the characteristics of tangible assets. (Unit-III, Q.No. 6)
2. Define Intangible assets. Explain the characteristics of intangible assets. (Unit-III, Q.No. 7)
3. Explain various methods of Inventory Valuation. (Unit-III, Q.No. 12)
4. Define goodwill. Explain the factors effecting goodwill. (Unit-III, Q.No. 15)
5. Explain the concept of depreciation. (Unit-III, Q.No. 17)

UNIT - IV**Part - A****Multiple Choice Questions**

1. _____ is a legal measure to reduce the tax liability. [b]
(a) Tax avoidance (b) Tax planning
(c) Tax evasion (d) Tax income.
2. Cash Flow Statement is also known as [c]
(a) Statement of Changes in Financial Position on Cash basis
(b) Statement accounting for variation in cash
(c) Both a and b
(d) None of the above.
3. Cash Flow Statement is based upon [a]
(a) Cash basis of accounting
(b) Accrual basis of accounting
(c) Credit basis of accounting
(d) None of the above

Fill in the Blanks

4. Cash flow statement is useful for _____. (Short-term financial analysis)
5. Working capital = _____. (Current Assets -Current Liabilities)
6. Buy back of shares comes under _____. (Financing activity)

Short Notes

7. Paid Costs (Unit-IV, SAQ - 7)
8. Unpaid Costs/Expenses (Unit-IV, SAQ - 8)
9. Define financial statement analysis (Unit-IV, SAQ - 9)
10. Limitations of Financial Statement Analysis (Unit-IV, SAQ - 10)

Part - B

1. Distinguish between cash profits and book profits. (Unit-IV, Q.No. 13)
2. Describe the Advantages and Disadvantages of Cash Flow Statements. (Unit-IV, Q.No. 14)
3. What is Funds Flow in Accounting (Unit-IV, Q.No. 17)
4. "Is a Funds flow statement a better substitute for an income statement". Comment. (Unit-IV, Q.No. 20)
5. Explain the differences Funds Flow and Cash Flow Statement. (Unit-IV, Q.No. 24)

UNIT - V**Part - A****Multiple Choice Questions**

1. Profitability ratios are based on _____. [c]
(a) Sales (b) Investment
(c) Both (a) and (b) (d) Purchases.
2. Dividend coverage ratio = [c]
(a) $\frac{\text{PBIT}}{\text{Interest}}$ (b) $\frac{\text{PAT}}{\text{Interest}}$
(c) $\frac{\text{PAT}}{\text{Dividend}}$ (d) $\frac{\text{PBIT}}{\text{Dividend}}$
3. The ratio which establishes relationship between net sales and working capital. [a]
(a) Working capital turnover ratio
(b) Debtors turnover ratio
(c) Stock turnover ratio
(d) None.

Fill in the Blanks

4. EBIT Means _____. (Earning before interest and tax)
5. Ratio analysis suffers from lack of _____. (Consistency)
6. Leverage ratios are also known as _____. (Capital structure ratios)

Short Notes

7. Operating Profit Ratio (Unit-V, SAQ - 2)
8. Trend Analysis (Unit-V, SAQ - 3)
9. Comparative Income Statement (Unit-V, SAQ - 4)
10. What is Ratio Analysis? (Unit-V, SAQ - 5)

Part - B

1. Explain the advantages of ratio analysis. (Unit-V, Q.No. 9)
2. What are the Limitations of Ratio Analysis. (Unit-V, Q.No. 10)
3. What is Solvency? Explain various types of Solvency Ratios. (Unit-V, Q.No. 13)
4. Explain any two Accounting Standard issued by ICAI. (Unit-V, Q.No. 20)
5. Explain Accounting Standard 6 (Revised) related to Depreciation Accounting. (Unit-V, Q.No. 21)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

M.B.A I Year I Semester Examination

R22

Model Paper - I

FINANCIAL REPORTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 60

Note : This question paper contains two parts **A** and **B**.

Part A is compulsory which carries 10 marks. Answer all questions in **Part A**.

Part B consists of 5 Units. Answer any **One** full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (10 × 1 = 10 Marks)

ANSWERS

1. (a) Define Accounting. (Unit-I, SQA-2)
- (b) Full Disclosure. (Unit-I, SQA-11)
- (c) What is the difference between Journal and Ledger? (Unit-II, SQA-1)
- (d) Advantages of ledger. (Unit-II, SQA-4)
- (e) Define depreciation. (Unit-III, SQA-2)
- (f) What are the objectives of depreciation? (Unit-III, SQA-7)
- (g) What information can be Obtained from Cash Flow? (Unit-IV, SQA-3)
- (h) How can the Net increase in working capital be computed ? (Unit-IV, SQA-6)
- (i) Operating Profit Ratio. (Unit-V, SQA-2)
- (j) Limitations of Ratio Analysis. (Unit-V, SQA-8)

PART - B (5 × 10 = 50 Marks)

2. (a) "Accounting is a service activity its function is to provide qualitative information". Comment. (Unit-I, Q.No. 1)
- (OR)
- (b) Explain in detail the various accounting conventions. (Unit-I, Q.No.13)
3. (a) The total debit side of a Trial balance of a company as at 31st Dec 2017 is 25,000 and credit side is Rs.5,000

The following mistakes were discovered.

Particulars	Correct fig. Rs	Fig. in Trial Balance R.s
Opening stock	17,500	25,700
Rent and rates	250	520
Sundry creditors	15,000	5,000
Commission received taken on the debit side	750	750
Miscellaneous income	60	30

Ascertain the correct total of Trial balance.

(Unit-II, Prob.10)

(OR)

- (b) Following balances are extracted from the books of Kautilya & Co. on 31st March, 2013. You are required to make the necessary closing entries and to prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date :

Particulars	₹	Particulars	₹
Opening Stock	500	Commission (Cr.)	200
Bills Receivable	2,250	Returns Outward	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inward	400	Rent & taxes	550
Commission (Dr.)	400	Carriage Outward	725
Interest on Capital	350	Sales	25,000
Stationery	225	Bills Payable	1,500
Returns Inward	650	Creditors	9,825
		Capital	8,950

The Closing Stock was valued at ₹ 12,500.

(Unit-II, Prob.23)

4. (a) Define inventory state the objectives of inventory.

(Unit-III, Q.No.9)

(OR)

- (b) India Ltd. charges depreciation on plant and machinery under Reducing balance Sheet @15% Per Annum. On 1.4.2014 the balance in Ledger stood at Rs. 4,60,000. The following particulars are given to plant and machinery during three four years ended 31.3.2018

- (i) 1.9.2014 : A machine purchased for Rs. 20,000 (Installation Expenses Rs. 1,000) on 1.5.2012 was fully destroyed in an accident
- (ii) 1.7.2015 : Purchased a new machine costing Rs. 50,000 (Installation Expenses Rs. 2,500). A sum of Rs. 30,000 was paid on the same date and balance was paid in May 2,000
- (iii) 31.8.2016 : Plant purchased on 1.4.2013 for Rs. 30,000 (Installation Expenses Rs. 1,500) was disposed off Rs. 36,000.
- (iv) 1.11.2017 : Some old machineries (Book value on 1.4.2014 at Rs. 10,000) were sold for Rs. 4,000

Show the plant and machinery Accounts as would appear in books of the company for the four year ended 31.3.2018 assuming depreciation is charged proportionately even if the asset is sold (or) destroyed.

(Unit-III, Prob.17)

5. (a) 12. From the following information relation to A Limited, prepare
- Statement of changes in the requirements of working capital
 - Funds Flow statement and
 - Cash flow statement

Liabilities (Rs.000)	2013	2014	Assets (Rs.000)	2013	2014
Share capital	300	400	Cash	30	90
Reserves	100	50	Receivables	105	150
Retained Earnings	30	60	Inventories	50	195
Payables	45	135	Fixed Assets	190	210
	475	645		475	645

Additional Information:

The company purchased the worth of Rs. 40000 Furniture, Rs. 10000 Loose

Tools by issue of share capital

A Piece to fixed asset, book value of which is Rs 10000/- depreciation on it is

Rs. 3000/-, sold for Rs. 5000/-

Tax paid during the year Rs. 43000

Dividend paid during the year Rs. 26000

(Unit-IV, Prob.12)

(OR)

- (b) Write the procedure for preparing cash flow statement. (Unit-IV, Q.No.15)
6. (a) What are the Tools and Techniques of Financial Analysis ? (Unit-V, Q.No.1)
- (OR)

(b) From the balance sheet given below, calculate:

i) Working capital,

ii) Current Ratio,

iii) Acid test Ratio

iv) Debt Equity Ratio,

v) Assets Proprietorship Ratio

BALANCE SHEET OF ABC COMPANY LTD.,

as on 31st December 2006

Liabilities	Amount	Assets	Amount
Shareholders fund:		Fixed assets	1,80,000
Equity share capital:	1,50,000	Current assets:	
12% Preference	30,000	Cash in Hand:	2,000
share capital:		Cash at bank:	4,000
Reserves and surplus:	24,000	Sundry Debtors:	10,000
	2,04,000	Stores:	12,000
15% Debentures	48,000	Stock-in-Trade:	32,000
Bank overdraft:	12,000		
	60,000	Preliminary expenses	48,000
Sundry creditors:	16,000		
Proposed dividend:	2,000		
Provision for taxation:	10,000		
Discount on issue of	4,000		
Debenture			
	2,92,000		2,92,000

(Unit-V, Prob.7)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

M.B.A I Year I Semester Examination

R22

Model Paper - II

FINANCIAL REPORTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 60

Note : This question paper contains two parts **A** and **B**.**Part A** is compulsory which carries 10 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any **One** full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (10 × 1 = 10 Marks)**ANSWERS**

1. (a) "Accounting is an information system". Explain the statement. (Unit-I, SQA-7)
- (b) Objectives of Accounting. (Unit-I, SQA-6)
- (c) Explain the features of Incomplete Records. (Unit-II, SQA-2)
- (d) What is Suspense Account? (Unit-II, SQA-7)
- (e) Define Asset. (Unit-III, SQA-8)
- (f) Objectives of Inventory. (Unit-III, SQA-10)
- (g) Paid Costs. (Unit-IV, SQA-7)
- (h) Define financial statement analysis. (Unit-IV, SQA-9)
- (i) What are International Financial Reporting Standards? (Unit-V, SQA-10)
- (j) Advantages of ratio analysis. (Unit-V, SQA-7)

PART - B (5 × 10 = 50 Marks)

2. (a) Explain the meaning of GAAP and identify the institutions that influence the development of GAAPs. (Unit-I, Q.No.16)
- (OR)
- (b) Explain in detail the various accounting concepts. (Unit-I, Q.No.12)
3. (a) Record the following transactions in the journal of Divakar and post them to appropriate Ledger account,

2007	Particulars	
1-1-07	Capital brought in for the commencement of the business	2,50,000
3-1-07	Rental advance	50,000
3-1-07	Purchased furniture	30,000
5-1-07	Purchased goods	1,00,000
6-1-07	Purchased goods from Raman	50,000
7-1-07	Sold goods for cash	40,000

10-1-07	Sold goods to Ravi	60,000
12-1-07	Goods returned to Raman	2,000
15-1-07	Cash paid to Raman	40,000
18-1-07	Received cash from Ravi	40,000
22-1-07	Deposited cash in Bank	60,000
30-1-07	Paid Rent	5,000
31-1-07	Paid Salaries	10,000
31-1-07	Paid Electricity Bill	2,000
31-1-07	Insurance paid	5,000

(Unit-II, Prob.8)

(OR)

- (b) What are the advantages and disadvantages of single entry system?

(Unit-II, Q.No.50)

4. (a) A company had bought machinery for Rs. 20,00,000 including a boiler worth Rs. 2,00,000. The machinery account had been credited for depreciation on the Reducing Instalment System for the past four years at the rate of 10% p.a. In the beginning of the fifth year, the boiler because useless on account of damage to some of its vital parts and the damaged boiler is sold for Rs. 40,000. You are required to write up the machinery account for five years.

(Unit-III, Prob.20)

(OR)

- (b) Balaji industries had an opening stock of 300 units materials values at

Rs. 600 Receipts and Issues during August 2017 were as follows :

	Units	Value (Rs.)
August 2 received	200	440
August 4 issued	150	—
August 6 received	200	460
August 11 issued	150	—
August 19 issued	200	—
August 22 received	200	480
August 31 issued	250	—

Show the stores ledger using LIFO Method.

(Unit-III, Prob.4)

5. (a) Define Cash Flow Statement. What are the Advantages and Disadvantages of Cash Flow Statements.

(Unit-IV, Q.No.14)

(OR)

- (b) 10. Balance Sheets of M/s Sanjay Enterprises on 1/1/1992 and 31/12/1992 were as follows :

Liabilities	1.1.92 Rs.	31.12.92 Rs.	Assets	1.1.92 Rs.	31.12.92 Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Loan from Ram	25,000	–	Debtors	30,000	50,000
Loan from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery less prov. For Depreciation	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provision for depreciation against the machinery as on 1.1.1992 was Rs. 25,000 and on 31.12.1992 was Rs. 40,000.

You are required to prepare cash flow statement.

(Unit-IV, Prob.10)

6. (a) From the following information, prepare the Balance Sheet of PQR Company Limited as on 31-03.2012, with as many details as possible
- Paid up capital Rs. 50 lakhs
 - Plant and Machinery Rs. 125 Lakhs
 - Total Annual Sales Rs. 500 lakhs
 - Gross profit margin 25 percent
 - Annual Credit sales 80 percent of net sales
 - Current ratio 2 Inventory turnover ratio 4
 - Fixed assets turnover ratio 2
 - Sales returns 20 percent of sales
 - Average collection period 73 days
 - Bank credit to trade credit 2
 - cash to inventory 1 : 15
 - Total debt to current liabilities 3

(Unit-V, Prob.9)

(OR)

- (b) Enlist some of the Accounting Standards issued by ICAI by focusing on the importance of standards to give a general view on financial accounting practices.

(Unit-V, Q.No.20)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

M.B.A I Year I Semester Examination

R22

Model Paper - III

FINANCIAL REPORTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 60

Note : This question paper contains two parts **A** and **B**.**Part A** is compulsory which carries 10 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any **One** full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (10 × 1 = 10 Marks)**ANSWERS**

1. (a) Accounting Equation. (Unit-I, SQA-10)
- (b) What are Accounting Principles? (Unit-I, SQA-8)
- (c) Under what conditions, Revenue expenditure becomes capital expenditure. (Unit-II, SQA-10)
- (d) Capital expenditure. (Unit-II, SQA-8)
- (e) Last In First Out. (Unit-III, SQA-5)
- (f) Define depreciation. (Unit-III, SQA-2)
- (g) Distinguish between differences Funds Flow and Cash Flow Statement. (Unit-IV, SQA-2)
- (h) Unpaid Costs/Expenses. (Unit-IV, SQA-8)
- (i) Trend Analysis. (Unit-V, SQA-3)
- (j) What is Ratio Analysis? (Unit-V, SQA-5)

PART - B (5 × 10 = 50 Marks)

2. (a) What is an accounting cycle? List the sequential steps in accounting process. (Unit-I, Q.No.27)
- (OR)
- (b) Show the Accounting Equation on the basis of the following and present a balance sheet on the last new equation balances:

S.No.	Particulars	(`)
(i)	Manu started business with cash	50,000
(ii)	Bought furniture for	500
(iii)	Purchased goods on credit	4,000
(iv)	Sold goods on cash (cost ` 500) for	700
(v)	Received rent	200
(vi)	Purchased goods for cash	1,000
(vii)	Withdrew for personal use	700
(viii)	Paid to creditors	400
(ix)	Paid for salaries	200

(Unit-I, Prob.3)

3. (a) From the following Trail Balance, Prepare the Trading and Profit and Loss Account of Mr. Ramu for the year ended December 31, 2015 and the Balance sheet as on the date

Particulars	Debit Rs.	Credit Rs.
Ramu Capital –	4,000	
Plant and Machinery	5,000	–
Office Furniture's and fitting	260	
Stocks on January 1, 2015	4,800	–
Motor Van	1,200	–
Sundry Debtors	4,470	–
Cash in Hand 40	–	
Cash in bank	650	
Wages	15,000	
Salaries	1,400	–
Purchases	21,350	–
Sales	–	48,000
Bills Receivable	720	–
Bills payable	–	560
Sundry Creditors	–	5,200
Returns Inwards	930	
Provisions for doubtful debts	–	250
Drawings	700	–
Return outwards	–	550
Rent	600	
Factory Lighting and heating	80	–
Insurance	680	–
General Expenses	250	–
Bad debts	200	–
Discount	650	420
	58,980	58,980

The Following adjustments are to be made

- (a) Stock on December 31, 2015, Rs. 5,200/-
- (b) 3 months factory lighting and heating is due but not paid Rs. 30/-
- (c) 5% Depreciations to be written off on furniture,
- (d) Write off further bad debts Rs.70

(Unit-II, Prob.26)

(OR)

- (b) (i) Discuss the various transactions involved in ascertainment of missing figures. **(Unit-II, Q.No.57)**
 (ii) What type of errors cannot be disclosed in a trial balance? **(Unit-II, Q.No.23)**
 4. (a) Explain the Methods of Valuation of Goodwill. **(Unit-III, Q.No.16)**

(OR)

- (b) The following transactions occurs in purchase and issue of materials.

Jan.-2 Purchased 4,000 units@ Rs. 4.00 per unit,
 Jan.20 Purchased 500 units@ Rs. 5.00 per unit
 Feb.-5 Issued 2,000 units
 Feb.-10 Purchased 6,000 units@ Rs. 6.00 per unit
 Feb.-12 Issued 4,000 units
 Mar.-2 Issued 1,000 units
 Mar.-15 Purchased 4,500 units@ rs. 5.50 per unit
 Mar.-20 Issued 3,000 units

From the above, prepare stores ledger account in two ways : (i) by adopting LIFO method, and (ii) by adopting FIFO method of charging material issues. What would be the valuation of stock at the end of the period according to each of the methods ?

(Unit-III, Prob.5)

5. (a) The summarized balance sheet of Jay Ltd as on 31.12.06 and 31.12.2007 are as follows:

Liabilities	2005	2006	Assets	2005	2006
Share capital	1,00,000	1,00,000	Building	46,800	45,000
General Reserve	38,400	42,000	Plant and Machinery	38,280	42,030
Creditors	9,750	6,380	Goodwill	13,000	13,000
Tax provision	19,000	21,000	Investment	10,000	11,250
Prov. for doubtful debt	1,000	1,200	Stock	30,000	28,000
			Debtor	22,070	22,300
			Cash	8,000	9,000
	1,68,150	1,70,580		1,68,150	1,70,580

After taking the following information in to account, prepare a cash flow statement for the year ending 31.12.2007

- The profit for 2006-2007 was Rs. 8,600 against this had been charged Dep. Rs.3,050 and increase in provision for doubtful debt Rs.200
- Income tax Rs.18,000 was paid during the year charged against the provision and in addition Rs. 20,000 was charged against profit and carried to the provision.
- An interim dividend of Rs. 5,000 was paid in January 2007
- Additional plan was purchased in September 2006 for Rs. 5,000
- Investments (cost Rs.5,000) were sold 2007 for Rs. 4800 and on 1st march 2007 another investment was made for Rs.6,250

(Unit-IV, Prob.9)

(OR)

- (b) What are the Difference between Funds Flow and Cash Flow Statement. **(Unit-IV, Q.No.24)**
6. (a) (i) Explain the advantages of ratio analysis. **(Unit-V, Q.No.9)**
- (ii) What are the Limitations of Ratio Analysis. **(Unit-V, Q.No.10)**

(OR)

- (b) The following financial statement is summarized from the books of Akhilesh Ltd. as 31st March, 2016 :

Liabilities	Amount(Rs.)	Assets	Amount(RS.)
Liabilities	15,00,000	Fixed Assets	16,50,000
Reserves & Surplus	6,00,000	Stock in trade	9,10,000
Debentures	5,00,000	Book Debts	12,40,000
Bank overdraft	2,00,000	Short term investments	1,60,000
Sundry creditors	12,00,000	Cash	40,000
	40,00,000		40,00,000

Additional information :

Annual sales : Rs. 74,40,000 and Gross profit : Rs. 7,44,000

Bank overdraft is payable on demand

You are required to calculate the following ratios for year and comment on the financial position as revealed by these ratios :

- a) Debt equity ratio b) Current ratio c) Proprietary ratio
- d) Gross profit ratio e) Debtor-Turnover ratio, and f) Stock-Turnover ration

(Unit-V, Prob.13)

Note: This question paper contains two **Parts A** and **B**.

Part A is compulsory which carries 25 marks. Answer all questions in **Part A**.

Part B consists of 5 Units. Answer any one full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)

ANSWERS

1. Answer the following :

- | | |
|--|---------------------------------|
| (a) Concept of Disclosure. | (Unit-I, SQA-11) |
| (b) Diminishing Balance Method | (Unit-III, SQA-6) |
| (c) FIFO & LIFO | (Unit-III, SQA-4, 5) |
| (d) Paid costs and Unpaid costs | (Unit-IV, SQA-7, 8) |
| (e) Vertical analysis, Horizontal analysis and Trend analysis. | (Unit-IV, SQA-5, Unit-V, SQA-3) |

PART - B (5 × 10 = 50 Marks)

2. Explain the benefits and limitations of the Financial Accounting. (Unit-I, Q.No. 3)

OR

3. What are the Basic Accounting concepts and explain their implication? (Unit-I, Q.No. 12)

4. Journalise the following transactions and prepare the following accounts

- | | | | | |
|--------------|--|----------|----------|--------------|
| (a) Purchase | (b) Sales | (c) Cash | (d) Hari | (e) Discount |
| 1-Jan-2014 | Giridhar commenced business with cash Rs. 7,500/- | | | |
| 3-Jan-2014 | Goods purchase for cash Rs.1,000/- | | | |
| 4-Jan-2014 | Bought goods from Hari Rs. 250/- | | | |
| 8-Jan-2014 | Furniture purchased from murari for cash Rs. 50/- | | | |
| 9-Jan-2014 | Furniture purchased from murari 250/- | | | |
| 12-Jan-2014 | Cash paid to Hari in full settlement of this account Rs.240/- | | | |
| 15-Jan-2014 | Goods purchase from Anil and he allowed us Discount 10%
Rs. 350/- | | | |
| 20-Jan-2014 | Paid cash to Anil in full satisfaction Rs. 300/- | | | |
| 21-Jan-2014 | Prince Behari bought from us Rs. 115/- | | | |

- 22-Jan-2014 Cash paid by Prince Behari Rs. 15/-
- 25-Jan-2014 Prince Behari became insolvent, a financial composition of 50p in the rupee received from his official receiver out of a debit of Rs. Rs. 100/- Rs. 50/-
- 26-Jan-2014 Paid for miscellaneous expenses Rs. 25/-
- 28-Jan-2014 Withdrawn by Giridhar for his personal use Rs. 100/-

(Unit-II, Prob. 7)

OR

5. A firm purchase a leasehold for a period of five years for Rs. 10,000 on 1.1.1995, it decides to write off the lease by Annuity Method presuming the rate of interest at 5% p.a. The annuity table shows that the annual amount necessary to write off Re 1 at 5% p.a. 0.230976. You are required to prepare the lease hold property account for five years and shows the net amount to be charged to the Profit & Loss account for these five years.

(Unit-III, Prob. 19)

6. The financial year of Mr. X ends on 31st March 1995 but the stock on hand was physically verified only on 7th April 1995. You are required to ascertain the value of closing stock as on 31st March 1995 from the following information
- (a) The stock as verified on 7th April 1995 was Rs. 1,54,000
 - (b) Sales have been entered in the Sales Day Book only after the dispatch of goods and sales returns only on receipt of the goods.
 - (c) Purchases have been entered in the Purchases Day Book on receipt of the purchase invoice irrespective of the receipt of the goods
 - (d) Sales as per Sales Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 68,800 of which goods of sale value Rs. 12,000 had not been delivered) at the verification
 - (e) Purchases as per Purchase Day Book for the period 1st April 1995 to 7th April 1995 (before the actual verification) amounted to Rs. 58,000 of which goods for purchases of Rs. 15,000 had not been received at the date of verification and goods for purchases Rs. 20,000 had been received prior 31st March 1995
 - (f) In respect of goods costing Rs. 50,000 received prior to 31st March 1995, invoices had not been received until the date of verification of stocks
 - (g) The gross profit is 25% on sales

(Unit-III, Prob. 6)

OR

7. Explain the Single Entry System. State its disadvantages and explain how the profit can be determined under this system. **(Unit-II, Q.No. 48, 50)**
8. From the following Balance Sheet of Rhino Retreading Ltd. Hosur make out
(a) Statement of Changes in working Capital, and (b) Funds flow statement.

Balance Sheet of Rhino Retreating Ltd., Hosur as at 31st March

Liabilities	1983 Rs.	1984 Rs.	Assets	1983 Rs.	1984 Rs.
Share Capital 12% Redeemable	3,00,000	4,00,000	Goodwill	1,00,000	1,70,000
Debentures	1,50,000	1,00,000	Buildings	2,00,000	1,70,000
Capital Reserve	–	20,000	Plant	80,000	2,00,000
General Reserve	40,000	50,000	Investment	20,000	30,000
P & L A/c	30,000	48,000	Debtors	1,40,000	1,70,000
Proposed Dividend	42,000	50,000	Stock	77,000	1,90,000
Sundry Creditors	45,000	63,000	Bills Receivable	20,000	30,000
Liability for Expenses	30,000	36,000	Cash at Bank	25,000	18,000
Provision for Taxation	40,000	50,000	Preliminary Expenses	15,000	10,000
	6,77,000	8,17,000		6,77,000	8,17,000

Additional Information :

- A piece of Land has been sold out in 1984 and the Profit on sale has been credited to capital reserve.
- A machine has been sold for Rs. 10,000. The written down value of the machine was Rs. 12,000. Depreciation of Rs. 10,000 is charged on plant for the year ended 31st March, 1984.
- The investments are trade investments Rs. 30,000 by way of dividend is received including Rs. 1,000 form pre-acquisition Profit which has been credited to investment account.
- An interim dividend of Rs. 20,000 has been paid in November, 1983 **(Incomplete Problem)**

OR

9. (a) Balance Sheets of M/s Sanjay Enterprises on 1/1/1992 and 31/12/1992 were as follows :

Liabilities	1.1.92 Rs.	31.12.92 Rs.	Assets	1.1.92 Rs.	31.12.92 Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Loan from Ram	25,000	–	Debtors	30,000	50,000
Loan from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery less prov. For Depreciation	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provision for depreciation against the machinery as on 1.1.1992 was Rs. 25,000 and on 31.12.1992 was Rs. 40,000.

You are required to prepare cash flow statement.

(Unit-IV, Prob. 10)

- (b) Explain the differences between cash profits and book profits.

(Unit-IV, Q.No. 13)

10. With the following ratios and further information given below, prepare a Trading Account, profit and Loss Account and a Balance Sheet of Shri Narain

- | | |
|---|--------------------------------|
| (a) Gross Profit Ratio 25% | (b) Net Profit Ratio 20% |
| (c) Stock Turnover Ratio 10 | (d) Net profit / Capital 1/5 |
| (e) Capital to Total Liabilities | (f) Fixed Assets / Capital 5/4 |
| (g) Fixed Assets/Total Current Assets 5/7 | (h) Fixed Assets Rs. 10,00,000 |
| (i) Closing Stock Rs. 1,00,000 | |

(Incomplete Problem)

OR

11. Explain Accounting Standard 6 (Revised) related to Depreciation Accounting. (Unit-V, Q.No. 21)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I-Semester Examinations

June / July - 2018

R17

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

Note: This question paper contains two **Parts A** and **B**.**Part A** is compulsory which carries 25 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any one full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)**ANSWERS**

1. (a) What are the limitations of Accounting ? (Unit-I, SQA-4)
- (b) Under what conditions, Revenue expenditure becomes capital expenditure ? (Unit-II, SQA-10)
- (c) Why is Single entry system of Accounting considered as an incomplete system ? (Unit-II, SQA-2)
- (d) How can the Net increase in working capital be computed ? (Unit-IV, SQA-6)
- (e) How do you compute 'Operating Expenses Ratio'? (Unit-V, SQA-2)

PART - B (5 × 10 = 50 Marks)

2. What are the basic Accounting records to be maintained in a business organization that is adopting Double entry system of Accounting ? Elaborate the procedure in detail. (Unit-I, Q.No. 28)
OR
3. What do you understand by 'Generally Accepted Accounting Principles'? Enumerate the various institutions that influence the Indian GAAP. (Unit-I, Q.No. 12, 13, 16)
4. (a) What are the objectives of preparing a Trial Balance ? How can validate the balances entered in either column of a Trial Balance ? (Unit-II, Q.No. 13, 22)
- (b) What types errors cannot be disclosed in a Trial Balance ? (Unit-II, Q.No. 23)
OR
5. Aswin purchased a machine for Rs. 2,50,000 with an expected life of 10 years, on 1st April, 2010 and spent Rs. 20,000 towards transportation and installation. He followed straight line method for providing depreciation for 2 years and found unsuitable. On 1st April, 2012, he switched over to Diminishing balance method and continued up to 31st March, 2015. Prepare Machinery Accounts for the entire period and ascertain the book value on 1st April, 2015. (Unit-III, Prob. 8)

6. (a) What factors do you consider while deciding the pricing methods for materials ?

(Unit-III, Q.No. 14)

- (b) The following transactions occurs in purchase and issue of materials.

Jan.-2 Purchased 4,000 units@ Rs. 4.00 per unit,

Jan.20 Purchased 500 units@ Rs. 5.00 per unit

Feb.-5 Issued 2,000 units

Feb.-10 Purchased 6,000 units@ Rs. 6.00 per unit

Feb.-12 Issued 4,000 units

Mar.-2 Issued 1,000 units

Mar.-15 Purchased 4,500 units@ rs. 5.50 per unit

Mar.-20 Issued 3,000 units

From the above, prepare stores ledger account in two ways : (i) by adopting LIFO method, and (ii) by adopting FIFO method of charging material issues.

What would be the valuation of stock at the end of the period according to each of the methods ?

(Unit-III, Prob. 5)

OR

7. Define the concept 'Goodwill' and bring out the different factors that influence the value of Goodwill of a business firm. Illustrate with imaginary data, any two popular methods of Goodwill.

(Unit-III, Q.No. 15)

8. From the following abridge balance sheets of Hansraj as on 31st March, 2015 and 2016, you are required to prepare a schedule of changes in working capital and a fund flow statement :

Liabilities	31.3.2015	31.3.2016	Assets	31.3.2015	31.3.2016
Share capital	Rs.3,00,000	Rs.4,50,000	Fixed Assets	Rs.5,00,000	Rs.6,00,000
Long term borrowings	1,10,000	1,30,000	Less (Accumulated Depreciation)	50,000	60,000
Short term borrowings	80,000	70,000	Net value of Assets	4,50,000	5,40,000
Current liabilities	40,000	30,000	Current Assets	50,000	1,00,000
			P & L Account	30,000	40,000
	5,30,000	6,80,000		5,30,000	6,80,000

(Unit-IV, Prob. 17)

OR

9. (a) What are the differences between Cash flow statements and Funds flow statements ?

(Unit-IV, Q.No. 24)

(b) What are the limitations of Cash flow statements ? (Unit-IV, Q.No. 14)

(c) How are cash flows classified as per AS-3 ? (Unit-IV, Q.No. 15)

10. The following financial statement is summarized from the books of Akhilesh Ltd.
as 31st March, 2016 :

Liabilities	Amount(Rs.)	Assets	Amount(RS.)
Liabilities	15,00,000	Fixed Assets	16,50,000
Reserves & Surplus	6,00,000	Stock in trade	9,10,000
Debentures	5,00,000	Book Debts	12,40,000
Bank overdraft	2,00,000	Short term investments	1,60,000
Sundry creditors	12,00,000	Cash	40,000
	40,00,000		40,00,000

Additional information :

Annual sales : Rs. 74,40,000 and Gross profit : Rs. 7,44,000

Bank overdraft is payable on demand

You are required to calculate the following ratios for year and comment on the financial position as revealed by these ratios :

- a) Debt equity ratio b) Current ratio c) Proprietary ratio
d) Gross profit ratio e) Debtor-Turnover ratio, and f) Stock-Turnover ration

(Unit-V, Prob. 13)

OR

11. (a) What are the objectives setting up Accounting standard for business units ? (Unit-V, Q.No. 19)
(b) Discuss briefly the various types of Solvency ratios. (Unit-V, Q.No. 13)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I-Semester Examinations

December - 2018

R17

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

Note: This question paper contains two **Parts A** and **B**.**Part A** is compulsory which carries 25 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any one full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)**ANSWERS**

1. (a) Define Accounting. Give the Classification of Accounts. (Unit-I, SQA-2, 3)
- (b) What is mean by 'Depreciation'? List out any three objectives of providing Depreciation. (Unit-III, SQA-2, 7)
- (c) Explain the concept of inventory Valuation. (Unit-III, SQA-3)
- (d) What information can be obtained from cash flow? (Unit-IV, SQA-3)
- (e) Draw Du Pont Control Chart by providing required data. (Unit-V, SQA-1)

PART - B (5 × 10 = 50 Marks)

2. Describe the meaning of "Accounting principles". What are the essential features ? (Unit-I, Q.No. 11, 12, 13)

OR

3. Describe the managerial uses, applications and limitations of accounting. (Unit-I, Q.No. 3, 9)
4. From the following Trail Balance, Prepare the Trading and Profit and Loss Account of Mr. Ramu for the year ended December 31, 2015 and the Balance sheet as on the date

Particulars	Debit Rs.	Credit Rs.
Ramu Capital	–	4,000
Plant and Machinery	5,000	–
Office Furniture's and fitting	260	–
Stocks on January 1, 2015	4,800	–
Motor Van	1,200	–
Sundry Debtors	4,470	–
Cash in Hand	40	–

Cash in bank	650	
Wages	15,000	
Salaries	1,400	–
Purchases	21,350	–
Sale	–	48,000
Bills Receivable	720	–
Bills payable	–	–
Sundry Creditors	–	5,200
Returns Inwards	930	
Provisions for doubtful debts	–	250
Drawings	700	–
Return outwards	–	550
Rent	600	
Factory Lighting and heating	80	–
Insurance	680	–
General Expenses	250	–
Bad debts	200	–
Discount	650	420
	58,980	58,980

(Unit-II, Prob. 26)

The Following adjustments are to be made

- Stock on December 31, 2015, Rs. 5,200/-
- 3 months factory lighting and heating is due but not paid Rs. 30/-
- 5% Depreciations to be written off on furniture,
- Write off further bad debts Rs.70

OR

- India Ltd. charges depreciation on plant and machinery under Reducing balance Sheet @15% Per Annum. On 1.4.2014 the balance in Ledger stood at Rs. 4,60,000. The following particulars are given to plant and machinery during three four years ended 31.3.2018
 - 1.9.2014 : A machine purchased for Rs. 20,000 (Installation Expenses Rs. 1,000) on 1.5.2012 was fully destroyed in an accident
 - 1.7.2015 : Purchased a new machine costing Rs. 50,000 (Installation Expenses Rs. 2,500). A sum of Rs. 30,000 was paid on the same date and balance was paid in May 2,000
 - 31.8.2016 : Plant purchased on 1.4.2013 for Rs. 30,000 (Installation Expenses Rs. 1,500) was disposed off Rs. 36,000.
 - 1.11.2017 : Some old machineries (Book value on 1.4.2014 at Rs. 10,000) were sold for Rs. 4,000

Show the plant and machinery Accounts as would appear in books of the company for the four year ended 31.3.2018 assuming depreciation is charged proportionately even if the asset is sold (or) destroyed.

(Unit-III, Prob. 17)

(b) What are the ingredients necessary for calculating depreciation ?

(Unit-III, Q.No. 22)

6. (a) Balaji industries had an opening stock of 300 units materials values at

Rs. 600 Receipts and Issues during August 2017 were as follows

	Units	Value (Rs.)
August 2 received	200	440
August 4 issued	150	–
August 6 received	200	460
August 11 issued	150	–
August 19 issued	200	–
August 22 received	200	480
August 31 issued	250	–

Show the stores ledger using LIFO Method.

(Unit-III, Prob. 4)

(b) Describe the limitations of single entry system of accounting.

(Unit-II, Q.No. 50)

OR

7. Shri Shankar keeps his book on single entry and following is disclosed from his records.

Particulars	31.12.06 Rs.	31.12.07 Rs.
Balance at bank	(Cr) 2,1000	(Cr) 5,600
Stock in trade	15,000	20,000
Sundry debtors	30,000	28,500
Furniture	5,000	5,000
Investments	5,000	5,000
Cash in hand	100	400
Sundry creditors	25,000	27,000
Bills payable	1,000	500
Loan from Dayalan		3,000

Shri Shankar transferred Rs. 250 each month during first half year and Rs. 200 each month for the remaining period from the business to his daughters banking account by way of drawings. In addition he withdraws Rs. 5000 for his daughters marriage and Rs. 1000 for charitable purpose. He also withdraws goods worth Rs. 5000 of which he invested into the business Rs. 4000. he sold his private car Rs. 3500 and proceeds were utilized for business.

He wants his furniture to be depreciated at 10% and reserve for doubtful debts to be created at 5%. He does not paid two months salary to his clerk @Rs. 150 Pm and two months rent of shop was outstanding amounting to Rs. 200. Commission earned but not yet received by him was Rs. 24000, prepare statement of profit (or) loss for the year ending 31.12.2007.

(Unit-II, Prob. 32)

8. From the following data of national Ltd. for the year 2015 and 2016, Prepare a cashflow statement :

Particulars	2015 Rs.	2016 Rs.
Cash	2,000	2,500
Accounts receivable	2,400	2,700
Inventories	3,100	3,200
Other current assets	800	700
Fixed assets	5,000	5,800
Accumulated depreciation	2,100	2,500
Accounts payable	2,000	2,100
Long term debt	1,400	1,300
Equity capital	5,000	5,300
Retained earning	2,800	3,700

The following additional information is also available

- Fixed assets costing Rs. 1200 were purchased for cash.
- Fixed assets (Original cost of Rs. 400 accumulated depreciation Rs. 150 were sold for Rs. 200).
- Depreciation for the year 2016 amounted to Rs. 550 and duly debited to profit & loss account.
- Dividend paid amounted to Rs. 300 in 2016.
- Reported income for 2016 was Rs. 2,400.

(Unit-IV, Prob. 16)

OR

9. Describe the advantages and limitations of cash flow analysis. (Unit-IV, Q.No. 14)

10. With the help of the following Ratio regarding Narmadha Tex, draw the Trading Profit and Loss A/c and balance Sheet of the company for the year 2017

- (a) Current Ratio : 2.5
- (b) Liquidity Ratio : 1.5
- (c) Net working capital : Rs. 3,00,000
- (d) Stock Turnover Ratio : 6 times (cost of sales / Closing stock)
- (e) Gross Profit Ratio : 20%
- (f) Fixed assets Turnover Ratio (on cost of sales) : 2 times
- (g) Debt Collection Period : 2 Months
- (h) Fixed Assets to Shareholder's Net worth : 0.80
- (i) Reserves and Surplus to Capital : 0.5

(Unit-V, Prob. 12)

OR

11. The comparative Balance sheet of Kowranth Ltd. are given below Balance sheet as on 31.12.2016 and 2017

Liabilities	2016	2017	Assets	2016	2017
Equity share capital	800	1,200	Cash	236	20
Capital Reserve	120	220	Debtors	418	380
General Reserve	444	418	Stock	320	260
Sinking funds	80	100	Others	64	26
6% Debentures	400	650	Investments	540	340
Current liabilities					
Sundry creditors	510	234	Fixed Assets		
Others	14	20	Furniture less Depri	18	36
			Building Less Depri	620	1,572
			Land	40	60
			Others Assets	112	148
	2,368	2,842		2,368	2,842

(Unit-V, Prob. 3)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I-Semester Examinations

April / May - 2019

R17

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

Note: This question paper contains two **Parts A** and **B**.**Part A** is compulsory which carries 25 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any one full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)**ANSWERS**

1. (a) Accounting has been often called the language of business. Do you agree?
What could be deficient with this description? (Unit-I, SQA-9)
- (b) What is depreciation ? What is the objective of providing for depreciation?
List out the various methods of depreciation. (Unit-III, SQA-2, 7)
- (c) What is goodwill? How is it treated in the books of accounts? (Unit-III, SQA-1)
- (d) What information can be obtained from cash flow? Explain how cash
flow statements are prepared. (Unit-IV, SQA-3, 4)
- (e) Explain the differences between horizontal and vertical analysis. (Unit-IV, SQA-5)

PART - B (5 × 10 = 50 Marks)

2. Classify the following under Personal, Real and Nominal account.
(a) Capital account (b) Accrued interest (c) Interest on capital
(d) Interest on drawings (e) Goodwill (f) Patent and trade marks
(g) Salary (h) Rent (i) Current account of a partner
(i) Fixtures (Unit-I, Prob. 1)
- OR
3. (a) Describe the basic concepts and conventions of accounting. (Unit-I, Q.No. 12, 13)
(b) What is basic account equation ? (Unit-I, Q.No. 28)
 4. The total debit side of a Trial balance of a company as at 31st Dec 2017 is 25,000
and credit side is Rs.5,000

The following mistakes were discovered.

Particulars	Correct fig. Rs	Fig. in Trial Balance R.s
Opening stock	17,500	25,700
Rent and rates	250	520
Sundry creditors	15,000	5,000
Commission received	750	750
taken on the debit side		
Miscellaneous income	60	30

Ascertain the correct total of Trial balance.

(Unit-II, Prob. 10)

OR

5. Following are the extracts from the Trial balance of a firm as on 31st March 2017

Name of the account	Dr. (Rs.)	Cr. (Rs.)
Furniture and fittings	4,00,000	–
Motor vehicles	2,00,000	–
Plant	2,00,000	–

Additional information :

- Furniture of Rs. 20,000 was purchased on 1st July 2016. Write 10% off the furniture.
- Motor vehicle of Rs. 20,000 was acquired on 1st July 2016. Depreciate the motor vehicles at 20% p.a.
- The plant of Rs. 20,000 was acquired during the year, charge depreciation on plant at 10% p.a.

Pass necessary journal entries and show how the items will appear in the firms's final accounts.

(Unit-II, Prob. 24)

6. (a) Calculate the missing figure :

Capital at the	Rs. 18,000
Capital introduced during the year	Rs. 3,000
Drawings	Rs. 4,000
Loss	Rs. 1,000
Capital at the beginning	?

- (b) Calculate the capital of Mr. Ganesh as at 31st December 2015 from the following information.

(Unit-II, Prob. 31)

OR

7. Determine the values of stock as per books of AT Ltd., as at 31st March 2016 from the following information :
- The cost of stock as per physical verification as on 24th March amounted to Rs. 1,00,000.
 - Purchases as per Purchase Book after stock taking till 31st March amounted to Rs. 1,00,000 and included the following :
Rs. 5,000 for goods received on 1st April
Rs. 10,000 for goods delivered on 1st April.
 - Sales as per Sales Book after stock-taking till 31st March amounted to Rs. 1,00,000 and included the following :
Rs. 5,000 for goods delivered till 23rd March.
Rs. 10,000 for goods delivered on 1st April.
 - Goods are sold by the trader at a profit of 25% on cost.

Also determine the cost of physical stock as on 31st March 2016.

(Unit-III, Prob. 3)

8. The following information and the balance sheet relate to Shyamsons Ltd.

Particulars	Year 1 Rs.	Year 2 Rs.
Assets		
Cash	10,000	15,000
Receivables	20,000	25,000
Inventory	20,000	35,000
Plant and machinery at cost	85,000	85,000
Less : Accumulated depreciation	(15,000)	(10,000)
	1,20,000	1,20,000
Liabilities and Capital		
Sundry creditors	8,000	10,000
Outstanding expenses	7,000	10,000
Debenture payable	10,000	5,000
Long terms loans	5,000	25,000
Capital	50,000	50,000
Retained earnings	40,000	50,000
	1,20,000	1,50,000

Net profit for the period after charging Rs. 5,000 on account of depreciation was Rs. 20,000. A piece of equipment costing Rs. 25,000 on which depreciation accumulated in the amount of Rs. 10,000 was sold for Rs. 10,000. Dividend paid during the year amounted to Rs. 10,000.

Prepare a source and use of funds statement.

(Unit-IV, Prob. 15)

OR

9. (a) How does the statement of cash flows differ from the funds flow statement ? **(Unit-IV, Q.No. 24)**
- (b) How will the following transaction be shown in the statement of cash flows:
- (i) Acquisition of the assets of another company by issuance of shares for Rs. 1,60,000.
 - (ii) Conversion of 10,000 preference shares of Rs. 100 each to 50,000 equity shares at a premium of Rs. 10 per share.
 - (iii) Entering into finance lease for a new plant with a value of Rs.2,30,000 ? **(Unit-IV, Prob. 6)**

10. The National Bank Limited has been approached by two customers for a short term loan of rs. 50,000. The following summarized financial information is available from the latest financial statements :

Particulars	Granny foods Rs.	Home foods Rs.
Net sales	9,10,000	7,50,000
Gross profit margin	3,82,200	2,92,500
Interest expenses	20,000	8,200
Income tax	75,000	50,000
Profit after tax	82,000	56,250
Inventories	90,000	65,200
Debtors	70,000	56,000
Cash	6,000	18,000
Current liabilities	1,82,600	1,16,000
Long term liabilities	1,60,000	1,30,000
Shareholders equity	1,80,000	1,40,000

The bank intends to accept one of the two loan requests. Which customer's loan request should be accepted ? Why ?

(Unit-V, Prob. 10)

OR

11. (a) A five year comparative analysis of Low Light Company's current ratio and quick ratio follows :

Particulars	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
Current ratio	1.19	1.85	2.50	3.40	4.02
Acid test ratio	1.15	1.02	0.98	0.72	0.50

- (i) What has been happening on the liquidity of Low Light Company over the five years presented ?
- (ii) Considering both ratios what does the trend indicate about, what has happened to the makeup of Low Light's current assets over the five year period ? **(Unit-V, Prob. 11)**
- (b) What is solvency ? Define and explain two of the ratios used for solvency. **(Unit-V, Q.No. 13)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I - Semester Examinations

January - 2020

R19

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

Note: This question paper contains two **Parts A** and **B**.**Part A** is compulsory which carries 25 marks. Answer all questions in **Part A**.**Part B** consists of 5 Units. Answer any one full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)**ANSWERS**

1. (a) Explain any three accounting conventions. (Unit-I, SQA-1)
- (b) What is the difference between Journal and Ledger. Explain with example ? (Unit-II, SQA-1)
- (c) What are the possible reasons for keeping incomplete records ? Explain any three. What are the features of incomplete records ? (Unit-II, SQA-11, 2)
- (d) What is funds flow in accounting ? Distinguish between Funds Flow and Cash Flow Statement. (Unit-IV, SQA-1, 2)
- (e) What is DuPont Chart Analysis ? Draw the Dupont and explain its significance. (Unit-V, SQA-1)

PART - B (5 × 10 = 50 Marks)

2. (a) What is Book-Keeping ? Difference between Single Entry and Double Entry with examples. (Unit-I, Q.No. 2, Unit-II, Q.No. 53)
- (b) What are generally accepted accounting principles(GAAP) issued by ICAI ? (Unit-I, Q.No. 12, 13)

OR

3. (a) Discuss the following accounting standards accepted under IAS
 - (i) AS 2 - Valuation of Inventory (Unit-III, Q.No. 9)
 - (ii) AS 3 - Cash flow statement (Unit-IV, Q.No. 14)
 - (iii) AS 6 - Depreciation Accounting (Unit-III, Q.No. 17)
 - (iv) AS 10 - Accounting for fixed assets (Unit-III, Q.No. 2)

- (b) Explain the following :
- (i) Cash Vs Credit transactions (Unit-II, Q.No. 7)
 - (ii) Sundry debtors Vs. Bills Receivables (Unit-II, Q.No. 7)
 - (iii) Simple average method of material issues (Unit-III, Q.No. 12)
4. (a) Explain the concept of depreciation ? What is accumulated depreciation?
Discuss the different methods of depreciation with their relative merits and demerits. (Unit-III, Q.No. 17, 23, 24, 25)
- (b) Explain the following :
- (i) Current Assets Vs. Fixed Assets (Unit-II, Q.No. 8)
 - (ii) Cash Expenses Vs. Non-cash expenses (Unit-II, Q.No. 8)
 - (iii) Depletion Vs. Amortization (Unit-III, Q.No. 34)
5. From the following ledger balances of M/s Aravind and Company as on 31-12-2013 prepare (a) Trial Balance (b) Final Accounts
- | | |
|------------------------|-----------|
| i) Capital | 72000 |
| ii) Creditors | 17440 |
| iii) Bills Payable | 5054 |
| iv) Sales | 156364 |
| v) Loan | 24000 |
| vi) Debtors | 7770 |
| vii) Salaries | 8000 |
| viii) Discount - Dr. | 2000 |
| ix) Postage | 546 |
| x) Bad debts | 574 |
| xi) Interest - Dr | 2590 |
| xii) Insurance | 834 |
| xiii) Machinery | 2000 |
| xiv) Stock as 01.01.13 | 19890 |
| xv) Purchases | 124000 |
| xvi) Wages | 8600 |
| xvii) Buildings | 47560 |
| xviii) Furniture | 32310 and |
| xix) Vehicles | 28600 |
- (Incomplete Problem)
6. Why is Inventory valuation necessary ? Discuss various methods of Inventory valuation with their relative merits and demerits. (Unit-III, Q.No. 9, 12)

OR

7. Define Goodwill ? How does the Nature of Business and the Quality of Product affect the value of goods will of a firm ? Discuss and explain any two methods of valuation of goodwill with suitable example. **(Unit-III, Q.No. 15, 16)**
8. From the following information relation to A Limited, prepare
- Statement of changes in the requirements of working capital
 - Funds Flow statement and
 - Cash flow statement

Liabilities (Rs.000)	2013	2014	Assets (Rs.000)	2013	2014
Share capital	300	400	Cash	30	90
Reserves	100	50	Receivables	105	150
Retained Earnings	30	60	Inventories	50	195
Payables	45	135	Fixed Assets	190	210
	475	645		475	645

Additional Information:

The company purchased the worth of Rs. 40000 Furniture, Rs. 10000 Loose Tools by issue of share capital

A Piece of fixed asset, book value of which is Rs 10000/- depreciation on it is Rs. 3000/-, sold for Rs. 5000/-

Tax paid during the year Rs. 43000

Dividend paid during the year Rs. 26000

(Unit-IV, Prob. 12)

9. (a) Ramco Cements presents the following information and you are required to calculate Funds From Operation.

Dr.		Profit and Loss Account		Cr.	
Particulars	Amount	Particulars	Amount		
By Gross Profit b/d	215000				
To Operation Expenses	100000				
To Depreciation	40000	By Gain on sale of plant	5000		
To Loss on sale of building	10000				
To Advertisement suspense a/c	5000				
To Discount Allowed	500				
To Discount on issue of shares	500				
To Goodwill written off	12000				
To Net Profit c/d	52000				
	220000				220000

(Unit-IV, Prob. 13)

- (b) The Balance Sheets of National Company as on 31st December, 2017 and 2018 has been presented below :

Liabilities (Rs.)	2017	2018	Assets (Rs.000)	2017	2018
Share Capital	5,00,000	7,00,000	Buildings	80,000	1,20,000
Profit and Loss Account	1,00,000	1,60,000	Machinery	5,00,000	8,00,000
General Reserve	50,000	70,000	Stock	1,00,000	75,000
Sundry Reserve	1,53,000	1,90,000	Debtors	1,50,000	1,60,000
Bills Payable	40,000	50,000	Cash	20,000	20,000
Expenses outstanding	4,000	3,000			
Outstanding telephone Charges	3,000	2,000			
	8,50,000	11,75,000		8,50,000	11,75,000

From the above, prepare the statement of changes in the requirements of working capital.

(Unit-IV, Prob. 14)

10. Following is the summarized Balance Sheet of ABC Company as on 31-12-2015

Liabilities	Amount	Assets	Amount
Equity share capital	250000	Goodwill	20000
6% preference capital	150000	Buildings	250000
General Reserve	20000	Machinery	175000
Profit and loss Account	15000	Furniture	10000
5% Debentures	100000	Stock	90000
Sundry creditors	28000	Sundry debtors	21000
Bills payable	12000	Cash at Bank	5000
Preliminary expenses	4000		
	575000		575000

Other Information :

Total Sales Rs. 4 Lakhs. 20 percent of which is made on credit. Gross Profit and Net Profit (after tax) for the year ended amounted to Rs. 80000 and 20000 respectively.

Calculate and interpret the following ratios :

- Current Ratio
- Liquid Ratio
- Proprietary fund ratio
- Fixed Assets to proprietary fund ratio
- Debt-equity ratio
- Capital gearing ratio
- Gross Profit ratio

- h) Net Profit Ratio
- i) Stock turnover Ratio
- j) Debtors turnover ratio
- k) Return on proprietors fund
- l) Turnover to fixed assets ratio

(Unit-V, Prob. 8)

11. From the following information, prepare the Balance Sheet of PQR Company Limited as on 31-03.2012, with as many details as possible

- a) Paid up capital Rs. 50 lakhs
- b) Plant and Machinery Rs. 125 Lakhs
- c) Total Annual Sales Rs. 500 lakhs
- d) Gross profit margin 25 percent
- e) Annual Credit sales 80 percent of net sales
- f) Current ratio 2 Inventory turnover ratio 4
- g) Fixed assets turnover ratio 2
- h) Sales returns 20 percent of sales
- i) Average collection period 73 days
- j) Bank credit to trade credit 2
- k) cash to inventory 1 : 15
- i) Total debt to current liabilities 3

(Unit-V, Prob. 9)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I - Semester Examinations

October / November - 2020

R19

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 2 Hours]

[Max. Marks : 75

Answer any five questions
All questions carry equal marks

ANSWERS

1. (a) Explain briefly the basic concepts and conventions of accounting. (Unit-I, Q.No. 12, 13)
(b) "Accounting is a service activity its function is to provide qualitative information". Comment. (Unit-I, Q.No. 1)
2. (a) Explain the Methods of depreciation and their impact on measurement of business accounting. (Unit-III, Q.No. 24, 15)
(b) State the accounts involved in the following transactions and which account is to be debited and which account is credited.
April 2016
 1. Karthik commences business with Rs. 1,00,000.
 2. Purchase furniture for Rs. 5,000.
 3. Sold goods for cash Rs. 5,000.
 4. Sold goods to Raj for Rs. 20,000.
 5. Paid salaries Rs. 10,000.
 6. Purchased goods from Ram for cash Rs. 9,000.
 7. Commission received Rs. 800.
 8. Paid outstanding expenses Rs. 900. (Unit-II, Prob. 1)
3. (a) Explain the procedure for valuation of Tangible and Intangible assets. (Unit-III, Q.No. 6, 7)
(b) On January 1st, 2009 an asset was purchased for Rs. 1,50,000/-. What would be its book value after three years, if it was depreciated by straight line and written down value methods at the rate of 10% p.a.? (Unit-III, Prob. 16)
4. (a) Explain the advantages and disadvantages of single entry system. (Unit-II, Q.No. 50)
(b) The following purchases and issue were made in a company:

Date	Particulars	Units	Rate
1-8-2006	Purchases	300	Rs. 15
6-8-2006	Issues	200	
10-8-2008	Purchases	400	Rs. 20
15-8-2006	Issues	450	
22-8-2006	Purchases	400	Rs. 25

What will be the value of stock on 22-8-2006 as per FIFO method ?

(Unit-III, Prob. 1)

5. (a) What is Goodwill? Explain the methods of valuation of goodwill. (Unit-III, Q.No. 15, 16)
 (b) Explain the accounting treatment for calculation of missing figures. (Unit-II, Q.No. 57)
6. (a) Discuss briefly the major classification of cash flow as per AS-3 (revised). (Unit-IV, Q.No. 15)
 (b) Balance sheet of ABC Ltd., for two years is given below :

Liabilities	31.12.2014	31.12.2015
Share Capital	200000	260000
P&L Account	39690	41220
Reserves	50000	50000
Sundry creditors	39500	41135
Bills payable	33780	11525
Bank over draft	59510	—
Provision for taxation	40000	50000
	462480	453880

Assets	31.12.2014	31.12.2015
Goodwill	—	20000
Land and Building	112450	116200
Plant and Machinery	148000	144250
Stocks	111040	97370
Sundry Debtors	85175	72625
Bills receivable	2315	735
Cash	2500	2700
	461480	453880

Additional information:

- During the year ending 31.12.2015, an interim dividend of Rs.2600 was paid.
- Income tax paid during the year amounted to Rs.25000
- The net profit for the year before tax was Rs. 62530

You are required to prepare statement of changes on working capital, treating provision for taxation as a current liability. (Unit-IV, Prob. 11)

7. (a) "Financial analysis is a continuous process being applicable to every business to evaluate its past performance and current financial position".
 Comment. (Unit-V, Q.No. 1)
- (b) From the balance sheet given below, calculate:
- Working capital,
 - Current Ratio,
 - Acid test Ratio
 - Debt Equity Ratio,
 - Assets Proprietorship Ratio

BALANCE SHEET OF ABC COMPANY LTD.,
as on 31st December 2006

Liabilities	Amount	Assets	Amount
Shareholders fund:		Fixed assets	1,80,000
Equity share capital:	1,50,000	Current assets:	
12% Pref. share capital:	30,000	Cash in Hand:	2,000
Reserves and surplus:	24,000	Cash at bank:	4,000
	2,04,000	Sundry Debtors:	10,000
15% Debentures	48,000	Stores:	12,000
Bank overdraft:	12,000	Stock-in-Trade:	32,000
	60,000		
Sundry creditors:	16,000	Preliminary expenses	48,000
Proposed dividend:	2,000		40,000
Provision for taxation:	10,000		
Discount on issue of	4,000		
Debenture			
	2,92,000		2,92,000

(Unit-V, Prob. 7)

8. (a) Bring out a general view on Financial Accounting practices issued by ICAI. (Unit-V, Q.No. 20)
- (b) What are International Financial Reporting Standards (IFRS)? Explain. (Unit-V, Q.No. 27)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I - Semester Examinations

R19

October / November - 2021

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 2 Hours

Max. Marks : 75

Answer any five questions
All questions carry equal marks

ANSWERS

1. (a) What is accounting? Explain its objectives and principles. (Unit-I, Q.No. 1, 5, 11, 12, 13)
- (b) What is accounting system? Explain the implications of accounting system. (Unit-I, Q.No. 19)
2. (a) What is ledger ? What is meant by sub-division of ledger? (Unit-II, Q.No. 10)
- (b) Give Journal entries for the following transactions of Neeraj for the year 2017.
 - (i) Started business with cash Rs. 18,000.
 - (ii) paid rent in advance Rs. 400.
 - (iii) Purchased goods for cash Rs. 5,000 and on credit Rs. 2,000.
 - (iv) Sold goods for cash Rs. 4,000 (costing Rs. 2,400).
 - (v) Rent paid Rs. 1,000 and rent outstanding Rs. 200.
 - (vi) Bought motor-cycle for personal use Rs. 500.
 - (vii) Purchased equipments for cash Rs. 500.
 - (viii) Paid to creditors Rs. 600. (Unit-II, Prob. 2)
3. (a) What is depreciation ? Explain any two methods of depreciation. (Unit-III, Q.No. 17, 24, 25)
- (b) From the following trial balance of Goldern fair and Company, prepare trading and Profit and Loss account and Balance Sheet.

Trial Balance as on 31st December 2010.

Particulars	Debit (Rs.)	Credit (Rs.)
Cash in hand	2,400	
Purchase	2,40,000	
Stock on 1 st January 2005	70,000	
Debtor	1,00,000	
Plan and Machinery	1,20,000	
Furniture	30,000	
Bills Receivable	40,000	
Rent and Rates	20,000	

Wages	32,000	
Salaries	37,600	
Capital		2,00,000
Bills payable		44,000
Creditors		48,000
Sales		4,00,000
Total	6,92,000	6,92,000

Additional Information :

- (i) Closing inventory as on 31st December 2005 Rs. 50,000
(ii) Outstanding wages Rs. 5,000
(iii) Depreciation on Plant and Machinery at 10 percent and furniture at 5 percent.

(Unit-II, Prob. 25)

4. (a) Explain the various methods of inventory valuation.
(b) The following purchases and issue were made in a company :

(Unit-III, Q.No. 12)

Date	Particulars	Units	Rate
1-8-2006	Purchases	300	Rs. 15
6-8-2006	Issues	200	
10-8-2006	Purchases	400	Rs. 20
15-8-2006	Issues	450	
22-8-2006	Purchases	400	Rs. 25

What will be the value of stock on 22-8-2006 as per FIFO method ?

(Unit-III, Prob. 1)

5. (a) Explain the process of ascertainment of profit from incomplete records.
(b) Discuss the Accounting Treatment as per the statement of affairs method.
6. (a) "Is a Funds flow statement a better substitute for an income statement".
Comment.

(Unit-IV, Q.No. 20)

- (b) Balance Sheets of M/s Sanjay Enterprises on 1/1/1992 and 31/12/1992 were as follows :

Liabilities	1.1.92 Rs.	31.12.92 Rs.	Assets	1.1.92 Rs.	31.12.92 Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Loan from Ram	25,000	–	Debtors	30,000	50,000
Loan from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery less prov. For Depreciation	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provision for depreciation against the machinery as on 1.1.1992 was Rs. 25,000 and on 31.12.1992 was Rs. 40,000.

You are required to prepare cash flow statement.

(Unit-IV, Prob. 10)

7. (a) Explain the advantages and limitations of Ratio Analysis.

(Unit-V, Q.No. 9, 10)

(b) Calculate :

(i) Current Assets

(ii) Current Liability

(iii) Stock turnover ratio from the following formation :

Current Ratio : 2.5

Working Capital : Rs. 60,000

Opening Stock : Rs. 29,000

Closing Stock : Rs. 31,000

Sales : Rs. 3,20,000

Gross profit ratio : 25% on sales.

(Unit-V, Prob. 6)

8. (a) Explain Dupoint analysis with chart.

(Unit-V, Q.No. 17)

(b) Mention any Five Accounting Standards. Explain the significance of Accounting Standard.

(Unit-V, Q.No. 20)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA I - Semester Examinations

October / November - 2022

R19

FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours

Max. Marks : 75

Answer any five questions
All questions carry equal marks

ANSWERS

1. (a) What is an accounting cycle? List the sequential steps in accounting process. (Unit-I, Q.No. 27)
 (b) Prove that the accounting equation is satisfied in all the following transactions of Suresh.
 Commenced business with a cash Rs. 36,00,000
 Paid rent in advance Rs. 30,000
 Purchased goods for cash Rs. 18,00,000 and credit Rs. 12,00,000.
 Sold goods for cash Rs. 18,00,000 costing Rs. 12,00,000.
 Paid salary Rs. 30,000 and salary outstanding Rs. 6,000.
 Bought secondhand car for personal use Rs. 3,00,000. (Unit-I, Prob. 6)
2. (a) Explain the basic accounting principles. (Unit-I, Q.No. 11, 12, 13)
 (b) What is double entry system of accounting? What are its advantages? (Unit-I, Q.No. 23, 24)
3. Below are selected transactions from journal of PFM Co. Ltd. during the past month. Post them to respective accounts and then prepare a Trial Balance.

Date	Account Title	Debit Rs.	Credit Rs.
Sep. 01	Cash	18,55,000	
	Common Stock		18,55,000
01	Photo equipment	17,50,000	
	Cash		4,00,000
	Bills payable		13,50,000
15	Cash	5,25,000	
	Service revenue		5,25,000
26	Bills receivable	11,82,500	
	Services revenue		11,82,500
30	Cash	1,65,000	
	Bills receivable		1,65,000

(Unit-II, Prob. 11)

4. A company had bought machinery for Rs. 20,00,000 including a boiler worth Rs. 2,00,000. The machinery account had been credited for depreciation on the Reducing Instalment System for the past four years at the rate of 10% p.a. In the beginning of the fifth year, the boiler because useless on account of damage to some of its vital parts and the damaged boiler is sold for Rs. 40,000. You are required to write up the machinery account for five years.

(Unit-III, Prob. 20)

5. Gopal keeps his books by the single entry method. His position on 31st December 2020 and on 31st December 2021 are as follows :

Particulars	31 st Dec. 2020 Rs.	31 st Dec. 2021 Rs.
Cash in hand	30,000	20,000
Cash at Bank	2,50,000	2,80,000
Debtors	1,80,000	2,50,000
Stock	2,90,000	3,10,000
Furniture	50,000	60,000
Machinery	50,000	50,000
Creditors for goods	1,80,000	2,50,000
Expenses outstanding	15,000	-----
Prepaid insurance	-----	4,000

On 1st October 2020 Gopal introduced Rs. 50,000 as further capital in the business and withdrew on the same date Rs. 20,000 for personal use.

Depreciation is to be calculated on machinery at 10% p.a. A provision for doubtful debts is to be created on sundry debtors at 5%. Goods taken for personal use amounted to Rs. 15,000. Also provide interest on capital at 10% p.a.

Prepare the necessary statement showing the profit or loss made by him during the year ending 31st Dec. 2021.

(Unit-II, Prob. 33)

6. A company started on 1st January 2021 purchased raw material during 2021 as stated below:

Jan 02	800 kg.	@ Rs. 62 per kg.
Feb. 26	1,200 kg.	@ Rs. 57 per kg.
April 13	2,500 kg.	@ Rs. 59 per kg.
July 10	3,000 kg.	@ Rs. 56 per kg.
Sep. 18	1,500 kg.	@ 60 per kg.
Nov. 29	1,000 kg.	@ 65 per kg.

While preparing its final accounts on 31st Dec. 2021 the company had 1,30 kgs of raw material in its stores. Calculate the values of closing stock of raw materials according to FIFO, LIFO and weighted average basis.

(Incomplete Problem)

7. What is cash flow statement? What is fund flow statement? What are their applications? (Unit-IV, Q.No. 14, 17)
8. (a) A Company sells goods on cash as well as credit (thought not on deferred intalment terms). The following particulars are extracted from their books of accounts for the calender year 2020.

Particulars	Rs.
Total gross sales	20,00,000
Sales return	4,00,000
Total debtors for sales on 31-12-2020	1,40,000
Bills receivable on 31-12-2020	1,80,000
Provision for doubtful debts 31-12-2020	40,000
Total creditors	20,000

Calculate the average collection period. (Unit-V, Prob. 14)

- (b) What are the main ratios on which ROI depends upon? (Unit-V, Q.No. 16)