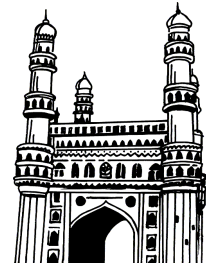


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## UNIT - I

**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 with adjustments. Rectification of Errors, Valuation of Fixed Assets -Tangible vs. Intangible assets. Depreciation, Methods of depreciation–their impact on measurement of business Accounting.

## UNIT - III

**Inventory Valuation:** Methods of inventory valuation and valuation of goodwill, methods of valuation of goodwill. 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 - IV

**Financial 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.

## UNIT - V

**Financial Analysis-II:** Analysis and interpretation of financial statements, Horizontal Analysis and Vertical Analysis of Company, Financial Statements, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart –Accounting Standards Issued by ICAI- Focus on importance of Standards to give a general view on Financial Accounting practices, International Financial Reporting Standards (IFRS).

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# 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.**

*Ans :*

### Meaning of Accounting

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 of Accounting

**According to American Accounting Association** "Accounting is the process of identifying, measuring and communicating information to permit judgement and decisions by the users."

**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."

**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."

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

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

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 :*

**Advantages of Accounting**

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 of Accounting**

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 :*

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,

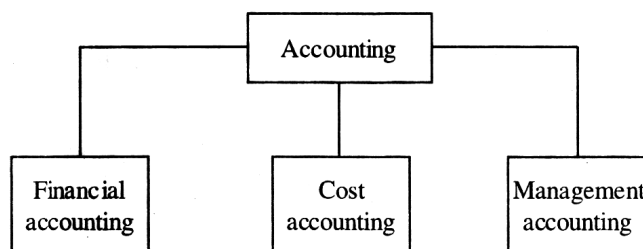


Fig: Classification of Branches of Accounting

**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.

**Compare and contrast financial accounting, cost accounting and management accounting**

Point of Difference	Financial Accounting	Cost Accounting	Management Accounting
1. <b>Objective</b>	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. <b>Periodicity</b>	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. <b>Importance</b>	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. <b>Principles</b>	It follows only some accounting principles and standards.	It is compulsory to follow all the principles and procedures in cost accounting.	
5. <b>Analysis or report</b>	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. <b>Nature</b>	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. <b>Scope</b>	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.

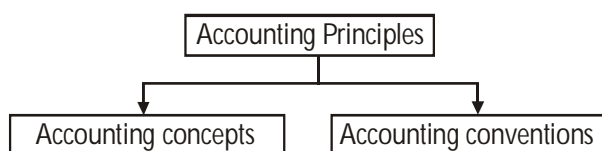
## 1.2 ACCOUNTING PRINCIPLES

### Q7. 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".



These principles are categorized into two groups.

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

#### 1.2.1 Accounting Concepts

### Q8. Explain in detail the various accounting concepts.

(or)

**Discuss the various accounting concepts.**

*Ans :*

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

### Q9. Explain in detail the various accounting conventions.

*Ans :*

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".

**Q10. 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.

**Q11. What are the limitations of accounting principles.**

*Ans :*

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)

**Q12. Explain the meaning of GAAP and identify the institutions that influence the development of GAAPs.**

*Ans :*

#### **GAAP**

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 trustworthiness. 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 practice. 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.

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**Q13. 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.

---

**Q14. 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****Q15. Explain the implications of GAAP on accounting system.***Ans :***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 help 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 help 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.

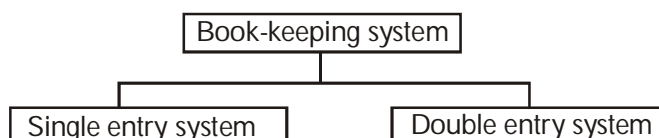
**6. Useful to Government**

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****Q16. 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.



**Q17. Define book keeping? What are the objectives of 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. Book-Keeping is the record making phase of accounting. Accounting is based on a careful and an efficient book-keeping system.

**Book-Keeping - 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".

**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."

**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 of Book-Keeping**

- 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.

**Q18. 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 :

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.

**Q19. What do you understand by double entry system? Discuss its features.**

*Ans :*

Double entry also allows for the accounting equation (assets = liabilities + owner's equity) to always be in balance. In our example involving Advertising Expense, the accounting equation remained in balance because expenses cause owner's equity to decrease. In that example, the asset Cash decreased and the owner's capital account within owner's equity also decreased.

A third aspect of double entry is that the amounts entered into the general ledger accounts as debits must be equal to the amounts entered as credits.

### Features of Double Entry System

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.

**Q20. Explain advantages and disadvantages of double entry system.**

*Ans :*

**Advantages of Double Entry System**

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 of Double Entry System**

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.

**Q21. What are business transaction? What are the principles used for recording business transactions?**

*Ans :*

**Business Transactions**

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.

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

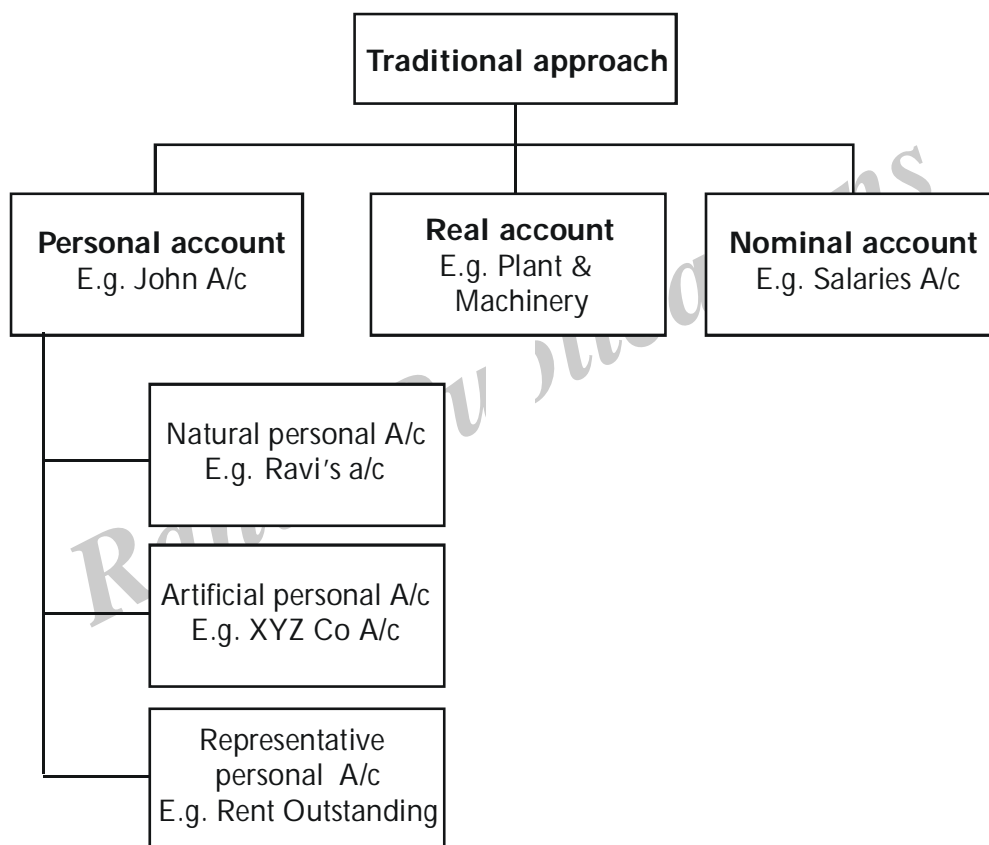
**Q22. Briefly describe the classification of accounts.**

*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:

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

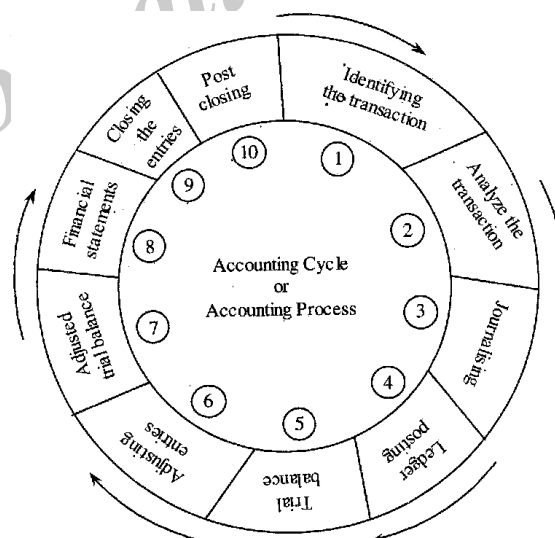
5. **Expense A/c** : These accounts relate to the amount of loss or incurred in the process of earning revenue. Ex. Purchase A/c, Loss by Theft A/c.

**1.6 ACCOUNTING CYCLE**

**Q23. What is accounting cycle ? Explain the various steps involved in it.**

*Ans :*

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.

## Short Question and Answers

### 1. Define Accounting.

*Ans :*

#### Meaning of Accounting

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 of Accounting

**According to American Accounting Association** "Accounting is the process of identifying, measuring and communicating information to permit judgement and decisions by the users."

**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."

**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."

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

### 2. Disadvantages 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**

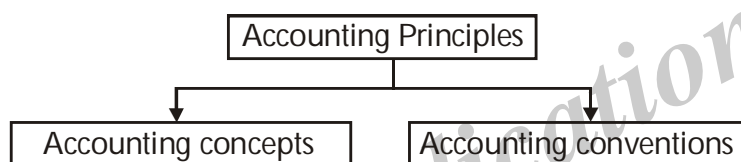
Accounting statements are influenced by the personal judgement of the accountant. He may select any method of depreciation, valuation of stock, amortisation of fixed assets, treatment of deferred revenue expenditure. Such judgement based on integrity and competency of the accountant will definitely affect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

**3. 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".



These principles are categorized into two groups.

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

**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. 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.

**5. 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,

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

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.

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**6. 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.

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**7. Generally Accepted Accounting Principles (GAAP)**

*Ans :*

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.

**8. Features of Double Entry System**

*Ans :*

The features of double entry system are as follows :

**i) 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.

**ii) Entry in Two Accounts**

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

**iii) 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.

**iv) 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.

Rahul Publications

## UNIT II

**The Accounting Process:** Overview, Books of Original Record; Journal, ledger, Trial Balance, Classification of capital and revenue expenses, Final Accounts with adjustments. Rectification of Errors, Valuation of Fixed Assets - Tangible vs. Intangible assets. Depreciation, Methods of depreciation – their impact on measurement of business Accounting.

### 2.1 THE ACCOUNTING PROCESS-OVERVIEW

**Q1. Define Accounting Process. Explain the steps involved in Accounting Process.**

*Ans :*

Accounting consists of a number of sequential steps of activities. Those include identifying, recording, classifying, summarizing and communicating financial transactions. The sequence of the steps to be followed in accounting activities is known as accounting process. The accounting process takes the form of a cycle. The sequential steps of accounting activities are taken in cyclical order. The cyclical order starts from the beginning of the transaction till financial results are derived by preparing final accounts at the end of the accounting year.

#### Steps in the Accounting Process

The accounting process is actually three separate types of transactions that are intended to record business transactions into the accounting records and then aggregate this information into financial statements. The transaction types are:

1. The first transaction type is to ensure that reversing entries from the previous period have, in fact, been reversed.
2. The second group is comprised of the steps needed to record individual business transactions in the accounting records.
3. The third group is the period-end processing required to close the books and produce financial statements.

**Q2. Explain the various Parts of Accounting Process.**

*Ans :*

There are three parts of the accounting process given below.

#### A) Beginning of Period Processing

Verify that all transactions designated as reversing entries in preceding periods have actually been reversed. These transactions are usually flagged as being reversing entries in the accounting software, so the reversal should be automatic. Nonetheless, examine the accounts at the beginning of the period to verify the reversals. It is quite possible that a reversing flag was not set, and so an entry must be reversed manually, with a new journal entry.

#### B) Individual Transactions

The steps required for individual transactions in the accounting process are:

##### 1. Identify the Transaction

First, determine what kind of transaction it may be. Examples are buying goods from suppliers, selling products to customers, paying employees, and recording the receipt of cash from customers.

##### 2. Prepare Document

There is frequently a business document to be prepared or recognized to initiate the transaction, such as an invoice to a customer or an invoice from a supplier.



**3. Identify Accounts**

Every business transaction is recorded in an account in the accounting database, such as a revenue, expense, asset, liability, or stockholders' equity account. Identify which accounts are to be used to record the transaction.

**4. Record the Transaction**

Enter the transaction in the accounting system. This is done either with a journal entry or an on-line standard transaction form (such as is used to record cash receipts against open accounts receivable). In the latter case, the transaction forms record information in a predetermined set of accounts (which can be overridden).

These four steps are the part of the accounting process used to record individual business transactions in the accounting records.

**C) Period-End Processing**

The remaining steps in the accounting process are used to aggregate all of the information created in the preceding steps, and present it in the format of financial statements. The steps are:

**1. Prepare trial balance**

The trial balance is simply a listing of the ending balances in every account. The total of all the debits in the trial balance should equal the total of all the credits; if not, there was an error in the entry of the original transactions that must be researched and corrected.

**2. Adjust the Trial Balance**

It may be necessary to adjust the trial balance, either to correct errors or to create allowances of various kinds, or to accrue for revenues or expenses in the period.

**3. Prepare adjusted Trial Balance**

This is the original trial balance, plus or minus all adjustments subsequently made.

**4. Prepare Financial Statements**

Create the financial statements from the adjusted trial balance. The asset, liability, and shareholders' equity line items form the balance sheet, while the revenue expense line items form the income statement.

**5. Close the period**

This involves shifting the balances in the revenue and expense accounts into the retained earnings account, leaving them empty and ready to receive transactions for the next accounting period.

**6. Prepare a post-closing trial balance**

This version of the trial balance should have zero account balances for all revenue and expense accounts.

In reality, any accounting software package will automatically create all versions of the trial balance and the financial statements, so the actual steps in the accounting process may be considerably reduced. Instead, the steps used in a computerized environment are likely to be:

**1. Prepare financial statements.** This information is automatically compiled from the general ledger by the accounting software.

**2. Close the period**

The accounting staff closes the accounting period that has just been completed, and opens the new accounting period. Doing so prevents current-period transactions from being inadvertently entered into the prior accounting period. In a multi-division company, it may be necessary to complete this period closing step in the software for each subsidiary.

**2.2 BOOKS OF ORIGINAL RECORD / JOURNAL**

**Q3. What is journal ? Explain the objectives of journal.**

*Ans :*

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 :**

**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."

**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."

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

**Objectives of Journal**

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.

**Q4. 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 :

- 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.
- 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.
- 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.
- Debit Amount:** The amount to be debited is recorded against debit amount in this column.
- Credit Amount:** The amount to be credited is recorded against credit amount in this column.

**Q5. 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.

**Q6. 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.

**Q7. 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. Journalise the following transactions :****2008**

<b>July 1</b>	<b>Opened a bank account</b>	<b>50,000</b>
<b>5</b>	<b>Purchased goods for cash</b>	<b>5,000</b>
<b>10</b>	<b>Purchased machinery from A</b>	<b>15,000</b>
<b>12</b>	<b>Paid wages</b>	<b>500</b>
<b>13</b>	<b>Goods sold to B for cash</b>	<b>2,000</b>
<b>15</b>	<b>Paid electricity bill</b>	<b>200</b>
<b>18</b>	<b>Paid to A on account</b>	<b>5,000</b>
<b>20</b>	<b>Sold old newspapers</b>	<b>50</b>

*Sol :***Journal**

<b>Date</b>	<b>Particulars</b>	<b>L.F.</b>	<b>Dr. Amount</b>	<b>Cr. Amount</b>
2008 July 1	Bank A/c Dr. To Cash A/c (Being an account opened with bank)		50,000	50,000
July 5	Purchases A/c Dr. To Cash A/c (Being goods purchased for cash)		5,000	5,000
July 10	Machinery A/c Dr. To A A/c (Being machinery purchased from A)		15,000	15,000
July 12	Wages A/c Dr. To Cash A/c (Being wages paid)		500	500
July 13	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		2,000	2,000
July 15	Electricity bill A/c Dr. To Cash A/c (Being electricity bill paid)		200	200
July 18	A A/c Dr. To Cash A/c (Being amount paid to A for purchase of machinery)		15,000	15,000
July 20	Cash A/c Dr. To Newspaper A/c (Being old newspaper sold)		50	50

**2. Journalise the following transactions:**

1. Paid wages Rs. 500 and salaries Rs. 1,000 and rent Rs. 1,000.
2. Bought goods from A Rs. 10,000 and paid the half amount in cash.
3. Cash received from B Rs. 2,900 and allowed him a discount of Rs. 100.
4. Withdrew for personal use, cash Rs. 900 and goods Rs. 100.
5. Purchased building Rs. 50,000 and furniture for Rs. 10,000 for cash.

*Sol :*

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
1.	Wages A/c Dr. Salaries A/c Dr. Rent A/c Dr. To Cash A/c (Being wages, salaries and rent paid in cash)		500 1,000 1,000	2,500
2.	Purchases A/c Dr. To Cash A/c To A A/c (Being goods purchased from A and half the amount paid in cash)		10,000	5,000 5,000
3.	Cash A/c Dr. Discount allowed A/c Dr. To B A/c (Being cash received and discount allowed)		2,900	100 3,000
4.	Drawings A/c Dr. To Cash A/c To Purchases A/c (Being cash and goods withdrawn by proprietor)		1,000	900 100
5.	Building A/c Dr. Furniture A/c Dr. To Cash A/c (Being building and furniture purchased)		50,000 10,000	60,000

3. Give the opening entry from following balances which appeared in the books of Mr. Mandeep Singh on 1st April, 2008:

**Assets :** Cash Balance Rs. 10,000; Bank Balance Rs. 25,000; Bills Receivable Rs. 5,000; Debtors Rs. 5,000; Stock Rs. 12,000; Investments Rs. 34,000; Machinery Rs. 75,000; Building Rs. 50,000.

**Liabilities:** Creditors Rs. 30,000; Loan Rs. 20,000; Bills Payable Rs. 13,000.

*Sol :*

### Opening Entry

In the journal of Sh. Mandeep Singh

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2008				
April 1	Cash A/c Dr.		10,000	
	Bank A/c Dr.		25,000	
	Bills Receivable A/c Dr.		5,000	
	Debtors A/c Dr.		5,000	
	Stock A/c Dr.		12,000	
	Investment A/c Dr.		34,000	
	Machinery A/c Dr.		75,000	
	Building A/c Dr.		50,000	
	To Creditors A/c			30,000
	To Loan A/c			20,000
	To Bills Payable A/c			13,000
	To Capital (Bal. Fig.)			1,53,000
	(Being the balances of previous year brought forward)			

4. 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	LF No.	Debit Amount	Credit Amount
2005 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	Mahesh A/c ..... Dr To Sales A/c [Being goods sold to Mahesh]		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



## 5. Journalize the following transactions in the journal of Mr. Ranbir Malhotra. 2004

Nov. 1<sup>st</sup> Ranbir commenced business with a capital of ₹ 1,00,000Nov. 4<sup>th</sup> Bought furniture for cash ₹ 10,000Nov. 6<sup>th</sup> Purchased goods for cash ₹ 5,000Nov. 7<sup>th</sup> Sold goods to Mr. Mahesh ₹ 25,000Nov. 10<sup>th</sup> Purchased a cycle for office use ₹ 2,000Nov. 15<sup>th</sup> Paid insurance premium ₹ 800Nov. 19<sup>th</sup> Purchased goods from Mr. Suresh ₹ 10,000Nov. 21<sup>st</sup> Rent paid ₹ 5,400Nov. 25<sup>th</sup> Returned goods to Mr. Suresh ₹ 1,250Nov. 30<sup>st</sup> Paid salaries ₹ 4,200.*Sol :*

## Journal Entries in the books of Mr. Ranbir Malhotra

Date	Particulars	L.F	Debit Amount	Credit Amount
2004 Nov. 1 <sup>st</sup>	Cash a/c Dr To Capital a/c (Being the amount invested in business)		1,00,000 –	– 1,00,000
Nov. 4 <sup>th</sup>	Furniture a/c Dr To Cash a/c (Being furniture purchased)		10,000	– 10,000
Nov. 6 <sup>th</sup>	Purchases a/c Dr To Cash a/c (Being goods purchased for cash)		5,000 –	– 5,000
Nov. 7 <sup>th</sup>	Mahesh a/c Dr To Sales a/c (Being goods sold to Mahesh on credit)		25,000 –	– 25,000
Nov. 10 <sup>th</sup>	Cycle a/c Dr To Cash a/c (Being cycle purchased for office use)		2,000 –	– 2,000
Nov. 15 <sup>th</sup>	Insurance a/c Dr To Cash a/c (Being insurance premium paid)		800 –	– 800
Nov. 19 <sup>th</sup>	Purchases a/c Dr To Suresh a/c (Being goods purchased from Suresh on credit)		10,000 –	– 10,000

Nov. 21 <sup>st</sup>	Rent a/c To Cash a/c (Being rent paid)	Dr	5,400 –	– 5,400
Nov. 25 <sup>th</sup>	Suresh a/c To Purchase return a/c (Being goods returned to Suresh)	Dr	1,250 –	– 1,250
Nov. 30 <sup>th</sup>	Salaries a/c To Cash a/c (Being salaries paid)	Dr	4,200 –	– 4,200

6. Transactions of Ravi for April, 2010 are given below. Journalize them.

2010	Particulars	₹
April 1	Ravi started business with cash	50,000
April 2	Paid into SBI .	28,000
April 3	Bought goods for cash	2,500
April 4	Drew cash from bank for office use	1,000
April 5	Sold goods to Krishna on credit	2,000
April 10	Bought from Shyam goods on credit	4,200
April 15	Received from Krishna	1900
	Allowed him discount	100
April 20	Paid to Shyam	4,100
	Discount received	100
April 30	Cash sales for the month	10,000
April 30	Paid rent	5,000
April 30	Paid salaries	5,000

Sol :

#### Journal Entries in the Books of Ravi

Date	Particulars	LF	Debit Amount	Credit Amount
2010 April-1	Cash a/c To Capital a/c (Being cash invested in business)	Dr	50,000 –	– 50,000
April-2	Bank a/c To cash a/c (Being cash deposited in bank)	Dr	28,000 –	– 28,000
April-3	Purchases a/c To Cash a/c (Being good purchased on cash)	Dr	2,500 –	– 2,500

April-4	Cash a/c To Bank a/c (Being cash withdrawn from bank for office use)	Dr	1,000 –	– 1,000
April-5	Krishna a/c To Sales a/c (Being goods sold to Krishna on credit)	Dr	2,000 –	– 2,000
April-10	Purchases a/c To Shyam a/c (Being goods purchased from Shyam on credit)	Dr	4,200 –	– 4,200
April-15	Cash a/c Discount Allowed a/c To Krishna a/c (Being cash received and discount allowed to Krishna)	Dr Dr	1,900 100 –	– – 2,000
April-20	Shyam a/c To Cash a/c To Discount received a/c (Being cash paid and discount received from Shyam)	Dr	4,200 – –	– 4,100 100
April-30	Cash a/c To Sales a/c (Being goods sold for the month on cash)	Dr	10,000 –	– 10,000
April-30	Rent a/c To Cash a/c (Being rent paid)	Dr	5,000 –	– 5,000
April-30	Salaries a/c To Cash a/c (Being salaries paid)	Dr	5,000 –	– 5,000

7. Journalise the following transactions:

2008	Particulars	(Rs.)
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**

Date 2008	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
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 cash paid to A)	Dr.		30,000 30,000
July 12	A a/c To Cash a/c (Being cash paid to A)	Dr.		3,000 3,000
July 15	Cash a/c Dr. To P a/c (Being cash received from P)		10,000	10,000
July 21	Wages a/c Dr. To Cash a/c (Being wages paid)		1,500	1,500
July 25	Furniture a/c Dr. To Cash a/c (Being furniture purchased from Sunil Kumar)		5,000	5,000
July 28	Rent a/c Dr. To Cash (Being rent paid)		5,000	5,000
July 31	Salaries a/c Dr. To Cash (Being salaries paid)		2,000	2,000

### 2.3 LEDGER

**Q8. Define ledger? Explain the advantages of 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.

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.

#### **Advantages of Ledger**

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.

**Q9. How is posting done in ledger accounting.**

*Ans :*

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.

**Q10. Distinguish between Journal Vs Ledger.***Ans :*

S.No.	Basis	Journal	Ledger
1.	<b>Meaning</b>	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.	<b>Type of book</b>	It is a book of primary record.	It is a book of final entry.
3.	<b>Process</b>	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.	<b>Organization of data</b>	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.	<b>Nature</b>	Journal is not balanced except for the cash book.	Every account in the ledger is balanced.
6.	<b>Accuracy</b>	It is very difficult to test the accuracy of the books.	The availability of lists of balances ensures easy accuracy testing.
7.	<b>Narration</b>	Narration is required for each entry.	Narration is not required.
8.	<b>Record</b>	It maintains the record in sequential manner.	It maintains the record in conclusive manner.
9.	<b>Folio</b>	It includes the ledger folio.	It includes the journal or sub-journal folio.
10.	<b>Preparation of final accounts</b>	It does not facilitate the preparation of final accounts.	It serves as a basis for the preparation of final accounts.
11.	<b>Required information</b>	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.	<b>Recording transaction</b>	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.	<b>Appearance</b>	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.	<b>Importance</b>	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 ON LEDGER**

8. Journalise the following transactions, post them in the concerned ledger accounts and balance the accounts

1997	Particulars	Rs.
Jan. 1	Manoj commenced business with	80,000
" 2	Deposited in bank	75,000
" 5	Bought goods on credit from Srinath	8,000
" 8	Sold goods to Sridhar on credit	10,000
" 10	Purchased machinery, payment made by cheque	25,000
" 12	Paid Srinath - by cheque	6,000
" 16	Received cash from Sridhar	7,500
" 20	Bought Stationery from Govind Venkatesh for cash	300
" 24	Paid Rs. 500 as travelling expenses to Mukesh	
" 27	Bought goods for cash	3,000
" 31	Paid rent to landlord by cheque	400

*Sol :*

**JOURNAL**

Date	Particulars	LF No.	Debit Amount	Credit Amount
1997 Jan 1	Cash Account Dr. To Capital Account [Being cash brought into business]		80,000	80,000
Jan 2	Bank Account Dr. To Cash Account [Being cash deposited in bank]		75,000	75,000
Jan 5	Purchases Account Dr. To Srinath's Account [Being goods purchased on credit]		8,000	8,000
Jan 8	Sridhar's Account Dr. To Sales Account [Being goods sold on credit]		10,000	10,000
Jan 10	Machinery Account Dr. To Bank Account [Being machinery purchased]		25,000	25,000
Jan 12	Srinath's Account Dr. To Bank Account [Being cheque issued to Srinath]		6,000	6,000

Jan 16	Cash Account Dr. To Sridhar's Account [Being cash received from Sridhar]	7,500	7,500
Jan 20	Stationery Account Dr. To Cash Account [Being stationery purchased for cash]	300	300
Jan 24	Travelling Expenses Account Dr. To Cash Account [Being travelling expenses paid]	500	500
Jan 27	Purchases Account Dr. To Cash Account [Being goods purchased for cash]	3,000	3,000
Jan 31	Rent Account Dr. To Bank Account [Being rent paid by cheque]	400	400

**Ledger Accounts****Capital Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 31	To Balance c/d		80,000	1997 Jan. 1	By Cash A/c		80,000
			80,000				80,000
				Jan. 1	By Balance b/d		80,000

**Bank Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 2	To Cash A/c		75,000	1997 Jan. 10	By Machinery A/c		25,000
				Jan. 12	By Srinath A/c		6,000
				Jan. 31	By Rent A/c		400
				Jan. 31	By Balance c/d		43,600
			75,000				75,000
Feb. 1	To Balance b/d		43,600				



**Purchases Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997				1997			
Jan. 5	To Srinath A/c		8,000	Jan. 31	By Balance c/d		11,000
Jan. 27	To Cash A/c		3,000				
			11,000				11,000
Feb. 1	To Balance b/d		11,000				

**Sales Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997				1997			
Jan. 10	To Balance c/d		10,000	Jan. 8	By Sridhar A/c		10,000
			10,000				10,000
				Feb. 1	By Balance b/d		10,000

**Srinath Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997				1997			
Jan. 10	To Bank A/c		6,000	Jan. 5	By Purchase A/c		8,000
Jan. 31	To Balance c/d		2,000				
			8,000				8,000
				Feb. 1	By Balance b/d		2,000

**Sridhar Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997				1997			
Jan. 10	To Sales A/c		10,000	Jan. 16	By Cash A/c		7,500
				Jan. 31	By Balance c/d		2,500
			10,000				10,000
Feb. 1	To Balance b/d		2,500				

**Machinery Account**

Dr.

Cr.

Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 10	To Bank A/c		25,000	1997 Jan. 31	By Balance c/d		25,000
			25,000				25,000
Feb. 1	To Balance b/d		25,000				

**Stationery Account**

Dr.

Cr.

Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 20	To Cash A/c		300	1997 Jan. 31	By Balance c/d		300
			300				300
Feb. 1	To Balance b/d		300				

**Travelling Expenses Account**

Dr.

Cr.

Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 10	To Cash A/c		500	1997 Jan. 31	By Balance c/d		500
			500				500
Feb. 1	To Balance b/d		500				

**Rent Account**

Dr.

Cr.

Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997 Jan. 10	To Bank A/c		400	1997 Jan. 31	By Balance c/d		400
			400				400
Feb. 1	To Balance b/d		400				

## Cash Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1997				1997			
Jan. 1	To Capital A/c.		80,000	Jan. 2	By Bank A/c		75,000
Jan. 10	To Sridhar A/c		7,500	Jan. 20	By Stationery		300
				Jan. 24	By Travelling expenses A/c		500
				Jan. 27	By Purchases A/c		3,000
				Jan. 31	By Balance (c/d)		8,700
			87,500				87,500
Feb. 1	To Balance (b/d)		8,700				

9. Enter the following transactions in the journal of Nayar and post them into ledger accounts.

1999	Particulars	Rs.
Dec. 1	Commenced business with cash	45,000
" 4	Purchased goods for cash	25,000
" 5	Paid wages	500
" 9	Goods sold for cash	8,000
" 11	Purchased goods from Lalitha	7,000
" 15	Goods sold to Sekhar	5,000
" 23	Received cash from Sekhar	1,000
" 31	Paid office Rent	400
" 31	Paid salaries	1,000

Ans :

## Journal of Nayar

Date	Particulars	LF No.	Debit Amount	Credit Amount
1999 Dec 1	Cash Account Dr To Nayar's capital account [Being capital brought into business]		45,000	45,000
Dec 4	Purchases Account Dr. To Cash Account [Being goods purchased for cash]		25,000	25,000
Dec 5	Wages Account Dr. To Cash Account [Being wages paid]		500	500

Dec 9	Cash Account Dr. To Sales Account [Being goods sold for cash]	8,000	8,000
Dec 11	Purchases Account Dr. To Lalitha's Account [Being goods purchased on credit from Lalitha]	7,000	7,000
Dec 15	Sekhar Account Dr. To Sales Account [Being goods sold to Sekhar]	5,000	5,000
Dec 23	Cash Account Dr. To Sekhar Account [Being Cash received from Sekhar]	1,000	1,000
Dec 31	Office Rent Account Dr. To Cash Account [Being Office Rent Paid]	400	400
Dec 31	Salaries Account Dr. To Cash Account [Being Salaries paid]	1,000	1,000

## Nayar's Capital Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 31	To Balance (c/d)		45,000	1999 Dec. 1	By Cash Account		45,000
			45,000				45,000
				2000 Jan. 1	By Balance (b/d)		45,000

## Cash Account

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec 1	To Nayar's capital account		45,000	1999 Dec. 4	By Purchase A/c		25,000
Dec 9	To Sales Account		8,000	Dec. 4	By Wages A/c		500
Dec 23	To Sekhar Account		1,000	Dec. 31	By Office rent A/c		400
				Dec. 31	By Salaries A/c		
				Dec. 31	By Balance (c/d)		28,100
			54,000				54,000
Jan 2000	To Balance (b/d)		28,100				

**Purchase Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 4	To Cash Account		25,000	1999 Dec. 31	By Balance (c/d)		32,000
Dec. 11	To Lalitha's A/c		7,000				
			32,000				32,000
2000 Jan. 1	To Balance (b/d)		32,000				

**Sales Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 31	To Balance (c/d)		13,000	1999 Dec. 9	By Cash Account		8,000
				Dec. 15	By Sekhar Account		5,000
			13,000				13,000
					By Balance (b/d)		13,000

**Wages Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 5	To Cash		500	1999 Dec. 31	By Balance (c/d)		500
			500				500
2000 Jan. 1	To Balance (b/d)		500				

**Lalitha's Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 31	To Balance (c/d)		7,000	1999 Dec. 11	By Purchases Account		7,000
			7,000				7,000
				2000 Jan. 1	By Balance (b/d)		7,000

**Sekhar's Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 15	To Sales Account		5,000	1999 Dec. 23	By Cash Account		1,000
				Dec. 31	By Balance (c/d)		4,000
			5,000				5,000
2000 Jan. 1	To Balance (b/d)		5,000				

**Office Rent Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 31	To Sales Account		400	1999 Dec. 31	By Balance (c/d)		400
			400				400
2000 Jan. 1	To Balance (b/d)		400				

**Salaries Account**

Dr.				Cr.			
Date	Particulars	L.F.	Amount Rs.	Date	Particulars	L.F.	Amount Rs.
1999 Dec. 31	To Cash Account		1,000	1999 Dec. 31	By Balance (c/d)		1,000
			1,000				1,000
2000 Jan. 1	To Balance (b/d)		1,000				

10. 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 Capita 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 To Cash a/c (Being cash paid to Raman)	Dr	40,000 –	– 40,000
18 Jan 07	Cash a/c To Ravi a/c (Being cash received from Ravi)	Dr	40,000 –	– 40,000
22 Jan 07	Bank a/c To Cash a/c (Being cash deposited in bank)	Dr	60,000 –	– 60,000
30 Jan 07	Rent a/c To Cash a/c (Being rent paid in cash)	Dr	5,000 –	– 5,000
31 Jan 07	Salaries a/c To Cash a/c (Being salaries paid in cash)	Dr	10,000 –	– 10,000
31 Jan 07	Electricity Bills a/c To Cash a/c (Being electricity bill paid in cash)	Dr	2,000 –	– 2,000
31 Jan 07	Insurance a/c To Cash a/c (Being insurance premium paid in cash)	Dr	5,000 –	– 5,000

## Cash Account

Dr.

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
			<b>3,30,000</b>				<b>3,30,000</b>
1.Feb.07	To Balance b/d		28,000				



**Capital a/c**

Dr.

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
			<b>2,50,000</b>				<b>2,50,000</b>
				1 Feb 07	By Balance b/c		2,50,000

**Prepaid Rent a/c**

Dr.

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
			<b>50,000</b>				<b>50,000</b>
1 Feb 07	By Balance b/d		50,000				50,000

**Furniture a/c**

Dr.

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
			<b>30,000</b>				<b>30,000</b>
1 Feb 07	By Balance b/d		30,000				

**Purchases a/c**

Dr.

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				<b>1,50,000</b>
			<b>1,50,000</b>				
	To Balance b/d		1,50,000				

**Raman's a/c**

Dr.

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				<b>50,000</b>
			<b>50,000</b>	1 Feb 07	By Balance b/d		8,000

## Purchase Returns a/c

Dr.

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
			<b>2,000</b>				<b>2,000</b>
				1 Feb 07	By Balance b/ d		2,000

## Sales a/c

Dr

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
			<b>1,00,000</b>	10 Jan 07	By Ravi a/c		60,000
							<b>1,00,000</b>
				1 Feb 07	By Balance b/d		1,00,000

## 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
			<b>60,000</b>	31 Jan 07	By Balance c/d		20,000
1 Feb 07	To Balance b/d		20,000				<b>60,000</b>

## Bank a/c

Cr.

Dr.

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
			<b>60,000</b>				<b>60,000</b>
1 Feb 07	To Balance b/d		60,000				

## Rent a/c

Dr.

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
			<b>5,000</b>				<b>5,000</b>
1 Feb.07	To Balance b/d		5,000				

**Salaries a/c**

Cr.

Dr.

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
			<b>10,000</b>				<b>10,000</b>
1 Feb.07	To Balance b/d		10,000				

**Electricity Bill a/c**

Dr.

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
			<b>2,000</b>				<b>2,000</b>
1 Feb.07	To Balance b/d		2,000				

**Insurance a/c**

Dr.

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
			<b>5,000</b>				<b>5,000</b>
1 Feb.07	To Balance b/d		5,000				

**2.4 TRIAL BALANCE**

**Q11. Define trial balance ? What are the objectives of 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. 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 of Trial Balance**

**According to Carter,** "Trial Balance is a statement of debit and credit balances derived from the ledger, including cash and bank balances."

**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."

**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."

**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 of Trial Balance

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.

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### Q12. 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.

**Q13. 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.

**Q14. 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.

**Q15. 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 ON TRIAL BALANCE****11. Prepare a trial balance as on 31<sup>st</sup> 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 31<sup>st</sup> 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	-
	54,700	54,700

12. Prepare trial balance from the information given below.

Particulars	(₹)	Particulars	(₹)
Salaries account	12,000	Furniture account	25,000
Bank account	10,000	Cash account	18,000
Mahesh (prop) capital account	50,000	Prepaid insurance account	500
Insurance paid account	2000	Outstanding rent account	1,000
Goodwill account	15,000	Plant and Machinery account	20,000
Bank loan account (taken)	40,000	Sundry creditors account	28,000
Discount received account	500	Commission received account	1,000
Sundry debtors account	18,000		

Sol :

#### Trial Balance

Particulars	Debit Amount (₹)	Particulars	Credit Amount (₹)
Salaries	12,000	Mahesh (proprietor) capital	50,000
Bank	10,000	Bank loan (taken)	40,000
Insurance paid	2000	Discount received	500
Goodwill	15,000	Prepaid insurance	500
Sundry debtors	18,000	Sundry creditors	28,000
Furniture	25,000	Commission received	1,000
Cash	18,000	Suspense a/c (b/f)	1,000
Outstanding rent	1,000		
Plant & Machinery	20,000		
	1,21,000		1,21,000

13. Ramya is not an expert in accountig she prepared the following trial abalance your are requested to correct it and prepare a correct trial balance of Ramya.

Particulars	Dr	Cr
Ramya Capital		25,500
Ramya drawings	500	
Promises	7,000	
Sales		50,000
Debtors		5,500
Purchases	20,000	
Purchase returns	2,000	
Loan from the bank		2,500
Creditors	6,000	
Trade and Office expenses	700	
Cash at Bank	1,500	
Bills Payable	1,000	
Salaries	1,300	
Opening stock		3,000
Rent	2,500	
Sales returns	6,000	
Machinery	39,000	
Discount allowed		1,000
Discount received	1,000	
Bills receivable		1,000
Sold old news paper	500	–
Old Furniture Sold	–	500

*Sol :*

#### Trial Balance

Particulars	Dr	Cr
Ramya Capital	–	25,500
Ramy drawings	500	–
Premises	7,000	–
Sales	–	50,000
Debtors	5,500	–
Purchases	20,000	–
Purchases returns	–	2,000
Loan from the bank	–	2,500



Creditors	–	6,000
Trade and Office Expenses	700	–
Cast at Bank	1500	–
Bills payable	–	1,000
Salaries	1,300	–
Opening Stock	3,000	–
Rent	2,500	–
Sales Returns	6,000	–
Machinery	39,000	–
Discount allowed	1,000	–
Discount received	–	1,000
Bills receivable	1,000	–
Sold old news papers	–	500
Old Furnitures	–	500
Total	<u>89,000</u>	<u>89,000</u>

## 2.5 CLASSIFICATION OF CAPITAL AND REVENUE EXPENSES

**Q16. What do you understand by capital expenditure? Give some examples of capital expenditure.**

*Ans :*

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:

- 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;
- The expenditure results in some more or less long term benefit to the business;
- 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

- Purchase of land, building, plant and machinery, furniture, vehicles and any other fixed asset.
- 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.

**Q17. Explain 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.

**Q18. What do you understand by Revenue expenditure? Give some examples of revenue expenditure**

*Ans :*

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.

**Q19. 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.

**Q20. Distinguish between capital expenditure and revenue expenditure.***Ans :*

Sl. 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, e.g., overhauling 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.

**Q21. 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.

**Q22. In what situations revenue expenditure becoming 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.

**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.

**2.6 FINAL ACCOUNTS WITH ADJUSTMENTS**

**Q23. 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 calendar 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.

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)

**Q24. 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 whichever 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.

**Q25. 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.

**Q26. 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 lona 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.

**2.6.1 Preparation of Trading Account****Q27. Define trading account ? What are the advantages of trading account.**

*Ans :*

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.

**Cost of Goods Sold = Purchase price of the goods + Expenses incurred on purchases**

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

**Cost of Goods Sold = Opening Stock + Net Purchases (Cash + Credit – Returns)  
+ Direct expenses – Closing stock of goods**

**Gross Profit / Loss = Net Sales – 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.

**Q28. 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
<b>Purchase expenses:</b>		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			
<b>Direct Expenses:</b>		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			(Transferred to		
and Loss account)		XX	Profit & Loss a/c)		XX
		<u>XXX</u>			<u>XXX</u>

### 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****13. 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	14,760
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			
	<u>23,640</u>			<u>23,640</u>

**14. 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		
	<u>79,450</u>		<u>79,450</u>

**15. Prepare the Trading Account from the following balances.**

	Rs.
Stock 1-1-1986	
Raw Materials	5,000
Partly finished goods	14,000
Finished goods	30,000
Purchases	50,000
Sales	1,55,000
Sales returns	2,500
Purchases Returns	2,000
Carriage & cartage	1,000
Productive wages	1,000
Coal & coke	1,000
Freight	1,000
Factory lighting & heating	2,000

Dock charges	1,000
Factory rent, rates and taxes	500
Marine Insurance	500
Stock 31-12-1986	
Raw materials	5,000
Partly finished goods	9,000
Finished goods	14,000

*Sol.:*

Dr Trading Account for the year ending 31-12-1986 Cr			
Particulars	Rs.	Particulars	Rs.
To Opening stock		By Sales	1,55,000
Raw Materials	5,000	Less : Sales returns	2,500
Partly-finished goods	14,000		1,52,500
Finished goods	30,000	By Closing stock (31-12-'86)	
To Purchase returns	50,000	Raw Materials	5,000
Less : Purchases		Partly finished goods	9,000
returns	2,000	Finished goods	14,000
	48,000		28,000
To Productive Wages	1,000		
To Freight	1,000		
To Carriage & cartage	1,000		
To Coal & Coke	1,000		
To Factory lighting and heating	2,000		
To Factory rent, rates and taxes	500		
To Marine Insurance	500		
To Dock charges	1,000		
To Gross profit	75,500		
(Transferred to profit and loss Account)			
	1,80,500		1,80,500

16. From the following information prepare trading account of Shylaja Traders for the year ending 31.12.2018:

Opening Stock	40,000
Purchases	85,000
Sales	1,80,000
Purchase Returns	3,000
Sales Returns	5,000
Wages	8,000
Carriage	2,000
Coal & Gas and Fuel	7,000
Factory Rent	4,000
Closing Stock	9,000

*Sol:*

**Trading account of Shylaja Traders  
for the year ended 31.12.2018**

Dr.

Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		40,000	By Sales	1,80,000	
To Purchases	85,000		Less: Sales Returns	5,000	1,75,000
Less: Purchase Returns	3,000	82,000	By Closing Stock		9,000
To Wages		8,000			
To Carriage		2,000			
To Coal ,Gas& Fuel		7,000			
To Factory Rent		4,000			
To Gross Profit		41,000			
(Transferred to Profit & Loss A/C)					
		1,84,000			1,84,000

**17. From the following information, prepare Trading Account of Swamy as on 31.12.2018:**

Opening Stock	8,000
Purchases	20,000
Sales	35,000
Carriage on Purchases	2,000
Factory Insurance	1,000
Gas & Water Charges	3,000
Return Inwards	2,000
Return Outwards	4,000
Wages	5,000
Import Duties	1,000
Closing Stock	6,000

*Sol.:***Trading account of Mr. Swamy for the year ended 31.12.2018**

Dr.			Cr.		
Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		8,000	By Sales	35,000	
To Purchases	20,000		Less: Sales Returns	<u>2,000</u>	33,000
Less: Purchase Returns	<u>4,000</u>	16,000	By Closing Stock		6,000
To Carriage		2,000			
To Factory Insurance		1,000			
To Gas and Water		3,000			
To Wages		5,000			
To Import Duties		1,000			
To Gross Profit (Transferred to Profit & loss A/c)		3,000			
		<u>39,000</u>			<u>39,000</u>

**2.6.2 Profit & Loss Account****Q29. What is Profit & Loss Account? What are the advantages of Profit & Loss Account?***Ans.:*

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.

**Q30. 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
<b>To Administrative Expenses</b>			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			
<b>To Selling &amp; Distribution Expenses</b>					
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			
<b>To Financial Expenses:</b>					
To Discount Allowed	XXX				
To Interest on Capital	XXX				
To Interest on Loans	XXX	XXX			
<b>To Losses:</b>					
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**

18. 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)			
	<u>26,000</u>		<u>26,000</u>

19. 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			
Profit and Loss Account for the year ending 31 -12-1995			
Dr			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 (transferred to capital account & of Balance Sheet)	22,000		
	<u>40,000</u>		<u>40,000</u>



**20. Prepare Profit & Loss A/c of Naveen Kumar Traders as on 31.03.2018**

Particulars	₹	Particulars	₹
Rent	1,500	Discount paid	3,500
Printing & Stationary	2,000	Telephone charges	1,500
Salaries & Wages	8,000	Interest	2,000
Interest received	3,000	Insurance	1,800
Bad Debts recovered	2,000	Repairs	800
Advertisements	5,000	Postage	1,200
Gross profit	39,500	Bad debts	3,200

*Sol.:***Profit & Loss A/c of Naveen Kumar Traders as on 31.12.2018****Dr.****Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Rent		1,500	By Gross Profit b/d		39,500
To Discount Paid		3,500	By Interest received		3,000
To Telephone Charges		1,500	By Bad Debts recovered		2,000
To Interest		2,000			
To Insurance		1,800			
To Repairs		800			
To Postage		1,200			
To Bad Debts		3,200			
To Printing & Stationary		2,000			
To Salaries & Wages		8,000			
To Advertisements		5,000			
To Net Profit (Transferred to Capital Account of B/S)		14,000			
		<u>44,500</u>			<u>44,500</u>

21. From the following balances, prepare Profit & Loss a/c of Harini for the year ended 31-12-2018

Particulars	₹	Particulars	₹
General Charges	475	Discount received	950
Insurance	300	Profit on Sale of Investments	1200
Rent & Taxes	250	Gross loss	500
Commission	125		
Discount	275		
Depreciation	325		
Bad Debts	450		
Carriage on sales	250		
Interest on Capital	325		

*Sol :*

**Profit & Loss A/c of Harini for the year ended 31st Dec., 2018**

Dr.

Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Gross Loss b/d		500	By Discount Received		950
To General Charges		475	By Profit on sale of investments		1200
To Insurance		300	By Net Loss		1125
To Rent and Taxes		250	(Transferred to capital a/c of balance sheet)		
To Commission		125			
To Discount		275			
To Depreciation		325			
To Bad debts		450			
To Carriage on Sales		250			
To Interest on Capital		325			
		<u>3,275</u>			<u>3,275</u>

### 2.6.3 Preparation of Balance Sheet

**Q31. What do you understand by balance sheet?**

*Ans :*

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.

### Q32. 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.

### Q33. 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.

#### **Q34. 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.

#### **Q35. 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.

#### **Q36. 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.

**Q37. 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 . . . . .**

<b>Capital and Liabilities</b>	<b>Rs.</b>	<b>Assets</b>	<b>Rs.</b>
<b>Current Liabilities</b>		<b>Current Assets</b>	
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
<b>Loans</b>		Unexpired expenses	xxx
Short term loans	xxx	Accrued income	xxx
Long term loans	xxx	<b>Fixed Assets</b>	
<i>Reserve Fund</i>		Furniture and Fittings	xxx
<b>Capital</b>	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	<b>Intangible or Invisible</b>	

			<b>Assets</b>	
	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		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.
<i>Capital</i>		<i>Intangible or Invisible Assets</i>	
Opening Balance	xxx	Goodwill	xxx
Add : Additional Capital introduced	xxx	Copy rights	
Interest on capital	xxx	Trade marks	xxx
Net Profit	xxx	Patents	xxx
	xxx	<i>Fixed Assets</i>	
		Motor vehicles	xxx
Less : Drawings	xxx	Freehold property	xxx
Interest on Drawing	xxx	Leasehold property	xxx
Income Tax	xxx	Land & Buildings	xxx
Insurance	xxx	Plant and Machinery	xxx
Premium of properties	xxx	Furniture and Fittings	xxx
	xxx	<i>Current Assets</i>	
<i>Reserve Fund</i>	xxx	Accrued Income	xxx
<i>Loans</i>		Unexpired expenses	xxx
Long term loans	xxx	Closing stock	xxx
Short term loans	xxx	Investments	xxx
<i>Current Liabilities</i>		Sundry debtors	xxx
Income received in advance	xxx	Bills Receivable	xxx
Outstanding expenses	xxx	Cash at bank	xxx
Mortgage	xxx	Cash in hand	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 MESSERS 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	By Closing Stock	12,500
To Wages	1,400		
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 MESSRS 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	<u>12,600</u>	Sundry Debtors	15,000
	21,550	Office Fixtures	500
	<u>32,875</u>		<u>32,875</u>

24. From the following balances of Ramesh, prepare trading and profit and loss account for the year ending 31st March, 2004 and a balance sheet as on that date.

Particulars	Amount	Particulars	Amount
Capital	70,000	Cash in hand	3,600
Buildings	37,500	S. Creditors	20,000
Returns Inwards	900	Debtors	14,000
Salaries	2,220	General Expenses	1,600
Discount allowed	400	Rent Paid	7,420
Stock (1.4.2003)	33,000	Drawings	1,300
Bills Payable	10,000	Electricity charges	380
Sales	1,27,000	Carriage Inwards	1,700
Purchases	93,700	Cash at Bank	6,000
Wages	5,000	Machinery	18,500
Returns Outwards	220		
Closing stock was valued at	36,420.		

*Sol.:*

**Trading and Profit and Loss Account of Ramesh as on 31.03.2004**

Particulars	Amount	Particulars	Amount
To Opening Stock	33,000	By Sales	1,27,000
To Purchases	93,700	Less: Returns	900
Less: Returns Outward	<u>220</u>	By Closing Stock	<u>36,420</u>
To Wages	5,000		
To Carriage Inward	1,700		
To Gross Profit c/d	29,340		
	<u>1,62,520</u>		<u>1,62,520</u>

To Salaries	2,220	By Gross Profit b/d	29,340
To Discount allowed	400		
To General Expenses	1,600		
To Rent	7,420		
To Electricity charges	380		
To Net Profit (carried to Capital )A/c	17,320		
	<u>29,340</u>		<u>29,340</u>

**Balance Sheet of Ramesh as on 31.03.2004**

Liabilities	Amount	Assets	Amount
Sundry Creditors	20,000	Cash in hand	3,600
Bills Payable	10,000	Cash at Bank	6,000
Capital	70,000	Debtors	14,000
Add: Net Profit	<u>17,320</u>	Closing Stock	36,420
	87,320	Machinery	18,500
Less: Drawings	<u>1,300</u>	Buildings	37,500
	<u>86,020</u>		
	<u>1,16,020</u>		<u>1,16,020</u>

25. From the following trial balance of Kerala Sons prepare trading and profit and loss account and balance sheet.

**Trial Balance as on 31.03.2003**

Debit Balances	Amount	Credit Balances	Amount
Stock at the end	19,270	Capital	90,000
Purchases less Returns	24,720	Creditors	59,160
Investments	20,000	Loans	19,500
Wages & Salaries	15,965	Reserve	2,000
Furniture	9,840	Income from Investment	453
Carriage (Inward)	2,150	Sales	94,500
Premises	25,000		
Goodwill	30,000		
Taxes & Insurance	4,175		
Trade Expenses	8,142		
Debtors	88,140		
Horses and Carts	5,165		
Stable Expenses	2,473		
Discount	928		
Bad Debts	1,485		
Bank Charges	475		
Cash in hand and at bank	7,685		
	<u>2,65,613</u>		<u>2,65,613</u>

Dr. Trading and Profit and Loss Account Kerala Sons as on 31.03.2003 Cr.			
Particulars	Amount	Particulars	Amount
To Purchase less returns	24,720	By Sales	94,500
To Wages and Salaries	15,965		
To Carriage Inward	2,150		
To Gross Profit c/d	51,665		
	<u>94,500</u>		<u>94,500</u>
To Stable Expenses	2,473	By Gross Profit b/d	51,665
To Taxes and Insurance	4,175	By Income from investments	453
To Trade Expenses	8,142		
To Discount	928		
To Bad Debts	1,485		
To Bank Charges	475		
To Net Profit	34,440		
	<u>52,118</u>		<u>52,118</u>

**Balance Sheet of Kerala Sons as on 31.02.2003**

Liabilities	Amount	Assets	Amount
Creditors	59,160	Cash in hand and at bank	7,685
Loan	19,500	Debtors	88,140
Reserve	2,000	Investments	20,000
Capital 90,000		Closing Stock	19,270
Add. Net Profit 34,440	1,24,440	Furniture	9,840
		Horses and Carts	5,165
		Premises	25,000
		Goodwill	30,000
	<u>2,05,100</u>		<u>2,05,100</u>

26. The following trial balance is extracted from the books of Vinit on 31st March, 2003. Stock is valued at Rs 11,360. Prepare Trading and Profit and Loss Account for the year ending 31st March, 2003 and a balance sheet as on that date :

Particulars	Dr. Amount	Cr. Amount
Sundry Debtors and Creditors	9,000	8,800
Cash at Bank	3,040	—
Furniture	10,000	—
Stock	9,180	—
Purchases and Sales	44,500	67,200

Returns	860	1,500
Salaries	9,000	—
Rent	1,000	—
Advertisement	400	—
Drawings	5,000	—
Printing and Stationary	100	—
Freight on Sales	180	—
Trade Expenses	1,600	—
Capital	—	16,000
Discount Received	—	360
	<u>93,860</u>	<u>93,860</u>

*Sol.:***Dr. Trading and Profit and Loss Account of Vinit as on 31<sup>st</sup> March, 2003 Cr.**

Particulars	Amount	Particulars	Amount
To Opening Stock	9,180	By Sales	67,200
To Purchases	44,500	Less : Returns	860
Less : Returns	1,500	By Closing Stock	11,360
To Gross Profit c/d	25,520		
	<u>77,700</u>		<u>77,700</u>
To Salaries	9,000	By Gross Profit b/d	25,520
To Rent	1,000	By Discount Received	360
To Advertisement	400		
To Printing and Stationery	100		
To Trade Expenses	1,600		
To Freight on Sales	180		
To Net Profit c/d	13,600		
	<u>25,880</u>		<u>25,880</u>

**Balance Sheet of Vinit as on 31.03.2003**

Liabilities	Amount	Assets	Amount
Creditors	8,800	Cash at Bank	3,040
Capital	16,000	Sundry Debtors	9,000
Add. Net Profit	13,600	Closing Stock	11,360
	29,600	Furniture	10,000
Less: Drawings	5,000		
	<u>24,600</u>		
	<u>33,400</u>		<u>33,400</u>

**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

Bad Debts + Further Bad Debts + New Provision – Old Provision

(T.B.)                      (Adjustment) (Adjustment)                      (T.B.)

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.

**18. Goods Distribution as Free Samples**

Sometimes proprietor distributes the goods as free samples for the purpose of advertisement or for increasing the sales.

**Entry:**    Free Samples A/c      Dr.

                    To Purchases A/c

(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.

**19. Charity in the form of Goods**

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.

**Entry :**    Charity A/c      Dr.

                    To Purchases A/c

(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.

**20. Commission on Net Profit Payable to Manager**

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.

**Entry:**    Manager Commission A/c Dr.

                    To Outstanding Commission A/c

(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.

**Formulas for Calculation****i) On net profit before charging such commission :**

Commission = Net Profit before Commission x

**ii) On net profit after charging such commission:**

= Net Profit after Commission x

**Process for Calculation**

- 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.

**21. Contingent Liability**

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.

**Treatment:** These are shown as footnotes below the balance sheet only.

**22. Deferred Revenue Expenditure**

Sometimes an expenditure is made, the benefit of which is likely to be derived over next few years also, this is called as deferred revenue expenditure. Therefore, the amount of expenditure is spread over the period for which benefit will accrue. Every year the amount written off is transferred to profit and loss account.

**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.

**23. Goods Sold and Despatched but Omitted to be Recorded**

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 on credit)

**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.

**24. Goods Sold on 'Sales or Return Basis**

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 goods sold on sales or return basis rectified)

**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**

**27. From the following trial balance of Mahindra Traders, prepare final accounts for the year ended 31.12.2018:**

Trial Balance		
Particulars	Debit Bal.	Credit Bal.
Capital		32,000
Salaries	1,000	
Purchases	20,000	
Purchase Returns		400
Sales		25,000
Cash	5,000	
Wages	1,200	
Factory Rent	200	
Insurance	750	
Carriage	400	
Office Expenses	800	
Carriage Outwards	200	
Machinery	10,000	
Furniture	7,000	

Discount allowed	450	
Discount received		1,600
Goodwill	5,000	
Opening stock	2,000	
Debtors	9,000	
Creditors		4,000
<b>Total</b>	<b>63,000</b>	<b>63,000</b>

**Adjustments:**

- (1) Value of Closing Stock 2,500  
 (2) Prepaid Insurance 250  
 (3) Outstanding Salaries 300

*Sol.:*

**Trading and Profit & Loss Account of Mahindra Trader's  
for the year ended 31.12.2018**

**Dr.****Cr.**

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		2,000	By Sales		25,000
To Purchases	20,000		By Closing Stock		2,500
Less: Returns	400	19,600			
To Wages		1,200			
To Factory Rent		200			
To Carriage		400			
To Gross Profit c/d		4,100			
		<u>27,500</u>			<u>27,500</u>
To Salaries	1,000		By Gross Profit b/d		4,100
Add: Outstanding Salaries	300	1,300	By Discount Received		1,600
To Insurance	750				
Less: Prepaid Insurance	250	500			
To Office Expenses		800			
To Carriage outwards		200			
To Discount allowed		450			
To Net Profit (Transferred to Capital A/c)		2,450			
		<u>5,700</u>			<u>5,700</u>

**Balance Sheet of Mahindra Trader's as on 31.12.2018**

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	32,000		Cash		5,000
Add: Net Profit	2,450	34,450	Machinery		10,000
Creditors		4,000	Furniture		7,000
Outstanding Salaries		300	Goodwill		5,000
			Debtors		9,000
			Prepaid Insurance		250
			Closing Stock		2,500
		<u>38,750</u>			<u>38,750</u>

**28. Prepare Final Accounts of Telangana Traders for the year ended 31.12.2018.****Trial Balance**

Debit Balances	Amount	Credit Balances	Amount
Opening Stock	7,000	Capital	1,00,000
Purchases	9,000	Interest	1,500
Rent	1,200	Return Outwards	500
Salaries	1,500	Sales	16,000
Wages	1,000	Commission	1,000
Carnage Inwards	1,050	Creditors	6,000
Carriage Outwards	450		
Land & Buildings	50,000		
Investments	20,000		
Loose Tools	12,000		
Discount	1,500		
Interest	500		
Telephone Charges	700		
Printing & Stationary	900		
Furniture	18,000		
Return Inwards	200		
	<u>1,25,000</u>		<u>1,25,000</u>

**Adjustments**

Closing Stock: 12000, Outstanding Wages: 500, Interest Received in Advance: 600, Commission Receivable: 400.

*Sol :*

**Trading and Profit & Loss Account of Telangana Trader's  
for the year ended 31.12.2018**

Dr

Cr

Particulars	Amount `	Amount `	Particulars	Amount `	Amount `
To Opening Stock		7,000	By Sales	16,000	
To Purchases	9,000		Less: Returns	200	15,800
Less: Returns	500	8,500	By Closing Stock		12,000
To Wages	1,000				
Add: Outstanding Wages	500	1,500			
To Carriage		1,050			
To Gross Profit c/d		9,750			
		<u>27,800</u>			<u>27,800</u>
To Salaries		1,500	By Gross Profit b/d		9,750
To Rent		1,200	By Interest Received	1,500	
			Less: Int. Recd in		
To Carriage outwards		450	advance	600	900
To Discount		1,500	By Commission	1,000	
To Interest		500	Add: Comm. Receivable	400	1,400
To Telephone charges		700			
To Printing & Stationary		900			
To Net Profit					
(Transferred to Capital A/c)		5,300			
		<u>12,050</u>			<u>12,050</u>

**Balance Sheet of Telangana Trader's as on 31.12.2018**

Liabilities	Amount `	Amount `	Assets	Amount `	Amount `
Capital	1,00,000		Land & Buildings		50,000
Add: Net Profit	5,300	1,05,300	Investments		20,000
Creditors		6,000	Loose tools		12,000
Interest Received in Advance		600	Furniture		18,000
Outstanding wages		500	Commission Receivable		400
		<u>1,12,400</u>	Closing stock		12,000
					<u>1,12,400</u>

29. From the following trial balance, prepare Mahesh Trader's final accounts for the year ended 31.03.2018:

Trial Balance

Debit Balances	Amount	Credit Balances	Amount
Opening stock	5,000	Capital	22,000
Purchases	4,700	Creditors	3,000
Wages	800	Bills Payable	5,400
Carriage	500	Discount	2,400
Rent	1,000	Sales	9,000
Salaries	1,200	Overdraft	2,000
Discount	400		
Advertisement Expenses	800		
Customs Duty	600		
Factory Insurance	300		
Machinery	12,000		
Debtors	6,000		
Furniture	9,000		
Speed post charges	700		
Bad Debts	800		
	<b>43,800</b>		<b>43,800</b>

## Adjustments

1. Value of Closing Stock: 5,400
2. Prepaid Wages: 300
3. Outstanding Rent: 400
4. Depreciation on Machinery: 5%, Depreciation on Furniture: 10%

Sol.:

**Trading and Profit & Loss Account of Mahesh Trader's  
for the year ended 31.03.2018**

Dr.

Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		5,000	By Sales		9,000
To Purchases		4,700	By Closing Stock		5,400
To Wages	800				
Less: Prepaid Wages	300	500			
To Carriage		500			
To Customs duty		600			



To Factory insurance		300			
To Gross Profit c/d		2,800			
		<u>14,400</u>			<u>14,400</u>
To Salaries		1,200	By Gross Profit b/d		2,800
To Rent	1,000		By Discount		2,400
Add: Outstanding Rent	400	1,400			
To Discount		400			
To Advertisement Expenses		800			
To Speed Post charges		700			
To Depreciation on Machinery		600			
To Depreciation on Furniture		900			
To Bad Debts		800	By Net Loss (Transferred to Capital A/c)		1,600
		<u>6,800</u>			<u>6,800</u>

**Balance Sheet of Mahesh Trader's as on 31.12.2018**

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	22,000		Machinery	12,000	
Less: Net loss	1,600	20,400	Less: Depreciation	600	11,400
Creditors		3,000	Furniture	9,000	
Bills Payable		5,400	Less: Depreciation	900	8,100
Overdraft		2,000	Debtors		6,000
Outstanding Rent		400	Prepaid Wages		300
			Closing Stock		5,400
		<u>31,200</u>			<u>31,200</u>

30. From the following trial balance of Arun Goyal, prepare trading and profit & loss account for the year ended on 31st March, 2006 and a balance sheet as on that date :

Name of Accounts	Dr.	Cr.
Capital	—	3,00,000
Drawings	22,000	—
Fixed Assets	2,90,000	—
Purchases and Sales	3,40,000	6,50,000
Returns Inwards	8,000	—
Returns Outwards	—	6,000
Carriage	15,600	—
Wages	36,000	—

Salaries	20,000	—
Rent	—	13,000
Insurance	1,200	—
Audit Fees	500	—
Debtors and Creditors	1,68,000	47,500
Bills Receivable and Bills Payable	4,800	3,600
Printing and Stationery	1,500	—
Commission	—	400
Opening Stock	45,000	—
Cash in hand	14,300	—
Cash at bank	62,250	—
Bank Loan	—	10,000
Interest on Loan	1,350	—
	<u>10,30,500</u>	<u>10,30,500</u>

**Adjustments**

1. Stock at the end Rs. 51,700.
2. Depreciate fixed assets by 10%.
3. Allow 7% p.a. interest on capital and charge Rs. 2,600 as interest on drawings.
4. Rent received in advance Rs. 1,000.
5. Commission earned but not received amounted to Rs. 150.
6. Interest on bank loan @ 18% p.a. is unpaid for the last 3 months.

*Sol.:*

**Trading and Profit and Loss Account for the  
year ending 31st March, 2006**

**Dr.****Cr.**

Particulars	Amount	Particulars	Amount
To Opening Stock	45,000	By Sales	6,50,000
To Purchases	3,40,000	Less: Returns	8,000
Less: Returns	6,000		<u>        </u>
	3,34,000	By Closing Stock	51,700
To Carriage	15,600		
To Wages	36,000		
To Gross Profit c/d	2,63,100		
	<u>6,93,700</u>		<u>6,93,700</u>

To Salaries	20,000	By Gross Profit b/d	2,63,100
To Insurance	1,200	By Rent	13,000
To Audit Fees	500	Less: Received in Advance	1,000
To Printing and Advertising	1,500	By Commission	400
To Interest on Loan	1,350	Add: Accrued Commission	150
Add: Outstanding Interest	450	By Interest on Drawings	2,600
To Depreciation on Fixed Assets	29,000		
To Interest on Capital	21,000		
To Net Profit c/d	2,03,250		
	<u>2,78,250</u>		<u>2,78,250</u>

## Balance Sheet as on 31-03-2006

Liabilities	Amount	Assets	Amount
Bills Payable	3,600	Cash in hand	14,300
Creditors	47,500	Cash at Bank	62,250
Bank Loan	10,000	Bills Receivable	4,800
Add: Outstanding Interest	450	Debtors	1,68,000
Rent Received in Advance	1,000	Closing Stock	51,700
Capital	3,00,000	Accrued Commission	150
Add: Interest on Capital	21,000	Fixed Assets	2,90,000
Add: Net Profit	2,03,250	Less: Depreciation	29,000
	<u>5,24,250</u>		<u>2,61,000</u>
Less: Drawings	22,000		
Less: Interest on Drawings	2,600		
	<u>4,99,650</u>		
	<u>5,62,200</u>		<u>5,62,200</u>

31. From the following figures, prepare the trading and profit and loss account for the year ended on 31 st December, 2008 and the balance sheet as on that date :

Particulars	Rs.
Stock on 1-1-2008	2,000
Book Debts	2,000
Plant and Machinery	1,000
Wages	500

Salaries	200
Capital	5,000
Land and Building	3,000
Creditors	1,000
Bad Debts	100
Trading Expenses	250
Provision for Bad Debts	950
Discount Received	50
Purchases	10,000
Sales	15,000
Cash	2,000
Drawings	1,050

The following adjustments are to be made :

- Stock on 31st December, 2008 was of Rs. 2,500.
- Make a provision of 5% on debtors.
- Bad debts Rs. 200.
- Write off 10% depreciation on plant and machinery.
- Due to salesman for salary Rs. 50.
- Wages paid in advance for Rs. 20
- Make a provision for discount on debtors and creditors @2%.

*Sol.:*

**Trading and Profit & Loss A/c as on 31-12-2008**

Dr		Cr	
Particulars	Amount	Particulars	Amount
To Opening Stock	2,000	By Sales	15,000
To Purchases	10,000	By Closing Stock	2,500
To Wages 500			
Less: Prepaid Wages 20	480		
To Gross Profit c/d	5,020		
	17,500		17,500
To Salaries 200		By Gross Profit b/d	5,020
Add: Outstanding Salary 50	250	By Discount Received	50
To Trading Expenses	250	By Old Provision	950
To Depreciation on Machinery	100	Less: Bad Debts	100
To Provision for Discount on Debtors	34.20		850
To Net Profit c/d	5115.80	Less: Further Bad Debts	200
			650
		Less: New Provision	90
		By Provision for Discount on Creditors	20
	5,650		5,650

### Balance Sheet as on 31-12-2003

<b>Liabilities</b>		<b>Amount</b>	<b>Assets</b>		<b>Amount</b>
Creditors	1,000		Cash		2,000
Less: Prov. for Discount on creditors	20	980	Book Debts	2,000	
	<u>          </u>				
Capital	5000		Less: Further Bad debts	200	
Add: New Profit	5115.80			<u>      </u>	
	<u>10115.80</u>		Less: New Provision for Doubtful Debts on 1800 @ 5%	90	
Less: Drawings	1050.00	9,065.80		<u>      </u>	
	<u>          </u>			1710	
Outstanding Salary		50	Less: Provision for Discount on Debtors @ 2%	34.20	1,675.80
				<u>      </u>	
			Plant and Machinery	1,000	
			Less: Depreciation	100	900
				<u>      </u>	
			Land and Building		3,000
			Prepaid Wages		20
			Closing Stock		2,500
					<u>      </u>
					10,095.80
					<u>10,095.80</u>

32. From the following balances of Ramesh, prepare trading and profit and loss account for the year ending 31st March, 2004 and a balance sheet as on that date.

Particulars	Amount	Particulars	Amount
Capital	70,000	Cash in hand	3,600
Buildings	37,500	S. Creditors	20,000
Returns Inwards	900	Debtors	14,000
Salaries	2,220	General Expenses	1,600
Discount allowed	400	Rent Paid	7,420
Stock (1.4.2003)	33,000	Drawings	1,300
Bills Payable	10,000	Electricity charges	380
Sales	1,27,000	Carriage Inwards	1,700
Purchases	93,700	Cash at Bank	6,000
Wages	5,000	Machinery	18,500
Returns Outwards	220		
Closing stock was valued at	36,420		

*Sol.:***Dr                      Trading and Profit and Loss Account of Ramesh as on 31.03.2004                      Cr**

Particulars	Amount	Particulars	Amount
To Opening Stock	33,000	By Sales	1,27,000
To Purchases	93,700	Less: Returns	900
Less: Returns Outward	220	By Closing Stock	36,420
To Wages	5,000		
To Carriage Inward	1,700		
To Gross Profit c/d	29,340		
	1,62,520		1,62,520
To Salaries	2,220	By Gross Profit b/d	29,340
To Discount allowed	400		
To General Expenses	1,600		
To Rent	7,420		
To Electricity charges	380		
To Net Profit (carried to Capital )A/c	17,320		
	29,340		29,340

**Balance Sheet of Ramesh as on 31.03.2004**

Liabilities	Amount	Assets	Amount
Sundry Creditors	20,000	Cash in hand	3,600
Bills Payable	10,000	Cash at Bank	6,000
Capital	70,000	Debtors	14,000
Add: Net Profit	17,320	Closing Stock	36,420
	87,320	Machinery	18,500
Less: Drawings	1,300	Buildings	37,500
	86,020		
	1,16,020		1,16,020

33. From the following trial balance of Arun Goyal, prepare trading and profit & loss account for the year ended on 31st March, 2006 and a balance sheet as on that date:

Name of Accounts	Dr.	Cr.
Capital	—	3,00,000
Drawings	22,000	—
Fixed Assets	2,90,000	—
Purchases and Sales	3,40,000	6,50,000
Returns Inwards	8,000	—

Returns Outwards	—	6,000
Carriage	15,600	—
Wages	36,000	—
Salaries	20,000	—
Rent	—	13,000
Insurance	1,200	—
Audit Fees	500	—
Debtors and Creditors	1,68,000	47,500
Bills Receivable and Bills Payable	4,800	3,600
Printing and Stationery	1,500	—
Commission	—	400
Opening Stock	45,000	—
Cash in hand	14,300	—
Cash at bank	62,250	—
Bank Loan	—	10,000
Interest on Loan	1,350	—
	<u>10,30,500</u>	<u>10,30,500</u>

**Adjustments**

1. Stock at the end Rs. 51,700.
2. Depreciate fixed assets by 10%.
3. Allow 7% p.a. interest on capital and charge Rs. 2,600 as interest on drawings.
4. Rent received in advance Rs. 1,000.
5. Commission earned but not received amounted to Rs. 150.
6. Interest on bank loan @ 18% p.a. is unpaid for the last 3 months.

*Sol :***Dr Trading and Profit and Loss Account for the year ending 31<sup>st</sup> March, 2006 Cr**

Particulars	Amount	Particulars	Amount
To Opening Stock	45,000	By Sales	6,50,000
To Purchases	3,40,000	Less: Returns	8,000
Less: Returns	6,000		
	<u>3,34,000</u>	By Closing Stock	51,700
To Carriage	15,600		
To Wages	36,000		
To Gross Profit c/d	2,63,100		
	<u>6,93,700</u>		<u>6,93,700</u>

To Salaries	20,000	By Gross Profit b/d	2,63,100
To Insurance	1,200	By Rent	13,000
To Audit Fees	500	Less: Received in Advance	1,000
			12,000
To Printing and Advertising	1,500	By Commission	400
To Interest on Loan	1,350	Add: Accrued Commission	150
			550
Add: Outstanding Interest	450	By Interest on Drawings	2,600
To Depreciation on Fixed Assets	29,000		
To Interest on Capital	21,000		
To Net Profit c/d	2,03,250		
	2,78,250		2,78,250

**Balance Sheet as on 31-03-2006**

Liabilities	Amount	Assets	Amount
Bills Payable	3,600	Cash in hand	14,300
Creditors	47,500	Cash at Bank	62,250
Bank Loan	10,000	Bills Receivable	4,800
Add: Outstanding Interest	450	Debtors	1,68,000
Rent Received in Advance	1,000	Closing Stock	51,700
Capital	3,00,000	Accrued Commission	150
Add: Interest on Capital	21,000	Fixed Assets	2,90,000
Add: Net Profit	2,03,250	Less: Depreciation	29,000
			2,61,000
	5,24,250		
Less: Drawings	22,000		
Less: Interest on Drawings	2,600		
	4,99,650		
	5,62,200		5,62,200

34. Mr. A, a shop keeper, had prepared the following Trial Balance from his ledger as on 31st March, 2008.

Particulars	Amount	Particulars	Amount
Purchases	3,10,000	Motor Car	48,000
Sales	4,15,000	Bad Debts	2,000
Stock of goods as on 1.4.2007	50,000	Cash Discount allowed	4,000
Cash in Hand	2,100	General Expenses	14,000
Cash at Bank	12,000	Carriage Inwards	10,000
Mr. A's Capital	2,88,600	Carriage Outwards	22,000
Drawings	4,000	Outstanding Liability for Expenses	11,000



Rates and Taxes	5,000	Sundry Creditors	40,000
Salaries	32,000	Sundry Debtors	1,00,000
Postage and Telephone	11,500	Advertising	17,000
Salesman's Commission	35,000	Furniture and Fittings	22,000
Insurance	9,000	Printing and Stationery	3,000
Wages	20,000		

**Additional Information:**

- Cost of goods in stock as on 31 st March, 2008 ` 1,45,000.
- Mr. A had withdrawn goods worth ` 5,000 during the year.
- Printing and Stationery ` 11,000 relating to previous accounting year had not been provided in that year but was paid in this year by debiting outstanding liabilities.
- Purchases include purchase of furniture worth ` 10,000.
- Debtors include ` 5,000 bad debts.
- Creditors include purchases of 4,000 to the credit of L.M. Corporation in respect of which it has been decided and settled with the party to pay only ` 1,000.
- Sales include goods worth ` 15,000 sent to S.M. and Co., on approval and remaining unsold as on 31st March. The cost of the goods was 10,000.
- Provision for doubtful debts is to be created at 5% of Sundry Debtor.
- Depreciate furniture and fittings by 10%. Motor Car by 20%.
- The Salesmen are entitled to a commission of 10% on sales.

Prepare the Trading and Profit and Loss Account for the year ending on 31st March, 2008 and balance sheet as on that date.

*Sol :*

**Trading and Profit and Loss Account of Mr. A  
for the year ended 31st March, 2008**

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening Stock	50,000	By Sales	4,15,000
		<b>Less:</b> Sales Return	15,000
To Purchases	3,00,000		4,00,000
<b>Less:</b> Returns	5,000	By Closing Stock	1,45,000
	2,95,000	<b>Add:</b> Goods sent on approval	10,000
To Wages	20,000		1,55,000
To Carriage Inward	10,000		
To Gross Profit c/d	1,80,000		
	5,55,000		5,55,000

To Salaries	32,000	By Gross Profit b/d	1,80,000
To Rates and Taxes	5,000	By Miscellaneous Income	
To Postage and Telephone	11,500	(` 4,000 – ` 1,000)	3,000
To Insurance	9,000		
To Printing and Stationery	3,000		
To General Expenses	14,000		
To Depreciation on:			
Furniture	3,200		
Motor Car	9,600		
To Advertising	17,000		
To Carriage Outward	22,000		
To Bad Debts	7,000		
To Cash Discount	4,000		
To Provision for Doubtful Debts	4,000		
To Salesmen Commission	40,000		
To Net Profit transferred to Capital A/c	1,700		
	<u>1,83,000</u>		<u>1,83,000</u>

**Balance Sheet of Mr. A**  
**as on 31st March, 2008**

Liabilities			Assets		
Capital Account:			Fixed Assets:		
Opening Balance	2,88,600		Furniture and Fittings	22,000	
<b>Add:</b> Net Profit	1,700		<b>Add:</b> Addition	<u>10,000</u>	
				32,000	
	<u>2,90,300</u>		<b>Less:</b> Depreciation	<u>3,200</u>	28,800
<b>Less:</b> Drawings	9,000		Motor Car	48,000	
<b>Less:</b> Stationery & Printing			<b>Less:</b> Depreciation	<u>9,600</u>	38,400
for previous year	<u>11,000</u>	2,70,300	Stock in trade (at cost)		1,55,000
Current Liabilities:			Current Assets:		
Sundry Creditors (` 40,000 – ` 3,000)		37,000	Sundry Debtors	80,000	
Liability for Expenses (Salesmen Commission)		5,000	<b>Less:</b> Provision @ 5%	<u>4,000</u>	76,000
			Cash at Bank		12,000
			Cash in Hand		2,100
		<u>3,12,300</u>			<u>3,12,300</u>

**2.7 RECTIFICATION OF ERRORS**

**Q40. 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**

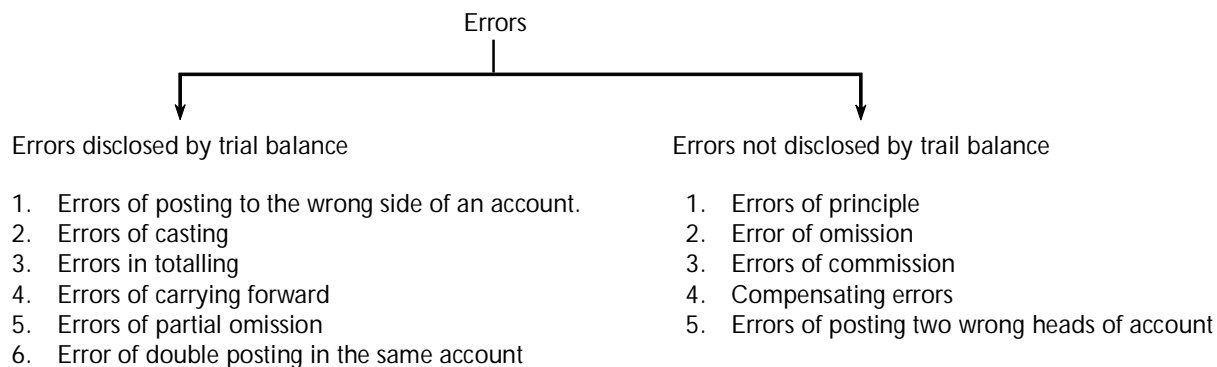
- i) Error of omission,
- ii) Error of commission.
  - a) Taking wrong account
  - b) Taking wrong amount
  - c) Taking to the wrong side

**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.

**(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 for recording credit purchases of goods meant for resale and not fixed assets. Trial 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.

---

**Q41. 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

**Q42. 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.

**Q43. Define Suspense Account.**

*Ans :*

Sometimes, despite of an accountant's best efforts, the trial balance may not agree. In such circumstances, the difference between the debit and credit totals should be transferred to an account

called Suspense Account. By doing so, the trial balance is made to agree and delay in the preparation of final accounts can be avoided.

Suspense account is an imaginary account, opened and used as a temporary measure to make two sides of the trial balance agree. As and when the errors which caused the disagreement in trial balance are detected, rectification entries should be passed through suspense account. Detection and rectification of all the errors will result in the automatic closure of Suspense Account'.

If the debit total in the trial balance is in excess of credit total, suspense account should be credited with the difference. Similarly, suspense account should be debited with the difference when credit side total is more than the debit side total. In other words, suspense account will appear on that side of the trial balance whose total is less than the total of other side.

Following points should be kept in mind while passing rectification entries through 'Suspense Account'.

- i) Suspense account is used to rectify those errors which affect the trial balance.
  - a) If the account which is to be rectified is debited in the rectifying entry, suspense account will be credited to complete the double entry.
  - b) If the account which is to be rectified is credited in the rectifying entry, suspense account will be debited to complete the double entry.

#### Q44. Explain the impact of errors on profits.

*Ans :*

The error affects the nominal account/ accounts, it will increase or decrease the profit because all nominal accounts are transferred to Trading and Profit and Loss Account. In this connection following points may be noted:

#### 1. Profit will increase or loss will reduce if a transaction is omitted to be debited to a nominal account

On rectification of an error of such a type, profit will decrease or loss will increase.

For example, depreciation on furniture' is omitted to be posted to Depreciation Account. This error will increase profit because depreciation will not be debited to Profit and Loss Account-. Depreciation Account will be debited on rectification of this error and as a result, profit will reduce.

#### 2. Similarly, profit will reduce or loss will increase if a nominal account is wrongly debited

With the rectification of such an error, profit will increase or loss will decrease.

For example, an amount of ` 1,000 spent on erection of machinery wrongly debited to Repairs Account instead of Machinery Account will reduce net profit by ` 1,000.

On rectification of this error, Machinery Account will be given debit and Repairs Account will be credited. Consequently, profit will increase because Repairs Accounts will be transferred to the credit side of Profit and Loss Account.

#### 3. Profit will increase or loss will decrease if a nominal account is wrongly credited

With the rectification of this type of error, profit will decrease or loss will increase.

For example, overcasting of the Sales Book by ` 100 will give more credit to Sales Account and consequently profit will increase. On rectification, Sales Account will be debited with ` 100 to cancel the excess credit given previously, so profit will reduce by ` 100.

#### 4. Profit will decrease or loss will increase if a transaction is omitted to be credited to a nominal account

On rectification, the nominal account omitted to be credited will be credited and Profit will increase or loss will reduce.

Thus, profit is increased or decreased on account of errors in nominal accounts. Balance Sheet will also be affected by the errors in nominal accounts because profit is ultimately transferred to Capital Account which is a part of the Balance Sheet. So, it can be concluded that errors in nominal accounts will affect both Profit and Loss Account and Balance Sheet.



**PROBLEMS ON RECTIFICATION OF ERRORS****35. 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**

Sl. 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 a/c 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

**36. Rectify the following through passing Journal Entries:**

- a) Office Furniture bought for ₹ 7200 wrongly debited to Office Expenses A/c.
- b) A credit sale ₹ 1500 to Pradeep has been passed through purchases book.
- c) Received cheque for amount ₹ 1600 from Venkat is dishonoured and wrongly entered in Sales Return Book.

- d) Goods sold to Sudha ₹ 4000, not recorded in the Books.  
 e) ₹ 12000 received from Sudheer has been wrongly credited to Sandeep's A/c.

*Sol.:*

**Rectification Entries**

Sl. 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

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

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

*Sol.:***Rectification Entries**

Sl. 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

**38. Rectify the following errors.**

- Received cash from Laitha ₹ 200 has been posted to her account as ₹ 180.
- Goods sold to Ashok ₹ 75 were omitted to be entered in his account.
- Credit side of Hari's account was overcast by ₹ 200.
- Goods returned from Ramesh ₹ 650 were not posted to his account.
- Sales book under cast by ₹ 500.

*Sol.:***Rectification Entries**

Sl. No.	Particulars	L.F	Debit (₹)	Credit (₹)
a)	Suspense a/c Dr. To Lalitha a/c (Being wrong amount recorded in the Lalitha a/c rectified)		20	20
b)	Ashok a/c Dr. To Suspense a/c (Being the omission of posting of sales to Ashok account rectified)		75	75
c)	Hari's a/c Dr. To Suspense a/c (Being credit side of Hari's a/c over casting rectified)		200	200
d)	Suspense a/c Dr. To Ramesh's a/c (Being the omission of posting of sales returns in Ramesh a/c now rectified)		650	650
e)	Suspense a/c Dr. To Sales a/c (Being rectification of overcast in Sales Book)		500	500

**39. Rectify the following errors.**

- a) Received cash from Anand ` 188 has been posted to his a/c as ` 180.
- b) Goods sold to Vardlian ` 75 were omitted to be entered in his account.
- c) Credit side of Dikshith account was overcast by ` 20.
- d) Goods returned by Radhika ` 35 was not posted to her account.

*Sol. :***Rectification Entries**

Sl. No.	Particulars	L.F	Debit (₹)	Credit (₹)
a)	Suspense a/c Dr. To Anand a/c (Being wrong amount recorded in the Anand a/c rectified)		8	8
b)	Vardhan a/c Dr. To Suspense a/c (Being the omission of posting of sales to Vardhan account rectified)		75	75
c)	Dikshith a/c Dr. To Suspense a/c (Being credit side of Dikshith a/c over casting rectified)		20	20
d)	Suspense a/c Dr. To Radhika's a/c (Being omission of posting of sales returns in Radhika account rectified)		35	35

**40. Rectify the following errors with the help of Suspense a/c**

- a) Purchases book overcast by ` 400.
- b) Purchases returns book undercast ` 260.
- c) ` 660 received from Sunder has been entered in his account ` 1160.
- d) Goods sold to Param for ` 550 was posted to his account as ` 450.
- e) ` 1050 received from Kiran were posted to the debit side of his account.

Sol.:

## Rectification Entries

Sl. No.	Particulars	L.F	Debit (₹)	Credit (₹)
a)	Suspense a/c Dr. To Purchase a/c (Being the entry to rectify over casting of purchase book)		400	400
b)	Suspense a/c Dr. To Purchases Returns a/c (Being the entry to rectify under casting of purchases returns book)		260	260
c)	Sunder's a/c Dr, To Suspense a/c (Being the entry to rectify under casting of purchase returns book)		1000	1000
d)	Param a/c Dr. To Suspense a/c (Being credit sale to Rajesh ₹. 550, posted as ₹. 450 is rectified)		100	100
e)	Suspense a/c Dr. To Kiran a/c (Being instead of credit, debit given to Kiran a/c is rectified)		2100	2100

41. An accountant could not tally the Trial balance. The difference of ₹ 5,180 was temporarily placed to the credit of suspense account for preparing the final accounts. The following errors were later located.

- Commission of ₹ 500 paid, was posted twice, once to discount allowed account and once to commission account.
- The sales book was undercast by ₹ 1,000.
- A credit sale of ₹ 2,780 to Sudha though correctly entered in sales book, was posted wrongly to her account as ₹ 3,860.
- A credit purchase from Nataraj of ₹ 1,500, though correctly entered in purchases book, was wrongly debited to his personal account
- Discount column of the payments side of the cash book was wrongly added as ₹ 2,800 instead of ₹ 2,400.

You are required to pass necessary rectifying entries and prepare suspense account.

*Sol.:***Rectification Entries**

Sl. No.	Particulars	L.F	Debit (₹)	Credit (₹)
a)	Suspense A/c Dr. To Discount allowed A/c (Amount wrongly debited to discount account, now rectified)		500	500
b)	Suspense A/c Dr. To Sales A/c (Sales book undercast by ₹ 1000, now rectified)		1000	1000
c)	Suspense A/c Dr. To Sudha A/c (Wrong posting of sale of ₹ 2,780 to Sudha as ₹ 3,860, now rectified)		1080	1080
d)	Suspense A/c Dr. To Nataraj A/c (Credit purchase of ₹ 1,500 from Nataraj wrongly debited to his personal account now rectified]		3000	3000
e)	Discount received A/c Dr. To Suspense A/c (Excess credit in discount account, now rectified)		400	400

42. The books of account A Co. Ltd for the year ending 31st December, 2013 were closed with a difference in books carried forward. The following errors were detected in 2014:

- Returns Outward Book was undercast by ₹ 150.
- ₹ 1,500 being the total of the discount column on the credit side of the Cash Book was not posted in General Ledger.
- ₹ 6,000 being the cost of purchase of office furniture was entered in the Purchase Account.
- A credit sale of ₹ 760 was wrongly posted as ₹ 670 to the Customer's Account in the Sales Ledger.
- Closing stock was overstated by ₹ 9,000, being casting error in the schedule of inventory.

Pass rectification entries, prepare Suspense Account and find out the effect of corrections on 2013 profit.

*Sol.:*

**In the books of A. Co Ltd.  
Journal**

Date	Particulars	L.F.	Dr. ₹.	Cr. ₹.
(a)	Suspense A/c Dr. To Profit & Loss Adjustment A/c (Being return outward book was undercast by ₹.150, now rectified)		150	150
(b)	Suspense A/c Dr. To Profit & Loss Adjustment A/c (Being discount received was not posted from Cash Book to Ledger, now rectified)		1,500	1,500
(c)	Office Furniture A/c Dr. To Profit & Loss Adjustment A/c (Being purchase of office furniture was wrongly entered in the Purchases A/c, now rectified)		6,000	6,000
(d)	Customer A/c Dr. To Suspense A/c (Being credit sale of ₹. 760 was wrongly posted as ₹. 670 to the Customer's A/c, now rectified)		90	90
(e)	Profit & Loss Adjustment A/c Dr. To Opening Stock A/c (Being closing stock was overcast by ₹. 9,000, now rectified)		9,000	9,000

Dr.			Suspense Account			Cr.	
Date	Particulars	₹.	Date	Particulars	₹.		
	To Profits Loss Adjustment A/c	150		By Balance b/f (Balancing figure)	1,560		
	To Profit & Loss Adjustment A/c	1,500		By Customer A/c	90		
		<u>1,650</u>			<u>1,650</u>		

Dr.			Profit & Loss Adjustment Account			Cr.	
Date	Particular	₹.	Date	Particular	₹.		
	To Opening Stock A/c	9,000		By Suspense A/c	150		
				By Suspense A/c	1,500		
				By Office Furniture A/c	6,000		
				By Net Profit (transferred)	1,350		
		<u>9,000</u>			<u>9,000</u>		

**Note : Effect of correction on 2013 profit** – Profit will be reduced by ₹. 1,350 subject to Depreciation on Furniture of ₹. 6,000.

43. The Trial Balance of M/s Roy & Sen & Co at 31.3.2013 did not agree. In order to close the books, the accountant placed the difference to the Suspense Account newly opened and carried forward this difference to the next period for necessary adjustments. Later, the following errors, arising in 2012-2013 were detected:

- (a) An item of purchase of ₹. 162 was recorded in the Purchase Day Book as ₹. 62 and posted to the debit of the Supplier's Account as ₹. 26.
- (b) Sales Day Book was overcast by ₹. 100 in January, 2013.
- (c) Furniture purchased for ₹. 2,500 cash was posted to the Purchase Account in the Ledger.
- (d) Credit sale of ₹. 97 was posted to the credit of the Customer's Account as ₹. 79.
- (e) ₹. 50 allowed as cash discount to a trade debtor was not debited to the Discount Account.

Show the necessary Journal entries to rectify these errors and show Suspense Account; and Profit and Loss Adjustment Account and state the ultimate effect of these correcting entries in the books for 2012-2013.

*Sol. :*

**In the books of M/s Roy & Sen & Co  
Journal**

Date	Particulars	L.F.	Dr. ₹.	Cr. ₹.
(a) April 1	Profit & Loss Adjustment A/c Dr. Suspense A/c Dr. To Supplier A/c (Being purchase of ₹.162 entered in the Purchases Book as ₹. 62 but posted to the debit of Supplier A/c as ₹. 26, now rectified)		100 88	188
(b)	Profit & Loss Adjustment A/c Dr. To Suspense A/c (Being Sales Day Book was overcast by ₹. 100, now rectified)		100	100
(c)	Furniture A/c Dr. To Profit & Loss Adjustment A/c (Being furniture purchased has been posted to the Purchases A/c, now rectified)		2,500	2,500
(d)	Customer A/c To Suspense A/c (Being credit sale of ₹. 97 wrongly posted to the credit of Customer's A/c, as ₹. 79)		176	176
(e)	Profit & Loss Adjustment A/c Dr. To Suspense A/c (Being discount allowed not posted to Discount Allowed A/c, now rectified)		50	50



Dr.			Suspense Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
	To Balance b/f (Balancing figure)	238		By Profit & Loss Adjustment A/c	100			
	To Supplier A/c	88		By Customer A/c	176			
				By Profit & Loss Adjustment A/c	50			
		<u>326</u>			<u>326</u>			
Dr.			Profit & Loss Adjustment Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
	To Supplier's A/c	100		By Furniture A/c	2,500			
	To Suspense A/c	100						
	To Suspense A/c	50						
	To Partners' Capital A/c	2,250						
		<u>2,500</u>			<u>2,500</u>			

## 2.8 VALUATION OF FIXED ASSETS

**Q45. Define fixed assets. Explain the nature of fixed assets.**

*Ans :*

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.

**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 of Fixed Assets**

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.

**Q46. 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.

**Q47. What are the differences between fixed assets and current assets.**

*Ans :*

Basis of Difference	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.

## 2.8.1 Classification of Fixed Assets

### 2.8.1.1 Tangible vs. Intangible Assets

**Q48. Define tangible assets. Explain the characteristics of tangible assets.**

*Ans :*

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 or 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 of Tangible Assets

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.

**Q49. Define intangible assets. Explain the characteristics of intangible assets.**

*Ans :*

#### Meaning of Intangible Assets

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.

The area of finance that deals with intangible assets is known as Intangible Asset Finance.

Intangible asset is an asset that is not physical in nature. Corporate intellectual property (items such as patents, trademarks, copyrights, business methodologies), goodwill and brand recognition are all common intangible assets in today's marketplace. An intangible asset can also be classified as either indefinite or definite depending on the specifics of that asset. A company brand name is considered to be an indefinite asset, as it stays with the company as long as the company continues operations. However, if a company enters a legal agreement to operate under another company's patent, with no plans of extending the agreement, it would have a limited life and would be classified as a definite asset.

**According to the Uniform Commercial Code (Section 9-102(a)(42)),** "General Intangibles" are any personal property...other than accounts, chattel paper, commercial claims, deposit accounts, documents, goods, instruments, investment property, letter of credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.

**According to ASB 138,** an intangible asset is an identifiable non monetary asset without physical substance. Intangibles must be identifiable in order to distinguish them from goodwill. An intangible asset is identifiable when it:

1. It is separable (i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability); or
2. Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

While intangible assets don't have the obvious physical value of a factory or equipment, they can prove very valuable for a firm and can be critical to its long-term success or failure. **For example,** a company such as Coca-Cola wouldn't be nearly as successful was it not for the high value obtained through its brand-name recognition. Although brand recognition is not a physical asset you can see or touch, its positive effects on bottom-line profits can prove extremely valuable to firms such as Cpc-a-Cola, whose brand strength drives global sales year after year.

### 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.

**Q50. Distinguish between tangible assets and Intangible Assets.***Ans :*

Basis of Difference	Tangible Assets	Intangible Assets
1) <b>Meaning</b>	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) <b>Classification</b>	Tangible assets are classified into physical tangible assets and financial tangible assets.	Intangible assets are classified into legal intangibles and competitive intangibles assets.
3) <b>Valuation</b>	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) <b>Accounting Standard</b>	Accounting Standard 10 (AS 10) is for accounting for tangible assets.	Accounting Standard 26 (AS 26) is for accounting for intangible assets.
5) <b>Acceptance in Security</b>	Lenders accept such assets as security for a loan given.	Lenders usually do not accept such assets as security for a loan given.
6) <b>Depreciation or Amortization</b>	Tangible assets depreciate over the lifespan.	Intangible assets are amortized,
7) <b>Risk of Loss due to Fire</b>	The assets may be lost due to fire.	These assets cannot be lost due to fire.
8) <b>Example</b>	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.
9) <b>Fixed vs. Current</b>	Tangible assets can be fixed or current asset.	Intangible assets usually fall in the category of fixed assets.
10) <b>Risk of Loss due to Fire</b>	These assets may be lost due to fire.	These assets cannot be lost due to fire,

## 2.9 DEPRECIATION

**Q51. Define depreciation. Explain the features of depreciation.**

*Ans :*

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.

### Definition

**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".

**According to R.N. Carter,** "Depreciation is the gradual and permanent decrease in the value of an asset from any cause".

**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"

**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 of Depreciation

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.

**Q52. 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  $\frac{1}{20}$ 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.

**Q53. 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.

**2.9.1 Methods of Depreciation - Their Impact on Measurement of Business Accounting****2.9.1.1 Fixed or Equal Installment or Straight Line Method**

**Q54. Define Fixed or Equal Installment or Straight Line Method? Explain the advantages and disadvantages of straight line method.**

*Ans :*

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:

$$\text{Depreciation} = \frac{₹ 1,00,000 - ₹ 10,000}{10 \text{ years}} = ₹ 9,000 \text{ per year}$$

**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.

### PROBLEMS

44. 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.:

$$\text{Depreciation} = \frac{\text{Rs. } 1,00,000 - \text{Rs. } 10,000}{10 \text{ years}} = \text{Rs. } 9,000 \text{ per year}$$

45. Calculate the rate of depreciation under straight line method (SLM) in each of the following alternative cases.

Case	Purchase price of machine Rs.	Expenses to be capitalized Rs.	Estimated residual value Rs.	Expected useful life
(a)	80,000	20,000	40,000	4 years
(b)	17,000	3,000	2,000	10 years

Sol.:

#### Step 1 : Calculation of Total Cost of Asset

Total cost of Asset = Purchase price + Expenses to be capitalized

Case (a) = Rs. 80,000 + Rs. 20,000 = Rs. 1,00,000

Case (b) = Rs. 17,000 + Rs. 3,000 = Rs. 20,000

**Step 2 : Calculation of Amount of Depreciation per year amount of depreciation**

$$= \frac{\text{Total cost of asset} - \text{Estimated residual value}}{\text{Expected useful life}}$$

$$\text{Case (a)} = \frac{1,00,000 - 40,000}{4} = \text{Rs. } 15,000$$

$$\text{Case (b)} = \frac{20,000 - 2,000}{10} = \text{Rs. } 1,800$$

**Step 3 : Calculation of the Rate of Depreciation under SLM Rate of Depreciation (under SLM)**

$$= \frac{\text{Amount of Depreciation}}{\text{Total cost of asset}} \times 100$$

$$\text{Case (a)} = \frac{15,000}{1,00,000} \times 100 = 15\%$$

$$\text{Case (b)} = \frac{1,800}{1,00,000} \times 100 = 9\%$$

- 46. 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		
		<u>1,10,000</u>			<u>1,10,000</u>		
2005	To Balance b/d	88,000	2006	By Depreciation A/c	22,000		
Apr 1		<u>88,000</u>	Mar 31	By Balance c/d	66,000		
		66,000			<u>88,000</u>		
2006	To Balance b/d	66,000	2007	By Depreciation A/c	22,000		
Apr 1		<u>66,000</u>	Mar 31	By Balance c/d	44,000		
		44,000			<u>66,000</u>		
2007	To Balance b/d	44,000	2008	By Depreciation A/c	22,000		
Apr 1		<u>44,000</u>	Mar 31	By Balance c/d	22,000		
		22,000			<u>44,000</u>		
2008	To Balance b/d						
Apr 1							

47. Manohar purchased a Machinery for his business at Rs. 1,00,000 on 1-1-1990. Assuming annual depreciation is 10%; show Machinery Account for 5 years under Fixed Instalment Method.

*Sol/ :*

Dr	Machinery		Cr
Particulars	Rs.	Particulars	Rs.
1-1-1990		31-12-1990	
To Bank Account	1,00,000	By Depreciation Account	10,000
		$\left(1,00,000 \times \frac{10}{100}\right)$	
		By Balance c/d	90,000
	<u>1,00,000</u>		<u>1,00,000</u>
1-1-1991		31-12-1991	
To Balance b/d	90,000	By Depreciation Account	10,000
		By Balance c/d	80,000
	<u>90,000</u>		<u>90,000</u>
1-1-1992		31-12-1992	
To Balance b/d	80,000	By Depreciation Account	10,000
		By Balance c/d	70,000
	<u>80,000</u>		<u>80,000</u>
1-1-1993		31-12-1993	
To Balance b/d	70,000	By Depreciation Account	10,000
		By Balance c/d	60,000
	<u>70,000</u>		<u>70,000</u>
1-1-94		31-12-1994	
To Balance b/d	60,000	By Depreciation Account	10,000
		By Balance c/d	50,000
	<u>60,000</u>		<u>60,000</u>
1-1-95			
To Balance b/d	50,000		

48. A company, whose accounting year is financial year, purchased on 1<sup>st</sup> July, 2002, Machinery costing ` 40,000. It purchased further Machinery on 1<sup>st</sup> January of 2003 costing ` 20,000 and on 1<sup>st</sup> October, 2003 costing ` 20,000.

On 1<sup>st</sup> April 2004, one fourth of Machinery installed on 1<sup>st</sup> July, 2002 became obsolete and was sold for ` 3,000. Show how Machinery Account would appear in the books, if Machinery was depreciated by Fixed Installment Method @ 10% per annum.

*Sol.:*

Dr. Machinery A/c			Cr.		
Date	Particulars	Amount	Date	Particulars	Amount
2002 July 1	To Bank A/c (I)	40,000	2003 Mar 31	By Depreciation A/c @ 10% (on 40,000 for 9 months on 20,000 for 3 month)	3,500
2003 Jan 1	To Bank A/c (II)	20,000		By Balance c/d	56,500
		60,000			60,000
2003 Apr 1	To Balance b/d (37,000 + 19,500) (I + II)	56,500	2004 Mar 31	By Depreciation A/c @ 10% (on 60,000 for 1 year on 20,000 for 6 months)	7,000
Oct 1	To Bank (III)	20,000		By Balance c/d	69,500
		76,500			76,500
2004 Apr 1	To Balance b/d (33,000 + 17,500 + 19,000) (I + II + III)	69,500	2004 April 1	By Bank A/c (Sale) By Profit & Loss A/c (loss on sale)	3,000 5,250
		69,500	2005 Mar 31	By Depreciation A/c (I on 30,000 for 1 year 3,000 II On 20,000 for 1 year 2,000 III On 20,000 for 1 year 2,000) By Balance c/d	7,000 54,250
		69,500			69,500
2005 Apr 1	To Balance b/d	54,250			

**Profit / Loss on sale of Machine**

1/4 of machine installed on 1 <sup>st</sup> July, 2002	10,000
Less : Depreciation for 9 months (2002)	750
Book Value as on 31 March 2003	9,250
Less : Depreciation for 2003	1,000
Book Value on April, 2004	8,250
Less : Amount realized	3,000
Loss on sale of machinery	5,250

(OR)

1/4 <sup>th</sup> of the Book Value of Machine-I (33,000 × 1/4)	8,250
Sale Value	3,000
Loss on Sale of Machinery	5,250

**2.9.1.2 Diminishing or Reducing or Written down value method****Q55. Define Diminishing or Reducing or Written down value method.***Ans :*

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:

$$\text{1st year on ₹ 1,00,000 @ 10\% } \frac{10}{100} \times 1,00,000 = 10,000$$

$$\text{2nd year on ₹ 90,000 i.e. ₹ 1,00,000 - 10,000 = 90,000} \times \frac{10}{100} = 9,000$$

$$\text{3rd year on ₹ 81,000 i.e. ₹ 90,000 - 9,000 = 81,000} \times \frac{10}{100} = 8,100$$

$$\text{4th year on ₹ 72,900 i.e. ₹ 81,000 - 8,100 = 72,900} \times \frac{10}{100} = 7,290 \text{ and so on.}$$

**Q56. What are the advantages and disadvantages of Diminishing or Reducing or Written down value method.***Ans :*

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 of Written Down Value Method**

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

**PROBLEMS**

- 49. M/s Ram Ltd. purchased a Plant costing ` 2,50,000 on 1<sup>st</sup> 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			
		<u>2,70,000</u>			<u>2,70,000</u>			

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
		<u>2,49,750</u>			<u>2,49,750</u>
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
		<u>2,24,775</u>			<u>2,24,775</u>
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
		<u>2,02,297</u>			<u>2,02,297</u>
2009					
Apr 1	To Balance b/d	1,82,067			

50. M/s Manikanta Industries purchase a Machine on 1st April, 2000 for ₹ 1,50,000 paid installation charges ₹ 60,000 and labor charges ₹ 10,000. Another Machine costing ₹ 80,000 was purchased on October 1<sup>st</sup>, 2001. On October 1<sup>st</sup>, 2002 a portion of Machine -1 (Value 1/4 of Machine) was sold for ₹ 60,000. Depreciation is charged at 20% under Written-down Value Method. Show the Machinery Account for 4 years with necessary workings.

Sol.:

Dr.			Machinery A/c			Cr.		
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)			
2000	To Bank A/c I	1,50,000	2001	By Depreciation A/c	44,000			
Apr. 1	To Bank A/c (installation)	60,000	Mar 31	(on 2,20,000 @ 20%)				
	To Bank A/c (labor)	10,000		By Balance c/d	1,76,000			
		<u>2,20,000</u>			<u>2,20,000</u>			
2001			2002	By Depreciation	43,200			
Apr. 1	To Balance b/d	1,76,000	Mar 31	(on I - 1,76,000 @ 20% (on II - 80,000 @ 20% for 6 months) (35,200 + 8,000)				
				By Balance c/d				
Oct. 1	To Bank A/c II	80,000			2,12,800			
		<u>2,56,000</u>			<u>2,56,000</u>			
2002	To Balance b/d	2,12,800	2002	By Bank A/c (sales)	60,000			
Apr. 1	(1,40,800 + 72,000) (I + II)		Oct 1	By Depreciation A/c (on sold machine)	3,520			

2002			2003		
Oct. 1	To P & L A/c (Profit on sale of machine)	28,320	Mar 31	By Depreciation A/c (Profit on sale of Machine) (21,120 + 14,400 )	35,520
				By Balance c/ d	1,42,080
		<u>2,41,120</u>			<u>2,41,120</u>
2003			2004	By Depreciation A/c	28,416
Apr. 1	To Balance b/d	1,42,080	Mar 31	By Balance c/d	1,13,664
		<u>1,42,080</u>			<u>1,42,080</u>
2004					
Apr .1	To Balance b/d	1,13,664			

**Profit or Loss on sale of Machine**

1/4 of machine installed on 1 <sup>st</sup> April, 2000 ( $2,20,000 \times 1/4$ )	55,000
<b>Less:</b> Depreciation for 2000-01	<u>11,000</u>
W.D.V on 1-4-2001	44,000
<b>Less:</b> Depreciation for 2001-02	<u>8,800</u>
W.D.V on 1-4-2002	35,200
<b>Less:</b> Depreciation for 2002 (6 months)	<u>3,520</u>
Book Value	31,680
<b>Less:</b> Amount realized on sale of machine	<u>60,000</u>
Profit on sale of machine	<u>28,320</u>

(OR)

WDV on 1.4.2002 ( $1,40,800 \times 1/4$ )	35,200
<b>Less:</b> Depreciation for 2002 (6 months)	<u>3,520</u>
Book Value	31,680
<b>Less:</b> Amount realized on sale of machine	<u>60,000</u>
Profit on sale of machine	<u>28,320</u>

**Depreciation on remaining Machine**

Machine I W.D.V. on 1.4.2002 ( $1,40,800 \times 3/4$ )	1,05,600
Depreciation @ 20%	21,120
Machine II Depreciation @20% on 72,000	14,400



51. The Machinery Account of a factory showed a balance of ₹ 1,80,000 on 1<sup>st</sup> April, 2000. Accounts were closed on 31<sup>st</sup> March of each year and 10% per annum depreciation is written off under Diminishing Balance Method. On 1<sup>st</sup> September, 2000 new Machinery was acquired at a cost of ₹ 30,000 and installation charges incurred was ₹ 890 on the same date. On 30<sup>th</sup> September, 2000, a Machine which had cost ₹ 6,000 on 1<sup>st</sup> April 1997 was sold for ₹ 750, another Machine which had cost ₹ 600 on 1<sup>st</sup> April, 1998 was scrapped on the same date and it realized nothing.

Write up Plant and Machinery A/c for the year 2000 allowing the same rate of Depreciation as in the past calculating Depreciation the nearest multiple of a Rupee.

Sol.:

Dr.			Machinery A/c			Cr.		
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)			
2000			2000					
Apr 1	To Balance b/d I	1,80,000	Sep 30	By Bank A/c	750			
Sep 1	To Bank A/c II	30,890		By Depreciation A/c (on Machine-I sold)	219			
				By P & LA/c (loss on sale of Machine-I)	3,405			
				By Depreciation (on scrapped Machine-II)	24			
				By P & LA/c (loss on Machine-II)	462			
			2001					
			Mar 31	By Depreciation A/c (Machine -III)	19,316			
				By Balance c/d	1,86,714			
					<u>2,10,890</u>			
2001								
Apr 1	To Balance b/ d	1,86,714						

#### Working Notes

##### (1) Calculation of loss on sale of Machine-I on 1-9-2002

Cost on 1- 4 -1997	6,000
<b>Less :</b> Depreciation from 1-4-97 to 30-9-2000 [600 + 540 + 486 + 219]	1,845
Value on 30-9-2000	4,155
<b>Less :</b> Sale amount realized	750
Loss on sale of Machine	3,405

**(2) Loss on Machine-II Scrapped**

Cost on 1-4-98	600
<b>Less :</b> Depreciation from 1-4-98 to 30-9-2000 [60 + 54 + 24]	138
Value on 30-9-2000	462
<b>Less :</b> Scrap realized	—
Profit & Loss A/c (Loss)	462

**(3) Depreciation Remaining Plant**

On (1,80,000 - 4374 - 486 ) 1,75,140 @ 10%	17,514
New Machine (7 months) 30,890 @ 10%	1,802
Total Depreciation	19,316

**Q57. Distinguish between straight line method and written down value method.**

*Ans :*

Basic of Distinction	Straight Line Method	Written Down Value Method
1) <b>Basic of Calculation</b>	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) <b>Amount of Depreciation</b>	The amount of depreciation remains constant.	The amount of depreciation goes on decreasing.
3) <b>Total Charge (i.e., depreciation plus repairs and renewals)</b>	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) <b>Book Value/Zero-Level</b>	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) <b>Suitability</b>	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) <b>Calculation-Easy or difficult</b>	It is easy to calculate the rate of depreciation.	It is difficult to calculate the rate of depreciation,
7) <b>Effect on profit and loss account</b>	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,

**2.9.1.3 Sum of Year Digits Method****Q58. 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.

**PROBLEMS**

52. M/s Raj & Co. purchased machine for ₹ 1,00,000. Estimated useful life and scrap value were 10 years and ₹ 12,000 respectively. The machine was put to use on 1-1-90. Show machinery account and depreciation account in their books for 1995 by using sum of year's digits method.

*Sol :***In the books of M/s Raj & Co.****Machinery Account**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
1995 Jan. 1	To Balance b/d		36,000	1995 Dec. 1	By Dep. A/c		8,000
				Dec. 31	By Balance c/d		28,000
			<u>36,000</u>				<u>36,000</u>
1996 Jan. 1	To Balance b/d		28,000				

**Depreciation Account**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
1995 Jan. 1	To Machinery A/c.		8,000	1995 Dec. 31	By P & L A/c		8,000
			<u>8,000</u>				<u>8,000</u>

**Working Notes :**

Total of sum of digit depreciation for 1990 – 1994

$$= (\text{₹ } 1,00,000 - \text{₹ } 12,000) \times \frac{10+9+8+7+6}{\frac{10(10+1)}{2}} = \text{₹ } 88,000 \times \frac{40}{55} = 64,000$$

Written down values as on 1.1.95

$$= \text{₹ } 1,00,000 - \text{₹ } 64,000 = \text{₹ } 36,000$$

Depreciation for 1995

$$(\text{₹ } 1,00,000 - \text{₹ } 12,000) \times \frac{5}{55} = \text{₹ } 8,000$$

**2.9.1.3 Sinking Fund Method / Depreciation Fund Method**

**Q59. Define Sinking Fund Method / Depreciation Fund Method. Explain the steps involved in Sinking Fund Method.**

*Ans :*

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.

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**Q60. 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.

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**2.9.1.4 Annuity Method**

**Q61. What do you understand by Annuity Method?**

*Ans :*

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:

$$\text{Value of Annuity} = \frac{r(1+r)^n}{(1+r)^n - 1}$$

### Q62. 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.

**PROBLEMS**

53. 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 lease 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				
			<u>21,000.00</u>				<u>21,000.00</u>				
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				
			<u>16,127.75</u>				<u>16,127.75</u>				
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				
			<u>11,011.89</u>				<u>11,011.89</u>				
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				<u>5,640.24</u>				
			<u>5,640.24</u>								

**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

## Exercises Problems

**1. Prepare the Ledger account of Mr. Solkar from the following :**

- March 1 Debit balance ` to his account ` 2,000  
March 3 Sold goods on credit to him worth ` 10,800  
March 8 Received cash from him ` 12,600 and allowed discount of ` 200  
March 10 Solkar bought goods on credit ` 3,000  
March 15 Received cash from him ` 2,900 and allowed him discount ` 100  
March 20 Purchased goods on credit from Solkar worth ` 2,000  
March 25 Paid cash to Solkar ` 1,000  
March 28 Returned goods to him ` 200  
March 31 Paid cash to him in full settlement of his account ` 780

**[Ans : Solkar's Account Total ` 17,800]**

**2. From the following transactions prepare only personal accounts in the ledger for April 2013.**

- April 1 Govind started business with cash ` 2,000 goods ` 3,000 and furniture ` 4,000  
April 5 Sold goods to Raghu ` 600 and for cash ` 400  
April 9 Received from Raghu on account ` 400  
April 12 Bought goods from Mohan ` 1,000  
April 15 Paid Mohan ` 500  
April 20 Paid Interest to Mohan ` 25  
April 21 Cash withdrawn by Govind for personal use ` 200

**[Ans : [Govind's Capital A/c ` 8,800 (Cr.); Raghu ` 200 (Dr.), Mohan ` 500 (Cr.)]**

**3. Prepare the personal A/c of Mr. Balaji from the following transactions in the books of Ganesh.**

**2013**

March

- " 1 Debit balance of Balaji's A/c ` 8,200  
" 4 Bought of Balaji ` 1,500  
" 7 Cheque of ` 2,000 issued to Balaji  
" 10 Goods sold to Balaji ` 1,200  
" 13 'Balaji sold goods to Ganesh ` 800  
" 16 Received an account payee cheque from Balaji ` 1,200  
" 20 Goods worth ` 230 returned to him  
" 24 Balaji bought goods from Ganesh ` 1,400  
" 26 Balaji claimed an allowance of ` 300 for damaged goods.  
" 28 A bearer cheque received from Balaji for ` 800  
" 29 Balaji received goods returned by Ganesh ` 270  
" 31 Received ` 8,500 in settlement of ` 8,700 from Balaji.

**[Ans : Balaji's A/c Total ` 13,300]**



## 4. Re-write the following Trial Balance to correct the same

Trial Balance on 31st March, 2013

Debit	₹	Credit	₹
Wages	2,630	Capital	10,000
Purchases	12,490	Sales	31,080
Salaries	520	Rent Paid	500
Carriage	50	Discount Received	120
Building	12,010	Light Charges	160
Bank Overdraft	470	Suppliers	800
Cash in Hand	60	opening Stock	9,260
Customers	1,490	Furnitures	3,250
	29,770		55,170

[Ans: Total of Correct Trial Balance ₹ 42,470]

## 5. Give rectification entries for the following errors.

- Wages payable to furniture maker ₹ 670 debited to Wages a/c.
- A credit sale of ₹ 150 to Srinivas debited to Shiva Ram.
- Payment of salary to Varshini not passed through books at all.
- A credit purchase of ₹ 140 to Harshini, recorded in the books as ₹ 410.

## 6. Rectify the following errors.

- An amount of ₹ 100 paid for the repairs of furniture was debited to furniture account.
- Sales book total was overcast by ₹ 500.
- Expenses 1500 were posted in the ledger as 150.
- A sale of ₹ 200 to Mr. S. was wrongly debited to the account of Mr. V.
- Old furniture sold has been credited to sales A/c ₹ 500.

## 7. Pass Journal entries for rectification of the following errors.

- The total of purchases book was under cast by ₹ 200.
- A credit purchase from Vaishnavi for ₹ 1000 has been wrongly passed through the sales book.
- Wages paid ₹ 200 was wrongly debited to salaries account.
- ₹ 100 received on account interest stands wrongly credited to commission account.
- Salary of ₹ 500 paid to manager Mr. Krishna is debited to his personal account.

## 8. Rectify the following error discovered Before preparation of the trail balance.

- Furniture purchased ₹ 3500 has been entered in the purchases book.
- The returns inward book was overcast by ₹ 250.

(c) ₹ 800 paid for repairs to machinery was debited to machinery account.

(d) A sale of ₹ 750 made to Sriman Narayana was entered in sales book but credited to his account.

(e) A purchase of ₹ 760 made from Radhika was credited to his account ₹ 670.

9. Prepare final accounts of Yadadri Trader's as on 31.12.2018

**Trial Balance as on 31.12.2018**

Debit Balances	Amount (₹)	Credit Balances	Amount (₹)
Cash	4,200	Sales	20,000
Purchases	10,000	Interest	4,000
Carriage	1,000	Discount	3,500
Factory rent	1,200	Overdraft	2,500
Salaries & Wages	2,400	Capital	50,000
Machinery	6,000	Creditors	3,000
Discount	700		
Copyright	10,000		
Carriage on sales	400		
Clearing charges	300		
Bills Receivable	12,000		
Opening Stock	3,000		
Printing & Stationery	2,500		
Coal & Gas	800		
Debtors	10,000		
Drawings	1500		
Furniture	15,000		
Office Expenses	1,500		
Internet charges	500		
	<u>83,000</u>		<u>83,000</u>

**Adjustments**

(1) Closing stock: 6500, (2) Prepaid Salaries & Wages: 400, (3) Create 6% Provision for Bad & Doubtful Debts (4) Depreciation on Machinery: 10% (5) Interest on Capital: 6% (6) MD's Commission on Net Profit is 10% before charging such commission.

**(Ans : GP: ₹ 10,200; Net Profit: ₹ 5,310; Balance Sheet: ₹ 62,900).**

10. Prepare final Accounts of Srivasthava Traders as on 31-12-2018

**Trial Balance as on 31.12.2018**

Debit Balances	Amount (₹)	Credit Balances	Amount (₹)
Cash	4,000		
Opening Stock	2,100		
Wages	700		
Carriage on Purchases	600		
Carriage on Sales	400		
Audit Fee	800		
Drawings	4,500		
Debtors	15,000		
Freight	700		
Loose Tools	6,500		
Buildings	11,000		
Power & Fuel	500		
Salaries	850		
Purchases	10,000		
Sales Returns	1,000		
Goodwill	7,500		
Patents	5,000		
Postage & Stamps	850		
		Capital	40,000
		Creditors	5,000
		Interest Received In Adv.	250
		Bills payable	2,650
		Bank Overdraft	3,000
		Sales	16,000
		Rent Received	2,600
		Purchase Returns	500
		Bad Debts Reserve	2,000
	<u>72,000</u>		<u>72,000</u>

**Adjustments**

- 1) Closing stock value: ₹ 6000
- 2) Outstanding Salary: ₹ 450
- 3) Interest on Drawings: 10%
- 4) Provide Reserve for Doubtful Debts: 5% and Create Provision for Discount on Debtors 2%
- 5) Depreciation on Buildings: 10%
- 6) Goods worth of ₹ 2000 distributed as free samples.

**(Ans : Gross Profit: ₹ 8,900; Net Profit: ₹ 6,465; Balance Sheet Total: ₹ 52,865).**

11. From the following Trial Balance prepare Trading and Profit and Loss Account for the year ended 31st Dec. 1992 and Balance Sheet as on that date.

Particulars <sub>p</sub>	Dr. `	Cr. `
Drawings	10,000	
Stock on 1-1-1992	46,000	
Purchases and purchases returns	1,50,200	600
Cash in hand	3,400	
Bank Balance	22,660	
Freehold premises	38,600	
Trade expenses	840	
Printing, Stationery and Advertising	1,640	
Professional charges	280	
Commission received	---	3,300
Investments as on 1st Jan @ 10%	4,000	
Interest on above	---	200
Sundry debtors and creditors	36,000	29,000
Wages	25,000	
Salaries	14,000	
Capital	1,14,000	
Income Tax	1,600	
Discount allowed and received	6,300	4,600
Sales returns and sales	550	2,08,950
Bills receivable/Bills payable	3,200	10,000
Office furniture	3,050	
Rent, Rates and Insurance	4,000	
Bad debts provision	670	
	<u>3,71,320</u>	<u>3,71,320</u>

### Adjustments

1. Provide for wages ` 5,000.
2. Write off 5% depreciation on freehold premises and 10% on office furniture.
3. Insurance to the extent of ` 200 relates 1993.
4. Stock on 31-12-95 is ` 52,000.
5. Charge interest on capital at 5% and on drawings ` 300.
6. Further bad debts are ` 1,000.
7. Provide for doubtful debts @ 5% on sundry debtors.
8. Make provision for discount on debtors and reserve for discount on creditors @ 2%.

(Ans : Gross Profit ` 34,800 ; Net profit ` 6,440 ; Balance Sheet ` 1,57,660).

## Short Question and Answers

### 1. What is journal ?

*Ans :*

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 :

**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."

**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."

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

### 2. Explain the advantages of journal.

*Ans :*

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

- (i) **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.

- (ii) **Explanation of the Transaction:** An entry in the journal book includes a brief explanation of the transaction called 'narration'.

- (iii) **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.

- (iv) **Permanent Record:** The journal has permanent record. It has date-wise record of every transaction and can be used for auditing, whenever required.

- (v) **Convenient Distribution of Work:** Division of journal into subsidiary books helps the administration in the distribution of work among employees.

- (vi) **Location of Errors:** Errors can be easily located through journal.

### 3. Advantages of Ledger

*Ans :*

The main advantages of ledger are as follows:

- (i) **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.

- (ii) **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.

- (iii) **Helpful in Preparing Trial Balance**

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

**(iv) 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.

**4. Define 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. 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 of Trial Balance**

**According to Carter,** "Trial Balance is a statement of debit and credit balances derived from the ledger, including cash and bank balances."

**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."

**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."

**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."

**5. 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 :

- (i) Transaction has not been entered at all in the journal.
- (ii) A wrong amount has been written in both columns of the journal.
- (iii) A wrong account has been mentioned in the journal.
- (iv) An entry has not at all been posted in the ledger.
- (v) Entry is posted twice in the ledger.

**6. Explain the features of capital expenditure.**

*Ans :*

Special features of capital expenditure are as under :

- (i) Capital expenditure is incurred for acquiring fixed assets.
- (ii) It increases the values of assets.
- (iii) It increases the profit earning capacity of business.
- (iv) These expenditures are casually incurred.
- (v) The assets acquired through these expenditures are not meant for sales.
- (vi) These expenditures are shown at the assets side of the balance sheet.

**7. Explain the features of revenue expenditure.**

*Ans :*

Special features of these expenditures are as follows :

- (i) These are routine expenses.
- (ii) It is usually incurred
- (iii) It does not add to the value of assets but maintain it, i.e., white washing and repairs.
- (iv) Revenue expenditure does not increase the profit earning capacity of the firm but simply maintains it.
- (v) Current assets acquired through these expenditures are meant for sale.
- (vi) Revenue expenses are shown at the debit side of the trading and profit and loss account.

### 8. Explain the uses of final accounts?

*Ans :*

- (i) It is used in evaluating approximately the organisation's earning ability.
- (ii) It facilitates the investors to take appropriate investment decisions.
- (iii) It assists in giving complete information about the cash inflows and outflows of the organisation to the financial institutions.
- (iv) It helps in ascertaining the true and fair financial position of the organisation and helps in deciding about the credit worthiness of the organisation.
- (v) It also helps in making various fiscal policies for the organisation.

### 9. Explain the Characteristics of a Balance Sheet.

*Ans :*

Following are the main characteristics :

- (i) It is prepared on a particular date and not for a particular period.
- (ii) It is prepared after the preparation of Trading and Profit & Loss Account.
- (iii) As assets must be equal to total liabilities, the two sides of the Balance Sheet must have the same total.

- (iv) It shows the financial position of a business as a going concern.
- (v) It is a statement of assets (debit balances) and liability (credit balances) and not an account. Information that Balance Sheet Convey to Outsiders.

### 10. Define Suspense Account.

*Ans :*

Sometimes, despite of an accountant's best efforts, the trial balance may not agree. In such circumstances, the difference between the debit and credit totals should be transferred to an account called Suspense Account. By doing so, the trial balance is made to agree and delay in the preparation of final accounts can be avoided.

Suspense account is an imaginary account, opened and used as a temporary measure to make two sides of the trial balance agree. As and when the errors which caused the disagreement in trial balance are detected, rectification entries should be passed through suspense account. Detection and rectification of all the errors will result in the automatic closure of Suspense Account'.

If the debit total in the trial balance is in excess of credit total, suspense account should be credited with the difference. Similarly, suspense account should be debited with the difference when credit side total is more than the debit side total. In other words, suspense account will appear on that side of the trial balance whose total is less than the total of other side.

Following points should be kept in mind while passing rectification entries through 'Suspense Account'.

- i) Suspense account is used to rectify those errors which affect the trial balance.
  - a) If the account which is to be rectified is debited in the rectifying entry, suspense account will be credited to complete the double entry.
  - b) If the account which is to be rectified is credited in the rectifying entry, suspense account will be debited to complete the double entry.

**11. What are the causes of depreciation.**

*Ans :*

The causes of depreciation are as follows:

**(i) 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'.

**(ii) 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.

**(iii) 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.

**(iv) 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.

**(v) 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.



## UNIT III

**Inventory Valuation:** Methods of inventory valuation and valuation of goodwill, methods of valuation of goodwill. 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.

### 3.1 INVENTORY VALUATION

**Q1. Define inventory state the objectives of inventory.**

*Ans :*

**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 of Inventory**

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.

**Q2. 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.

### Q3. **Explain the Importance Inventory Valuation.**

*Ans :*

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.

### Q4. **Define Perpetual Inventory Method.**

*Ans :*

Perpetual Inventory Method is regular checking and valuing of stock. There is no need for checking at the end. If facilities reliable and direction of errors and proper utilization of current assets. A system of records maintained by the controlling department, which reflects the physical movements of stocks and their current balance. Under this method stock registers are maintained to make a record of the physical movements of stocks and their current balance. Stores ledger is maintained to keep a record of the various items of materials; it makes a record of the physical movements of the stock on the receipts and issues of the materials and also reflects the balances in the stores.

## 3.2 METHODS OF INVENTORY VALUATION

### Q5. **Enumerate the different methods of inventory valuation.**

*Ans :*

Broadly all the methods are divided into two types. They are,

- (a) Based on cost price
- (b) Based on National Price Method

#### (a) **Based on Cost Price**

Based on cost the different methods are,

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 method is based on the assumption that the oldest items in inventory are used first so that the inventories which remain unsold are the more recent purchases. The materials issued are priced at the oldest cost price and there by closing the inventory is valued at latest price. The use of FIFO does not necessarily mean that the units in the inventory which were longest in stock are exhausted first but it means that the oldest costs are first used for accounting purposes. Thus, under this method, the physical flow of goods need not necessarily coincide with the pattern of cost flow assumptions. But in practice, it is usually found that the most firms sell oldest merchandise first as protection against deterioration.

- (i) The valuation of closing inventory or stock tends to be nearer current market prices.
- (ii) Being based on cost, no unrealized profits enter into financial result of the period.
- (iii) If prices of materials or goods do not fluctuate very frequently, this method is easy to operate.
- (iv) This method is realistic as it assumes that units sold for issued to production are in order of their purchases.

This method is considered more suitable in times of falling prices.

- (a) On a rising market it reports larger profits this will lead to higher incidence of income tax.
- (b) Calculation become cumbersome.
- (c) In times of rising prices, charge to productions unduly low.
- (d) Comparison between different jobs executed by concern is rendered difficult.

FIFO method is most suitable in the following cases,

- (i) The size and cost of materials is very large.
- (ii) Materials are easily identified as belonging to a particular purchase log.
- (iii) Not more than two or three different receipts are on material card at one time.
- (iv) Prices of items of stock do not fluctuate very often so that clerical labour involved may not be negligible.
- (v) Where material is subject to deterioration and obsolescence.

**Advantages of FIFO Method**

- (i) Prices are based on actual costs. No profit or loss on stocks results from using this method.
- (ii) Stock balances are of fair commercial value representing the latest market prices.
- (iii) This method is suitable in case of slow moving materials.
- (iv) It is appropriate in situations of falling prices to charge the jobs with higher prices purchased earlier.

**Disadvantages of FIFO Method**

- (i) Possibility of more clerical errors due to more number of calculations.
- (ii) The cost of similar jobs differ if the prices fluctuate.
- (iii) In times of rising prices, the cost of jobs does not reflect current market prices. This inflates the profits unnecessarily, resulting in higher taxes.

## 2. Last In First Out (LIFO)

The LIFO method assumes that the latest purchased or acquired units are sold first and the oldest purchases are still in stock. Thus, the cost of recent acquisitions or purchases are matched against the sales revenue of the period and those of the oldest purchases are carried forward as an asset on the assets side of the balance sheet. The LIFO method has the reverse effect, to FIFO on the measurement of income and closing inventory valuation. LIFO reflects the latest cost price of the particular product.

The main object of LIFO method is to apply current costs to current sales.

### Advantages of LIFO

- (i) This is a consistent and objective method of valuation of closing inventories and cost of sales.
- (ii) Cost of sales is determined by using current replacement costs.
- (iii) In a rising (or inflationary) market, the gross profit reported is a very low figure implies saving in taxes.
- (iv) No unrealized profit or loss is usually made.

### Disadvantages of LIFO

- (i) More often, cost flow under LIFO does not correspond with the normal flow of goods.
- (ii) When costs of most recent purchases are matched, it does not necessarily imply the matching of current costs against current revenue.
- (iii) It is purely a tax-saving device not to accept this method in a falling market.

(iv) LIFO does not value the closing inventory at current value though it is shown in the balance sheet as a current asset.

(v) Current ratio (current assets/ current liabilities) and stock turnover ratio (cost of sales/ average inventory or stock) calculated become irrelevant.

## 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.

## 4. Average Cost Method

Where goods have been purchased from time to time and are mixed up on such a manner that individual units purchased cannot be identified, than 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 in 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 quantity. 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

- (1) It is simple and easy to calculate the issue price.
- (2) This method reduces the effect of fluctuation of prices by averaging the price.

##### Disadvantages

- (1) This method does not take into account the quantity purchased at each price. This may lead to absurd results.
- (2) As the actual price is not used, Profit or Loss on material will usually arise.
- (3) The value of closing stocks under this method is absurd. When price fluctuates sharply, the costing stock shows credit balance, that is negative figure !

#### (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.

##### Advantage

- (1) This method is suitable where the prices vary very much from one purchase to another. As it uses quantities for calculation of average prices, the fluctuations are evened out.
- (2) The basis of calculation in the method is simple as the price is calculated by dividing the value of materials by their quantity.
- (3) A new price is calculated when new materials are purchased. All the subsequent issues are made at the price calculated until next lot is received. Thus, the clerical work is simplified and reduced.
- (4) The stock balance reflects fair prices which may be taken for financial

##### Disadvantages

- (1) This method is more complicated than simple average price as it takes into account the total quantity and value.

- (2) Since actual price is not used, Profit or Loss may arise in material cost by using this method.
- (3) Where receipts are numerous, calculations will be many and may result in errors.
- (4) The price may have to be taken upto three or four decimal places to calculate the correct value of large quantities. Otherwise, approximation may lead to difference in accounts.

**(b) National Price Methods**

This group of methods are either predetermined prices or some other prices other than the original purchase prices, not even the average of the purchase price. Thus, the prices charged under these methods are completely different from the actual purchase prices.

**(i) Standard Price**

This price is a predetermined price fixed on the basis of all factors affecting the price. A standard price is fixed and the actual price is compared with the standard price. If actual price is more than the standard price, loss occurs and if actual price is less than the standard price, a profit will be obtained. While operating the pricing method the issue price is uniform for all quantities issued. The loss or profit on material is termed as 'Material price variance'.

**Advantages**

- This method is relatively simple to operate as a single issue price is used during the accounting period.
- Comparison of jobs becomes easier as the issue price is same.
- It eliminates clerical errors as issue price is fixed.
- This method facilitates ascertaining efficiency or otherwise of material purchases.

**Disadvantage**

- This method may show profit or loss on issue and closing stock may show absurd figures.

**(ii) Inflated Price**

This method aims at covering the costs of contingencies in addition to the purchase price. The issue price includes purchase price plus losses due to evaporation, wastage in handling and storage, carrying costs, etc. This method aims at recovering the full material cost.

**(iii) Re-use Price Method**

This method is followed in pricing of materials issued for 're-use'. Materials originally purchased for a particular purpose but returned to the stores from the concerned department may be reissued to another department for a different purpose. The price charged is the normal price of material used for such works and not the original purchase price. Usually, material loss is incurred when re-use price method is employed.

**(iv) Replacement Price**

The current market price of materials is charged on the issues. The method is used to reflect the production cost at current market prices. This method shows profit during rising prices and losses during falling prices on the material issues. Stocks also do not represent correct values.

**Q6. What are the difference between FIFO and LIFO.**

*Ans :*

**Distinction between FIFO and LIFO Method**

Basic of Distinction	FIFO	LIFO
<b>1) Basic Assumption</b>	Goods received first are issued first	Goods received last are issued first
<b>2) Cost of Goods Sold</b>	Cost of goods sold represents cost of earlier purchases.	Cost of goods sold represents cost of recent purchases.
<b>3) Ending Inventory</b>	Ending inventory represents cost of recent purchases.	Ending inventory represents cost of earlier purchases.
<b>4) In case of Rising prices</b>	Higher income is reported since old costs (which are lower than current costs) are matched with current revenue. As a result, income tax liability is increased.	Lower income is reported since current costs (which are higher than the old costs) are matched with current revenue. As a result, income tax liability is reduced.
<b>5) Distortion in Balance Sheet</b>	Balance sheet shows the ending inventory at a value nearer the current market price	Balance sheet is distorted because ending inventory is understated at old costs.

**PROBLEMS ON INVENTORY VALUATION**

1. The following is a summary of receipts and issues of materials in a factory during a month in 2015.

Jan. 1 Opening balance 5000 units at Rs. 25 per unit

Jan. 3 Issue 250 units

Jan. 10 Received from supplier 400 units at Rs. 24.50 per unit.

Jan. 15 Returned to store 20 units

Jan. 20 Issue 180 units

Jan. 24 Purchased 200 units at 25.50 per unit

Jan. 25 Issue 120 units

Jan. 26 Returned to store 15 units.



A physical verification taken on Jan 22 reveals a shortage of 5 units. Compute the material value as on 31<sup>st</sup> Jan. 2015 by using FIFO method.

*Sol :*

Stores Ledger [FIFO]

Date	Particulars	Receipts			Issues			Balance		
		Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
Jan. 1.	Balance	-	-	-	-	-	-	500	25	12,500
3	Issue	-	-	-	250	25	6,250	250	25	6,250
10	Received	400	24.50	9,800	-	-	-	250	25	6,250
								400	24.50	9,800
15	Returned to store	20	25	500	-	-	-	250	25	6,250
								400	24.5	9,800
								20	25	500
20	Issue	-	-	-	180	25	4,500	70	25	1,750
								400	24.5	9,800
								20	25	500
22	Shortage				5	25	125	65	25	1,625
								400	24.5	9,800
								20	25	500
24	Purchases	200	25.5	5,100	-	-	-	65	25	1,625
								400	24.5	9,800
								20	25	500
								200	25.5	5,100
25	Issue	-	-	-	65	25	1,625	345	24.5	8,453
					55	24.5	1,348	20	25	500
								200	25.5	5,100
26	Returned	15	24.5	368	-	-	-	345	24.5	8,453
								20	25	500
								200	25.5	5,100
								15	24.5	368
					Closing stocks			580	-	14,421

2. The following is a summary of receipts and issues of materials in a factory during a month in 2015.

Jan. 1      Opening balance 1000 units at ` 5 per unit

Jan. 3      Issued 500 units

Jan. 9      Issued 300 units

Jan. 10 Received from supplier 400 units at ₹ 4.50 per unit

Jan. 15 Returned to store 20 units from goods issued on 3<sup>rd</sup> Jan.

Jan. 20 Issued 480 units

Jan. 24 Purchased 200 units at 5.50 per unit

Jan. 25 Issued 120 units

Jan. 26 Returned to store 15 units

A physical verification taken on Jan 22 reveals a shortages of 5 units. Compute the inventory value as on 31<sup>st</sup> Jan. by using LIFO method.

*Sol :*

Stores Ledger [LIFO Method]

Date	Particulars	Receipts			Issues			Balance		
		Units	P.U	Amount	Units	P.U	Amount	Units	P.U	Amount
Jan. 1.	To Balance	-	-	-	-	-	-	1000	5	5,000
3.	Issued	-	-	-	500	5	2500	500	5	2500
9.	Issued	-	-	-	300	5	1500	200	5	1000
10.	Received	400	4.50	1800	-	-	-	200	5	1000
								400	4.50	1800
15.	Returned	20	5	100	-	-	-	200	5	1000
								400	4.5	1800
								20	5	100
20.	Issued	-	-	-	20	5	100	140	5	700
					400	4.5	1800			
					60	5	300			
22.	Shortage	-	-	-	5	5	25	135	5	675
24.	Received	200	5.5	1,100	-	-	-	135	5	675
								200	5.5	1,100
25.	Issued	-	-	-	120	5.5	660	135	5	675
								80	5.5	440
26.	Returned	15	5	75	-	-	-	135	5	675
								80	5.5	440
								15	5	75
								<b>230</b>		<b>110</b>
						<b>Balance</b>				

3. The following information is extracted from the stores ledger of lishanth industries, for the material item 786.

**Purchases :**

10-01-2014 : 2000 units @ Rs. 20 per unit

16-01-204 : 4,000 units @ Rs. 35 per unit

**Issues :**

20-01-2014 : 1,000 units

28-01-2014 : 2,000 units

**Returns to stores :**

29-01-2014 50 units

There was a stock verification on 31-01-2014 and found 2750 units in the stores. Record the above transactions in the stores ledger under LIFO stating clearly the treatment of shortage of material and returns.

*Sol :*

**Stores Ledger [LIFO]**

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Rs.	Units	Rate	Rs.	Units	Rate	Rs.
2014										
Jan 10 <sup>th</sup>	Purchases	2000	20.00	40,000	-	-	-	2000	20.00	40,000
Jan 16 <sup>th</sup>	Purchases	4000	35.00	1,40,000	-	-	-	2000	20.00	40,000
								4000	35.00	1,40,000
Jan 20 <sup>th</sup>	Issue	-	-	-	1000	35.00	35,000	2000	20.00	40,000
								3000	35.00	1,05,000
Jan 28 <sup>th</sup>	Issue	-	-	-	2000	35.00	70,000	2000	20.00	40,000
								1000	35.00	35,000
Jan 29 <sup>th</sup>	Returns.	50	35.00	1750	-	-	-	2000	20.00	40,000
								1000	35.00	35,000
								50	35.00	1750
Jan 31 <sup>st</sup>	Stock	-	-	-						
					50	35.00	1750	2000	20.00	40,000
					250	35.00	8750	750	35.00	26,250
Jan 31 <sup>st</sup>	Closing stock							2750		66,250

4. General Traders are the distributors for a certain brand of products. Following information is available for Jan. 2014.

Sales: Rs. 9,50,000

Administrative overheads: Rs. 20,000

Opening stock: 1,000 units @ Rs. 300 each

Purchases for the month:

Jan. 5<sup>th</sup> : 2,000 units @ Rs. 285 each

Jan. 22<sup>nd</sup>: 1,000 units @ Rs. 303 each

Closing stock on Jan. 31: 1,300 units

Compute

(i) Value of inventory on 31<sup>st</sup> January

(ii) Amount of cost of goods sold for January; and

(iii) Profit or Loss for January

Under

FIFO and LIFO methods.

*Sol :*

#### Calculation of Issue Units

$$\begin{aligned}\text{Issue units} &= \text{Opening stock units} + \text{Purchases unit} - \text{Closing stock units} \\ &= 1000 + [2000 + 1000] - 1300 = 2,700 \text{ units.}\end{aligned}$$

#### Stores Ledger [FIFO]

Date	Particulars	Receipts			Issues			Balances		
		Units	Rate	Rs.	Units	Rate	Rs.	Units	Rate	Rs.
Jan 1st	Opening stock							1000	300.00	3,00,000
Jan 5th	Purchases	2000	285.00	5,70,000	-	-	-	1000	300.00	3,00,000
								2000	285.00	5,70,000
Jan 22nd	Purchases	1000	303.00	3,03,000	-	-	-	1000	300.00	3,00,000
								2000	285.00	5,70,000
								1000	303.00	3,03,000
Jan 23rd	Issue	-	-	-	1000	300.00	3,00,000			
					1700	2,85,00	4,84,500	300	285.00	85,500
								1000	303.00	3,03,000
Jan 31	Closing stock							1300		3,88,500

## Stores Ledger [LIFO]

Date	Particulars	Receipts			Issues			Balances		
		Units	Rate	Rs.	Units	Rate	Rs.	Units	Rate	Rs.
Jan 1 <sup>st</sup>	Opening stock							1000	300.00	3,00,000
Jan 5 <sup>th</sup>	Purchases	2000	285.00	5,70,000	-	-	-	1000	300.00	3,00,000
								2000	285.00	5,70,000
Jan 22 <sup>nd</sup>	Purchases	1000	303.00	3,03,000	-	-	-	1000	300.00	3,00,000
								2000	285.00	5,70,000
								1000	303.00	3,03,000
Jan 23 <sup>rd</sup>	Issue	-	-	-	1000	303.00	3,03,000	1000	300.00	3,00,000
					1700	2,85,00	4,84,500	300	285.00	85,500
Jan 31 <sup>st</sup>	Closing stock							1300		3,85,500

## Calculation of Cost of Goods Sold

Particulars	(Rs.)	(Rs.)
	FIFO	LIFO
Opening stock	3,00,000	3,00,000
(+) Purchases		
Jan 5th 5,70,000	5,70,000	
Jan 22nd	3,03,000	3,03,000
	11,73,000	11,73,000
(-) Closing stock	3,88,500	3,85,500
Cost of goods sold	7,84,500	7,87,500

## Calculation of profit (or) Loss

Particulars	(Rs.)	(Rs.)
	FIFO	LIFO
Sales	9,50,000	9,50,000
(-) Cost of goods sold	7,84,500	7,87,500
Gross Profit	1,65,500	1,62,500
(-) Administrative expenses	20,000	20,000
Profit	1,45,500	1,42,500

5. Show the stores ledger entries as would appear when using, (i) FIFO (ii) LIFO method of pricing issues in connection with the following transactions.

April 2012		Units	Value
1	Balance in hand B/F	300	600
2	Purchased	200	440
4	Issued	150	--
6	Purchased	200	460
12	Issued	150	--
20	Issued	200	--
25	Purchased	200	480
30	Issued	250	--

*Sol.:*

Stores Ledger [FIFO]

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Value	Units	Rate	Value	Units	Rate	Value
2012										
April. 1.	Opening Balance	-	-	-	-	-	-	300	2.00	600
2.	Purchases	200	2.20	440	-	-	-	300	2.00	600
								200	2.20	440
4.	Issue	-	-	-	150	2.00	300	150	2.00	300
								200	2.20	440
6.	Purchases	200	2.30	460	-	-	-	150	2.00	300
								200	2.20	440
								200	2.30	460
12.	Issue	-	-	-	150	2.00	300	200	2.20	440
								200	2.30	460
20.	Issue	-	-	-	200	2.20	440	200	2.30	460
25.	Purchases	200	2.40	480	-	-	-	200	2.30	460
								200	2.40	480
30.	Issue	-	-	-	250					
					200	2.30	460			
					50	2.40	120	150	2.40	360
30.	Closing balance							150		360

## Stores Ledger [LIFO]

Date	Particulars	Receipts			Issues			Balance		
		Units	Rate	Value	Units	Rate	Value	Units	Rate	Value
2012										
April 1.	Opening Balance	-	-	-	-	-	-	300	2.00	600
2.	Purchases	200	2.20	440	-	-	-	300	2.00	600
								200	2.20	440
4.	Issue	-	-	-	150	2.20	3.30	300	2.00	600
								50	2.20	100
6.	Purchases	200	2.30	460	-	-	-	300	2.00	600
								50	2.20	110
								200	2.30	460
12.	Issue	-	-	-	150	2.30	345	300	2.00	600
								50	2.20	110
								50	2.30	115
20.	Issue	-	-	-	200	-	-	-	-	-
					50	2.30	115			
					50	2.20	110			
					100	2.00	200	200	2.00	400
25.	Purchases	200	2.40	480	-	-	-	200	2.00	400
								200	2.40	480
30.	Issue	-	-	-	250					
					200	2.40	480			
					50	2.00	100	150		300
30.	Closing balance							150	2.00	300

6. From the following information prepare a stores ledger by adopting the weighted average method and ascertain the value of the closing stock.

2011

April 1 Opening stock 600 units @ Rs. 30 per unit

April 4 Purchases 1200 units @ Rs. 40 per unit

April 6 Issued 1000 units

April 10 Purchased 1400 units @ Rs. 40 per unit

April 15 Issued 1600 units

April 20 Purchased 600 units @ Rs. 50 per unit

April 25 Issued 200 units

*Sol :***Stores ledger A/c (Weighted Average Method)**

Date	Particulars	Receipts			Issues			Balance	
		Units	Rate	Amount	Units	Rate	Amount	Units	Amount
2011									
Apr 1 <sup>st</sup>	Opening balance	–	–	–	–	–	–	600	18,000
Apr 4 <sup>th</sup>	Purchases	1,200	40.00	48,000	–	–	–	1,800	66,000
Apr 6 <sup>th</sup>	Issue	–	–	–	1,000	36.67	36,670	800	29,330
Apr 10 <sup>th</sup>	Purchases	1,400	40.00	56,000	–	–	–	2,200	85,330
Apr 15 <sup>th</sup>	Issue	–	–	–	1600	38.78	62,048	600	23,282
Apr 20 <sup>th</sup>	Purchases	600	50.00	30,000	–	–	–	1,200	53,282
Apr 25 <sup>th</sup>	Issue	–	–	–	200	44.40	8,880	1,000	44,402
Apr 30 <sup>th</sup>	Closing Stock							1,000	44,402

**7. Prepare the Stores Ledger Account for the month of March 2012 under****(a) Simple average method****(b) Weighted average price method.**

Date	Particulars	Quantity (kg.)	Rate per Unit
March 2	Received	2000	10
6	Received	300	12
9	Issued	1200	—
10	Received	200	14
11	Issued	1000	—
22	Received	300	11
31	Issued	200	—

*Sol :***Stores Ledger (Weighted Average Method)**

Date	Particulars	Receipts			Issues			Balance	
		Units	Rate	Amt.	Units	Rate	Amt.	Units	Amt.
Mar 2	Received	2,000	10.00	20,000	–	–	–	2,000	20,000
" 6	Received	300	12.00	3,600	–	–	–	2,300	23,600
" 9	Issue	–	–	–	1200	10.26	12312	1100	11,288
" 10	Received	200	14.00	2800	–	–	–	1300	14,088
" 11	Issue	–	–	–	1000	10.83	10830	300	3,258
" 22	Received	300	11.00	3300	–	–	–	600	6,558
" 31	Issue	–	–	–	200	10.93	2186	400	4,372
" 31	Closing Stock							400	4372



**Working Notes :**

Calculation of Weighted Average issue Price

$$\text{March 9}^{\text{th}} = \frac{11,288}{1100} = 10.26$$

$$\text{March 11}^{\text{th}} = \frac{10,830}{1000} = 10.83$$

$$\text{March 31}^{\text{st}} = \frac{4372}{400} = 10.93$$

**Stores Ledger (Simple Average)**

Date	Particulars	Receipts			Issues			Balance	
		Units	Rate	Amt.	Units	Rate	Amt.	Units	Amt.
Mar 2	Received	2000	10.00	20,000	—	—	—	2,000	20,000
" 6	Received	300	12.00	3600	—	—	—	2300	23,600
" 9	Issue	—	—	—	1200	11.00	13,200	1100	10,400
" 10	Received	200	14.00	2800	—	—	—	1300	13,200
" 11	Issue	—	—	—	1000	13.00	13,000	300	200
" 22	Received	300	11.00	3300	—	—	—	600	4500
" 31	Issue	—	—	—	200	12.50	2500	400	2000
" 31	Closing Stock							400	2000

**Working Notes :**

Calculation of Issue Price

$$\text{March 9}^{\text{th}} = \frac{10.00 + 12.00}{2} = \frac{22}{2} = 11$$

$$\text{March 11}^{\text{th}} = \frac{12.00 + 14.00}{2} = \frac{26}{2} = 13$$

$$\text{March 31}^{\text{st}} = \frac{14.00 + 11.00}{2} = \frac{25}{2} = 12.50$$

8. From the following information prepare a stores ledger under Simple Average Method of pricing of issues of materials.

2011

1 Feb. Purchased 150 units @ ` 30 per unit

4 Feb. Purchased 300 units @ ` 40 per unit

6 Feb. Issued 200 units

10 Feb. Purchased 300 units @ ₹ 50 per unit

15 Feb. Issued 500 units

20 Feb. Purchased 200 units @ ₹ 60 per unit

23 Feb. Issued 100 units.

*Sol :*

#### Stock Ledges (Simple Average)

Date	Particulars	Receipts			Issues			Balance	
		Qty	Price	Value	Qty	Price	Value	Qty	U.P.
Feb 1	Purchases	150	30	4,500	–	–	–	150	4,500
Feb 4	Purchases	300	40	12,000				450	16,500
Feb 6	Issue	–	–	–	200	35	7000	250	9,500
Feb 10	Purchases	300	50	15,000	–	–	–	550	24,500
Feb 15	Issue	–	–	–	500	45	22,500	50	2,000
Feb 20	Purchases	200	60	12,000	–	–	–	250	14,000
Feb 23	Issue	–	–	–	100	55	5500	150	8500

#### Working Notes :

##### Calculation of Issue Price

$$\text{Feb 6}^{\text{th}} = \frac{30 + 40}{2} = \frac{70}{2} = 35$$

$$\text{Feb 15}^{\text{th}} = \frac{40 + 50}{2} = \frac{90}{2} = 45$$

$$\text{Feb 23}^{\text{th}} = \frac{50 + 60}{2} = \frac{110}{2} = 55$$

### 3.3 VALUATION OF GOODWILL

**Q7. Define goodwill. Explain the factors effecting goodwill.**

*Ans :*

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 :

**According to J.O. Magee,** "The capacity of a business to earn profits in future is basically what is meant by the term goodwill".

**According to Lord Lindley,** "The terms goodwill is generally used to denote benefit arising from connections and reputation".

**According to Lord Eldon,** "Goodwill is nothing more than the probability, that the old customers will resort to the old place".

**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".

**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 Affecting the Value of Goodwill

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.

#### 3.3.1 Methods of Valuation of Goodwill

**Q8. Explain the various methods of valuation of goodwill.**

*Ans :*

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 :

$$\text{i) Average profit} = \frac{\text{Total profits}}{\text{Number of years}}$$

$$\text{ii) Capitalized value of average profit} = \text{Average profit} \times \frac{100}{\text{Normal rate}}$$

$$\text{iii) Goodwill} = \text{Capital required} - \text{Capital employed}$$

**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 :

$$\text{i) Average profit} = \frac{\text{Total profits}}{\text{Numbers of years}}$$

$$\text{ii) Normal profit} = \text{Capital employed} \times \frac{\text{Normal rate}}{100}$$

$$\text{iii) Super profit} = \text{Actual average profit} - \text{Normal profit}$$

$$\text{iv) Goodwill} = \text{Super profit} \times \frac{100}{\text{Normal rate}}$$

**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**

9. 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:*

- a) Calculation of average profit :

Years	₹
I year	40,000
II year	32,000
III year	15,000
IV year	13,000
	<hr/> 1,00,000

$$\begin{aligned}\text{Average profit} &= \frac{\text{Total Profit}}{\text{No. of years}} \\ &= \frac{1,00,000}{4} \\ &= 25,000\end{aligned}$$

- b) Calculation of Goodwill

$$\begin{aligned}\text{Goodwill} &= \text{Average Profit} \times \text{two years purchase} \\ &= 25,000 \times 2 \\ &= 50,000.\end{aligned}$$

10. 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
	<hr/>
Profit of 3 years	1,90,000
III year loss	(30,000)
	<hr/>
Total profit	1,60,000
	<hr/>

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{No. of years}} = \frac{1,60,000}{4} = 40,000$$

**b) Calculation of goodwill :**

$$\begin{aligned} \text{Goodwill} &= \text{Average Profit} \times \text{three years purchase} \\ &= 40,000 \times 3 \\ &= 1,20,000 \end{aligned}$$

- 11. 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 :*

**a) Calculation of Average Profit :**

I year	90,000
II year	1,00,000
III year	1,10,000
<hr/>	
Total Profit	3,00,000

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{No. of years}} = \frac{3,00,000}{3} = 1,00,000$$

**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**

$$\begin{aligned} &= 1,00,000 - 30,000 \\ &= ₹ 70,000. \end{aligned}$$

**d) Goodwill at two years' purchase of super profit :**

$$\begin{aligned} \text{Goodwill} &= \text{Super Profit} \times \text{No. of years of purchase} \\ &= 70,000 \times 2 = 1,40,000 \end{aligned}$$

- 12. A firm has earned an average profit of ₹ 7,40,000 during the last few years and the normal rate of return in similar type of business is 10%. The firm has net assets (Capital) worth ₹ 73,30,000. Find out the goodwill by capitalization method.**

*Sol :*

Capitalized value of average profit

$$= \text{Average profit} \times \frac{100}{\text{Normal rate of return}}$$

$$= 7,40,000 \times \frac{100}{10} = ₹ 74,00,000$$

Goodwill = Capitalized value – Net assets (i.e., capital employed)

$$= 74,00,000 - 73,30,000 = 70,000$$

- 13. Verma Brothers earn a profit of 90,000 with a capital of 74,00,000. The normal rate of return in the business is 15%. Use capitalization of super profit method to value the goodwill.**

*Sol :*

$$\text{Normal profit} = 74,00,000 \times 15/100 = 60,000$$

$$\text{Super profit} = 90,000 - 60,000 = 30,000$$

$$\text{Goodwill} = \text{Super profit} \times 100/\text{normal rate of return}$$

$$= 30,000 \times \frac{100}{15} = 2,00,000$$

- 14. Annual super profit = ₹ 18,000, Number of years = 4, Rate of interest = 6%.**

*Sol :*

The value of Goodwill

$$V = \frac{a}{i} \left[ 1 - \frac{1}{(1+i)^n} \right]$$

$$V = ₹ \frac{18,000}{0.06} \left[ 1 - \frac{1}{(1+0.06)^4} \right] = ₹ 62,376$$

When present value of an annuity of rupee one at certain rate of interest for certain period is given then also the value of good will may be calculated as follows :

At 6% for 4 years the present value of an annuity of ₹ 1 is ₹ 3.4651 (approximately)

Value of good will = Average annual super profit × Annual rate or discounted rate per ₹ 1

$$= ₹ 18,000 \times ₹ 3.4651 = ₹ 62,372 \text{ (approximately)}$$

- 15. 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 :

$$\text{Profit for 5 years} = 40,000 + 45,000 + 49,000 + 47,000 + 52,000 = 2,33,000$$

## Calculation of Adjusted Profit

Particulars	Amount (₹)
Profits for five years	2,33,000
<b>Add :</b> Extra ordinary Loss due to fire	4,300
	2,37,300
<b>Less :</b> Non - recurring profits	5,500
<b>Total Adjusted Profits for Five years</b>	<b>2,31,800</b>

$$\text{Average Profits} = \frac{2,31,800}{5} = ₹ 46,360$$

## Calculation of Expected Average Profits

Particulars	Amount (₹)
Average Profits	46,360
<b>Add :</b> Expenses saved by way of salary to manager (700 × 12) (present salary of manager who is replaced)	8,400
	54,760
<b>Less :</b> Loss due to leaving the employment of company	600
	54,160
<b>Less :</b> Expenses to be paid in future insurance premium	750
<b>Net Expected Average Profits</b>	<b>53,410</b>

Good will = Net expected Average Profits  $\times$  Number of years for which good will is calculated

$\therefore$  Good will =  $53,410 \times 3 = 1,60,230$ .

### 3.4 ACCOUNTING FROM INCOMPLETE RECORDS - SINGLE ENTRY SYSTEM

**Q9. What do you mean by incomplete Records. Explain the features of Incomplete Records.**

*Ans :*

Single entry system is actually an incomplete state of a double entry system. It is also known as "Incomplete Records System".

#### Definition

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.

#### Salient Features of Incomplete Records System

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).

#### Reasons of Incomplete Records

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.

### 3.4.1 Advantages and Disadvantages of Single Entry System

**Q10. What are the advantages and disadvantages of single entry system.**

*Ans :*

#### Advantages of Single Entry System

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 of Single Entry System

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.

### 3.4.2 Double Entry System

**Q11. Explain the meaning of double entry system. What are the characteristics of double entry system?**

*Ans :*

#### Meaning of Double Entry System

The double entry book-keeping refers to a system of accounting in which every transaction affects at least two Recounts. This is the basis of the accounting equation also.

In accountancy, the double-entry book keeping (or double-entry accounting) system is the basis of the standard system used by businesses and other organizations to record financial transactions. It was first described by the Italian mathematician Luca Pacioli. Its premise is that a business's (or other organization's) financial condition and results of operations are best recorded in accounts. Each account maintains a history of changes in monetary values about a particular aspect of the business.

This system is called double-entry because each transaction is recorded in atleast two accounts. Each transaction results in atleast one account being debited and at least one account being credited, with the total debits of the transaction equal to the total credits.

**For example,** if business A sells an item to business B and business B pays business A by cheque, the bookkeeper of the business A would credit the account called "Sales" and debit the account called "Bank". Conversely, the bookkeeper of business B would debit the account called "Purchases" and credit the account called "Bank".

Recording dual aspects of business transactions in terms of 'Debit and Credit' is Double Entry System.

**Characteristics of Double Entry System**

Following are the characteristics of double entry system:

1) **Every Business Transaction Affects Two Accounts**

There are two accounts involved in every business transaction. One of them is debited and the other is credited. Certain transactions may involve more than two accounts but the amount of the accounts to be debited and credited will always be equal.

2) **Every Account is Divided in Two Parts**

All the ledger accounts prepared on the basis of books of original record, i.e., journal and subsidiary books have two sides. Left hand side is 'Debit' and the right hand side is 'Credit'.

3) **Division of Amount Column**

The amount column is also divided in two parts, i.e., Debit and Credit.

4) **Dual Aspect of Every Transaction**

The system is based upon this accounting truth that every debit has got its corresponding credit. This is why, all the business transactions are recorded simultaneously at the debit and credit side.

5) **Based upon Accounting Concepts and Conventions**

The double entry system is based upon universally accepted accounting concepts and convention which one must follow while maintaining our books of accounts.

6) **Preparing Trial Balance**

According to double entry system, business transactions are recorded first in the subsidiary books and journal proper. With these books of original record one can prepare ledger accounts, whose balances are used for preparing trial balance, which is test of arithmetical accuracy in accounting.

7) **Preparation of Final Accounts**

At the end of accounting year, final accounts are prepared to assess business income and financial position of the business. Trial balance,

prepared with the balances of ledger accounts has also debit and credit balances. The total of these two balances are always equal showing the truth that every debit has its corresponding credit.

**3.4.3 Advantages and Disadvantages of Double Entry System**

**Q12. What are the advantages and disadvantages of double entry system.**

*Ans :*

**Advantages of Double Entry System**

The advantages of double entry system are as follows:

1) **Reliable Information at a Glance**

The system keeps complete records of business transactions in systematic and scientific way, so requisite information can be obtained at a glance. The information supplied by the system is also reliable.

2) **Scrutiny and Verification of Information**

The business can verify the value of assets and scrutinize the records, if necessary on the basis of documentary proof as vouchers.

3) **Knowledge of Gross Profit or Loss**

One can prepare trading account and find out gross profit or loss with this account.

4) **Knowledge of Net Profit or Loss**

Under the double entry system, one can prepare profit and loss account and ascertain net profit or net loss.

5) **Knowledge of Assets and Liabilities of the Business**

Position statement also known as balance sheet is prepared. It reflects the values of assets and liabilities of the business at the end of accounting year.

6) **Comparative Studies**

Financial statements prepared on the basis of double entry system can be compared with the statements of previous years. The actual performance can be compared with the desired performance. Weaknesses can be detected and remedial measures will be applied.

**7) Detection of Fraud**

The systematic and scientific recording of business transaction on the basis of this system minimizes the chances of embezzlement and frauds. It can be easily detected by vouching, verification and auditing of accounts. This exerts a moral pressure on the accountant and his staff.

**8) Complete Record of Every Transaction**

Under this system both the aspects of each and every transaction are recorded. So, it is possible to keep complete account.

**9) Possible to Verify the Arithmetical Accuracy**

Since both the aspects of a transaction are recorded, for each debit there must be a corresponding credit of an equal amount. Therefore, total debits must be equal to total credits. In fact, it is possible to verify the arithmetical accuracy of the books of account by ascertaining whether the two sides become equal or not through a process known as 'Trial Balance'.

**Disadvantages of Double Entry System**

The disadvantages of double entry system are as follows:

**1) Costlier System**

In double entry system use of a number of accounting books such as Journal, Ledger, Cash Book, and Subsidiary Journals is needed. Therefore, the book-keeping under this system become costlier, especially for small traders.

**2) Need Practical Knowledge**

Different types of accounts have different rules for their debit and credit. Therefore, proper education, practical knowledge, and training is required in order to maintain accounts on the double entry system.

**3) Accounting Errors**

Under double entry system only the arithmetical accuracy of accounts can be checked by preparing a Trial Balance. Many accounting errors, like errors of commission, errors of omission, errors of principle, and compensating errors may remain despite the agreement of Trial Balance.

**i) Errors of Omission**

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

**ii) Errors of Principle**

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

**iii) Compensating Errors**

If Ram's account is by mistake debited with ₹ 15 lesser and Mohan's account is also by mistake credited with ₹ 15 lesser, the trial balance will tally but mistake will remain in accounts.

4) **Harder to Understand**

Double entry bookkeeping is harder to understand and difficult to learn.

5) **Unsuitable for Small Concern**

This system is not suitable for small concerns, because it requires the maintenance of a number of books of accounts which is not possible in small concerns.

6) **Time Consuming**

It is a bit more time-consuming, because by its very definition, every transaction is entered twice and it requires multiple entries for the same transaction. Finding mistakes can take longer time.

**3.4.4 Differences between Single Entry System and Double Entry System****Q13. Distinguish between Single Entry System and Double Entry System.**

*Ans :*

**Differences between Double Entry System and Single Entry System**

Basis of Difference	Double Entry System	Single Entry System
1) <b>Recording</b>	It keeps a complete record of all business transactions	It does not maintain a complete record of all business transactions.
2) <b>Ascertainment of Profit &amp; Loss</b>	Correct profit or loss can be ascertained with the help of trading and profit and loss accounts.	It is not at all possible to ascertain the correct amount of profit or loss of the business.
3) <b>Financial Position</b>	Financial position can be known correctly by preparing the balance sheet.	Since true balance sheet cannot be prepared from incomplete records, true financial position cannot be known.
4) <b>Preparation of Accounts</b>	Since personal, real and nominal accounts are maintained properly, all business informations are available from it.	It is not possible to understand the detailed information since only cash accounts and personal account are prepared.
5) <b>Dual Aspect</b>	Since all transactions have a two - fold aspect, arithmetical accuracy can be possible by preparing a trial balance.	It is not possible
6) <b>Comparison of Accounts</b>	Comparisons between the two accounts for the two different periods can be made possible.	It is not possible since necessary accounts are not maintained.
7) <b>Detection of Errors</b>	Errors and frauds can be detected easily under this system.	It is not at all easy to detect errors and frauds committed by the accountant or any other person.
8) <b>Possibility of Alteration</b>	It is not possible to change or delete any item since it is based on fixed principles.	Any change can be made easily since it is not based on any fixed principle.

**3.5 PREPARATION OF ACCOUNTS AND ASCERTAINMENT OF PROFIT FROM INCOMPLETE RECORDS**

**Q14. Explain the concept of Preparation of Accounts (or) Ascertainment of Profit or Loss From Incomplete Records.**

*Ans :*

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.

**Q15. Define statment of affairs method. Explain the format of statement of affairs method.**

*Ans :*

**1. 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) <b>Add</b> : Drawings	xx	
	xxx	
(C) <b>Less</b> : 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

## 3.5.1 Accounting Treatment as per the Statement of Affairs Method

**Q16. Discuss the accounting treatment as per the statement of affairs method with its various models.**

*Ans :*

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

16. 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

17. 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	As on 31.12.2008
	Rs.	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

18. Mrs. Renu could not keep complete records. She provides you with the following details

Particulars	As on 1.4.2008 Rs.	As on 31.3.2009 Rs.
Bank balance	9,000	1,200 (Cr.)
Stock in trade	41,000	70,000
Sundry Debtors	30,000	40,000
Sundry Creditors	15,000	6,000
Bills payable	5,000	3,000
Bill receivable	13,000	17,000
Furniture and fixtures	6,000	6,000
Buildings	1,20,000	1,20,000

#### Further Information

She sold her private investments of Rs 6,000 @ 33 1/3% premium and brought this money in her business on June 1, 2008. Her drawings were Rs 1,500 per month. Stock costing Rs 9,000 was taken by her for personal use. Rs 5,000 is outstanding for wages and Rs 2,000 for salaries. Prepaid insurance Rs 500. outstanding medical expenses amounted to Rs 2,000. A provision @ 10% is required for doubtful debts. Depreciation is to be written off @ 5% on furniture and fixtures and 10% on buildings.

You are required to compute profit and loss by statement of affairs method for the year 2008-2009 and Balance Sheet as on Mar 31, 2009.

*Sol:*

- Calculation of opening and closing capital has to be made by preparing Statement of Affairs,
- Computation of profit or loss has to be made by preparing Statement of Profit or Loss. But here, after arriving profit or loss, all the other adjustments have to be carried out to arrive at net profit (this is the Step 6, the last step discussed)
- Finally a Balance Sheet has to be drawn as on Mar 31, 2009.

#### Stage I : Computation of Opening Capital and Closing Capital

##### Statement of Affairs of Mrs. Renu as on 1.4.2008 and as on 31.3.2009

Liabilities	1.4.2008 Rs.	31.3.2009 Rs.	Assets	1.4.2008 Rs.	31.3.2009 Rs.
Sundry Creditors	15,000	6,000	Cash at bank	9,000	—
Bills payable	5,000	3,000	Stock in trade	41,000	70,000
Bank overdraft	—	1,200	Sundry Debtors	30,000	40,000
Capital			Bills Receivable	13,000	17,000
(Balancing figure)	1,99,000	2,42,800	Furniture and fixtures	6,000	6,000
			Buildings	1,20,000	1,20,000
	2,19,000	2,53,000		2,19,000	2,53,000

**Stage II:** Calculation of profit or loss**Statement of Profit or Loss for the year ending on 31.3.2009**

Particulars	Rs.
Step 1 : Capital at the end (i.e., on 31.3.2009)	2,42,800
Step 2 : Add : Drawings (Cash Rs 1,500 x 12 + Stock Rs 9,000)	27,000
	2,69,800
Step 3 : Less: Additional capital (Rs 6,000 + 33 1/3 of Rs 6,000)	8,000
Step 4 : Adjusted capital at the end (1 + 2 - 3)	2,61,800
Step 5 : Less capital in the beginning (i.e., as on 1.4.2008)	1,99,000
Step 6 : Profit (4 > 5; 4 - 5) (but subject to adjustments)	62,800
Step 7 : Less: Other adjustments	
Provision for doubtful debts	4,000
Depreciation on furniture and fixtures	300
Depreciation on building	12,000
Outstanding Wages	5,000
Outstanding Salaries	2,000
Outstanding Medical Expenses	
	25,300
* Pre-paid insurance	(500)
	24,800
Step 8 : Net Profit for the year (Step 6 – Step 7)	38,000

**Stage III :** Preparation of Balance Sheet as on 31.3.2009**Balance Sheet of Mrs. Renu as on 31.3.2009**

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry Creditors		6,000	Stock in trade		70,000
Bills Payable		3,000	Sundry Debtors	40,000	
Bank Overdraft		1,200	Less: 10% Prov.	4,000	36,000
Outstanding Expenses			Bills Receivable		17,000
Wages	5,000				
Salaries	2,000		Prepaid Expenses (insurance)		500
Medical	2,000	9,000	Furniture and Fixtures	6,000	
Capital			Less: 5% Depreciation	300	5,700
Opening Balance	1,99,000				
Add: Net profit	38,000		Buildings	1,20,000	
Add: Additional Capital	8,000		Less: 10% Depreciation	12,000	1,08,000
	2,45,000				
Less: Drawings	27,000	2,18,000			
		2,37,200			2,37,200

**Notes :**

- (i) Care should be taken while recording bank balance by noting whether it is credit balance.
- (ii) Only net profit has to be added to the capital
- (iii) Pre-paid insurance - Pre-paid expense - see how it is treated in further adjustments
- (iv) While preparing the Balance Sheet, as usual, all the items pertaining to the date of the Balance Sheet will have to be recorded.

- 19. On 1.4.2008, Mr. B.P Singh started a business with a capital of Rs 1,00,000 with which he opened a bank account. In the same date, he bought furniture for Rs 15,000 and stock of goods for Rs 45,000.**

**On Mar 31, 2009, the stock in hand was valued at Rs 70,000 and fittings stood at Rs 13,500. Book debts amounted to Rs 50,000 of which Rs 2,000 was considered as bad. His bank balance as per cash book was Rs 10,000. A cheque of Rs 1,750 sent for deposit on Mar 29, 2009 was realised on Apr 7, 2009 and a cheque of Rs 900 issued on Mar 17, 2009 was not presented till Apr 3, 2009. Bank charges amounted to Rs 100, but the same was not intimated to him upto Mar 31, 2009. His drawings stood at Rs 750 per month. He also took goods worth Rs 7,500 for personal use from the business. Creditors stood at Rs.12,000 at the end. You are required to prepare a statement showing or of it or loss for the period ending on Mar 31, 2009.**

*Sol :*

- In this problem bad debts are shown. It has to be deducted from book debts.
- Some transactions relating to cheques are shown. Accounting treatment for them:
  - (i) A cheque of Rs 1,750 - even though sent for deposit on Mar 29 itself (i.e., during the accounting period), it was realised only on Apr 7 (i.e., next accounting period). So that transaction need not be taken into account.
  - (ii) Another cheque of Rs 900, even though it was issued on Mar 17 itself, it was not presented till Apr 3, 2009. So this also need not be recorded now.
  - (iii) Bank charges Rs 100, even though not intimated to the client it has to be deducted from cash at bank as per cash book, as it really affects the amount during the accounting.
- As opening capital is given, a statement of affairs for the closing capital has to be computed, with the adjustments, discussed as above.
- Finally a Statement of Profit or Loss for the year ending Mar 31, 2009 is to be prepared.

**Stage I : Statement of Affairs as on Mar 3,2009**

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	12,000	Cash at bank (as per cash book)	
		Rs. (10,000 - 100)	9,900
		(given) (bank charge)	
*Capital: (Balancing figure)	1,29,400	Stock (given)	70,000
		Furniture and Fittings (given)	13,500
		Book Debts (Rs 50,000 - 2,000)	48,000
	1,41,400		1,41,400

**Stage II:** Statement of Profit or loss for the year ending on Mar 31, 2009

	Rs.
1. Capital on Mar 3, 2009 (Computed as in Stage I)	1,29,400
2. Add: Drawings (Rs 750 per month x 12 + Stock worth Rs 7,500)	16,500
3. Adjusted Capital	1,45,900
4. Less: Capital on 1.4.2008 (Given in question)	1,00,000
5. Profit (3 > 4; 3-4) for the year	45,900

**20. Mr. Jain had Rs 2,00,000 in bank on Jan 1, 2008 on which date he started business. His incomplete records reveal:**

Particulars	31.3.2008 Rs.	31.3.2009 Rs.
Cash in hand	10,000	16,000
Stock in trade	25,500	32,500
Sundry Debtors	40,000	50,000
Sundry Creditors	22,500	16,500

On Feb 1, 2008, he started withdrawing Rs 2,500 per month from the business for his personal use. His account in the bank reveals:

Particulars	Deposits Rs	Withdrawals Rs
Jan 1, 2008	2,00,000	–
Jan 1, 2008 to Mar 31, 2008	–	1,25,000
Apr 1, 2008 to Mar 31, 2009	2,12,500	1,75,000

The above withdrawals included payments by cheques of Rs 1,06,000 and Rs 37,500, respectively, during the period from Jan 1, 2008 to Mar 31, 2008 and from Apr 1, 2008 to Mar 31, 2009 for purchase of machinery for the business. The deposits after Jan 1, 2008 consisted wholly of sale price received from customers by cheques. Determine the profit/loss of Mr. Jain for the year ended Mar 31, 2009.

*Sol.:*

As some transactions relate to bank and through cheques, while entering the amount relating to bank the following adjustments have to be made:

### Step 1

While preparing statement of affairs (on Mar 31, 2008), i.e. for the period from Jan 1, 2008 to 31 Mar, 2008, amount relating to, bank will be: deposits during the period - withdrawals during the period. Rs 2,00,000 - 1,25,000 = Rs 75,000, shown on the assets side.

### Step 2

Computation of cash at bank, for the preparation of Statement of Affairs (as on Mar 31, 2009) will be as follows.

Particulars	Rs
Opening balance of cash at bank (as worked out earlier) (i.e., on 1.4.2008)	75,000
Add: Deposits for this period i.e., From 1.4.2008 to 31.3.2009 (given in question)	2,12,500
	2,87,500
Less: Withdrawals for this period i.e., from 1.4.2008 to 31.3.2009 (given in question)	1,75,000
*2 Cash at bank on Mar 31, 2009	1,12,500

### Step 3

Statement of Affairs for both the dates have to be prepared, as usual.

### Step 4

Finally, Statement of Profit and Loss for the year ending Mar 31, 2009 is to be prepared.

### Stage I: Statement of Affairs as on Mar 31, 2008

Liabilities	Rs	Assets	Rs
Sundry Creditors	22,500	Cash in hand	10,000
Capital		Cash at bank	75,000
(Balancing figure)	2,34,000	Sundry Debtors	40,000
		Stock in hand	25,000
		Machinery	1,06,000
	2,56,500		2,56,500



**Stage II: Statement of Affairs as on Mar 31, 2009**

Liabilities	Rs	Assets	Rs
Sundry Creditors	16,500	Cash in hand	16,000
Capital		Cash at bank	1,12,500
(Balancing figure)	3,13,000	Stock in hand	32,500
		Sundry Debtors	25,000
		Machinery	1,43,500
	3,29,500		3,29,500

**Stage III: Statement of Profit/Loss for the year ending on Mar 31, 2009**

Particulars	Rs
Capital as on Mar 31, 2009	3,13,000
Add: Drawings (Rs 2,500 x 12)	30,000
Adjusted Capital	3,43,000
Less: Capital as on Mar 31, 2008	2,34,000
Net Profit (3 > 4; 3 - 4) for the year	1,09,000

**3.5.2 Conversion Methods**

**Q17. Explain briefly about conversion/final account method of incomplete record system. What are the steps involved in it?**

*Ans :*

**Conversion Method/Final Accounts Method**

In order to ascertain gross profit and net profit it is important to transfer single entry records into double entry records. The accounting procedure for converting single entry into double entry is known as "conversion method".

**Features of Conversion Method**

The following are some of the features of conversion method,

1. It does not involve any lengthy process for preparing accounts like journal, ledger and trial balance.
2. Final accounts can be prepared from the available information and is not necessary to depend totally on trial balance.
3. Missing figures can be ascertained from the ledger accounts.

**Steps Involved in Conversion Method**

1. There is a lengthy procedure for ascertaining missing figures.
2. For preparing total debtors and creditors account, bills receivable and bills payable account necessary figures have to be collected from every account.
3. Preparing the cash book is one of the most important step in conversion method.
4. Statement of Affairs is to be prepared in order to ascertain capital in the beginning. For missing figures it is suggested to the students to prepare statement of Affairs many times to find out the correct missing figures.

5. Computation of total purchases and total sales.
6. Apart from the above stated accounts, other accounts are also to be prepared. However, students look at the table to understand the Accounting methods to find out the missing figures.
7. Trial balance is to be prepared.
8. Trading, profit and loss and balance sheet can be formulated.

**In order to prepare Trading account in conversion method, the below stated information should be available.**

- (a) Sales
- (b) Purchases
- (c) Closing stock
- (d) Opening stock and
- (e) Direct expenses

### 3.5.3 Calculation of Missing Figures

**Q18. Discuss the various transactions involved in ascertainment of missing figures.**

*Ans :*

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

**Q19. Draw the format of cash book.**

*Ans :*

#### Format of Cash Book

Dr.

Cr.

Receipts	Cash Rs	Bank Rs	Payments	Cash Rs	Bank Rs
To Balance B/d	XX	XX	Cash Balance B/d (overdraft)	—	XX
To Cash Sales	XX	—	By Cash Purchases	XX	—
To Collection from debtors	XX	XX	By Payment to creditors	XX	XX
To B/R collected	XX	XX	By B/P discharged	XX	XX
To Additional capital	XX	XX	By Drawings	XX	XX
To Sale of fixed asset	XX	XX	By Purchase of fixed asset	XX	XX
To Sundry Incomes	XX	XX	By Sundry Expenses	XX	XX
To Balance C/d (overdraft)	—	XX	By Balance C/d	XX	XX
	XX	XX		XX	XX

If both the sides of a cash book are not tallied then the difference in the sides (both) may be treated as one of the following items:

**If credit side exceeds debit side**

1. Opening cash balance (or) Opening bank balance (or) Closing bank overdraft
2. Cash sales
3. Collection from debtors
4. B/R collected
5. Additional Capital
6. Sale of fixed asset
7. Sundry Income

**If debit side exceeds credit side**

1. Closing cash balance (or) Closing bank balance (or) Opening bank overdraft
2. Cash Purchases
3. Payment to creditors
4. B/P discharged
5. Drawings
6. Purchase of fixed asset
7. Sundry Expenses

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**Q20. How do you calculate missing figures for purchases ? Show the format of each account.**

*Ans :*

**Purchases**

1. The amount of cash purchases are ascertained from the amount of cash book.
2. Cash purchases are added to credit purchases and the resultant total purchases amount are shown during the preparation of trading account.
3. Thus, credit purchases need to be determined by preparing the following accounts,
  - (a) Total creditors account
  - (b) Bills payable account and
  - (c) Memorandum trading account,

**(a) Total Creditors Account**

Total creditors account is prepared to ascertain the following,

- (i) Cash paid to creditors (or)
- (ii) Credit purchases (or)
- (iii) Opening balance of creditors (or)
- (iv) Closing balance of creditors.

Dr		Proforma of Toral Creditors Account		Cr
Particulars	Amount ( ` )	Particulars	Amount ( ` )	
To returns outwards a/c	xxx	By balance b/d	xxx	
To bills payable a/c (B/P accepted)	xxx	(B/R By bills payable a/c cancelled)		
To bills receivable a/c (B/R endorsed)	xxx	By bank a/c (Cheque dishonoured)	xxx	
To transfer from debtors	xxx	By cash a/c (Paid for purchase return)	xxx	
To allowances	xxx	By interest charged	xxx	
To cash/bank a/c (Cash paid/cheque issued)	xxx	By credit purchases	xxx	
To discount a/c (received)	xxx	By total debtors a/c (endorsed B/R dishonoured)	xxx	
To balance c/d (closing balance)	xxx			
	xxx		xxx	

**(b) Bills Payable Account**

Bills payable has to be prepared to ascertain the figure that is relating to bills accepted in creditors favour. Hence, a kind of paymane is made to creditors through bills.

Dr		Format of Bills Payable Account		Cr
Particulars	Amount ( ` )	Particulars	Amount ( ` )	
To cash/bank A/c	xxx	By balance b/d	xxx	
To creditors A/c (B/P dishonoured/cancelled)	xxx	By total creditors A/c (B/f)	xxx	
To interest a/c (on retirement)	xxx			
To balance c/d	xxx			
	xxx		xxx	

**(c) Memorandum Trading Account**

Memorandum trading account is prepared to ascertain the sales amount as balancing figure.

**Example :**

Determine the amount of sales from the data. Stock in the beginning ` 30,000. Stock at the end ` 10,000 purchases ` 45,000 rate of G.P on sale = 1/6.

*Sol/ :*

Dr.		Memorandum Trading A/c		Cr.
Particulars	Amount ( ` )	Particulars	Amount ( ` )	
To Opening stock	30,000	By Sales (B/F)	78,000	
To Purchases	45,000	By Closing stock	10,000	
To Gross Profit (1/5 on C.G.S) i.e., 65000				

Cost of goods sold = Opening stock + Purchases – Closing stock

$$= 30,000 + 45,000 - 10,000 = ` 65,000$$

**Q21. What are the accounts which are needed to calculate the missing figures of sales ? Show the formats of each account.**

*Ans :*

To calculate the missing figures of sales, we have to ascertain both cash sales and credit sales. Cash sales amount are shown in the cash book whereas credit sales have to be computed by preparing the following two accountws,

1. Total Debtors Account and
2. Bills Receivable Account

Dr		Proforma of Total Debtors Account		Cr
Particulars	Amount ( ` )	Particulars	Amount ( ` )	
To balance b/d (Opening balance)	xxx	By sales returns	xxx	
To B/R A/c (B/R dishonored)	xxx	By cash a/c (cash received)	xxx	
		By Bank a/c (cheques received)	xxx	
To bank A/c (Discounted B/R dishonored)	xxx	By discount allowed	xxx	
To bank a/c (cheque dishonored)	xxx	By bad debts	xxx	
To interest (charged from customers)	xxx	By bills receivable a/c (B/R drawn)	xxx	
To cash (paid for sales returns etc.)	xxx			
To trade creditors a/c (Enclosed B/R dishonored)	xxx	By Balance c/d	xxx	
To credit sales	xxx			
	xxx			xxx

#### Format of Bills Receivable Account

Dr.		Bills Receivable Account		Cr.
Particulars	Amount ( ` )	Particulars	Amount ( ` )	
To balance b/d	xxx	By cash a/c (B/R collected)	xxx	
To total debtors A/c (B/R accepted received)	xxx	By bank a/c (B/R discounted)	xxx	
		By bankers discount a/c (Discounting charges)	xxx	
		By interest (on retirement)	xxx	
		By total creditors a/c (B/R endorsed)	xxx	
		By total debtors a/c (B/R dishonoured)	xxx	
		By balance c/d	xxx	
	xxx			xxx

**Q22. Draw the formats/proformas of the following accounts,**

(a) Revenue expenses

(b) Revenue incomes

*Ans :*

**(a) Revenue Expenses**

Revenue expenses a/c is prepared to determine the figure relating to expenses and thus, the balancing figure shows the missing figure. The format (or) proforma of revenue expenses a/c is as follows,

Dr.		Format of Revenue Expense A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)		
To balance b/d (Prepaid in the beginning)	xxx	By balance b/d (O/S in the beginning)	xxx		
To cash/bank/A/c (Expenses paid during the year)	xxx	By profit and loss A/c (Balancing figure)	xxx		
To balance c/d (O/s at the end)	xxx	By balance c/d (Prepaid at the end)	xxx		
	<b>xxx</b>		<b>xxx</b>		

Calculation of missing figures i.e., revenue expenses is understood by the following illustration.

**(b) Revenue Income**

Revenue income account is to be prepared to compute the amounts relating to income and the balancing figure represents the missing figure.

Dr.		Format of Revenue Income A/C		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)		
To balanced b/d (Accrued in the beginning)	xxx	By balance b/d (Unaccrued in the beginning)	xxx		
To profit and loss a/c (Balancing figure)	xxx	By cash/bank A/c (Income received)	xxx		
To balance c/d (unaccrued at the end)	xxx	By balance c/d (Accrued at the end)	xxx		
	<b>xxx</b>		<b>xxx</b>		



**PROBLEMS ON CALCULATION OF MISSING FIGURES**

21. From the following transactions, you are required to ascertain the missing figure by preparing cash book for the year 2008-2009; Collection from debtors Rs 60,000; Payment to creditors Rs 40,000; Bills Receivables collected Rs 20,000; Bills Payable discharged Rs 19,000; Cash sales deposited Rs 13,000; Cash purchases (by cheque) Rs 5,000; Capital introduced Rs 10,000; Drawings Rs 15,000; Commission received Rs 6,000; Wages paid Rs 20,000; Salaries paid Rs 12,000; Rent paid Rs 9,000; Insurance premium paid Rs 1,000; Carriage inwards Rs 1,000; Bank balance as on Apr 1, 2008 Rs 9,000. All the above transactions are made through cheque only.

*Sol:*

As, all the transactions took place through cheque only, cash book (with bank column alone) may be drawn and the items are transferred to it.

Dr.	Cash Book (Bank Column)		Cr.
Receipt	Rs	Payments	Rs
To Balance B/d	9,000	By Cash Purchases	5,000
To Sundry Debtors	60,000	By Drawings	15,000
To B/R	20,000	By Trade Creditors	40,000
To Commission	6,000	By B/P	19,000
To Cash sales	13,000	By Salaries	12,000
To Capital introduced	10,000	By Wages	20,000
To * Balance C/d (Balancing figure)	4,000	By Rent	9,000
		By Insurance	1,000
		By Carriage Inwards	1,000
	1,22,000		1,22,000

22. You are required to calculate total purchases from the following information:

Creditors as on Mar 31, 2009 Rs 4,000; creditors as on Mar 31, 2008 Rs 20,000; cash paid to creditors Rs 90,000; discount allowed by creditors Rs 3,000; purchase returns Rs 2,000; bills payable accepted Rs 15,000; cheques issued to creditors Rs 15,000; Bills Receivables endorsed in favour of creditors Rs 30,000 out of which 30% bills were dishonoured.

*Sol:*

- First credit purchases will be computed by preparing Trade Creditors' Account.
- Then it is added with cash purchases to get the figure for total purchases.

**Total Creditors' Account**

Dr		Cr	
Particulars	Rs	Particulars	Rs
To Cash A/c	90,000	By Balance B/d	20,000
To Bank A/c	15,000	(as on 31.3.2008)	
To Bills Receivable A/c	30,000	By Total Debtors' A/c	9,000
To Bills Payable A/c	15,000	(30% of Rs 30,000)	
To Discount	3,000	(B/R dishonoured)	
To Purchase Returns	2,000		
To Balance C/d		By Credit Purchases	1,30,000
(as on 31.3.2008)	4,000	(Balancing figure)	
	1,59,000		1,59,000

Total Purchases = Cash Purchases + Credit Purchases

= Rs 90,000 + Rs 1,30,000

= Rs 2,20,000

**23. You are required to determine the amount of sales from the data:**

**Stock in the beginning Rs 15,000; Purchases Rs 60,000; Stock at the end Rs 15,000;**

**Rate of G.P. on Sale = 16.**

*Sol.:*

**Notes**

- As items relating to debtors are not appearing, no need to prepare Debtors Account.
- Further items relating to Bills Receivable are also not shown.

As such, first, from the available figures, gross profit has to be calculated. Then by transferring these data to Memorandum Trading Account, sales (balancing figure) can be ascertained.

**Step I: Calculation of Cost of Goods Sold:**

Cost of goods sold = Opening Stock + Purchases - Closing Stock

= Rs 10,000 + 60,000 - 15,000

= Rs 55,000

**Step 2: Calculation of Gross Profit**

1/6 on sales will be 1/5 on cost

Gross profit on C.G.S = 1/5 x Rs 55,000

= Rs 11,000

**Step 3: Calculation of Sales**

(Preparation of Memorandum Trading Account)

## Memorandum Trading Account

Dr		Cr	
Particulars	Rs	Particulars	Rs
To Opening Stock	10,000	By Sales	66,000
To Purchases	60,000	(balancing figure)	
To Gross Profit	11,000	By Closing Stock	15,000
	81,000		81,000

Sales = Rs 66,000

24. From the following you are required to calculate total sales made during the year 2008.

Debtors as on Jan 1, 2008 Rs 30,600; cash received from debtors during the year (as per cash book) Rs 91,200; bad debts 3,600; cash sales (as per cash book) Rs 85,200; returns inwards Rs 8,100; by debtors as on Dec 31, 2008 Rs 41,400.

*Sol :*

Step 1: Preparation of Total Debtors Account to Determine Credit Sales

## Total Debtors Account

Dr		Cr	
Particulars	Rs	Particulars	Rs
To Opening balance	30,600	By Cash	91,200
*To Credit sales		By Bad debts	3,600
(Balancing figure)	1,13,700	By Returns	8,100
		By Closing balance	41,400
		(as on 31.12.2008)	
	1,44,300		1,44,300

Step 2: Total Sales

Cash sales Rs 85,200

Add: Credit sales Rs 1,13,700

Total sales Rs 1,98,900

25. From the following details you are required to calculate total sales

Particulars	Rs	Particulars	Rs
B/R in the beginning	3,900	Returns Inwards	4,300
Debtors in the beginning	15,400	B/R dishonoured	1,000
B/R encashed during the year	10,450	B/R at the end	3,000
Cash received from debtors	35,000	Debtors at the end	12,000
Bad Debts written off	1,400	Cash Sales	
		(as per cash book)	30,000

*Sol :*

**Step 1: Preparation of Bills Receivable A/c**

**Bills Receivable Account**

Dr

Cr

Particulars	Rs	Particulars	Rs
To Balance (opening)	3,900	By Cash	10,450
To Debtors [B/R received during the year (Balancing figure)]	10,550	By Debtors (B/R - dishonoured)	1,000
		By Balance (closing)	3,000
	14,450		14,450

**Step 2: Preparation of Total Debtor's Account**

**Total Debtor's Account**

Dr

Cr

Particulars	Rs	Particulars	Rs
To Opening Balance	15,400	By Cash	35,000
To B/R (dishonoured)	1,000	By Bad Debts	1,400
To Sales By Returns	4,300	By B/R (from B/R Account *1)	10,550
(Balancing figure)	46,850	By Closing Balance	12,000
	63,250		63,250

**Step 3: Total Sales**

Cash sales = Rs 30,000

Add: Credit sales = Rs 46,850

Total sales = Rs 76,850

**26. Ascertain missing figures through trading, profit and loss and balance sheet.**

Mr. Praveen keeps single entry system accounts in his cash book analysis,

Interest charges ` 100

Balance at bank as ` 2,425 on 31-3-2014

Personal withdrawals ` 2000

Cash in hand as on ` 75 on 31-3-2014

Cash sales ` 15,000

Staff salaries ` 8,500

Other business expenses ` 7,900

Received from debtors ` 25,000

Payments to creditors ` 15,000

**Additional Information :**

Particulars	1-4-2013 (₹)	31-3-2014 (₹)
Stock on hand	9,000	10,220
Furniture	1,000	1,000
Creditors	8,000	5,500
Office premises	15,000	15,000
Debtors	22,000	30,000

Determine trading, profit and loss a/c and balance sheet for the year ending 31-3-2014,

- (i) By providing ₹ 1500 for doubtful debts
- (ii) 5% interest on capital as on 1-4-2013
- (iii) 5% depreciation on all fixed assets
- (iv) After meeting all expenses and commission, provide 5% group incentive commission to staff for net profit.

*Sol :*

For calculating missing figures we need to prepare cash book, opening balance sheet, total debtors account and total creditors account.

**Dr** **Cash Book** **Cr**

Particulars	Amount (₹)	Particulars	Amount (₹)
To sales	15,000	By balance b/d (Bal. figure : Overdraft)	4,000
To debtors	25,000	By salaries	8,500
		By interest	100
		By expenses	7,900
		By drawings	2,000
		By balance at bank	2,425
		By cash	75
		By creditors	15,000
	40,000		40,000

The balancing figure amount has to be taken in the opening balance sheet liability side.

**Dr. Opening Balance Sheet as on 1-4-2013 Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
Capital (balancing figure)	35,000	Furniture	1,000
Bank overdraft	4,000	Debtors	22,000
Creditors	8,000	Stock in hand	9,000
		Office premises	15,000
	<b>47,000</b>		<b>47,000</b>

∴ Opening capital = ₹ 35,000

**Dr. Total Debtors Account Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To opening balance	22,000	By cash	25,000
To sales (bal. fig)	33,000	By closing balance	30,000
	<b>55,000</b>		<b>55,000</b>

Here (balancing figure) sales = 33,000

Total sales = Cash sales + Credit sales = 15,000 + 33,000 = ₹ 48,000

**Dr. Total Creditors Account Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash	15,000	By opening balance	8,000
To closing balance	5,500	By purchases (Bal.fig)	12,500
	<b>20,500</b>		<b>20,500</b>

∴ Purchases = ₹ 12,500

**Dr. Trading and profit and loss for the year ending 31-3-2014 Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To stock	9,000	By sales	48,000
To purchases	12,500	By closing stock	10,220
To gross profit	36,720		
	<b>58,220</b>		<b>58,220</b>

To salaries	8,500	By Gross profit	36,720
To interest	100		
To expenses	7,900		
To provision for doubtful debts	1,500		
To interest on capital (35000 @ 5%)	1,750		
To depreciation on furniture	50		
To depreciation on office premises	750		
To group commission	808.5		
To net profit	15,361.5		
	<b>36,720</b>		<b>36,720</b>

## Balance Sheet

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Capital	35,000		Stock in hand		10,220
<b>Add : Netprofit</b>	15,361.5		Cash in hand		75
<b>Add : Interest on capital</b>	1750		Cash at bank		2,425
	52111.5		Furniture	1000	
<b>Less : Drawing</b>	2000	50111.5	<b>Less : depreciation</b>	50	950
			Premises	15000	
Creditors		5500	<b>Less : Depreciation</b>	750	14,250
Group commission		808.5	Debtors	30,000	
			<b>Less : P.F.D.D</b>	1500	28,500
		<b>56,420</b>			<b>56,420</b>

## Working Notes :

Gross profit	36,720
<b>Less : All expenses except Commission</b>	20,550
Net profit before commission	16,170
<b>Less : 5% commission</b>	808.5
Net profit after commission	15,361.5

27. Mr. Arun maintains single entry accounting system and you are required to prepare Trading, Profit & loss account for the year ending 31<sup>st</sup> March, 2015 and balance sheet as on that date :

Receipts	Amounts (₹)	Payments	Amount (₹)
Closing bank balance	9,700	Interest	400
Closing cash balance	300	Personal withdrawals	8,000
Collections from debtors	1,00,000	Salaries	34,000
Cash sales	60,000	Sundry expenses	31,600
—	—	Payments to creditors	60,000

**Additional Information :**

	As on 1.4.14	As on 31.3.15		As on 1.4.14	As on 31.3.15
Stock	₹ 36,000	₹ 40,880	Furniture	4,000	4,000
Creditors	32,000	22,000	Equipment	60,000	60,000
Debtors	88,000	1,20,000	—	—	—

Provide 5% interest on capital available on 1.4.14.

Provide ₹ 6,000 towards doubtful debts.

Provide depreciation @ 5% on furniture and equipment.

*Sol :*

**Dr. Trading and Profit and Loss Account for the Year Ending 31-3-2015 Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock	36,000	By Sales (W.N) (60,000 + 1,32,000)	1,92,000
To Purchase (W.N)	50,000	By Closing stock	40,880
To Gross Profit c/d (Balancing figure)	1,46,880		
	<b>2,32,880</b>		<b>2,32,880</b>
To Salaries	34,000	By Gross Profit b/d	1,46,880
To Interest	400		
To Sundry expenses	31,600		
To Provision for doubtful debts	6,000		
To interest on capital (1,40,000 @ 5%) (W.N)	7,000		
To depreciation on furniture (4,000 @ 5%)	200		
To depreciation on equipment (60,000 @ 5%)	3,000		
To Net Profit c/d	64,680		
	<b>1,46,880</b>		<b>1,46,880</b>



## Balance Sheet as on 31-03-2015

Liabilities	Amount ( ` )	Assets	Amount ( ` )
Capital	1,40,000	Stock on hand	40,880
<b>Add : Net Profit</b>	64,680	Cash in hand	300
<b>Add : Interest on capital</b>	7,000	Cash at bank	9,700
	2,11,680	Debtors	1,20,000
<b>Less : Drawings</b>	8,000	<b>Less : P.F.D.D</b>	6,000
	2,03,680		1,14,000
Creditors	22,000	Furniture	4,000
		<b>Less : Depreciation</b>	200
			3,800
		Equipment	60,000
		<b>Less : Depreciation</b>	3,000
			57,000
	2,25,680		2,25,680

## Working Notes

Dr.	Cash Book		Cr.
Particulars	Amount ( ` )	Particulars	Amount ( ` )
To Sales	60,000	By balance b/d (Balance. Figure: Overdraft)	16,000
To Debtors	1,00,000	By Salaries	34,000
		By Interest	400
		By Sundry expenses	31,600
		By Drawings	8,000
		By Bank	9,700
		By Cash	300
		By Creditors	60,000
	1,60,000		1,60,000

The balancing figure has to be taken in the opening balance sheet liability side.

## Balance Sheet as on 31-3-2014

Liabilities	Amount ( ` )	Assets	Amount ( ` )
Capital (Blancing figure)	1,40,000	Stock	36,000
Bank overdraft	16,000	Debtors	88,000
Creditors	32,000	Furniture	4,000
		Equipment	60,000
	1,88,000		1,88,000

∴ Opening capital = 1,40,000

Dr. Total Debtors Account		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To opening balance (Given)	88,000	By cash	1,00,000
To credit sales (Balancing Figure)	1,32,000	By closing balance (Given)	1,20,000
	<b>2,20,000</b>		<b>2,20,000</b>

Here (balancing figure) 1,32,000

Total sales = Cash sales (Given) + Credit sales = 60,000 + 1,32,000 = 1,92,000

Dr. Total Creditors Account		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To cash	60,000	By opening balance	32,000
To closing balance	22,000	By purchase (Balancing Figure)	50,000
	<b>82,000</b>		<b>82,000</b>

∴ Purchase = ₹ 50,000.

## Exercises Problems

1. From the following particulars, prepare the Stores ledger Account under two methods of pricing materials:

(a) FIFO method, (b) Simple average. Find out the value of material on the last date of the month.

October 1	Opening balance 400 units @ ` 8 per unit
October 6	Issued 200 units
October 8	Received 250 units @ ` 8.50 per unit
October 13	Issued 300 units
October 19	Received 400 units @ ` 9.00 per unit
October 23	Issued 320 units
October 30	Received 300 units @ ` 8.80 per unit

**[Ans : (a) ` 4,710, (b) ` 4,690]**

2. The following transactions occur in the purchases and issue of material

January 19 <sup>th</sup>	Purchased 100 units @ ` 5.00 each
February 4 <sup>th</sup>	Purchased 25 units @ ` 5.25 each
February 12 <sup>th</sup>	Purchased 50 units @ ` 5.50 each
February 14 <sup>th</sup>	Issued 80 units
March 6 <sup>th</sup>	Purchased 50 units @ ` 5.50 each
March 20 <sup>th</sup>	Issued 80 units
March 27 <sup>th</sup>	Purchased 50 units @ ` 5.75 each

Prepare the stock account showing the balance on March 31<sup>st</sup> the end of accounting year. State clearly your method of pricing and value of the closing stock.

**[A [Ans : ` 612.50]**

3. Bharat Petroleum closes its accounts at the end of each month. The following information is available for the month of April 1983.

Sales	5,00,000
Administrative expenses	40,000
Inventory : April 1 <sup>st</sup> , 1983, 100 tons @ ` 1,000 per ton	1,00,000
Purchases	
April 10 <sup>th</sup> , 200 units @ ` 900 per ton	1,80,000
April 10 <sup>th</sup> , 200 units @ ` 900 per ton	1,60,000
Inventory : April 30 <sup>th</sup> , 1983, 100 tons	

Compute the following data by the FIFO method:

(i) Inventory valuation on April 30 (ii) Cost of goods sold in April (iii) Profit or Loss for April

**[Ans : (i) ` 80,000, (ii) ` 4,00,000, (iii) ` 1,00,000]**

4. From the particulars given below write up the stores ledger card :

1988

January 1	Opening stock	1,000 units at Rs. 26 each.
5	Purchased	500 units at Rs. 24.50 each
7	Issued	750 units.
10	Purchased	1,500 units at Rs. 24 each
12	Issued	1,100 units
15	Purchased	1000 units at Rs. 25 each
17	Issued	500 units
18	Issued	300 units
25	Purchased	1,500 units at Rs. 26 each
29	Issued	1,500 units.

Adopt the FIFO method of issue and ascertain the value of the closing stock.

**[Ans : 35,100]**

5. Draw a stores ledger card recording the following transactions under

(a) FIFO method and (b) LIFO method

1998 July 1	Opening stock 2,000 units at Rs. 10 each.
5	Received 1,000 units at Rs. 11 each
6	Issued 500 units.
10	Received 5,000 units at Rs. 12 each
12	Received back 50 units out of the issue made on 6th July
14	Issued 600 units
18	Returned to supplier 100 units out of goods received on 5th
19	Received back 100 units out of the issue made on 14th July.
20	Issued 150 units.
25	Received 500 units at Rs. 14 each
28	Issued 300 units

The stock verification report reveals that there was shortage of 10 units on 18 th July and another shortage of 15 units on 26th July.

**[Ans : (i) 82, 650, (ii) 79,670]**

6. The balance sheet of 'X' Ltd. as on 31<sup>st</sup> March 2005 is as follows :

Liabilities	Amount	Assets	Amount
8% 5,000 Pref. shares of ` 10 each	50,000	Godwill	10,000
10,000, Equity shares of ` 10 each	1,00,000	Fixed assets	1,80,000
Reserve (including provision for taxation ` 10,000)	1,00,000	Investment (5% Govt loan)	20,000
8% Debenture	50,000	Current assets	1,00,000
Creditors	25,000	Preliminary expenses	10,000
		Discount on debentures	5,000
	<b>3,25,000</b>		<b>3,25,000</b>

The average profit of the company (after deducting interest on debentures and taxes) is 31,000. The present market value of the machinery included in fixed assets is 5000 more.

Expected rate of return is 10%

Evaluate the good will of the company at five times of the super profits.

**[Ans : ₹ 57,500]**

7. Calculate the missing figure,

Particulars	Amount (₹)
Capital at the end	20,400
Capital introduced	5,000
Drawings	3,000
Loss	2,000
Capital at the beginning	20,400

**[Ans : ₹ 20,400]**

8. Jones keeps his books by single entry method. On 1<sup>st</sup> May 2010 his financial position was as follows :

Cash in hand ₹ 250, Cash at bank ₹ 3,000, Stock in trade ₹ 7,500. Fixtures and fittings ₹ 350, Sundry Debtors ₹ 9800, plant and machinery ₹ 15,100, sundry creditors ₹ 9,000. During the year Jones withdrew from the business various sums amounting to ₹ 5,900.

On 30<sup>th</sup> April 2011, his financial position was as follows :

Sundry creditors ₹ 7,500, plant and machinery ₹ 18,100, Fixtures and fitting ₹ 320, sundry debtors ₹ 13,300, stock in trade ₹ 14,000. Cash in hand ₹ 150, Bank overdraft ₹ 2,600.

You are required to prepare a statement of profit and a closing statement of affairs.

**[Ans : Profit ₹ 14,670]**

9. Mr. Sanjeev maintains books on single entry, who gives you the following information.

	31-3-2010	31-3-2011
Cash in hand	600	1,000
Stock of goods	100	150
Sundry debtors	5,000	6,000
Furniture	2,000	2,000
Buildings	10,000	10,000
Sundry creditors	3,500	4,000

Sanjeev introduced fresh capital ₹ 5,000 on the 1<sup>st</sup> July 2010, and had withdraw ₹ 2,500 during the year. Interest on capital is allowed at 10% p.a, write off depreciation on Building at 5% and on furniture at 10%. A provision of 5% on sundry debtors is required.

You are requested to find out Mr. Sanjeev's profit or loss for the year ending on 31<sup>st</sup> March 2011.

**[Ans : Net Loss ₹ 6,845, Capital on 31-3-2010, ₹ 20,200 & on 31-3-2011 ₹ 19,150]**

## Short Question and Answers

### 1. Define inventory.

*Ans :*

**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.

### 2. Objectives of Inventory.

*Ans :*

#### 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.

### 3. Define Perpetual Inventory Method.

*Ans :*

Perpetual Inventory Method is regular checking and valuing of stock. There is no need for

checking at the end. If facilities reliable and direction of errors and proper utilization of current assets. A system of records maintained by the controlling department, which reflects the physical movements of stocks and their current balance. Under this method stock registers are maintained to make a record of the physical movements of stocks and their current balance. Stores ledger is maintained to keep a record of the various items of materials; it makes a record of the physical movements of the stock on the receipts and issues of the materials and also reflects the balances in the stores.

#### 4. First In First Out.

*Ans :*

The FIFO method is based on the assumption that the oldest items in inventory are used first so that the inventories which remain unsold are the more recent purchases. The materials issued are priced at the oldest cost price and there by closing the inventory is valued at latest price. The use of FIFO does not necessarily mean that the units in the inventory which were longest in stock are exhausted first but it means that the oldest costs are first used for accounting purposes. Thus, under this method, the physical flow of goods need not necessarily coincide with the pattern of cost flow assumptions. But in practice, it is usually found that the most firms sell oldest merchandise first as protection against deterioration.

- (i) The valuation of closing inventory or stock tends to be nearer current market prices.
- (ii) Being based on cost, no unrealized profits enter into financial result of the period.
- (iii) If prices of materials or goods do not fluctuate very frequently, this method is easy to operate.
- (iv) This method is realistic as it assumes that units sold for issued to production are in order of their purchases.

This method is considered more suitable in times of falling prices.

- (a) On a rising market it reports larger profits this will lead to higher incidence of income tax.
- (b) Calculation become cumbersome.
- (c) In times of rising prices, charge to productions unduly low.
- (d) Comparison between different jobs executed by concern is rendered difficult.

#### 5. Last In First Out .

*Ans :*

The LIFO method assumes that the latest purchased or acquired units are sold first and the oldest purchases are still in stock. Thus, the cost of recent acquisitions or purchases are matched against the sales revenue of the period and those of the oldest purchases are carried forward as an asset on the assets side of the balance sheet. The LIFO method has the reverse effect, to FIFO on the measurement of income and closing inventory valuation. LIFO reflects the latest cost price of the particular product.

The main object of LIFO method is to apply current costs to current sales.

#### Advantages of LIFO

- (i) This is a consistent and objective method of valuation of closing inventories and cost of sales.
- (ii) Cost of sales is determined by using current replacement costs.
- (iii) In a rising (or inflationary) market, the gross profit reported is a very low figure implies saving in taxes.
- (iv) No unrealized profit or loss is usually made.

#### Disadvantages of LIFO

- (i) More often, cost flow under LIFO does not correspond with the normal flow of goods.

- (ii) When costs of most recent purchases are matched, it does not necessarily imply the matching of current costs against current revenue.
- (iii) It is purely a tax-saving device not to accept this method in a falling market.

#### 6. Simple Average Price.

*Ans :*

"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

- (1) It is simple and easy to calculate the issue price.
- (2) This method reduces the effect of fluctuation of prices by averaging the price.

##### Disadvantages

- (1) This method does not take into account the quantity purchased at each price. This may lead to absurd results.
- (2) As the actual price is not used, Profit or Loss on material will usually arise.
- (3) The value of closing stocks under this method is absurd. When price fluctuates sharply, the costing stock shows credit balance, that is negative figure !

#### 7. Weighted Average Price.

*Ans :*

"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.

##### Advantage

- (1) This method is suitable where the prices vary very much from one purchase to another. As it uses quantities for calculation of average prices, the fluctuations are evened out.
- (2) The basis of calculation in the method is simple as the price is calculated by dividing the value of materials by their quantity.
- (3) A new price is calculated when new materials are purchased. All the subsequent issues are made at the price calculated until next lot is received. Thus, the clerical work is simplified and reduced.
- (4) The stock balance reflects fair prices which may be taken for financial

##### Disadvantages

- (1) This method is more complicated than simple average price as it takes into account the total quantity and value.
- (2) Since actual price is not used, Profit or Loss may arise in material cost by using this method.



- (3) Where receipts are numerous, calculations will be many and may result in errors.
- (4) The price may have to be taken upto three or four decimal places to calculate the correct value of large quantities. Otherwise, approximation may lead to difference in accounts.

## 8. Define goodwill.

*Ans :*

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 :

**According to J.O. Magee,** "The capacity of a business to earn profits in future is basically what is meant by the term goodwill".

**According to Lord Lindley,** "The terms goodwill is generally used to denote benefit arising from connections and reputation".

**According to Lord Eldon,** "Goodwill is nothing more than the probability, that the old customers will resort to the old place".

**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".

**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.

## 9. Factors Affecting the Value of Goodwill.

*Ans :*

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.

**10. Salient Features of Incomplete Records System.**

*Ans :*

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).

**11. Advantages of Single Entry System.**

*Ans :*

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.

**12. Advantages of Double Entry System**

*Ans :*

The advantages of double entry system are as follows:

- 1) **Reliable Information at a Glance**  
The system keeps complete records of business transactions in systematic and scientific way, so requisite information can be obtained at a glance. The information supplied by the system is also reliable.
- 2) **Scrutiny and Verification of Information**  
The business can verify the value of assets and scrutinize the records, if necessary on the basis of documentary proof as vouchers.
- 3) **Knowledge of Gross Profit or Loss**  
One can prepare trading account and find out gross profit or loss with this account.
- 4) **Knowledge of Net Profit or Loss**  
Under the double entry system, one can prepare profit and loss account and ascertain net profit or net loss.

5) **Knowledge of Assets and Liabilities of the Business**

Position statement also known as balance sheet is prepared. It reflects the values of assets and liabilities of the business at the end of accounting year.

**13. Distinguish between Single Entry System and Double Entry System.**

*Ans :*

**Differences between Double Entry System and Single Entry System**

Basis of Difference	Double Entry System	Single Entry System
1) <b>Recording</b>	It keeps a complete record of all business transactions	It does not maintain a complete record of all business transactions.
2) <b>Ascertainment of Profit &amp; Loss</b>	Correct profit or loss can be ascertained with the help of trading and profit and loss accounts.	It is not at all possible to ascertain the correct amount of profit or loss of the business.
3) <b>Financial Position</b>	Financial position can be known correctly by preparing the balance sheet.	Since true balance sheet cannot be prepared from incomplete records, true financial position cannot be known.
4) <b>Preparation of Accounts</b>	Since personal, real and nominal accounts are maintained properly, all business informations are available from it.	It is not possible to understand the detailed information since only cash accounts and personal account are prepared.
5) <b>Dual Aspect</b>	Since all transactions have a two - fold aspect, arithmetical accuracy can be possible by preparing a trial balance.	It is not possible
6) <b>Comparison of Accounts</b>	Comparisons between the two accounts for the two different periods can be made possible.	It is not possible since necessary accounts are not maintained.
7) <b>Detection of Errors</b>	Errors and frauds can be detected easily under this system.	It is not at all easy to detect errors and frauds committed by the accountant or any other person.
8) <b>Possibility of Alteration</b>	It is not possible to change or delete any item since it is based on fixed principles.	Any change can be made easily since it is not based on any fixed principle.

**14. Statement of Affairs Method.**

*Ans :*

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.

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**15. How do you calculate missing figures for purchases ?**

*Ans .:*

1. The amount of cash purchases are ascertained from the amount of cash book.
2. Cash purchases are added to credit purchases and the resultant total purchases amount are shown during the preparation of trading account.
3. Thus, credit purchases need to be determined by preparing the following accounts,
  - (a) Total creditors account
  - (b) Bills payable account and
  - (c) Memorandum trading account,

## UNIT IV

**Financial 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.

### 4.1 FINANCIAL STATEMENTS ANALYSIS

#### Q1. Define financial statement analysis.

*Ans :*

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.

**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.

**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 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.

#### 3. 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 in 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.

### 4.2 FUNDS FLOW STATEMENT

#### Q5. Define funds flow statement. Explain the importance of funds flow statement.

*Ans :*

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.

**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".

**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 in 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.

#### Q6. 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.

**4.2.1 Statement of Changes in Working Capital**

**Q7. Define working capital. What are the concepts of working capital.**

*Ans :*

**Working Capital**

**According to Shubin,** "Working capital is the amount of funds necessary to cover the cost of operating the enterprise".

**According to Genestenberg,** "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, for example, from cash to inventories, inventories to receivables, receivables into cash".

Working capital can also be defined as excess of current assets over current liabilities or difference between the inflow and outflow of funds.

Working capital is required by the firm for the purpose of purchasing raw materials, payment of wages and other routine expenses, etc. It is required for financing current assets such as cash, marketable securities, debtors and inventories.

**Concepts of Working Capital**

Working capital concepts are being categorised into two main heads as follows,

1. Balance sheet concept and
2. Operating cycle (or) circular flow concept.

**1. Balance Sheet Concept**

The balance sheet concept explains the working capital in two ways as follows,

- (a) Gross working capital and
- (b) Net working capital.

**(a) Gross Working Capital**

Gross working capital helps in solving the problem of managing individual current assets in two aspects,

- (i) A firm must finance only those current assets which are useful and does not result in idle investment and inadequate return on investment in current assets, which ultimately increases the risk. If investment made in current assets which are not productive then they block the capital which leads to insufficient capital to meet current obligations of the firm. Hence, firm must maintain only adequate working capital which is required for its business.
- (ii) It is necessary for management to secure some amount of funds in order to finance the current assets. Firm must maintain adequate funds to meet additional working capital if business is increased. Financial manager must have knowledge of evaluating the level of current assets required and different sources of financing current assets.

**(b) Net Working Capital**

The concept of net working capital is useful for management in identifying the permanent sources for financing the working capital requirements. It represents the liquidity position of the firm. Net working capital explains that every firm must have current assets more than current liabilities to meet current obligations effectively. In order to maintain a margin of current assets, it must be twice of current liabilities. Quality of current assets implies the structure of current assets. The quality of current assets reflects the liquidity position of the firm. If a firm maintains high level of current assets but if its quality is not appropriate then it may lead to inadequate liquidity position which have impact on solvency of the firm.

When current liabilities are more than current assets it leads to negative net working capital which is harmful for the firm.

## 2. Operating Cycle (or) Circular Flow Concept

The time period needed to convert sales into cash is known as an operating cycle. In a manufacturing company, operating cycle consists of three stages,

- Purchase of resources which are required in a manufacturing company such as raw material, labour, power and fuel etc.
- Manufacturing of the product involves production process which is a conversion of raw material into work-in-progress and then transform into finished goods.
- The ultimate stage is, sale of the product which can be in cash or credit. Credit sales usually create account receivable for collection.

Firm must retain liquid assets for purchase of raw materials and payment of expenses like salaries and wages, taxes, operating expenses, etc. Gross operating cycle is the sum of inventory conversion period and debtors conversion period.

The inventory conversion period is the time period required for producing and selling the product.

The debtors conversion period is the time period needed to acquire the outstanding amount from customers to whom goods are sold on credit.

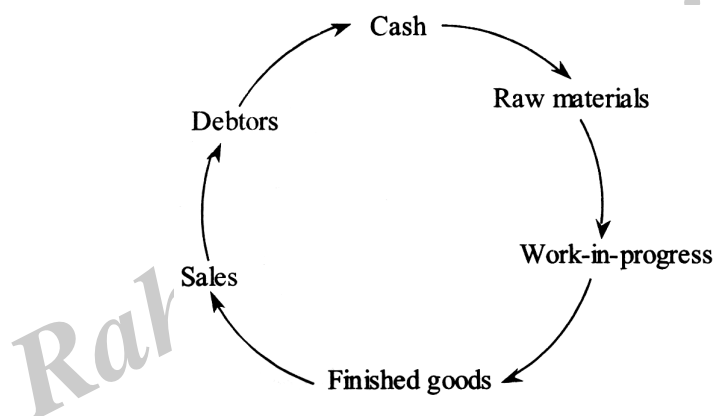


Fig. : Operating Cycle

Gross operating cycle = Inventory conversion period + Debtors conversion period

Net operating cycle = Gross operating cycle – payables deferral period

The need for working capital results in the growth and expansion of business of a firm.

### Q8. Differences between Gross Working Capital Vs Net Working Capital.

Ans :

Gross working capital (GWC)	Net Working Capital (NWC)
1. Gross Working Capital (GWC) refers to that amount of investment which has been invested by the firm in financing its current assets.	Net Working Capital (NWC) refers to the net amount which could be obtained by deducting the current liabilities from the current assets.  i.e., $NWC = \text{Current assets} - \text{Current liabilities}$

2. As it mainly deals with current assets, they can be easily converted into cash within an accounting year (which is usually less than an year). Example : Cash, debtors, bills receivable, stock etc.	As it represents a differential amount, which is actually the amount of investment made in current assets that have been financed by the long-term sources.
3. Through, gross working capital the liquidity position of the firm can be determined. Because of this liability, it is found to be of managerial interest.	Net working capital is highly significant as it enables the firm to meet its future needs.
4. If high amount is vested in the maintenance of gross working capital, then the firm is exposed to high risk of obsolescence.	If high amount is vested in the maintenance of net working capital, liquidity position of a firm can be considerably improved.
5. It helps the firm in maintaining the right amount of working capital at the right time.	It helps in maintaining the equilibrium or trade off between the current assets and the current liabilities.
6. It is suitable to the company form of organisation wherein the ownership management is separated from its control.	It is suitable for all types of business. However, its need varies based on the nature of a business.
7. The gross concept is based on an assumption that a small increase in the amount of funds causes even the working capital to increase.	It represents the liquidity position of a firm to their short-term creditors.

**Q9. Explain the factors determining the Working Capital requirements ?**

*Ans :*

The Working Capital requirements of a concern depend upon a large number of factors such as nature and size of business, the character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. It is not possible to rank them because all such factors are of different importance and the influence of individual factors changes for a firm over time. The following are the important factors generally influencing the Working Capital requirements:

**(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.

**(f) Working capital cycle**

In a manufacturing concern, the Working Capital cycle starts with the purchase of raw material and end with the realisation of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work-in-progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and this cycle continues again from cash to purchase of raw material and so on.

**(g) Rate of stock turnover**

There is a high degree of inverse co-relationship between the quantum of Working Capital and the velocity or speed with which the sales are effected. A firm having a high rate of stock turnover will need lower amount of Working Capital as compared to a firm having a low rate of turnover.

**(h) Credit Policy**

The credit policy of a concern in its dealings with debtors and creditors influence considerably the requirements of Working Capital. A concern that purchases its requirements on credit and sells its products/ services on cash requires lesser amount of Working Capital. A concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of Working Capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

**(i) Business cycle**

Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e. when the business is prosperous, there is a need for larger amount of Working Capital due to increase in sales, rise in prices, optimistic expansion of business etc. In the times of depression i.e. when there is a down swing of this cycle, the business contracts, sales decline, difficulties are faced in collections from debtors and firms may have a large amount of Working Capital lying idle.

**(j) Rate of growth of business**

The Working Capital requirements of a concern increase with the growth and expansion of its business activities. Although, it is difficult to determine the relationship between the growth in the volume of business and the growth in the Working Capital of a business, yet it may be concluded that for normal rate of expansion in the volume of business, we may have retained profits to provide for more Working Capital but in fast growing concerns, we shall require larger amount of Working Capital,

- l) Earning capacity and dividend policy :** Some firms have more earning capacity than others due to quality of their products, monopoly conditions etc. Such firms with high earning capacity may generate cash profits from operations and contribute to their Working Capital. The dividend policy of a concern also influences the requirements of its Working Capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits needs more Working Capital than the firm that retains larger part of its profits and does not pay so high rate of cash dividend.
- m) Price level changes:** Changes in the price level also affect the Working Capital requirements. The rising prices will require the firm to maintain large amount of working capital as more funds will be required to maintain the same current assets. The effect of rising prices may be different for different firms, Some firms may be affected much while some others may not be affected at all by the rise in prices.

**Q10. Explain the format of preparing working capital.**

*Ans :*

Statement or schedule of changes in working capital is a statement that compares the change in the amount of current accounts (current assets and current liabilities) on two balance sheets dated and highlights its impact on working capital. The format of this statement is as follows:

Particulars	Previous Year	Current Year	Effect on Working Capital	
			Increase	Decrease
<b>Current Assets :</b>				
Cash in hand	XXX	XXX		
Cash at bank	XXX	XXX		
Bills Receivable	XXX	XXX		
Sundry Debtors	XXX	XXX		
Temporary Investments	XXX	XXX		
Stocks/Inventories	XXX	XXX		
Prepaid Expenses	XXX	XXX		
Accrued Incomes	XXX	XXX		
<b>Total Current Assets (A)</b>	<b>XXX</b>	<b>XXX</b>		
<b>Current Liabilities:</b>				
Bills Payable	XXX	XXX		
Sundry Creditors	XXX	XXX		
Outstanding Expenses	XXX	XXX		
Bank Overdraft	XXX	XXX		
Short-term advances	XXX	XXX		
Dividends Payable	XXX	XXX		
Proposed dividends	XXX	XXX		
Provision for taxation	XXX	XXX		
<b>Total Current Liabilities (B)</b>	<b>XXX</b>	<b>XXX</b>		
<b>Working Capital (A-B)</b>				
<b>Net Increase (or) Decrease in Working Capital</b>				

**1. Transaction Affecting Working Capital**

- i) Working capital increases with increase in current assets.
- ii) Working capital decreases with decrease in current assets.
- iii) Working capital increases with the decrease in current liability.
- iv) Working capital decreases with increase in current liability.

**2. Transaction not Affecting Working Capital**

- i) An increase in current assets with the corresponding increase in current liability with the same amount.
- ii) Decrease in current assets with the corresponding decrease in current liability with the same value.

The changes in current accounts, i.e., current assets and current liabilities are to be computed by comparing the figures for such accounts in the current period with that of the previous period. The amount of change computed for each item of the current account along with its impact on the amount of working capital is to be recorded in the schedule of change in working capital.

To analyze the effect on working capital as a result of change in current assets and current liabilities, the following facts should be considered:

Particulars	Effect Working Capital
1) Increase in current asset	Increase (+)
2) Decrease in current asset	Decrease (-)
3) Increase in current liabilities	Decrease (-)
4) Decrease in current liabilities	Increase (+)

**PROBLEMS****1. The balance sheet of Ashok, Mukesh and Rakesh Ltd. is given below:****Balance Sheet of Ashok, Mukesh and Rakesh Ltd. as on March 31, 2010**

Liabilities	2009	2010	Assets		2009		2010
Equity Share Capital	20,000	20,000	Land		8,000		8,000
Reserve & Surplus	10,440	12,280	Building cost	14,500		16,800	
12% Debentures	5,000	7,000	<b>Less: Accumulated</b>	4,800	9,700	5,200	11,600
Accounts Payable	2,160	2,360	Depreciation				
Bills Payable	700	610	Plant and Machinery	18,750		19,950	
Expenses Payable	350	400	<b>Less: Accumulated</b>	6,800	11,950	7,850	12,100
			Depreciation				
			Furniture	2,890		3,650	
			<b>Less: Accumulated</b>	690	2,200	750	2,900
			Depreciation				
			Stock		2,500		3,350
			Accounts Receivable		3,450		3,400
			Cash on hand and at bank		850		1,300
	<b>38,650</b>	<b>42,650</b>			<b>38,650</b>		<b>42,650</b>

**Prepare statement of changes in working capital.**

*Sol :***Statement of Changes in Working Capital of Ashok, Mukesh and Rakesh Ltd.****for the year ended March 31,2010**

Particulars	2009	2010	Effect on Working Capital	
			Increase in Net working Capital	Decrease in Net working Capital
<b>Current Assets</b>				
Stock	2,500	3,350	850	
Accounts Receivable	3,450	3,400		50
Cash Balance	850	1,300	450	
<b>Total Current Assets</b>	6,800	8,050		
<b>Current Liabilities</b>				
Accounts Payable	2,160	2,360		200
Bills Payable	700	610	90	
Expenses Payable	350	400		50
<b>Total Current Liabilities</b>	3,210	3,370		
Net Working Capital (C.A – C.L)	<b>3,590</b>	<b>4,680</b>		
Net Increase in Working Capital				1,090
			<b>1,390</b>	<b>1,390</b>

**2. The summarized balance sheet of Sugree Ltd. as on 31st March is given below**

Liabilities	2009(₹)	2010(₹)	Assets	2009(₹)	2010(₹)
Share capital	2,00,000	2,50,000	Land & Building	2,00,000	1,90,000
Debentures	50,000	90,000	Machinery	1,50,000	1,74,000
Profit & Loss A/c	30,500	30,600	Inventory	1,00,000	74,000
Bank loan	70,000	—	Sundry debtors	80,000	94,200
Creditors	1,50,000	1,35,200	Cash	500	8,600
Provision for taxation	30,000	35,000			

Prepare statement of changes in working capital



Sol:

## Statement of Changes in Working Capital

Particulars	2009 Amount (₹)	Effect on Working Capital		
		2010 Amount (₹)	Increase (+) Amount (₹)	Decrease (-) Amount (₹)
<b>A. Current Assets:</b>				
Inventory	1,00,000	74,000		26,000
Sundry debtors	80,000	94,200	14,200	
Cash	500	8,600	8,100	
<b>Total Current Asset (A)</b>	<b>1,80,500</b>	<b>1,76,800</b>		
<b>B. Current Liabilities:</b>				
Creditors	1,50,000	1,35,200	14,800	
Provision for taxation	30,000	35,000		5,000
<b>Total Current Liabilities (B)</b>	<b>1,80,000</b>	<b>1,70,200</b>		
<b>Working Capital (A – B)</b>	<b>500</b>	<b>6,600</b>		
<b>Increase in Working Capital</b>				<b>6,100</b>
			<b>37,100</b>	<b>37,100</b>

3. From the following information provided by ABC company you are required to calculate the statement

Liabilities	Year (₹) 2009	Year (₹) 2010	Assets	Year (₹) 2009	Year (₹) 2010
Equity share capital	2,00,000	4,50,000	Fixed assets	2,00,000	4,00,000
5% Debentures	20,000	25,000	Inventories	20,000	40,000
Short term loans and advances	10,000	15,000	Cash	10,000	15,000
Bills payable	15,000	10,000	Bills receivable	2,000	4,000
Sundry creditors	50,000	45,000	Bank	5,000	6,000
			Debtors	58,000	80,000
	<b>2,95,000</b>	<b>5,45,000</b>		<b>2,95,000</b>	<b>5,45,000</b>

Sol :

## Statement of Changes in Working Capital

Particulars	Previous Year 2009 (₹)	Current Year 2010 (₹)	Working Capital	
			Increase	Decrease
<b>A) Current Assets</b>				
Inventories	20,000	40,000	20,000	–
Cash	10,000	15,000	5,000	–
Bills receivable	2,000	4,000	2,000	–
Bank	5,000	6,000	1,000	–
Debtors	58,000	80,000	22,000	–
<b>Total Current Assets (A)</b>	<b>95,000</b>	<b>1,45,000</b>		
<b>B) Current Liabilities</b>				
Sundry creditors	50,000	45,000	5,000	
Short term loans and advances	10,000	15,000		5,000
Bills payable	15,000	10,000	5,000	
<b>Total Current Liabilities (B)</b>	<b>75,000</b>	<b>70,000</b>		
<b>C) Working Capital (A – B)</b>	20,000	75,000		
<b>D) Increase in Working Capital</b>	55,000			55,000
	75,000	75,000	60,000	60,000

4. From the following balance sheets of Company prepare a statement showing changes in working capital.

Particulars	31 <sup>st</sup> December 2008 (₹)	31 <sup>st</sup> December 2007 (₹)
<b>Assets</b>		
Goodwill	10,000	15,000
Cash	60,000	70,000
Debtors	40,000	30,000
Closing stock	1,00,000	90,000
Long term investments	20,000	20,000
Land	25,000	30,000
Preliminary expenses	5,000	10,000
	2,60,000	2,65,000
<b>Liabilities</b>		
Trade creditors	30,000	40,000
Bills payable	50,000	15,000
Loans	30,000	10,000
Share capital	1,00,000	1,50,000
Profit and Loss account	50,000	50,000
	2,60,000	2,65,000

Sol.:

## Statement Showing Changes in Working Capital

Particulars	Previous year 2007 (₹)	Current year 2008 (₹)	Effect on working capital	
			Increase (₹)	Decrease (₹)
<b>Current Assets</b>				
Cash	70,000	60,000		10,000
Debtors	30,000	40,000	10,000	–
Closing stock	90,000	1,00,000	10,000	–
Total [A]	1,90,000	2,00,000		
<b>Current Liabilities</b>				
Trade creditors	40,000	30,000	10,000	–
Bills payable	15,000	50,000	–	35,000
Total [B]	55,000	80,000		
<b>Working Capital</b>				
[A-B]	1,35,000	1,20,000		
Net decrease in working capital		15,000	15,000	
	1,35,000	1,35,000	45,000	45,000

5. From the following two balance sheets as on 31<sup>st</sup> December 2006 and 2007, you are required to prepare a schedule of changes in working capital for 2007.

Particulars	31 <sup>st</sup> December 2006 (₹)	31 <sup>st</sup> December 2007 (₹)
<b>Assets</b>		
Cash	60,000	94,000
Debtors	2,40,000	2,30,000
Stock-in-trade	1,60,000	1,80,000
Land	1,00,000	1,32,000
	5,60,000	6,36,000
<b>Capital and Liabilities</b>		
Share capital	4,00,000	5,00,000
Trade creditors	1,40,000	90,000
Retained earnings	20,000	46,000
	5,60,000	6,36,000

*Sol :***Statement Showing Changes in Working Capital**

Particulars	Previous year 2006 (₹)	Current year 2007 (₹)	Effect on working capital	
			Increase (₹)	Decrease (₹)
<b>Current Assets</b>				
Cash	60,000	94,000	34,000	
Debtors	2,40,000	2,30,000	–	10,000
Stock-in-trade	1,60,000	1,80,000	20,000	–
Total [A]	4,60,000	5,04,000		
<b>Current Liabilities</b>				
Trade creditors	1,40,000	90,000	50,000	–
Total [B]	1,40,000	90,000	–	–
<b>Working Capital</b>				
[A – B]	3,20,000	4,14,000	–	–
Net increase in working capital	94,000	–	–	94,000
	4,14,000	4,14,000	1,04,000	1,04,000

**4.2.2 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 (₹)
<b>Profit and Loss Account (Closing Balance)</b>	xxx
<b>Add: Non-Fund or Non-Operating items (Debited to P &amp; L A/c)</b>	
(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
<b>Less: Non-Fund or Non-Operating Items (Credited to P&amp;LA/c)</b>	
(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**

6. The profit and loss a/c of XYZ Ltd., for the year ending 2007 is presented below,

Particulars	Amount (₹)	Amount (₹)
Sales		1,00,000
<b>Less</b>		
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		
<b>Add:</b>		
a. Loss on sale of furniture	300	
b. Depreciation written off	500	
c. Amortisation of intangible assets [Patents and preliminary expenses]	<u>400</u>	<u>1,200</u>
		94,200
<b>Less :</b> Non-fund and Non-operating items credited to P & L a/c		
a. Dividends received		<u>1,200</u>
<b>Funds from operations</b>		<u>93,000</u>

**7. Extracts from the balance sheets prepare funds flow statements.**

Particulars	31 <sup>st</sup> Dec 06 (₹)	31 <sup>st</sup> 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
<b>Add :</b>		
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	
		<u>40,000</u>
		1,90,000
<b>Less :</b>		
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	
		<u>1,05,000</u>
<b>Funds from operation</b>		85,000

8. 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
<b>Add : Non-fund or non-operating items which have been debited to P/L A/c</b>		
Transfer to general Reserve	5,000	
Goodwill written off	5,000	
Preliminary expenses written off	2,000	
Provision for depreciation	2,000	
		<u>14,000</u>
		54,000
<b>Less : Non-fund or non-operating items which have been credit to P/L A/c:</b>		
Balance as on 31st Dec. 2005	30,000	30,000
<b>Funds from Operations</b>		24,000

### 4.2.3 Preparation of Funds Flow Statement

**Q12. 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

**Q13. Explain the various sources and applications of funds flow statements.**

*Ans :*

#### 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**

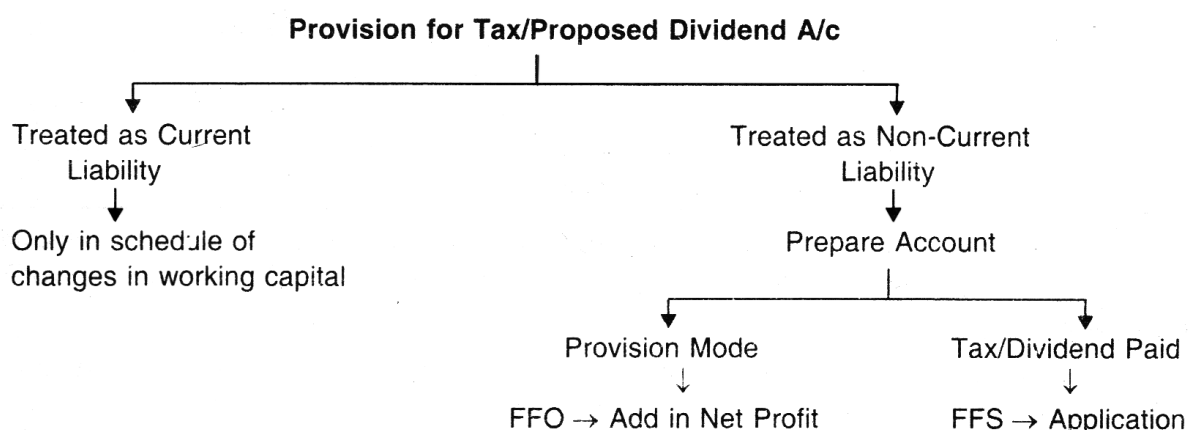
When a firm makes payment towards the realisation of non-trading operations like drawings, loss of cash, etc., then it is regarded as an application of funds.

**Q14. 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.

### PROBLEMS ON FUNDS FLOW STATEMENTS

9. From the summarised balance sheets of Kalpana Ltd. as on 31st March. 2008 and 2009, you are required to prepare a schedule of changes in working capital and a fund flow statement.

Liabilities	31st March 2008 (Rs.)	31st March 2009 (Rs.)	Assets	31st March 2008 (Rs.)	31st March 2009 (Rs.)
Share Capital	3,00,000	4,50,000	Fixed Assets	5,00,000	6,00,000
Borrowings (Long term)	1,10,000	1,30,000	Less: Accumulated Depreciation	50,000	60,000
Borrowings (Short term)	80,000	70,000		4,50,000	5,40,000
Current Liabilities	40,000	30,000	Current Assets	50,000	1,00,000
			Profit and Loss Account	30,000	40,000
	<u>5,30,000</u>	<u>6,80,000</u>		<u>5,30,000</u>	<u>6,30,000</u>

*Sol:***Schedule of Changes in Working Capital**

Particulars	31st March 2008	31st March 2009	Increase in w.c. (Rs.)	Decrease in w.c. (Rs.)
Current Assets (A)	50,000	1,00,000	50,000	
<b>Current Liabilities</b>	40,000	30,000	10,000	
Borrowing (short term)	80,000	70,000	10,000	
Total Current Liabilities (B)	1,20,000	1,00,000		
Net Working Capital (A - B)	- 70,000	Nil		
Net Increase in Working Capital	70,000	Nil		70,000
	Nil	Nil	70,000	70,000

**Statement of Funds From Operations**

Particulars	Rs.	Rs.
Net Loss for the year (Rs. 40,000 - Rs. 30,000)		10,000
<b>Less : Non Fund items:</b>		
Depreciation		10,000
Funds From Operations		Nil

**Funds Flow Statement**

Sources	Rs.	Applications	Rs.
Issue of Share Capital	1,50,000	Fixed Assets Purchased	1,00,000
Borrowing of long term loans	20,000	Increase in Working Capital	70,000
	<u>1,70,000</u>		<u>1,70,000</u>

**Working Note :**Dr. **Fixed Assets Account (On Original Cost)** Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d (Given)	5,00,000	By Balance c/d (given)	6,00,000
To Cash Purchases (B/F)	1,00,000		
	<u>6,00,000</u>		<u>6,00,000</u>

Dr. **Accumulated Depreciation Account** Cr.

Particulars	Rs.	Particulars	Rs.
To Balance c/d (Given)	60,000	By Balance b/d (given)	50,000
		By Profit and Loss A/c (B/F)	
		(Current Year Depreciation)	10,000
	<u>60,000</u>		<u>60,000</u>

**10. From the following balance sheets of XYZ Ltd. Prepare fund flow statement:**

Liabilities	2012 (₹)	2013 (₹)	Assets	2012 (₹)	2013 (₹)
Equity share capital	3,00,000	4,00,000	Goodwill	1,15,000	90,000
Preference shares	1,50,000	1,00,000	Buildings	2,00,000	1,70,000
Reserve fund	40,000	70,000	Machinery	80,000	2,00,000
Profit & loss A/c.	30,000	48,000	Bills receivables	20,000	30,000
Bills Payable	20,000	16,000	Debtors	1,60,000	2,00,000
Proposed dividend	42,000	50,000	Stock	77,000	1,09,000
Creditors	55,000	83,000	Cash on hand	15,000	10,000
Provision for taxation	40,000	50,000	Cash at bank	10,000	8,000
<b>Totals</b>	<b>6,77,000</b>	<b>8,17,000</b>		<b>6,77,000</b>	<b>8,17,000</b>

**Additional Information:**

- (i) Dividend provision made during 2012 has been paid during 2013.
- (ii) Depreciation: ₹ 10,000 on Machinery and ₹ 20,000 on Buildings.
- (iii) An interim dividend of ₹ 20,000 has been paid in 2013.
- (iv) Income Tax of ₹ 35,000 has been paid during 2013.

*Sol:***Statement of changes in working capital**

Particulars	2012 (₹)	2013 (₹)	Increase in W.C	Decreasing in W.C
Current Assets (C.A):				
Debtors	1,60,000	2,00,000	40,000	
Stock	77,000	1,09,000	32,000	
Cash in hand	15,000	10,000		5,000
Cash at bank	10,000	8,000		2,000
Bills receivable	20,000	30,000	10,000	
<b>(A) Total of C.A</b>	<b>2,82,000</b>	<b>3,57,000</b>		
Current Liabilities (C.L):				
Creditors	55,000	83,000		28,000
Bills payable	20,000	16,000	4,000	
<b>(B) Total of C.L</b>	<b>75,000</b>	<b>99,000</b>		
<b>Working capital (A - B)</b>	<b>2,07,000</b>	<b>2,58,000</b>		
Increase in W.C	51,000			51,000
	<b>2,58,000</b>	<b>2,58,000</b>	<b>86,000</b>	<b>86,000</b>

**Dr.****Machinery A/c****Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	80,000	By depreciation on machinery	10,000
To cash a/c (purchase)	1,30,000	By balance c/d	2,00,000
	<b>2,10,000</b>		<b>2,10,000</b>

Dr. Building A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	2,00,000	By depreciation	20,000
		By cash (Sale)	10,000
		By balance C/d	1,70,000
	<b>2,00,000</b>		<b>2,00,000</b>

Dr. Goodwill A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	1,15,000	By adjusted profit and loss A/c (Goodwill written off) (balancing figure)	25,000
		By balance c/d	90,000
	<b>1,15,000</b>		<b>1,15,000</b>

Dr. Equity share capital A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To balance c/d	4,00,000	By balance b/d	3,00,000
		By adjusted Profit and Loss a/c (Balancing figure)	1,00,000
	<b>4,00,000</b>		<b>4,00,000</b>

Dr. Redeemable preference share capital A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To cash (Redemption)	50,000	By balance b/d	1,50,000
To balance c/d	1,00,000		
	<b>1,50,000</b>		<b>1,50,000</b>

Dr. Reserve fund A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To cash (Redemption)	70,000	By balance b/d	40,000
		By adjusted profit and Loss A/c (Balancing figure)	30,000
	<b>70,000</b>		<b>70,000</b>

Dr.		Provision for Taxation A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)		
To cash (Income tax paid)	35,000	By balance b/d	40,000		
To balance c/d	50,000	By adjusted Profit and Loss A/c (Prov. Made during the year) (Balancing figure)	45,000		
	85,000		85,000		

Dr.		Adjusted Profit and Loss A/c		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)		
To Proposed dividend (2013)	50,000	By balance b/d	30,000		
To General Reserve	30,000	By Funds from Operations (Balancing figure)	2,18,000		
To Depreciation on Machine	10,000				
To Depreciation on Building	20,000				
To Goodwill written off	25,000				
To Provision for Taxation	45,000				
To interim dividend	20,000				
To balance c/d	48,000				
	2,48,000		2,48,000		

## Funds Flow Statement as on 2013

Sources	Amount (₹)	Applications	Amount (₹)
Issue of equity	1,00,000	Redemption of preference shares	50,000
Sales of building	10,000	Interim dividend paid	20,000
Funds from operations	2,18,000	Purchase of machinery during the year	1,30,000
		Income tax paid	35,000
		Proposed dividend	42,000
		Increase in working capital	51,000
	3,28,000		3,28,000

**11. From the following Balance Sheet of M/S Claris Otsuka Pvt. Ltd., prepare Fund Flow Statement.**

Liabilities	2013 (₹)	2014 (₹)	Assets	2013 (₹)	2014 (₹)
Share capital	80,000	85,000	Land and Building	50,000	50,000
Profit and loss appropriation account	14,500	24,500	Plant	24,000	34,000
Creditors	9,000	5,000	Stock	9,000	7,000
Bills payable		5,000	Debtors	16,500	19,500
			Cash at Bank	4,000	9,000
	<b>1,03,500</b>	<b>1,19,500</b>		<b>1,03,500</b>	<b>1,19,500</b>

*Sol.:*

**Changes in Working Capital**

Particulars	2013 (₹)	2014 (₹)	Increase in W.C (₹)	Decreasing in W.C (₹)
<b>A. Current Assets:</b>				
Stock	9,000	7,000		2,000
Debtors	16,500	19,500	3,000	—
Cash at bank	4,000	9,000	5,000	—
<b>A (Total)</b>	<b>29,500</b>	<b>35,500</b>		
<b>B. Current Liabilities</b>				
S. Creditors	9,000	5,000	4,000	—
Bills payable	—	5,000	—	5,000
<b>B (Total)</b>	<b>9,000</b>	<b>10,000</b>		
<b>C. Working Capital [A - B]</b>	<b>20,500</b>	<b>25,500</b>		
<b>D. Increase in Working Capital</b>	<b>5,000</b>			<b>5,000</b>
	<b>25,500</b>	<b>25,500</b>	<b>12,000</b>	<b>12,000</b>

**Plant A/C**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	24,000	By balanced c/d	34,000
To Bank purchase (balancing fig.)	10,000		
	<b>34,000</b>		<b>34,000</b>

**Funds Flow Statement**

Sources	Amount (₹)	Applications	Amount (₹)
Issue of share capital	5,000	Purchase of plant	10,000
P & L appropriation A/c	10,000	Increase in working capital	5,000
	<b>15,000</b>		<b>15,000</b>



12. The balance sheet of Tom Jerry Manufacturers Ltd. as at 31st March 2009 is given here

**Balance Sheet of Tom Jerry Manufacturers Ltd.  
as on 31st March 2009**

Particulars	2008 Amounts (₹)		2009 Amounts (₹)
<b>Liabilities</b>			
Equity Share Capital	20,00,000		20,00,000
Reserve & Surpluses	6,00,000		8,60,000
12% Debenture	5,00,000		7,00,000
Accounts Payable	2,70,000		3,60,000
Bills Payable	70,000		1,50,000
Expenses Payable	45,000		30,000
	<b>34,85,000</b>		<b>41,00,000</b>
<b>Assets</b>			
Goodwill	50,000		
Land	8,00,000		9,50,000
Building Cost 11,85,000		14,55,000	
<b>Less: Accumulated Depreciation</b> 2,85,000	9,00,000	3,25,000	11,30,000
Machinery 1,95,000		2,45,000	
<b>Less: Accumulated Depreciation</b> 45,000	1,50,000	75,000	1,70,000
Investment	5,60,000		6,50,000
Stock	4,90,000		5,30,000
Accounts Receivable	2,80,000		3,10,000
Bills Receivable	80,000		60,000
Prepaid Expenses	25,000		40,000
Cash at Bank	1,10,000		1,90,000
Cash in Hand	40,000		70,000
	<b>34,85,000</b>		<b>41,00,000</b>

The following additional information is provided:

1. A piece of machinery costing ₹ 50,000 (accumulated depreciation ₹ 10,000) was sold for ₹ 36,000.
2. During the year dividends were paid for ₹ 2,00,000.

Prepare statement of changes in working capital and statement of sources and uses of funds.

*Sol:***Statement of Changes in Working Capital of Tom Jerry Manufactures Ltd.****For the year ended 31st March 2009**

Particulars	2008 Amount `	2009 Amount `	Changes in working capital	
			Increase in Net Working Capital	Decrease in Net Working Capital
<b>Current Assets</b>				
Stock	4,90,000	5,30,000	40,000	
Accounts Receivable	2,80,000	3,10,000	30,000	
Bills Receivable	80,000	60,000		20,000
Prepaid expenses	25,000	40,000	15,000	
Cash at bank	1,10,000	1,90,000	80,000	
Cash in hand	40,000	70,000	30,000	
<b>Total Current Asset (A)</b>	<b>10,25,000</b>	<b>12,00,000</b>		
<b>Current Liabilities</b>				
Bill payable	70,000	1,50,000		80,000
Accounts Payable	2,70,000	3,60,000		90,000
Expenses Payable	45,000	30,000	15,000	
<b>Total Current Liabilities (B)</b>	<b>3,85,000</b>	<b>5,40,000</b>		
Net Working Capital	6,40,000	6,60,000	2,10,000	1,90,000
Net Increase in Working Capital	20,000			
	6,60,000	6,60,000	2,10,000	2,10,000

**Computation of Funds from Operation**

Particulars	Amount ( ` )
Net Increase in Reserve and Surpluses (8,60,000 - 6,00,000)	2,60,000
<b>Add:</b> Dividends paid	2,00,000
Depreciation on Buildings	40,000
Depreciation on Machinery	40,000
Loss on sale of Machinery	4,000
Goodwill written-off	50,000
<b>Funds from Operations</b>	<b>5,94,000</b>

**Statement of Sources and Uses of Funds**

Sources of Funds	Amount ( ` )	Uses of Funds	Amount ( ` )
Funds from Operation	5,94,000	Purchase of Land	1,50,000
Issue of Debenture	2,00,000	Purchase of Buildings	2,70,000
Sale of Machinery	36,000	Purchase of Machinery	1,00,000
		Purchase of Investment	90,000
		Payment of Dividends	2,00,000
		Net Increase in Working Capital	20,000
	<b>8,30,000</b>		<b>8,30,000</b>

**Working Notes**

Dr. Machinery Account		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/f	1,95,000	By Machinery sold	50,000
To Purchase of Machinery	1,00,000	By Balance c/f	2,45,000
<b>Total</b>	<b>2,95,000</b>	<b>Total</b>	<b>2,95,000</b>

Dr. Machinery Sold Account		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Machinery	50,000	By Accumulated depreciation on Machinery Sold	10,000
		By Bank	36,000
		By Loss on sale	4,000
<b>Total</b>	<b>50,000</b>	<b>Total</b>	<b>50,000</b>

Dr. Accumulated Depreciation on Machinery Account		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
To Accumulated Depreciation on Machinery sold	10,000	By Balance b/f	45,000
To Balance c/f	75,000	By Depreciation charged	40,000
	<b>85,000</b>		<b>85,000</b>

**4.3 PAID COST AND UNPAID COSTS**

**Q15. Write in detail about paid cost and unpaid cost or paid expenses and unpaid expenses.**

*Ans:*

**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		
<b>Less:</b> 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		
<b>Add:</b> 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.

#### 4.4 DISTINCTION BETWEEN CASH PROFITS AND BOOK PROFITS

**Q16. What are the difference between cash profits and book profits.**

(OR)

**Distinguish between cash profits and book profits.**

*Ans :*

S.No.	Basis	Cash Profits	Book Profits
1.	<b>Meaning</b>	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.	<b>Components</b>	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.	<b>Maintenances of Account</b>	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.	<b>Example</b>	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.	<b>Linkage or Relationship</b>	Adjustments made in cash profits results in book profits.	After the adjustments of cash profits, book profits are disclosed.

#### 4.5 CASH FLOW STATEMENT

**Q17. Define cash flow statement. What are the advantages and disadvantages of cash flow statements.**

*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.

### Advantages of Cash Flow Statement

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 of Cash Flow Statement

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.

**Q18. Write the procedure for preparing cash flow statement.***Ans :*

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 of Cash Flows Arising from Operating Activities**

1. Cash receipts from the sale of goods and the rendering of services;
2. Cash receipts from royalties, fees, commissions and other revenue;
3. Cash payments to suppliers for goods and services;

4. Cash payments to and on behalf of employees;
5. Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
6. Cash payments of refunds of income taxes unless they can be specifically identified with financing and investing activities; and
7. 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 of Cash Flows Arising from Investing Activities**

1. Cash payment to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets;
2. Cash receipts from disposal of fixed assets (including intangibles);

3. 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);
4. 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);
5. Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
6. Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
7. 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
8. 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 of Cash Flows Arising from Financing Activities

1. Cash proceeds from issuing shares or other similar instruments;
2. Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and
3. Cash repayments of amounts borrowed.

**Q19. 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 (₹)
<b>Cash Flows from Operating Activities:</b>		
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 ( ` )
<b>Cash Flows from Operating Activities</b>		
Net profit before taxation (excluding extraordinary profit/loss)	xxx	
<b>Add:</b> 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	
	<b>xxx</b>	
<b>Less:</b> Profit on sale of investment, assets etc	xxx	
Interest income (from long-term investments)	xxx	
Dividend income (from long-term investments)	xxx	
<b>Operating profit/Cash Generated from Operations Before Working Capital Charges</b>	<b>xxx</b>	
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	
<b>Cash Generated from Operations</b>	<b>xxx</b>	
<b>Less:</b> Income taxes paid	xxx	
<b>Net Cash from Operating Activities (A)</b>	<b>xxx</b>	
<b>Cash Flows from Investing Activities</b>		
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
<b>Net Cash from Investing Activities (B)</b>		<b>xxx</b>
<b>Cash Flows from Financing Activities</b>		
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)	
<b>Net Cash from Financing Activities (C)</b>		<b>xxx</b>
Net Increase in Cash and Cash Equivalents (A + B + C)		xxx
<b>Add:</b> Cash and Cash Equivalents at the Beginning of the Period		xxx
<b>Cash and Cash Equivalents at the End of the Period</b>		<b>xxx</b>

**Note:** The values in brackets indicate deductions i.e, (-) sign.

### PROBLEMS ON CASHFLOW STATEMENT

**13. From the following balance sheets of Vivek Ltd. prepare cash flow statement.**

Liabilities	2008	2009	Assets	2008	2009
Equity Share Capital	2,00,000	2,50,000	Goodwill	30,000	20,000
12% Preference Share Capital	50,000	40,000	Building	1,00,000	80,000
General Reserve	35,000	55,000	Plant	40,000	70,000
P&LA/c	15,000	17,000	Debtors	1,20,000	1,60,000
Creditors	23,000	5,000	Stock	18,000	20,000
	3,23,000	3,67,000	Cash	15,000	17,000
				3,23,000	3,67,000

Depreciation charged on Plant was ₹ 30,000 and on building ₹ 50,000.

*Sol:***Cash Flows Statement (Indirect Method)**

Particulars	Amount (₹)	Amount (₹)
<b>Cash Flows from Operating Activities:</b>		
Net Profit as per P & L A/c	2,000	
<b>Add:</b> Depreciation on Plant	30,000	
Depreciation on Building	50,000	
Goodwill written off	10,000	
Transfer to General Reserve	20,000	
<b>Operating Profit before Working Capital Changes</b>		1,12,000
<b>Less:</b> Decrease in creditors	(18,000)	
Increase in debtors	(40,000)	
Increase in stock	(2,000)	(60,000)
<b>Net Cash Flows from Operating Activities (A)</b>		52,000
<b>Cash Flows from Investing Activities:</b>		
<b>Less:</b> Purchase of Building	(30,000)	
Purchase of Plant	(60,000)	
<b>Net Cash flows from Investing activities (B)</b>		(90,000)
<b>Cash Flows from Financing Activities</b>		
<b>Add:</b> Issue of shares (equity)	50,000	
<b>Less:</b> Redemption of preference shares	(10,000)	
<b>Net Cash flows from Financing Activities (C)</b>		40,000
<b>Net increase in Cash &amp; Cash Equivalents (A + B + C)</b>		2,000
Cash & Cash Equivalents at the beginning of the year		15,000
Cash & Cash Equivalents at end of the year		17,000

**14. From the following balance sheets of Abha Ltd, Prepare a cash flow statement:**

Liabilities	2008(₹)	2009(₹)	Assets	2008(₹)	2009(₹)
Equity Share Capital	3,00,000	4,00,000	Fixed Assets	4,00,000	5,50,000
Profit and Loss A/c	85,000	1,10,000	Stock	2,00,000	2,25,000
Bank Loan	1,00,000	75,000	Debtors	2,10,000	1,90,000
Accumulated Depreciation	80,000	1,35,000	Bills Receivable	80,000	1,10,000
Creditors	3,10,000	2,95,000	Bank	30,000	–
Proposed dividend	45,000	60,000			
	9,20,000	10,75,000		9,20,000	10,75,000

**Additional Information:** A piece of Machinery costing ₹ 60,000 on which accumulated depreciation was ₹ 15,000 was sold for ₹ 30,000.

*Sol :***Cash Flows Statement (Indirect Method)**

Particulars	Amount (₹)	Amount (₹)
<b>Cash Flows from Operating Activities:</b>		
Net Profit as per P & L A/c	25,000	
<b>Add:</b> Depreciation	70,000	
Proposed dividend	60,000	
Loss from sale of Machinery	15,000	
<b>Operating Profit before Working Capital Changes</b>		1,70,000
<b>Add:</b> Decrease in Debtors	20,000	
<b>Less:</b> Increase in Stock	(25,000)	
Increase in Bill Receivable	(30,000)	
Decrease in Creditors	(15,000)	(50,000)
<b>Net Cash Flows from Operating Activities (A)</b>		1,20,000
<b>Cash Flows from Investing Activities:</b>		
<b>Add:</b> Sale of machinery	30,000	
<b>Less:</b> Purchase of Machinery	(2,10,000)	
<b>Net Cash flows from Investing Activities (B)</b>		(1,80,000)
<b>Cash Flows from Financing Activities:</b>		
<b>Add:</b> Increase in equity share capital	1,00,000	
<b>Less:</b> Repayment of Loan	(25,000)	
Dividend Paid	(45,000)	
<b>Net Cash Flows from Financing Activities (C)</b>		30,000
Net increase in Cash & Cash Equivalents (A + B + C)		(30,000)
Cash & Cash Equivalents at the beginning of the year		30,000
Cash & Cash Equivalents at end of the year		Nil

15. Given below is the summarized balance sheet and profit and loss account of Singhania Corporation.

**Balance Sheet of Singhania Corporation as on 31st March 2008 and 31st March 2009**

Liabilities	March 31, 2008 (₹)	March 31, 2009 (₹)	Assets	March 31, 2008 (₹)	March 31, 2009 (₹)
Capital	90,000	1,30,000	Plant (Cost)	1,60,000	1,65,000
Reserves	60,000	96,000	Accumulated Depreciation	(30,000)	(38,000)
Long-term loans (9%)	70,000	50,000	Patents		29,000
Dividend Proposed	8,000	10,000	Stock	80,000	90,000
Accounts Payable	40,000	30,000	Sundry Debtors	60,000	55,000
Outstanding Expenses	32,000	19,000	Prepaid Expenses	10,000	12,000
			Cash	20,000	22,000
	<b>3,00,000</b>	<b>3,35,000</b>		<b>3,00,000</b>	<b>3,35,000</b>

**Profit and Loss Account for the year ending March 31, 2009**

Particulars	(₹)	Particulars	(₹)
To Raw Material Consumed	2,00,000	By Sales	3,75,000
To Wages paid	40,000		
To Expenses	80,000		
To Depreciation	8,000		
To Patents Amortized	1,000		
To Net Profit	46,000		
	3,75,000		3,75,000
To Dividend Proposed	10,000	By Net Profit	46,000
To Profit Retained Total	46,000		
<b>Total</b>	<b>46,000</b>	<b>Total</b>	<b>46,000</b>

**Additional Information:** Loan was repaid to the extent of ₹ 20,000 on June, 2008. Interest is paid on monthly basis at the end of each month which is included in expenses.

Prepare Statement of Cash Flows statement.

*Sol:*

**Cash Flows Statement (Indirect Method)**

Particulars	Amount (₹)	Amount (₹)
<b>Cash Flows from Operating Activities</b>		
Net Profit	46,000	
<b>Add:</b> Depreciation	8,000	
Patents Amortized	1,000	
Interest paid	4,800	
<b>Operating Profit before Working Capital Changes</b>		59,800
<b>Add:</b> Decrease in Debtors	5,000	
<b>Less:</b> Increase in Stock	(10,000)	
Increase in Prepaid	(2,000)	
Decreased in Accounts Payable	(10,000)	
Decrease in outstanding Expenses	(13,000)	(30,000)
<b>Net Cash Flows from Operating Activities (A)</b>		29,800
<b>Cash Flows from Investing Activities</b>		
Cash payment for purchase of Plant	(5,000)	
Cash payment for purchase of patents	(30,000)	

<b>Net Cash Flows from Investing Activities (B)</b>		
<b>Cash Flows from Financing Activities</b>		(35,000)
Cash from issue of shares	40,000	
Cash paid for Repayment of Loans	(20,000)	
Cash paid for dividends	(8,000)	
Cash paid for Interest	(4,800)	
<b>Net Cash Flows from Financing Activities (C)</b>		7,200
Net increase in Cash & Cash Equivalents (A + B + C)		2,000
Cash & Cash Equivalents at the beginning of the year		20,000
Cash & Cash Equivalents at end of the year		22,000

#### 4.6 DIFFERENCE BETWEEN FUNDS FLOW AND CASH FLOW STATEMENT

**Q20. What are the Difference between Funds Flow and Cash Flow Statement.**

*Ans :*

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. 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,

## Exercise Problems

1. From the following Balance Sheet of X Co. Ltd. Prepare a Statement of Changes in Working Capital and the Funds Flow Statement for the year ended 31st March, 2006.

### BALANCE SHEETS as on 31st March

Liabilities	2005 Rs.	2006 Rs.	Assets Rs.	2005 Rs.	2006
Share Capital	3,00,000	3,50,000	Goodwill	1,00,000	80,000
Debentures	1,50,000	2,50,000	Machinery	4,10,000	5,40,000
General Reserve	1,00,000	1,50,000	Investment	30,000	80,000
Profit & Loss	60,000	70,000	Discount on Issue of		
Provision for			Debentures	5,000	–
Depreciation			Cash at Bank	1,20,000	1,30,000
on Machinery	90,000	1,30,000	Sundry Debtor	80,000	1,90,000
Sundry Creditors	75,000	1,10,000	Stock	40,000	55,000
Bills Payable	10,000	15,000			
	<u>7,85,000</u>	<u>10,75,000</u>		<u>7,85,000</u>	<u>10,75,000</u>

During the year investment costing Rs. 30,000 were sold for Rs. 28,000 A new machine purchased for Rs. 45,000 and the payment was made in fully paid shares.

**[Ans : 1,87,000]**

2. The following are the summarised Balance sheets of a company as on 31st Dec- 2005 and 2006:

	31-12-2005	31-12-2006
<b>Liabilities</b>	Rs.	Rs.
Equity share Capital	2,00,000	2,40,000
8% Debentures	50,000	–
Share Premium	–	10,000
General Reserve	30,000	50,000
Profit & Loss Account	48,000	68,000
Sundry Creditors	1,30,000	1,50,000
Proposed Dividend	20,000	24,000
Provision for Depreciation :		
Plant & Machinery	1,40,000	1,50,000
Furniture	6,000	4,000
	<u>6,24,000</u>	<u>6,96,000</u>

<b>Assets</b>		
Land and Buildings	1,05,000	1,50,000
Plant and Machinery (at cost)	2,90,000	3,20,000
Furniture (at cost)	9,000	10,000
Inventories	1,30,000	1,05,000
Sundry Debtors	75,000	85,000
Cash	15,000	26,000
	<u>6,24,000</u>	<u>6,96,000</u>

Additional information is as follows:

1. Furniture which cost Rs.5,000, Written down value 1,000 was sold during the year 2006 for Rs.2,000
2. Plant and Machinery which cost Rs.20,000 and in respect of which Rs. 13,000 had been written off as depreciation was sold during the year for Rs.3,000
4. The dividend of 2005 was paid during 2006.

You are required to prepare (a) a Statement of changes in working capital during 2000 and (b) Funds flow statement for the year 2000.

**[Ans : 1,71,000]**

3. The Balance Sheets of a firm as on 31st December 1999 and 2000 are given below

	<b>2005 Rs.</b>	<b>2006 Rs.</b>		<b>2005 Rs.</b>	<b>2006 Rs.</b>
Share Capital	1,00,000	1,60,000	Fixed Assets at cost	1,52,000	2,00,000
Retained Earnings	70,250	85,300	Inventory	93,400	89,200
Accumulated Depreciation	60,000	40,000	Debtors	30,800	21,000
12% Debentures	50,000	–	Expenses Prepaid	3,950	3,000
Sundry Creditors	28,000	48,000	Bank	28,100	20,000
	<u>3,08,250</u>	<u>3,33,300</u>		<u>3,08,250</u>	<u>3,33,300</u>

The following additional information for 2006 are also given:

1. Net Profit Rs. 27,050
2. Depreciation charged Rs. 10,000
3. Cash dividend declared during the period Rs. 12,000
4. An addition to the building was made during the year at a cost of Rs. 78,000 and fully depreciated equipment costing Rs. 30,000 was discarded as no salvage being realised

Prepare a Cash Flow Statement.



4. From the following the following Balance Sheets of Exe Ltd., make out Cash Flow Statement.

Liabilities	2005 Rs.	2006 Rs.	Assets	2005 Rs.	2006 Rs.
Equity Share Capital	3,00,000	4,00,000	Goodwill	1,15,000	90,000
8% Redeemable Preference Share Capital	1,50,000	1,00,000	Land & Buildings	2,00,000	1,70,000
General Reserve	40,000	70,000	Plant	80,000	2,00,000
Profit & Loss	30,000	48,000	Debtors	1,60,000	2,00,000
Proposed Dividend	42,000	50,000	Stock	77,000	1,09,000
Creditors	55,000	83,000	Bills Receivable	20,000	30,000
Bills Payable	20,000	16,000	Cash in hand	15,000	10,000
Provision for Taxation	40,000	50,000	Cash at Bank	10,000	8,000
	<u>6,77,000</u>	<u>8,17,000</u>		<u>6,77,000</u>	<u>8,17,000</u>

#### Additional Information

- Depreciation of Rs. 10,000 and Rs. 20,000 have been charged on Plant and Land and Building in 2006.
- An interim dividend of Rs. 20,000 has been paid in 2006.
- Rs. 35,000 income tax was paid during 2006.

## Short Question and Answers

### 1. Define financial statement analysis.

*Ans :*

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.

**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.

**According to Hampton,** "Analysis of financial statement i& the process of determining the significant operating and financial characteristics of a firm from accounting data."

### 2. Define funds flow statement.

*Ans :*

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.

**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".

**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".

### 3. Define working capital.

*Ans :*

**According to Shubin,** "Working capital is the amount of funds necessary to cover the cost of operating the enterprise".

**According to Genestenberg,** "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, for example, from cash to inventories, inventories to receivables, receivables into cash".

Working capital can also be defined as excess of current assets over current liabilities or difference between the inflow and outflow of funds.

Working capital is required by the firm for the purpose of purchasing raw materials, payment of wages and other routine expenses, etc. It is required for financing current assets such as cash, marketable securities, debtors and inventories.

**4. What are the difference between cash profits and book profits.**

*Ans :*

S.No.	Basis	Cash Profits	Book Profits
1.	<b>Meaning</b>	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.	<b>Components</b>	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.	<b>Maintenances of Account</b>	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.	<b>Example</b>	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.	<b>Linkage or Relationship</b>	Adjustments made in cash profits results in book profits.	After the adjustments of cash profits, book profits are disclosed.

**5. Define cash flow statement.**

*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.

**6. Advantages of Cash Flow Statement***Ans :***(i) 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.

**(ii) 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.

**(iii) 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.

**7. Operating activities***Ans :*

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 of Cash Flows Arising from Operating Activities**

- (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.

**8. Investing Activities***Ans :*

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

**Examples of Cash Flows Arising from Investing Activities**

- (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.

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# UNIT V

**Financial Analysis-II:** Analysis and interpretation of financial statements, Horizontal Analysis and Vertical Analysis of Company, Financial Statements, Liquidity, leverage, solvency and profitability ratios – Du Pont Chart – Accounting Standards Issued by ICAI- Focus on importance of Standards to give a general view on Financial Accounting practices, International Financial Reporting Standards (IFRS).

## 5.1 ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

**Q1. Explain the meaning, objectives, and procedure of analysis and interpretation of financial statement.**

*Ans :*

### Financial Statements Analysis and Interpretation

The financial statement analysis is basically a process of analyzing and interpreting the financial statement in order to determine the profitability and correct financial position of a firm, which helps further in the decision making process. It is a process by which the financial strengths and weakness of a firm can be easily identified. The purpose of financial statements analysis is to make inter firm and intra-firm comparisons.

According to Myers, "Financial statement analysis" is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statement and a study of the trends of these factors as shown in a series of statement".

### Objectives of Analysis and interpretation of Financial Statement

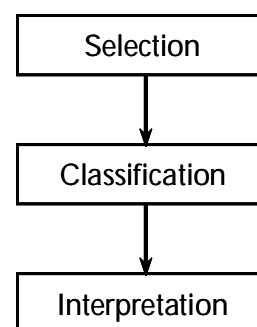
Some of the objectives of analysis and interpretation of financial statements are as follows,

1. Showing the current and future earning capacity and profitability of the business.
2. Ascertainment of short term and long term solvency of the company.
3. Manifest the effectiveness of the business department wise and as a whole.

4. Financial statement analysis aims at assisting the business concern in earning cut comparison between different firms and different departments within the firm.
5. Assist in evaluating the long term liquidity position of funds.
6. Assist in budget preparation.

### Procedure/Process of Financial Statement Analysis and Interpretation

The process of financial statement analysis and interpretation is basically three step process as shown in the following figure,



**Fig.: Process of Financial Statement Analysis and Interpretation**

### Step 1: Selection

The first step of financial statement analysis process is the selection of information which is relevant for the purpose of evaluation from the complete information which is present in the financial statement. The main points which needs to be considered by an analyst in order to carry out effective analysis is to have complete knowledge about the organizations objectives, plan and policies.

**Step 2: Classification**

The second step of this process is classification or grouping of information in such a manner that it focuses upon the significant relationship of each and every component of organization.

**Step 3: Interpretation**

The final step of process is the interpretation of the analysis in a very simple and understandable way which would help in drawing a meaningful relationship out of the grouped information. Such relationship can be measured with the help of various techniques of analysis such as, Ratio analysis, Trend analysis, Common size statement, Cash flow statements and so on.

The analysis and interpretation are closely interlinked with each other as interpretation is impossible without a proper analysis and any analysis which is not followed by interpretation becomes meaning less in nature. Thus, interpretation precedes a proper analysis.

**Q2. Explain the Importance of Financial Statement Analysis.**

*Ans :*

The financial statement analysis is important for different reasons:

**1. Holding of Share**

Shareholders are the owners of the company. They may have to take decisions whether they have to continue with the holdings of the company's share or sell them out. The financial statement analysis is important as it provides meaningful information to the shareholders in taking such decisions.

**2. Decisions And Plans**

The management of the company is responsible for taking decisions and formulating plans and policies for the future. They, therefore, always need to evaluate its performance and effectiveness of their action to realise the company's goal in the past. For that purpose, financial statement analysis is important to the company's management.

**3. Extension Of Credit**

The creditors are the providers of loan capital to the company. Therefore they may have to take decisions as to whether they have to extend their loans to the company and demand for higher interest rates. The financial statement analysis provides important information to them for their purpose.

**4. Investment Decision**

The prospective investors are those who have surplus capital to invest in some profitable opportunities. Therefore, they often have to decide whether to invest their capital in the company's share. The financial statement analysis is important to them because they can obtain useful information for their investment decision making purpose.

**Q3. Explain the uses of Financial Statement Analysis.**

*Ans :*

There are a number of users of financial statement analysis. They are:

**1. Creditors**

Anyone who has lent funds to a company is interested in its ability to pay back the debt, and so will focus on various cash flow measures.

**2. Investors**

Both current and prospective investors examine financial statements to learn about a company's ability to continue issuing dividends, or to generate cash flow, or to continue growing at its historical rate (depending upon their investment philosophies).

**3. Management**

The company controller prepares an ongoing analysis of the company's financial results, particularly in relation to a number of operational metrics that are not seen by outside entities (such as the cost per delivery, cost per distribution channel, profit by product, and so forth).

#### 4. Regulatory Authorities

If a company is publicly held, its financial statements are examined by the Securities and Exchange Commission (if the company files in the United States) to see if its statements conform to the various accounting standards and the rules of the SEC.

#### Problems with Financial Statement Analysis

While financial statement analysis is an excellent tool, there are several issues to be aware of that can interfere with your interpretation of the analysis results. These issues are:

##### 1. Comparability between Periods

The company preparing the financial statements may have changed the accounts in which it stores financial information, so that results may differ from period to period. For example, an expense may appear in the cost of goods sold in one period, and in administrative expenses in another period.

##### 2. Comparability between Companies

An analyst frequently compares the financial ratios of different companies in order to see how they match up against each other. However, each company may aggregate financial information differently, so that the results of their ratios are not really comparable. This can lead an analyst to draw incorrect conclusions about the results of a company in comparison to its competitors.

##### 3. Operational Information

Financial analysis only reviews a company's financial information, not its operational information, so you cannot see a variety of key indicators of future performance, such as the size of the order backlog, or changes in warranty claims. Thus, financial analysis only presents part of the total picture.

#### Q4. Explain the analysis and interpretation of financial statements of company. What are the different types of financial statement analysis?

*Ans :*

#### Analysis and Interpretation of Financial Statement

The terms analysis and interpretation corresponds with each. They are mostly used together. Analysis refers to the methodical categorization division of financial statements data. While interpretation refers to giving explanation about the meaning and importance of the classified data of the financial statement. Both the terms are dependent on each other. Analysis would be meaningless without interpretation and it would be difficult to interpret without analysis. Majority of the authors uses the word analysis in order to include the meaning of both terms under one heading i.e., Analysis. Therefore, financial statement analysis means analysis as well as interpretation of the financial statement.

The analysis and interpretation of the financial position of a company or firm is carried out by calculating the profitability and financial soundness of that company or firm. In order to calculate the profitability and financial soundness, the information of the income statement and balance sheet is taken into consideration.



### Types of Financial Statement Analysis

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 considerable 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 terms 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.

## 5.2 HORIZONTAL ANALYSIS AND VERTICAL ANALYSIS OF COMPANY, FINANCIAL STATEMENTS

**Q5. Define**

**(a) Horizontal Analysis**

**(b) 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.

**Q6. What are the difference between horizontal and vertical analysis.**

*Ans :*

Basis	Horizontal Analysis	Vertical Analysis
Need	Comparative Financial statement is needed to prepare horizontal analysis.	Financial statements of one accounting period are needed to prepare vertical analysis.
Items	It includes same items of different periods	It includes different items of same period.
Calculation	In this analysis, both absolute and percentage changes are computed.	In this analysis, only percentage change is computed.
Application	It is applicable to time series analysis.	It is applicable to cross-section analysis.

**Q7. 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 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.

**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.

## 5.3 RATIO ANALYSIS

### Q8. What is Ratio Analysis? What are the objectives of ratio analysis?

*Ans :*

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 of Ratio Analysis

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.

**Q9. 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.

**Q10. 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.

**Q11. 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.

**Q12. Explain the importance of ratio analysis***Ans :***Importance of Ratio Analysis**

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.

**Q13. What are the Limitations of Ratio Analysis.***Ans :*

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.

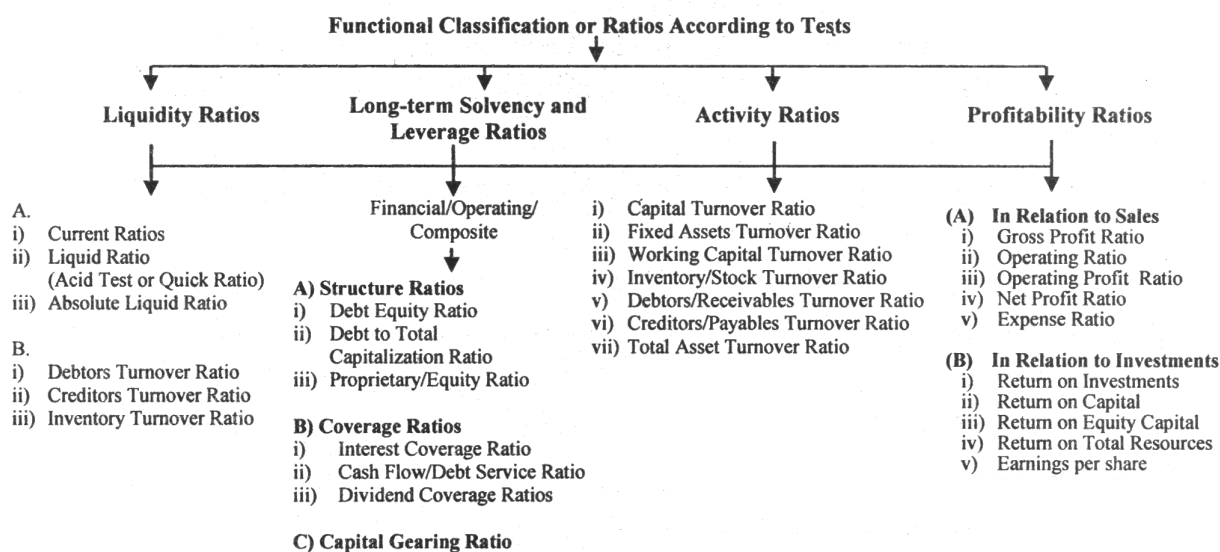
### 5.4 CLASSIFICATION OF RATIOS

**Q14. Explain the classification of ratios.**

*Ans :*

Functional Classification or Ratios According to Tests/Object:

- i) **Liquidity Ratio:** These are the ratios, which measures the short-term solvency or financial position of a firm. These ratios are calculated to comment upon the short-term paying capacity of a concern or the firm's ability to meet its current obligations. The various liquidity ratios are current ratio, liquid ratio and absolute liquid ratio. Further to see the efficiency with which the liquid resources have been employed by a firm, debtor's turnover and creditor's turnover ratios are calculated.



- ii) **Leverage Ratio:** Leverage ratios are the financial statement ratios which show the degree to which the business is leveraging itself through its use of borrowed money. By using a combination of assets, debt, equity, and interest payments, leverage ratios are used to understand a company's ability to meet its long term financial obligations.

The leverage ratios can further be classified as:

- Structure Ratios
- Coverage Ratios
- Capital Gearing Ratios



- iii) **Activity Ratios:** Activity ratios are calculated to measure the efficiency with which the resources of a firm have been employed. These ratios are also called **turnover ratios** because they indicate the speed with which assets are being turned over into sales, e.g., debtor's turnover ratio. The various activity or turnover ratios have been named in the chart classifying the ratios.
- iv) **Profitability Ratios:** These ratios measure the result of business operations or overall performance and effectiveness of the firm, e.g., gross profit ratio, operating ratio or return on capital employed. The various profitability ratios have been given in the chart exhibiting the classification of ratios according to test. Generally, two types of profitability ratios calculated are:
- In relation to sales, and
  - In relation to investments.

#### 5.4.1 Liquidity Ratios

**Q15. What is liquidity ratio. Explain various types of 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:

- Current Ratio or Working Capital Ratio
- Quick or Acid Test or Liquid Ratio
- 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:

- 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.

- 2) **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:**

- There may be slow moving stocks. The stocks will pile up due to poor sale.
- The figures of debtors may go up because debt collection is not satisfactory.
- 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:

1. **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
2. **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:

- 1) **Absolute liquid assets:** Absolute liquid assets include cash in hand and at bank and marketable securities or temporary investments.
- 2) **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:

$$\text{Absolute Liquid Ratio} = \frac{\text{Absolute Liquid Assets}}{\text{Current Liabilities}}$$

**5.4.2 Solvency and Leverage Ratios****Q16. Explain different types of leverage ratios.***Ans :*

These ratios provide an insight into the financial techniques used by a firm and focus, as a consequence, on the long term solvency position with regard to, periodic payment of interest during the period of loan, repayment of principal on maturity or in predetermined instalments on due dates.

The following ratios serve the purpose of determining the solvency of the concern.

1. Structure Ratios
  - i) Debt-Equity Ratio.
  - ii) Funded Debt to Total Capitalization Ratio.
  - iii) Proprietary Ratio or Equity Ratio.
2. Coverage Ratios
  - i) Interest Coverage Ratio (or Time-interest Earned Ratio or Debt-Service Ratio).
  - ii) Cash to Debt Service Ratio.
  - iii) Dividend Coverage Ratio.

**3. Capital Gearing Ratio****1. Structure Ratios**

The capital structure ratio shows the percent of long term financing represented by long term debt.

**i) Debt-Equity Ratio****Meaning**

This ratio establishes a relationship between long-term debts and share-holders' funds.

**Objective**

The objective of computing this ratio is to measure the relative proportion of debt and equity in financing the assets of a firm.

**Components**

There are two components of this ratio which are as under:

1. **Long-Term Debts:** Long-term debts mean long-term loans whether secured or unsecured (e.g., debentures, bonds, loans from financial institutions).
2. **Shareholders' Funds:** Shareholder's funds mean equity share capital plus preference share capital plus reserves and surplus minus fictitious assets (e.g., preliminary expenses)

**Computation**

This ratio is computed by dividing the long-term debts by the shareholders' funds. This ratio is usually expressed as a pure ratio e.g., 2:1. In the form of a formula, this ratio may be expressed as under:

$$\text{Debt - Equity Ratio} = \frac{\text{Long - term Debts}}{\text{Shareholder's Funds}}$$

(or)

$$\text{Debt to Equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

**Interpretation**

It indicates the margin of safety to long-term creditors. A low debt-equity ratio implies the use of more equity than debt which means a larger safety margin for creditors since owner's equity is treated as a margin of safety by creditors and vice versa.

**ii) Funded Debt to Total Capitalization Ratio****Meaning**

This ratio establishes a link between the long-term funds raised from outsiders and total long-term funds available in the business.

**Components**

The two words used in this ratio are:

1. Funded debt = Debentures + Mortgage loans + Bonds + Other long-term loans.
2. Total Capitalization = Equity Share Capital + Preference Share Capital + Reserves and Surplus + Other Undistributed Reserves + Debentures + Mortgage Loans + Bonds + Other long-term loans.

**Computation**

Funded debt is that part of total capitalization which is financed by outsiders. This ratio can be calculated as under:

Funded Debt to Total Capitalization Ratio

$$= \frac{\text{Funded debt}}{\text{Total Capitalisation}}$$

### Interpretation

Though there is no 'rule of thumb' but still the lesser the reliance on outsiders the better it will be. If this ratio is smaller, better it will be, upto 50% or 55% this ratio may be too tolerable and not beyond.

### iii) Proprietary Ratio/Equity Ratio

#### Meaning

This ratio measures a relationship between proprietors' funds and the total assets.

#### Objective

The objective of computing this ratio is to find out how the proprietors have financed the assets.

#### Components

There are two components of this ratio which are as under:

1. Proprietors' Funds (excluding fictitious assets like preliminary exp.)
2. Total Assets

#### Computation

This ratio is computed by dividing the proprietors' funds by total assets. The ratio can be calculated as under:

$$\text{Proprietary Ratio} = \frac{\text{Proprietors Funds}}{\text{Total Assets}}$$

**Note:** Proprietors' Funds mean the Shareholders' Funds.

### 2. Coverage Ratios

Coverage ratios tell us the debt servicing commitments and sourcing the funds to meet them. These ratios are used to test the adequacy of cash flows generated through earnings for the purposes of meeting debt and lease obligations.

#### i) Interest Coverage Ratio/ Debt-Service Ratio

##### Meaning

This ratio establishes a relationship between net profits before interest and taxes and interest on long-term debt.

### Objective

The objective of computing this ratio is to measure the debt-servicing capacity of a firm so far as fixed interest on long-term debt is concerned.

### Components

There are two components of this ratio which are as under:

1. Net profits before interest and taxes;
2. Interest on long-term debts.

### Computation

This ratio is computed by dividing the net profits before interest and taxes by interest on long-term debt. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

Interest Coverage Ratio

$$= \frac{\text{Net Profit before Interest and Taxes}}{\text{Interest on Long - term debt}}$$

### ii) Cash to Debt Service Ratio

#### Computation

Cash to debt service ratio, also known as Debt Cash Flow Coverage Ratio, is an improvement over the interest coverage ratio and is calculated as follows:

Cash to Debt Service Ratio

or

Debt Cash Flow Coverage

$$= \frac{\text{Annual Cash Flow before interest and taxes}}{\text{Interest} + \frac{\text{Sinking Fund Appropriation on Debt}}{1 - \text{Tax Rate}}}$$

$$\text{or CFCD} = \frac{\text{CF}}{1 + \frac{\text{SFD}}{1 - T}}$$

Where,

CF = Annual Cash Flow before Interest and Tax

I = Interest charges

SFD = Sinking Fund Appropriation on Debt

T = Rate of Tax

**Interpretation**

The logic of the ratio is that the interest payments are to be made out of cash inflow of the business and not from the profits and apart from interest, expenses sinking fund appropriations on debt (which are generally made by various firms to enable itself to make repayment of the loans) should be considered to find out debt cash flow coverage as a measure of long-term solvency of a firm. Generally, higher the coverage better it is, as far as, long-term solvency of the firm is concerned.

**iii) Dividend Coverage Ratio****Meaning**

This ratio measures the ability of a firm to pay dividend on preference shares which carry a stated rate of return. The ratio is expressed in 'X number of times'.

**Computation**

$$\text{Dividend Coverage Ratio} = \text{EAT} / (\text{Preference Dividend})$$

**Interpretation**

This ratio indicates margin of safety available to the preference share holders. Higher the ratio, more desirable on the part of preference share holders.

**iv) Capital Gearing Ratio****Meaning**

The term 'capital gearing' is used to describe the relationship between equity share capital including reserves and surpluses to preference share capital and other fixed interest-bearing loans.

**Computation**

This ratio can be calculated as under:

$$\text{Capital Gearing Ratio} = \frac{\text{Equity Share Capital} + \text{Reserve and Surplus}}{\text{Preference Capital} + \text{Long - term debt bearing fixed interest}}$$

**Interpretation**

If preference share capital and other fixed interest bearing loans exceed the equity share capital including reserves, the firm is said to be highly geared. The firm is said to be in low gear if preference share capital and other fixed interest-bearing loans are less than equity capital and reserves.

**Note:** Long term debts bearing fixed interest are raised through debt and long term loan.

**Q17. Explain briefly about various activity ratios?**

*Ans :*

**Activity Ratios**

Funds are invested in various assets in business to make sales and earn profits. The efficiency with which assets are managed directly affects the volume of sales. The better the management of assets, the larger is the amount of sales and the profits. Activity ratios measure the efficiency or effectiveness with which a firm manages its resources or assets. These ratios are also called turnover ratios because they indicate the speed with which assets are converted or turned over into sales. It includes the following ratios:

1. Capital Turnover Ratio
2. Fixed Assets Turnover Ratio
3. Working Capital Turnover Ratio
4. Stock Turnover Ratio
5. Debtors Turnover Ratio (or Receivables Turnover Ratio).
6. Creditors Turnover Ratio (or Payables Turnover Ratio).

## 1. Capital Turnover Ratio

### Meaning

This ratio establishes a relationship between net sales and capital employed.

### Objective

The objective of computing this ratio is to determine the efficiency with which the capital employed is utilized.

### Components

There are two components of this ratio which are as under:

1. Net Sales
2. Capital Employed

### Computation

This ratio is computed by dividing the net sales by the capital employed. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

$$\text{Capital Turnover Ratio} = \frac{\text{Net Sales}}{\text{Capital Employed}}$$

Net sales = Gross Sales – Sales return

Capital Employed = Long-term debt + Shareholder's Fund 1

## 2. Fixed Assets Turnover Ratio

### Meaning

This ratio establishes a relationship between net sales and fixed assets.

### Objective

The objective of computing this ratio is to determine the efficiency with which the fixed assets are utilized.

### Components

There are two components of this ratio which are as under:

1. Net Sales
2. Net Fixed (operating) Assets

**Note:** An advance for purchase of a fixed asset is not an operating fixed asset.

### Computation

This ratio is computed by dividing the net sales by the net fixed assets. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Net Total Fixed Assets}} = \frac{\text{Cost of goods sold}}{\text{Net Total Fixed Assets}}$$

Net Sales = Gross Sales – Sales Return

Net Fixed (operating) Assets = Gross Fixed Assets – Depreciation

### Interpretation

It indicates the firm's ability to generate sales per rupee of investment in fixed assets. In general, higher the ratio, the more efficient the management and utilization of fixed assets, and vice versa. It may be noted that there is no direct relationship between sales and fixed assets since the sales are influenced by other factors as well, e.g., quality of product, delivery terms, credit terms, after sales service, advertisement and publicity, etc.

### 3. Working Capital Turnover Ratio

#### Meaning

This ratio establishes a relationship between net sales and working capital.

The working capital is taken as:

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

#### Objective

The objective of working capital turnover ratio is to indicate the velocity of the utilization of net working capital. This ratio indicates the number of times the working capital is turned over in the course of a year.

This ratio measures the efficiency with which the working capital is being used by a firm.

#### Components

The components of this ratio are as under:

- 1) Net Sales
- 2) Working Capital

#### Computation

This ratio is computed by dividing the net sales by the working capital. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

$$\text{Working Capital Turnover Ratio} = \frac{\text{Net Sales}}{\text{Working Capital}} = \frac{\text{Cost of goods sold}}{\text{Net Working Capital}}$$

$$\text{Net Sales} = \text{Gross Sales} - \text{Sales return}$$

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

#### Interpretation

It indicates the firm's ability to generate sales per rupee of working capital. In general, higher the ratio, the more efficient the management and utilization of working capital and vice versa.

### 4. Stock Turnover Ratio

#### Meaning

This ratio establishes a relationship between costs of goods sold and average inventory.

#### Objective

The objective of computing this ratio is to determine the efficiency with which the inventory is utilized.

#### Components

There are two components of this ratio which are as under:

- 1) Cost of Goods Sold
- 2) Average Inventory



### Computation

This ratio is computed by dividing the cost of goods sold by the average inventory. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Cost of Goods sold} = \text{Sales} - \text{Gross Profit}$$

or

$$\text{Cost of Goods sold} = \text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

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

### Note:

- i) If opening stock is not known, closing stock can be taken.
- ii) If there is any difficulty in calculating cost of goods sold, then

$$\text{Stock Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Stock}}$$

### Interpretation

It indicates the speed with which the inventory is converted into sales. In general, a high ratio indicates efficient performance since an improvement in the ratio shows that either the same volume of sales has been maintained with a lower investment in stocks, or the volume of sales has increased without any increase in the amount of stocks. However, too high ratio and too low ratio, call for further investigation. A too high ratio may be the result of a very low inventory levels which may result in frequent stock-outs and thus the firm may incur high stock out costs. On the other hand, a too low ratio may be the result of excessive inventory levels, slow-moving or obsolete inventory and thus, the firm may incur high carrying costs. Thus, a firm should have neither a very high nor a very low stock turnover ratio; it should have a satisfactory level.

### Inventory Conversion Period (Stock Velocity)

It may also be of interest to see average time taken for clearing the stocks. This can be possible by calculating inventory conversion period. This period is calculated by dividing the number of days by inventory turnover. The formula may be as:

$$\text{Inventory Conversion Period} = \frac{12 \text{ months} / 52 \text{ weeks} / 365 \text{ days}}{\text{Stock Turnover Ratio}}$$

## 5 Debtors Turn over Ratio/Receivables Turn over Ratio

### Meaning

This ratio establishes a relationship between net credit sales and average trade debtors.

### Objective

The objective of computing this ratio is to determine the efficiency with which the trade debtors are managed.

**Components**

There are two components of this ratio which are as under:

1. Net Credit Sales
2. Average Trade Debtors

**Computation**

This ratio is computed by dividing the net credit sales by average trade debtors. This ratio is usually expressed as 'x' number of times. In the form of a formula, this ratio may be expressed as under:

$$\text{Debtors Turn over Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Trade Debtors}}$$

Net Credit Sales = Gross Credit Sales – Sales Returns

Trade Debtors = Sundry Debtors + Bills Receivables and Accounts Receivables

$$\text{Average Trade Debtors} = \frac{\text{Opening Trade Debtors} + \text{Closing Trade Debtors}}{2}$$

**Interpretation**

It indicates the number of times the debtors are turned over during a year. Generally, the higher the value of debtor's turnover the more efficient is the management of debtors/sales or more liquid are the debtors. Similarly, low debtors turnover implies inefficient management of debtors/sales and less liquid debtors. But a precaution is needed while interpreting a very high debtors turnover ratio because a very high ratio may imply a firm's inability due to lack of resources to sell on credit thereby losing sales and profits. There is no 'rule of thumb' which may be used as a norm to interpret the ratio as it may be different from firm to firm, depending upon the nature of business. This ratio should be compared with ratios of other firms doing similar business and a trend may also be found to make a better interpretation of the ratio.

**Debt Collection Period (or Debtors' Velocity)**

The debt collection period represents the average number of days for which a firm has to wait before its receivables are converted into cash. The ratio can be calculated as follows:

$$\text{i) Debt Collection Period} = \frac{\text{Average Trade Debtors (Drs + B/R)}}{\text{Sales per day}}$$

$$\text{ii) Sales per day} = \frac{\text{Net Sales}}{\text{No. of working days}}$$

or Debt Collection Period

$$= \frac{\text{Average Trade Debtors}}{\frac{\text{Net Sales}}{\text{No. of working days}}} = \frac{\text{Average Trade Debtors} \times \text{No. of working days}}{\text{Net Sales}}$$

If the period is in months:

$$\text{Debt Collection Period} = \frac{\text{Average Trade Debtors} \times \text{No. of Months}}{\text{Net Sales}}$$

## 6. Creditors Turnover Ratio/Payables Turnover Ratio

### Meaning

This ratio establishes a relationship between net credit purchases and average trade creditors.

### Objective

The objective of computing this ratio is to determine the efficiency with which the creditors are managed.

### Components

There are two components of this ratio which are as under:

1. Net credit Purchases
2. Average Trade Creditors

### Computation

This ratio is computed by dividing the net credit purchases by average trade creditors. This ratio is usually expressed as 'x' number of times. In the form of formula, this ratio may be expressed as under:

$$\text{Creditors Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Average Trade Creditors}}$$

$$\text{Net credit Purchases} = \text{Gross Credit Purchases} - \text{Purchases Returns}$$

$$\text{Average Trade Creditor} = \frac{\text{Opening Trade Creditor} + \text{Closing Trade Creditor}}{2}$$

### Interpretation

The average payment period ratio represents the average number of days taken by the firm to pay its creditors. Generally, lower the ratio, the better is the liquidity position of the firm and higher the ratio, less liquid is the position of the firm. But a higher payment period also implies greater credit period enjoyed by the firm and consequently larger the benefit reaped from credit suppliers. But one has to be careful in interpreting this ratio, as higher ratio may also imply lesser discount facilities availed or higher prices paid for the goods purchased on credit. To make correct interpretation of this ratio, a comparative analysis of different firms in the same industry and the trend may be found for various years.

### Debt Payment Period (or Creditors' Velocity)

This period shows an average period for which the credit purchases remain outstanding or the average credit period actually availed of.

$$\text{Debt Payment Period} = \frac{\text{Average Trade Creditors}}{\text{Average Net Credit Purchases Per day}}$$

$$= \frac{12 \text{ months} / 52 \text{ weeks} / 365 \text{ days}}{\text{Creditors Turnover Ratio}}$$

$$\text{Average Net Credit Purchases Per day} = \frac{\text{Net Credit Purchases for the year}}{\text{No. of working days in the year}}$$

**7. Total Assets Turnover Ratio****Meaning**

This ratio is the relationship between sales and total asset.

**Objective**

The objective is to measure the overall performance and activity of the business organization.

**Computation**

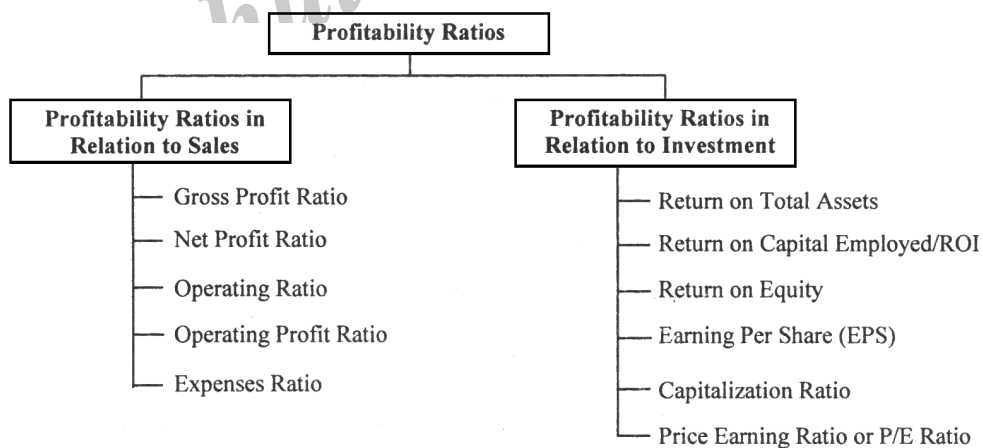
It is computed by dividing sales by total assets. The following formula is applied to compute this ratio:

$$\text{Total Assets Turnover} = \frac{\text{Sales}}{\text{Total Assets}}$$

**5.4.3 Profitability Ratios****Q18. 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:

**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:

	~
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:

$$\begin{aligned} \text{Operating Ratio} &= \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100 \\ \text{Operating Cost} &= \text{Cost of Good Sold} + \text{Operating Expenses} \\ &= \frac{\text{Cost of Good Sold} + \text{Operating Expenses}}{\text{Net Sales}} \times 100 \end{aligned}$$

**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:

$\text{Return on Total Assets} = \frac{\text{Net Profit before Interest and Tax}}{\text{Total Assets}} \times 100$
--

**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.

### PROBLEMS ON RATIO ANALYSIS

1. From the following information, calculate liquidity ratios for the two companies and give your interpretation of the liquidity position of the companies as revealed by the ratios.

	(Rupees in Lakhs)	
	Company X	Company Y
Cash	360	280
Debtors	2,800	6,400
Inventory	4,000	12,000
Bills payable	600	2,000
Creditors	1,600	10,000
Accrued Expenses	200	250
Tax payable	1,200	1,000

Sol :

- (i) **Current Ratio** =  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Current Assets	X	Y	Current Liabilities	X	Y
Cash	360	280	Bills payable	600	2,000
Debtors	2,800	6,400	Creditors	1,600	10,000
Inventory	4,000	12,000	Accrued expenses	200	250
			Tax payable	1,200	1,000
	<b>7,160</b>	<b>18,680</b>		<b>3,600</b>	<b>13,250</b>

$$\text{Current Ratio for X Co} = \frac{7,160}{3,600} = 1.98:1$$

$$\text{Current Ratio for Y Co} = \frac{18,680}{13,250} = 1.41:1$$

- (ii) **Quick Ratio** =  $\frac{\text{Quick Assets}}{\text{Current Liabilities}}$

Quick Assets = Current Assets – [Stock and Prepaid expenses]

Quick ratio for x co = 7,160 – 4,000 = Rs. 3,160

Quick ratio for y co = 18,680 – 12,000 = Rs. 6,680

$$\text{Quick ratio for x co} = \frac{3,160}{3,600} = 0.877$$

$$\text{Quick ratio for y co} = \frac{6,680}{13,250} = 0.50$$

(iii) **Absolute liquidity ratio** =  $\frac{\text{Absolute Liquid Assets}}{\text{Current Liabilities}}$

$$\text{Absolute liquid assets} = \text{QA} - [\text{Debtors} + \text{B/R}]$$

$$\text{Absolute liquid assets for x co.} = 3,160 - 2,800 = 360$$

$$\text{Absolute liquid assets for y co.} = 6,680 - 6,400 = 280$$

#### Absolute Liquidity Ratio

$$\text{x co} = \frac{360}{3,600} = 0.1$$

$$\text{y co} = \frac{280}{13,250} = 0.02$$

2. You are given Trading and Profit & Loss Account of Mahesh Company limited for the year ended 31st December 1992.

#### Trading and Profit & Loss Account

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Opening Stock	30,000	By Net Sales	1,10,000
To Purchases	60,000	By Closing Stock	20,000
To Wages	10,000		
To Gross Profit (c/d)	30,000		
	1,30,000		1,30,000
To Administrative Expenses	10,000	By Gross Profit (b/d)	30,000
To Selling & Distribution Expenses	5,000	By Sundry Receipt	5,000
To Net Profit	20,000		
	35,000		35,000

Calculate

1. Gross Profit Ratio
2. Net Profit Ratio
3. Operating Ratio
4. Operating Profit Ratio

*Sol:*

1. **Gross Profit Ratio** =  $\frac{\text{Gross profit}}{\text{Net sales}} \times 100$

$$\begin{aligned}\text{GP Ratio} &= \frac{30,000}{1,10,000} \times 100 \\ &= 27.27\%\end{aligned}$$

**2. Net Profit Ratio**

$$\text{NP Ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

$$\text{NP Ratio} = \frac{20,000}{1,10,000} \times 100$$

$$\therefore \text{NP Ratio} = 18.18\%$$

**3. Operating Ratio**

$$\text{Operating Ratio} = \frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Net sales}} \times 100$$

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

$$\begin{aligned}\text{COGS} &= 30,000 + 60,000 + 10,000 - 20,000 \\ &= 1,00,000 - 20,000\end{aligned}$$

$$\text{COGS} = 80,000$$

$$\text{Operating Ratio} = \frac{\text{COGS} + \text{Operating expenses}}{\text{Net sales}} \times 100$$

$$\text{Operating Ratio} = \frac{80,000 + 15,000}{1,10,000} \times 100$$

$$= \frac{95,000}{1,10,000} \times 100$$

$$\therefore \text{Operating Ratio} = 86.36\%$$

**4. Operating Profit Ratio**

$$\begin{aligned}100 - \text{Operating Ratio} \\ = 100 - 86.36\end{aligned}$$

$$\text{Operating Profit Ratio} = 13.64\%$$

3. From the following Trading and Profit & Loss A/c of Rim Zim Limited for the year ended 31st March 1993.

Calculate

- (i) Gross Profit Ratio
- (ii) Net Profit Ratio
- (iii) Operating Ratio
- (iv) Operating Profit Ratio. Rim Zim Company

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening Stock	5,00,000	By Sales	
To Purchases	11,00,000	Cash   3,00,000	
To Wages	3,00,000	Credit  17,00,000	20,00,000
To Factory Overheads	2,00,000	By Closing Stock	6,00,000
To Gross Profit (c/d)	5,00,000		
	26,00,000		26,00,000
To Administration Expenses	75,000	By Gross Profit (b/d)	5,00,000
To Selling & Distribution Exp.	50,000	By Dividend on Investment	10,000
To Interest on Debentures	20,000	By Profit on Sale of Furniture	20,000
To Depreciation	60,000		
To Loss on Sale of Motorcar	5,000		
To Net Profit	3,20,000		
	5,30,000		5,30,000

Sol.:

1. **Gross Profit Ratio** =  $\frac{\text{Gross profit}}{\text{Net sales}} \times 100$

$$\text{Gross Profit Ratio} = \frac{5,00,000}{20,00,000} \times 100$$

$$\therefore \text{GP Ratio} = 25\%$$

2. **Net Profit Ratio**

$$\text{NP Ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

$$= \frac{3,20,000}{20,00,000} \times 100$$

$$\therefore \text{NP Ratio} = 16\%$$



**2. Earnings Yield Ratio**

$$\text{EYR} = \frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

$$\text{EYR} = \frac{10}{25} \times 100$$

$$\therefore \text{EYR} = 40\%$$

**3. Price Earning Ratio (P/E Ratio)**

$$\text{P/E Ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

$$\text{P/E Ratio} = \frac{25}{10}$$

$$\text{P/E Ratio} = 2.5 \text{ times}$$

**4. Dividend Per Share (DPS)**

$$\text{DPS} = \frac{\text{Dividend available to equity share holders}}{\text{No. of Equity share holders}}$$

Dividend available to equity share holders

$$\text{DPS} = \text{Equity share capital} \times \frac{\text{Ratio}}{100}$$

$$= 1,00,000 \times \frac{5}{100}$$

$$\text{DPS} = \frac{5,000}{1,000}$$

$$\therefore \text{DPS} = 5$$

**5. Dividend Yield Ratio (DYR)**

$$\text{DYR} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

$$\text{DYR} = \frac{5}{25} \times 100$$

$$\therefore \text{DYR} = 20\%$$

**6. Payout Ratio**

$$\text{Payout Ratio} = \frac{\text{Dividend per share}}{\text{Earnings per share}} \times 100$$

$$= \frac{5}{10} \times 100$$

$$\text{Payout Ratio} = 50\%$$



5. Net Sales Rs. 10,00,000

Gross Profit 30% on sales

Stock turnover Ratio = 7 times

Calculate closing stock value if it is 30,000 excess of opening stock.

*Sol:*

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Net sales}} \times 100$$

$$0.30 = \frac{\text{Gross profit}}{10,00,000}$$

$$\text{Gross profit} = 3,00,000$$

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

$$= 10,00,000 - 3,00,000$$

$$\therefore \text{COGS} = 7,00,000$$

$$\text{Stock turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$7 = \frac{7,00,000}{\text{Average stock}}$$

$$\therefore \text{Average stock} = \frac{7,00,000}{7}$$

$$\text{Average stock} = \text{Rs. } 1,00,000.$$

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

$$1,00,000 = \frac{x + (x + 30,000)}{2}$$

$$2,00,000 = x + (x + 30,000)$$

$$2,00,000 = 2x + 30,000$$

$$2x = 2,00,000 - 30,000$$

$$2x = 1,70,000$$

$$x = \frac{1,70,000}{2}$$

$$\therefore \text{Opening Stock} = 85,000$$

$$\text{Closing Stock} = 85,000 + 30,000$$

$$\text{Closing Stock} = 1,15,000$$

6. Following is the balance sheet of Vijay Industries Ltd. as on 31<sup>st</sup> March 2013. Calculate its current ratio, liquid ratio and also absolute liquid ratio and comment on the short-term solvency of this company:

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital	7,80,000	Goodwill	4,60,000
Reserves and Surplus	2,12,000	Plant and Machinery	5,80,000
Debentures	3,80,000	Stock	3,00,000
Creditors	1,40,000	Debtors	1,60,000
Bills Payable	60,000	Cash Balance	48,000
Outstanding Expense	7,000	Prepaid Expenses	31,000
<b>Total</b>	<b>15,79,000</b>		<b>15,79,000</b>

*Sol :*

**a) Current Ratio**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Current Assets} &= \text{Stock} + \text{Debtors} + \text{Cash Balance} + \text{Prepaid Expenses} \\ &= 3,00,000 + 1,60,000 + 48,000 + 31,000 \\ &= 5,39,000. \end{aligned}$$

$$\begin{aligned} \text{Current Liabilities} &= \text{Creditors} + \text{Bills Payable} + \text{Outstanding Expenses} \\ &= 1,40,000 + 60,000 + 7,000 \\ &= 2,07,000 \end{aligned}$$

$$\begin{aligned} \therefore \text{Current Ratio} &= \frac{5,39,000}{2,07,000} \\ &= 2.6:1 \end{aligned}$$

**Comments**

The standard current ratio is 2:1 but in this case it is 2.6:1. It indicates that company have sufficient funds to meet its working capital requirements.

**b) Liquid Ratio**

$$\text{Liquid Ratio/Quick Ratio/Acid Test Ratio} = \frac{\text{Liquid / Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Liquid Assets} &= \text{Current Assets} - (\text{Stock} + \text{Prepaid Expenses}) \\ &= 5,39,000 - (3,00,000 + 31,000) \\ &= 2,08,000 \end{aligned}$$

$$\therefore \text{Liquid Ratio} = \frac{2,08,000}{2,07,000} = 1:1$$

**Comments**

The ideal debt - equity rule for ratio is 2:1 but, in this case, it is only 0.68 which is very less this indicates that shareholders are not satisfied as the firm has not utilized the outsider's funds efficiently to enhance their earnings.

**c) Absolute Liquidity Ratio**

$$\text{Absolute Liquidity Ratio} = \frac{\text{Absolute Liquidity Ratio}}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Absolute Liquidity Assets} &= \text{Cash Balance} \\ &= 48,000\end{aligned}$$

$$\therefore \text{Absolute Liquidity Ratio} = \frac{48,000}{2,07,000} = 0.23$$

**Comments**

The absolute liquid ratio is 0.23, which is lower than the standard 0.5. Hence it is not satisfactory and firm need to improve its short term financial position.

- 7. Current liabilities of a company are ₹ 5,60,000. Current Ratio is 5:2. Quick ratio is 2:1. Find the value of the stock.**

*Sol:*

Given that,

$$\text{Current Liabilities} = 5,60,000$$

$$\text{Current Ratio} = 5:2$$

$$\text{Quick Ratio} = 2:1$$

$$\text{Stock} = ?$$

$$\text{Stock} = \text{Current Assets} - \text{Quick/Liquid Assets}$$

$$\begin{aligned}\text{Current Assets} &= \text{Current Liabilities} \times \text{Current Ratio} \\ &= 5,60,000 \times 5:2\end{aligned}$$

$$\text{Current Assets} = 14,00,000$$

$$\begin{aligned}\text{Quick Assets} &= \text{Current Liabilities} \times \text{Quick Ratio} \\ &= 5,60,000 \times 2:1\end{aligned}$$

$$\text{Quick Assets} = 11,20,000$$

$$\begin{aligned}\text{Stock} &= 14,00,000 - 11,20,000 \\ &= 2,80,000.\end{aligned}$$

- 8. From the following balance sheet, calculate:**

(a) Current ratio

(b) Debt-equity ratio

(c) Fixed assets turnover ratio

(d) Return on capital employed and give your comments

Balance sheet as on 31.12.2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Equity share capital	12,00,000	Fixed Assets	17,00,000
Reserves and surplus	3,00,000	Stock	3,00,000
9% Debentures	7,00,000	Debtors	2,80,000
Creditors	2,80,000	Marketable securities	200,000
Bills Payable	50,000	Cash	50,000
	25,30,000		25,30,000

Profit before interest and tax for the year are ₹ 50 lakhs and sales are ₹ 30 lakhs.

Ans :

a) Calculation of Current Ratio

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

$$\begin{aligned} \text{Current assets} &= \text{Cash} + \text{Marketable securities} + \text{Debtors} + \text{Stock} \\ &= 50,000 + 2,00,000 + 2,80,000 + 3,00,000 \\ &= ₹ 8,30,000 \end{aligned}$$

$$\begin{aligned} \text{Current liabilities} &= \text{Bills payable} + \text{Creditors} \\ &= 50,000 + 2,80,000 \\ &= 3,30,000 \\ &= \frac{8,30,000}{3,30,000} = 2.5 \end{aligned}$$

#### Comments

The standard current ratio is 2:1 but in this case it is 2.5. It indicates that company have sufficient funds to meet its working capital requirements.

b) Calculation B = Debt – Equity ratio

$$\begin{aligned} \text{Debt equity ratio} &= \frac{\text{Outsider's funds}}{\text{Shareholder's funds}} \\ &= \frac{\text{Debentures} + \text{Creditors} + \text{Bills payable}}{\text{Equity share} + \text{Reserves and surplus}} \\ &= \frac{7,00,000 + 2,80,000 + 50,000}{12,00,000 + 3,00,000} \\ &= \frac{10,30,000}{15,00,000} = 0.6 \end{aligned}$$

**Comments**

The ideal debt - equity rule for ratio is 2 : 1 but, in this case, it is only 0.68 which is very less this indicates that shareholders are not satisfied as the firm has not utilized the outsider's funds efficiently to enhance their earnings.

**c) Calculation of Fixed Assets Turnover Ratio**

$$\begin{aligned}\text{Fixed assets turnover ratio} &= \frac{\text{Net sales}}{\text{Fixed assets}} \\ &= \frac{30,00,000}{17,00,000} \\ &= 1.76\end{aligned}$$

**Comments**

This ratio is not satisfactory as the firm did not make use of its fixed assets effectively.

$$\begin{aligned}\text{Return on capital employed} &= \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100 \\ &= \frac{50,00,000}{22,00,000} \times 100 \\ &= 2.27 \times 100 \\ &= 227.27\end{aligned}$$

**Working Notes**

$$\begin{aligned}\text{Capital employed} &= \text{Equity capital} + \text{Reserves} + \text{Debentures} \\ &= 12,00,000 + 3,00,000 + 7,00,000 \\ \text{Capital employed} &= ₹ 22,00,000\end{aligned}$$

**Comment**

This ratio indicates that the firm has the ability of generating profits efficiently.

**9. Current Ratio = 2.5 ; 1**

**Working Capital = 50,000 calculate**

**Current Assets and Current Liabilities.**

*Sol :*

$$\text{Given Current Ratio} = \frac{\text{CA}}{\text{CL}} \quad \dots (1)$$

$$\text{Working Capital} = \text{CA} - \text{CL}$$

$$50,000 = \text{CA} - \text{CL}$$

$$50,000 + \text{CL} = \text{CA} \quad \dots (2)$$

∴ Substituted to in No. 1

$$CR = \frac{CA}{CL}$$

$$2.5 = \frac{50,000 + CL}{CL}$$

$$2.5 CL = 50,000 + CL$$

$$2.5 CL - CL = 50,000$$

$$1.5 CL = 50,000$$

$$\therefore CL = \frac{50,000}{1.5}$$

$$\therefore \text{Current Liabilities} = 33,333$$

$$\begin{aligned} \therefore CA &= 50,000 + CL \\ &= 50,000 + 33,333 \end{aligned}$$

$$\therefore CA = 83,333.$$

**10. From the following Balance Sheet Calculate**

(a) Current Ratio

(b) Quick Ratio

(c) Absolute Quick Ratio

(d) Debt Equity Ratio

(e) Proprietary Ratio

(f) Solvency Ratio

(g) Fixed Assets to Net worth Ratio

(h) Fixed Assets Ratio

(i) Capital Gearing Ratio

(j) Ratio of Inventory to working capital

(k) Ratio of current assets to fixed assets.

Liabilities	Amount	Assets	Amount
Equity Share Capital	10,00,000	Goodwill	5,00,000
6% Preference Share Capital	5,00,000	Plant & Machinery	6,00,000
General Reserve	1,00,000	Land & Building	7,00,000
Profit & Loss A/c	4,00,000	Furniture	1,00,000
12% Debentures	5,00,000	Stock in trade (Inventory)	6,00,000
Creditors	80,000	Bills Receivables	30,000
Bank over draft	20,000	Debtors	1,50,000
Bills Payable	1,24,000	Bank Balance	2,00,000
Provision for Taxation	1,76,000	Marketable Securities	20,000
	29,00,000		29,00,000

*Sol.:***a) Current Ratio**

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Current Assets} &= \text{Stock in trade} + \text{Bills Receivable} + \text{Debtors} + \text{Bank Balance} + \text{Marketable securities} \\ &= 6,00,000 + 30,000 + 1,50,000 + 2,00,000 + 20,000 \\ &= 10,00,000\end{aligned}$$

**Current Liabilities**

$$= 80,000 + 20,000 + 1,24,000 + 1,76,000 = 4,00,000$$

$$\begin{aligned}\therefore \text{Current Ratio} &= \frac{10,00,000}{4,00,000} \\ &= 2.5 : 1\end{aligned}$$

**b) Quick Ratio**

$$\frac{\text{Quick Ratio}}{\text{Quick Liabilities}}$$

$$\begin{aligned}\text{Quick Assets} &= \text{Current Assets} - \text{Stock (Inventory)} \\ &= 10,00,000 - 6,00,000 \\ \text{Quick Assets} &= 4,00,000 \\ \text{Quick Liabilities} &= \text{Current liabilities} - \text{Bank over draft} \\ &= 4,00,000 - 20,000 \\ &= 3,80,000\end{aligned}$$

$$\therefore \text{Quick Ratio} = \frac{6,00,000}{3,80,000}$$

$$\therefore \text{Quick Ratio} = 1.58 : 1$$

**c) Absolute Quick Ratio**

$$\frac{\text{Absolute Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned}\text{Absolute Quick Assets} &= \text{Bank Balance} + \text{Marketable Securities} \\ &= 2,00,000 + 20,000 \\ &= 2,20,000\end{aligned}$$

$$\begin{aligned}\therefore \text{Absolute Quick Ratio} &= \frac{2,20,000}{4,00,000} \\ &= 0.55 : 1\end{aligned}$$

**d) Debt Equity Ratio**

$$\frac{\text{Long term debts}}{\text{Share holders fund}}$$

$$\text{Long term debts} = 5,00,000$$

$$\text{Share holders fund} = \text{Equity share capital} + \text{Preference share capital} + \text{Reserves} \\ + \text{P \& L A/c} - \text{Fictitious Assets}$$

$$= 10,00,000 + 5,00,000 + 1,00,000 + 4,00,000$$

$$= 20,00,000$$

$$\therefore \text{Debt / Equity Ratio} = \frac{5,00,000}{20,00,000} = 0.25 ; 1$$

**c) Proprietary Ratio**

$$\frac{\text{Share holders fund}}{\text{Total assets}} = \frac{20,00,000}{29,00,000} = 0.70 ; 1$$

**f) Solvency Ratio**

$$\frac{\text{Debt due to outsiders}}{\text{Total assets}}$$

$$= \text{Long term debts} + \text{Current liabilities}$$

$$= 5,00,000 + 4,00,000 = 9,00,000$$

$$\therefore \text{Solvency Ratio} = \frac{9,00,000}{29,00,000}$$

$$\therefore \text{Solvency Ratio} = 0.31 ; 1$$

**g) Fixed Assets to Networth**

$$\frac{\text{Fixed assets}}{\text{Share holders funds}}$$

$$\text{Fixed Assets} = \text{Goodwill} + \text{Plant \& Machinery} + \text{Land \& Building} + \text{Furniture}$$

$$= 5,00,000 + 6,00,000 + 7,00,000 + 1,00,000$$

$$= 19,00,000$$

$$\therefore \text{Fixed Assets to Networth} = \frac{19,00,000}{20,00,000}$$

$$= 0.95 ; 1$$



**h) Fixed Assets Ratio**

$$\frac{\text{Fixed Assets}}{\text{Capital Employed}}$$

$$\begin{aligned}\text{Capital Employed} &= \text{Equity share capital} + \text{Preference share capital} + \text{Reserves} \\ &\quad + \text{P \& L (Cr)} + \text{Debentures} - \text{Fictitious} \\ &= 10,00,000 + 5,00,000 + 1,00,000 + 4,00,000 + 5,00,000 \\ &= 25,00,000\end{aligned}$$

$$\therefore \text{Fixed Assets Ratio} = \frac{19,00,000}{25,00,000}$$

$$\therefore \text{Fixed Assets Ratio} = 0.76 ; 1$$

**i) Capital Gearing Ratio**

$$\frac{\text{Fixed Interest Securities}}{\text{Equity Share holders fund}}$$

$$\begin{aligned}\text{Fixed Interest Securities} &= \text{Preference share capital} + \text{Debentures} \\ &= 5,00,000 + 5,00,000 \\ &= 10,00,000\end{aligned}$$

$$\begin{aligned}\text{Equity share holders fund} &= \text{Equity share capital} + \text{Reserves} + \text{P \& L A/c (Cr) Balance} \\ &= 10,00,000 + 1,00,000 + 4,00,000 \\ &= 15,00,000\end{aligned}$$

$$\text{Capital Gearing Ratio} = \frac{10,00,000}{15,00,000}$$

$$= 0.67 ; 1$$

**j) Ratio of Inventory to Working Capital**

$$\frac{\text{Inventory}}{\text{Working Capital}}$$

$$\begin{aligned}\text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\ &= 10,00,000 - 4,00,000 = 6,00,000\end{aligned}$$

$$\frac{6,00,000}{6,00,000} = 1$$

$$\therefore 1 : 1$$

**k) Ratio of Current Assets to Fixed Assets**

$$\frac{\text{Current Assets}}{\text{Fixed Assets}}$$

$$= \frac{10,00,000}{19,00,000} = 0.53 ; 1$$

**11. The following is the Balance Sheet of A Ltd. as on 31-12-1990.**

Liabilities	Amount	Assets	Amount
Share capital (20,00 shares of Rs. 10/- each Rs. 5/- paid up)	1,00,000	Land & Building	1,25,000
Reserves & Surplus	65,000	Plant & Furnitures	75,000
5% Debentures	1,00,000	Stock	50,000
Creditors	18,000	Debtors	10,000
Bills Payable	7,000	Bills Receivables	5,000
		Cash at Bank	20,000
		Preliminary Expenses	5,000
	2,90,000		2,90,000

Sales for the year Rs. 6,00,000

Re arrange the above balance sheet in a form suitable for analysis and calculate the following ratios and offer your comments.

(1) Debt / Equity Ratios

(2) Proprietary Ratio

(3) Current Ratio

(4) Acid Test Ratio (Quick Ratio)

(5) Stock turnover ratio

(6) Average collection period.

*Sol.:*

**1. Debt / Equity Ratio**

$$\frac{\text{Long term debt}}{\text{Share holders fund}}$$

$$\begin{aligned} \text{Long term debt} &= \text{Debentures} + \text{Other long term liabilities} \\ &= 1,00,000 + 0 \\ &= 1,00,000 \end{aligned}$$

$$\begin{aligned} \text{Share holders fund} &= \text{Equity share capital} + \text{Reserves \& Surplus} \\ &\quad + \text{P \& L A/c} + \text{Preference share capital} - \text{Fictitious assets} \\ &= 1,00,000 + 65,000 - 5,000 \\ &= 1,65,000 - 5,000 = 1,60,000 \end{aligned}$$

$$\therefore \text{Debt / Equity Ratio} = \frac{1,00,000}{1,60,000} = 0.625 ; 1$$

$$\begin{aligned} 2. \quad \text{Proprietary Ratio} &= \frac{\text{Share holders fund}}{\text{Total assets}} \\ &= \frac{1,60,000}{2,85,000} = 0.56 ; 1 \end{aligned}$$

$$\begin{aligned} \text{Total Assets} &= \text{Total Assets} - \text{Fictitious Assets} \\ &= 2,90,000 - 5,000 = 2,85,000 \end{aligned}$$

### 3. Current Ratio

$$\begin{aligned} \text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ \text{Current Assets} &= \text{Stock} + \text{Debtors} + \text{Bills Receivable} + \text{Cash} \\ &= 50,000 + 10,000 + 5,000 + 20,000 = 85,000 \\ \text{Current Liabilities} &= \text{Creditors} + \text{Bills Payable} \\ &= 18,000 + 7,000 = 25,000 \end{aligned}$$

$$\therefore \text{Current Ratio} = \frac{85,000}{25,000}$$

$$\text{Current Ratio} = 3.4 ; 1$$

$$4. \quad \text{Quick Ratio} : \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Quick Assets} &= \text{Current Assets} - \text{Stock} \\ &= 85,000 - 50,000 = 35,000 \end{aligned}$$

$$\therefore \text{Quick Ratio} = \frac{35,000}{25,000} = 1.4 ; 1$$

### 5. Stock Turnover Ratio

$$\frac{\text{Net sales}}{\text{Closing stock}} = \frac{6,00,000}{50,000}$$

$$\text{Stock turnover ratio} = 12 \text{ times.}$$

$$6. \quad \text{Average Collection Period} \frac{\text{Average closing debtors}}{\text{Net sales}}$$

$$\text{In a day} = \frac{15,000}{6,00,000} \times 365 = 9.125 \text{ days.}$$

**Note :**

$$\text{Average Debtors} = \text{Sundry Debtors} + \text{Bills Receivable}$$

12. The following information is obtained from the books of Ever Green Co. Ltd. for the years ended 31st December 1991 and 1992.

Balance Sheet

Liabilities	1991	1992	Assets	1991	1992
Creditors	20,000	16,000	Cash at Bank	15,380	26,020
Bills payable	12,750	6,500	Trade Debtors	11,260	11,710
Debentures	1,00,000	1,00,000	Stock	56,160	49,460
Reserves	67,250	84,500	Fixed Assets	2,17,200	2,19,810
Capital	1,00,000	1,00,000			
	3,00,000	3,00,000		3,00,000	3,00,000
Sales	1,80,000	1,95,000			
Net Profit	16,000	17,250			
Gross Profit	40,000	60,000			

You are required to arrange to above balance sheet figures in form suitable for analysis and show separately the following ratios.

- (1) Gross profit ratio
- (2) Operating ratio
- (3) Proprietary ratio
- (4) Current Ratio
- (5) Debtors turnover ratio
- (6) Stock turnover ratio.

*Sol :*

#### 1. Calculation of Gross Profit Ratios

$$\frac{\text{Gross profit}}{\text{Net sales}} \times 100$$

$$1991 = \frac{40,000}{1,80,000} \times 100 = 22.22\%$$

$$1992 = \frac{60,000}{1,95,000} \times 100 = 30.77\%$$

#### 2. Calculation of Operating Ratio

$$\frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Net sales}} \times 100$$

Cost of Goods Sold = Sales – Gross Profit

$$1991 = 1,80,000 - 40,000$$

$$= 1,40,000$$

$$1992 = 1,95,000 - 60,000$$

$$= 1,35,000$$

Operating Expenses = Gross Profit – Net Profit

$$1991 = 40,000 - 16,000$$

$$= 24,000$$

$$1992 = 60,000 - 17,250$$

$$= 42,750$$

### Operating Ratio

$$1991 = \frac{1,40,000 + 24,000}{1,80,000}$$

$$= \frac{1,64,000}{1,80,000} = 91.11\%$$

$$1992 = \frac{1,35,000 + 42,750}{1,95,000}$$

$$= \frac{1,77,750}{1,95,000} = 91.15\%$$

### 3. Proprietary Ratio

$$\frac{\text{Share holders fund}}{\text{Total assets}}$$

(1991) Share holders fund = Capital + Reserves

$$1,00,000 + 67,250 = 1,67,250$$

$$(1992) 1,00,000 + 84,500 = 1,84,500$$

$$\therefore \text{Proprietary Ratio } 1991 = \frac{1,67,250}{3,00,000}$$

$$= 0.56 ; 1$$

$$= \frac{1,84,500}{3,07,000} = 0.60 ; 1$$

### 4. Calculation of Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets = Cash at Bank + Trade Debtors + Stock

$$1991 = 15,380 + 11,260 + 56,160$$

$$= 82,800$$

$$1992 = 26,020 + 11,710 + 49,460$$

$$= 87,190$$

Current Liabilities = Creditors + Bills Payable

$$1991 = 20,000 + 12,750 = 32,750$$

$$1992 = 16,000 + 6,500 = 22,500$$

$$\therefore \text{Current Ratio } = 1991 = \frac{82,800}{32,750}$$

$$= 2.53 ; 1$$

$$\therefore \text{Current Ratio } = 1992 = \frac{87,190}{22,500}$$

$$= 3.88 ; 1$$

### 5. Calculation of Debtors Turnover Ratio

Debtors Turnover Ratio

$$= \frac{\text{Net Sales}}{\text{Closing Trade Debtors}}$$

$$1991 = \frac{1,80,000}{11,260} = 15.99 \text{ times.}$$

$$1992 = \frac{1,95,000}{11,710} = 16.65 \text{ times}$$

### 6. Calculation of Stock Turnover Ratio

$$\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\text{Average Stock} = \frac{56,160 + 49,460}{2}$$

$$= \frac{1,05,620}{2} = 52,810$$

$$1991 = \frac{1,40,000}{56,160} = 2.49 ; 1$$

$$1992 = \frac{1,35,000}{52,810} = 2.56 ; 1$$

**13. Following is the Balance Sheet of C Limited as on 31st December, 2000**

Liabilities	Amount	Assets	Amount
Equity Sh. Capital	20,000	Goodwill	12,000
Capital Reserve	4,000	Fixed Assets	28,000
8% Loan on mortgage	16,000	Stocks	6,000
Trade Creditors	8,000	Debtors	6,000
Bank overdraft	2,000	Investments	2,000
Taxation : Current	2,000	Bank	6,000
Taxation : Future	2,000		
Profit and Loss A/c			
Profit 2000 after taxation and interest on fixed deposits			
Less : Tr. to Reserve (4,000)			
Less : Dividend (4,000)	6,000		
	60,000		60,000

- Calculate : a) Liquidity Ratio  
 b) Networking capital  
 c) Debt Equity Ratio  
 d) Proprietary Ratio.

*Sol :*

**a) Liquidity Ratio**

- (i) Current Ratio  
 (ii) Liquid Ratio

$$(i) \text{ Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{CA} &= \text{Stock} + \text{Debtors} + \text{Bank} \\ &= 6,000 + 6,000 + 6,000 = 18,000 \end{aligned}$$

$$\begin{aligned} \text{CL} &= \text{Trade Creditors} + \text{Bank Overdraft} + \text{Taxation (Current)} \\ &= 8,000 + 2,000 + 2,000 = 12,000 \end{aligned}$$

$$\therefore \text{Current Ratio} = \frac{18,000}{12,000} = 1.5$$

$$(ii) \text{ Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

$$\begin{aligned} \text{Liquid Assets} &= \text{Current Assets} - \text{Stocks} \\ &= 18,000 - 6,000 = 12,000 \end{aligned}$$

$$\therefore \text{Liquid Ratio} = \frac{12,000}{12,000} = 1$$

2. Net working Capital = Current Assets – Current Liabilities  
 = 18,000 – 12,000 = 6,000
3. Debt Equity Ratio =  $\frac{\text{Long term debts}}{\text{Shareholders funds}}$   
 Share holders funds = Equity share capital + Capital reserve  
 = 20,000 + (4,000 + 6,000) = 30,000  
 $\therefore$  Debt equity ratio =  $\frac{16,000}{30,000} = 0.53$
4. Proprietary Ratio =  $\frac{\text{Total Assets}}{\text{Proprietary funds or Share holder's funds}}$   
 =  $\frac{60,000}{30,000} = 2$

14. From the following particulars, prepare the balance sheet of ABC limited, which has only one class of capital :

Sales for the year : Rs. 20,00,000

Gross profit ratio : 25 percent

Current assets ratio : 1.50

Quick assets (cash and debtors) ratio : 1.25

Stock turnover ratio : 15

Debts collection period :  $1\frac{1}{2}$  months

Turnover to fixed assets : 1.5

Ratio of reserves to share capital : 0.33 (i.e.,  $\frac{1}{3}$ )

Fixed assets to net worth : 0.83 (i.e.,  $\frac{5}{6}$ ).

*Sol :*

#### Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital	9,00,000	Fixed Assets	10,00,000
Reserves	3,00,000	Current Assets	
Current Liabilities	4,00,000	Debtors	2,50,000
		Stock	1,00,000
		Cash	2,50,000
	16,00,000		16,00,000

**Working Notes**

$$1. \quad \text{Gross profit ratio} = 25\% \quad \text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

$$\text{Sales} = \text{Rs. } 20,00,000$$

$$25 = \frac{\text{Gross profit}}{20,00,000} \times 100$$

$$25 \times 20,00,000 = \text{Gross profit } 100$$

$$5,00,00,000 = 100 \text{ Gross profit}$$

$$\text{Gross Profit} = \frac{5,00,00,000}{100}$$

$$\text{Gross Profit} = 5,00,000$$

$$\text{Cost of goods sold} = \text{Sales} - \text{Gross Profit}$$

$$= 20,00,000 - 5,00,000$$

$$= \text{Rs. } 15,00,000$$

$$2. \quad \text{Stocks Turnover Ratio} = 15$$

$$\text{Cost of goods sold} / \text{Closing stock} = 15$$

$$15,00,000 / \text{Closing stock} = 15$$

By cross multiplying, we get

$$15 \times \text{Closing stock} = 15,00,000$$

$$\therefore \text{Closing stock} = \frac{15,00,000}{15}$$

$$= \text{Rs. } 1,00,000$$

$$3. \quad \text{Current Asset Ratio} - \text{Quick Asset Ratio} = \text{Stock}$$

$$1.50 - 1.25 = 0.25$$

$$\text{If } 0.25 = 1,00,000$$

$$1.50 = ?$$

$$= \text{Rs. } 6,00,000 = \text{Current Assets}$$

$$1.5 = \frac{6,00,000}{\text{Current Liabilities}}$$

$$\therefore \text{Current Liabilities} = \frac{6,00,000}{1.5} = \text{Rs. } 4,00,000$$

$$4. \quad \text{Turnover to Fixed Assets} = 1.5$$

$$\text{i.e., Cost of goods sold} / \text{Fixed assets} = 1.5$$

$$15,00,000 / \text{Fixed Assets} = 1.5$$

$$\therefore \text{Fixed Assets} = \frac{15,00,000}{1.5} = \text{Rs. } 10,00,000$$



5. Fixed Assets to Net worth = 0.83 (i.e.,  $\frac{5}{6}$ )

$$\text{Fixed Assets / Net worth} = \frac{5}{6}$$

$$10,00,000 / \text{Net worth} = \frac{5}{6}$$

$$\begin{aligned}\therefore \text{Net worth} &= \frac{10,00,000}{5/6} \\ &= \frac{10,00,000}{5} \times 6 \\ &= \text{Rs. } 12,00,000\end{aligned}$$

6. Reserves to Share Capital = 0.33 (i.e.,  $\frac{1}{3}$ )

$$\text{Reserves / Share Capital} = \frac{1}{3}$$

$$\text{Reserves} = \frac{1}{3} \text{ share capital}$$

$$\text{Reserves} = \text{Net worth} - \text{Share capital}$$

$$\Rightarrow \frac{1}{3} \text{ Share capital} = \text{Net worth} - \text{Share capital}$$

$$\frac{1}{3} \text{ Share capital} + \text{Share capital} = \text{Net worth}$$

$$\frac{1}{3} \text{ Share capital} + \text{Share capital} = 12,00,000$$

$$\text{Share capital} \left( \frac{1}{3} + 1 \right) = 12,00,000$$

$$\text{Share capital} \left( \frac{4}{3} \right) = 12,00,000$$

$$\begin{aligned}\therefore \text{Share capital} &= \frac{12,00,000}{4/3} \\ &= \frac{12,00,000}{4} \times 3 \\ &= \text{Rs. } 9,00,000\end{aligned}$$

$$\begin{aligned}\therefore \text{Reserves} &= 12,00,000 - 9,00,000 \\ &= \text{Rs. } 3,00,000\end{aligned}$$

## 7. Debtors Turnover Ratio

$$\text{Debts collection period} = 1 \frac{1}{2} \text{ month}$$

$$\text{Debtors turnover ratio} = \frac{12}{1.5} = 8$$

$$\text{Debtors turnover ratio} = \text{Sales} / \text{Average Debtors}$$

$$8 = 2,00,000 / \text{Average Debtors}$$

$$\therefore \text{Average Debtors} = \frac{20,00,000}{8}$$

$$= \text{Rs. } 2,50,000$$

$$\text{Current Assets} = \text{Stocks} + \text{Debtors} + \text{Cash}$$

$$6,00,000 = 1,00,000 + 2,50,000 + \text{Cash}$$

$$6,00,000 = 3,50,000 + \text{Cash}$$

$$\therefore \text{Cash} = 6,00,000 - 3,50,000$$

$$= \text{Rs. } 2,50,000.$$

## 15. Calculate the Balance Sheet items given in the undermentioned proforma with the help of following ratios:

Total Assets /Net Worth	=	3.5
Sales /Fixed Assets	=	6
Sales / Inventory	=	8
Sales / Inventory	=	15
Sales / Debtors	=	18
Current Ratio	=	2.5
Annual Sales	=	Rs. 25,00,000

*Sol.:*

## (1) Fixed Assets

$$\frac{\text{Sales}}{\text{Fixed Assets}} = 6$$

$$= \frac{\text{Rs. } 25,00,000}{\text{Fixed Assets}} = 6$$

$$\text{Fixed assets} = \frac{\text{Rs. } 25,00,000}{6}$$

$$= \text{Rs. } 4,16,667$$

**(2) Current Assets**

$$= \frac{\text{Sales}}{\text{Current Assets}} = 8$$

$$= \frac{\text{Rs. 25,00,000}}{\text{Current Assets}} = 8$$

$$\text{Current Assets} = \frac{\text{Rs. 25,00,000}}{8}$$

$$= \text{Rs. 3,12,500.}$$

**(3) Debtors**

$$= \frac{\text{Sales}}{\text{Debtors}} = 18$$

$$= \frac{\text{Rs. 25,00,000}}{\text{Debtors}} = 18$$

$$\text{Debtors} = \frac{\text{Rs. 25,00,000}}{18} = \text{Rs. 1,38,889}$$

$$\text{(4) Inventory : } = \frac{\text{Sales}}{\text{Inventory}} = 15$$

$$= \frac{\text{Rs. 25,00,000}}{\text{Inventory}} = 15$$

$$\text{Inventory} = \frac{\text{Rs. 25,00,000}}{15} = \text{Rs. 1,66,667}$$

$$\text{(5) Current Liabilities} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5$$

$$= \frac{\text{Rs. 3,12,500}}{\text{Current Liabilities}} = 2.5$$

$$= \text{Current Liabilities} = \frac{\text{Rs. 3,12,500}}{2.5} = \text{Rs. 1,25,000.}$$

$$\text{(6) Net Worth} = \frac{\text{Total Assets}}{\text{Net Worth}} = 3.5$$

$$= \text{Net Worth} = \frac{\text{Rs. 7,29,167}}{3.5} = \text{Rs. 2,08,333}$$

**(7) Long Term Debts**

= Total Assets – (Net Worth + Current Liabilities)

= Rs. 7,29,167 – (Rs. 1,78,667 + Rs. 1,25,000)

= Rs. 7,29,167 – Rs. 3,03,667

= Long – term debts Rs. 4,25,500

**Balance Sheet as on ....**

<b>Liabilities</b>	<b>Rs.</b>	<b>Assets</b>	<b>Rs.</b>
Net Worth	1,78,667	Fixed Assets	4,16,667
Long-Term Debts	4,25,500	Inventory	1,66,667
Current Liabilities	1,25,000	Debtors	1,38,889
		Liquid Assets	6,944
	7,29,167		7,29,167

**5.4 Du PONT CHART**

**Q19. Explain briefly about du point chart. What are the advantages and limitations of dupoint chart.**

*Ans :*

Du-Pont control chart has been designed by an American company, namely Du-Pont 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-Pont chart comprises two elements which are,

- (i) Net profit and
- (ii) Capital employed.

Net profit is related to the operating expenses of an organization, hence, every firm must reduce such expenses so that, increased profit margins can be obtained. 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.

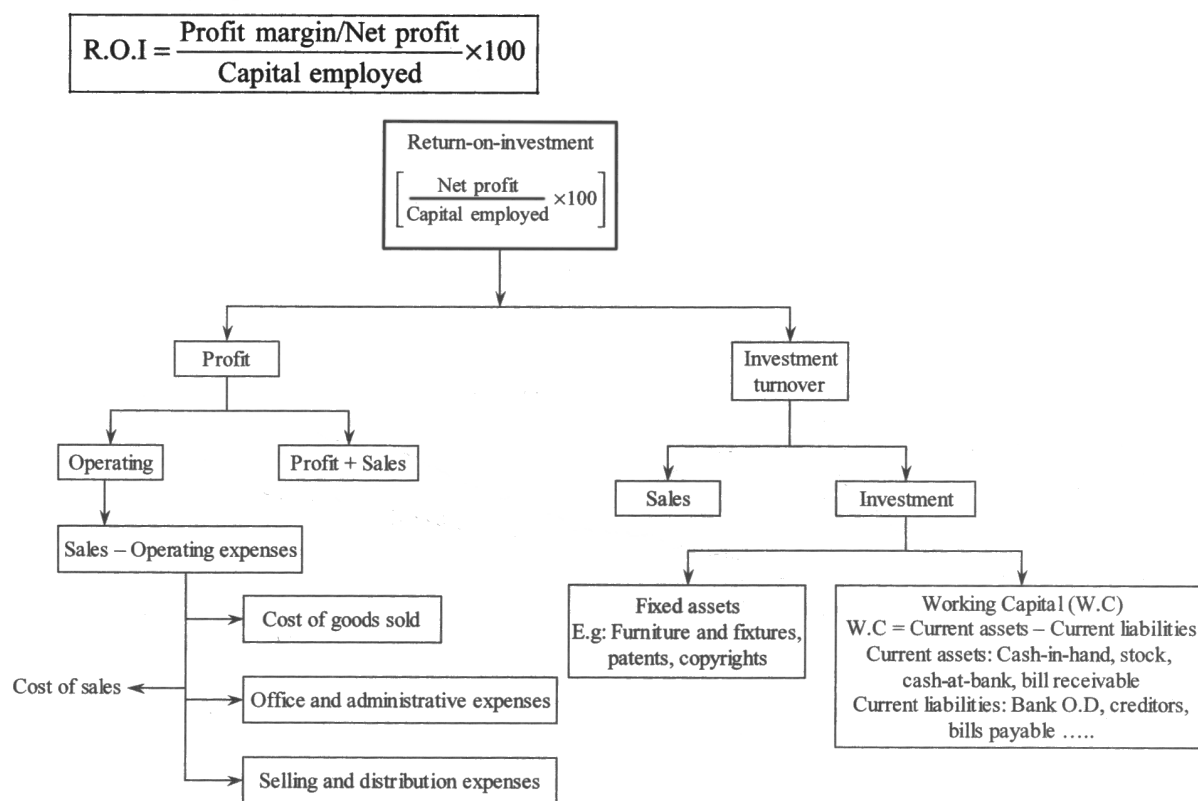
$$\text{Mathematically, percentage of profitability} = \frac{\text{Earnings}}{\text{Sales}}$$

$$\text{Earnings} = \text{Sales} - \text{Cost of sales}$$

(or)

$$= \text{Sales} - [\text{Cost of goods sold} + \text{Office and administrative expenses} + \text{Selling and distribution expenses}]$$

On the other hand, 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),



**Fig.: Du-Pont 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.

### Advantages of Dupont Chart

The advantages of Dupont chart analysis are as follows,

- (i) It draws a relation between net profit margin and total asset turnover ratio for the purpose to serve the best tool to measure the performance of the management.
- (ii) It helps in classification of different factors effecting the firm's performance.
- (iii) It can utilise the relation existing between the various aspects of financial statement effectively.

- (iv) It also helps in conducting comparative analysis of firm's data with previous year's data or competitor's data.
- (v) Based on Dupont chart analysis the firm can improve the ROI by increasing any one of the component or both effecting the ROI such as profit margin and investment turnover.

### Limitations of Dupont Chart

The following are some of the limitations of Dupont chart.

- (i) Dupont chart analysis is a measure that cannot be used in long run.
- (ii) It does not include after tax calculations.
- (iii) It is very difficult to establish targets on ROE.
- (iv) It does not include cost of capital and time value of money.
- (v) It is totally dependent on the accounting numbers which are not reliable.

**5.5 ACCOUNTING STANDARDS ISSUED BY ICAI FOCUS ON IMPORTANCE OF STANDARDS TO GIVE A GENERAL VIEW ON FINANCIAL ACCOUNTING PRACTICES**

**Q20. 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 of Accounting Standards

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.

**Q21. 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.**

*Ans :*

### Accounting Standards Issued by ICAI

The following are the various Accounting Standards issued by ICAI till April 2011,

#### 1. AS-1: Disclosure of Accounting Policies

ICAI issued AS-1 titled disclosure of accounting policies to facilitate easy understanding of the financial statements through disclosing the applicable financial accounting policies in those statements. It also ensure easy comparative and of financial statements of various firms. The rules, as per AS-1 are,

- (i) Firm should disclose all significant accounting policies and treat these disclosures as a part of preparation of financial statements.
- (ii) Firm should disclose, even the minor changes in the accounting policies.
- (iii) Firm should follow the general assumptions such as going concern consistency and accrual while preparing financial statements. It should disclose all the facts for not following the assumptions.
- (iv) The criteria for selection of accounting policy as per AS-1 is prudence, substance priority and materiality.

## 2. **AS-4: Accounting for Contingencies and Provisions after Balance Sheet Date**

The objective of the AS-4 is to facilitate the accounting of the contingencies and provisions in the financial statement that will happen after the balance sheet date but before the approval by Board of directors. According to this standard, contingency is a situation in which the outcomes are dependent on the occurrence of uncertain future events. For events that occur after the balance sheet date, adjustment should be made. One should represent the nature of the events but not include the contingencies and provisions for liabilities if they are expected to have a substantial effect on the financial statement in the future years.

If the receipts of profits (on credit side) or loss (on debit side) from these events is certain they should be mentioned in the financial statements.

## 3. **AS-5: Norms for Net Income and Changes in Accounting Policies**

The objective of AS-5 is to provide criteria for classification of items in the profit and loss account in order to facilitate the comparative analysis of different firms. It promotes the determination of profit/loss from different activities such as normal, extra-ordinary and prior period items, changes in accounting policies and estimates.

- (i) Extra-ordinary activities are different from normal activities including items from fire and flood.
- (ii) Prior period items are those that occur in the present year due to errors in Financial statements of previous year.

## 4. **AS-7: Accounting for Construction Contracts**

This standard determines the accounting policy for accounting the revenues and costs regarding the construction contracts. According to this standard, one should be very careful in the allocation of revenues and costs to the different accounting periods in which the contract has performed. The revenue can be ascertained using percentage of completion method.

## 5. **AS-8: Accounting for R & D**

This standard prescribes accounting for R&D contracts but it has been deleted with the introduction of AS-26.

## 6. **AS-9: Norms for Revenue Recognition**

This standard prescribes the criteria for recognition of revenue that is generated from the normal activities of a firm such as sale of goods, rendering of services, use of firm's resources by others for an interest, rent etc. According to AS- 9, the revenue recognition can be postponed under certain conditions by disclosing them. This standard is excepted for the revenue generated from construction contracts, hire purchase, lease, government grants and insurance companies.

## 7. **AS-12: Accounting for Government Grants**

The objective of AS-12 is to prescribe accounting treatment for only government grants but not for any other assistance provided by the government. The government grants are also called subsidiaries, cash incentives, duty drawbacks etc.

## 8. **AS-13: Accounting for Investments**

The objective of this standard is to prescribe accounting treatment for investment. Investments are the assets and revenue sources for the firm. The current and long term investments should be treated separately.

## 9. **AS-14: Accounting for Amalgamations**

This standard deals with accounting treatment of the amalgamations for the transferee company. The best method of accounting in this case is "pooling of interests".

## 10. **AS-20: Earnings per Share**

This standard 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.

## 11. **AS-21: Norms for Consolidated Financial Statements**

The financial statements of a group of firms are called consolidated statements. These are produced by parent firm which reflects the performance of its subsidiaries and parent firm as a single entity. AS-21 deals with the determination of accounting procedures for the preparation and presentation of consolidated financial statements.

**12. AS-22: Accounting for Taxes**

Tax is a key factor in the preparation of financial accounting. AS-22 provides the accounting policies for treatment of taxes on income. AS-22 defines deferred tax as the tax effect of timing differences i.e., the differences between the tax income and account income that occur in one period and can be reversed in the subsequent periods.

**5.6 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)**
**Q22. Explain the concept of International Financial Reporting Standards (IFRS).**

*Ans :*

The International Accounting Standards Board (IASB). It was founded on 1<sup>st</sup> 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 are separate from legal entities.
2. It also implies the going concern concept as the business continues 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 AICPA established Accounting Principles Board (APB) to make overall conceptual framework.



**Q23. Prepare a comparative statement showing differences between IAS, Indian GAAP and US GAAP.***Ans :*

The comparative statement between IAS, GAAP and US GAAP are as follows.

Point of Difference		IAS	Indian GAAP	US GAAP
1.	Financial statement contents	Balance sheet, profit and loss statement, cash flow statement and the statement of changes in shareholder's equity are 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 need 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 comprise 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.

Rahul Publications

1.	Equity Share Capital	10,00,000
	10% Pref. Share Capital	5,00,000
	18% Debentures	8,00,000
	Loan at 15% (Long period)	1,40,000
	Current Liabilities	3,00,000
	General Reserve	8,00,000
	Find out Capital Gearing from the above particulars.	

2. The following is the Balance Sheet of a company as on 31st March:

Liabilities	Rs.	Assets	Rs.
Share Capital	2,00,000	Land and Buildings	1,40,000
Profit & Loss Account	30,000	Plant and Machinery	3,50,000
General Reserve	40,000	Stock	2,00,000
12% Debentures	4,20,000	Sundry Debtors	1,00,000
Sundry Creditors	1,00,000	Bills Receivable	10,000
Bills Payable	50,000	Cash at Bank	40,000
	8,40,000		8,40,000

- (1) Current Ratio
- (2) Quick Ratio
- (3) Inventory to working Capital
- (4) Debt to Equity Ratio
- (5) Proprietary Ratio
- (6) Capital Gearing Ratio
- (7) Current Assets to Fixed Assets

3. Earn & Company supplies you the following information regarding the year ended 31st December.

	Rs.
Cash Sales	80,000
Credit sales	2,00,000
Return Inward	10,000
Opening Stock	25,000
Closing Stock	30,000
Gross Profit Ratio is 25%	

**Ans : 7.36 Times**

4. B. Raj and Co. Sells goods on cash as well as credit (though not on deferred instalment terms). The following particulars are extracted from their books of accounts for the calendar year 2006.

	Rs.
Total Gross Sales	1,00,000
Cash Sales (included in above)	20,000
Sales Returns	7,000
Total Debtors for Sales as on 31.12.2006	9,000
Bills Receivable on 31.12.2006	2,000
Provision for doubtful debts on 31.12.2006	1,000
Total creditors on 31.12.2006	10,000

Calculate the average collection period

**Ans : 55 days**

5. From the following particulars, draw up the Balance Sheet of the company :

Current Ratio	2.5
Quick Ratio	1.5
Net Working Capital	Rs. 30,000
Stock Turnover Ratio (Cost of Sales/Closing Stock)	6 Times
Gross Profit Ratio	20%
Fixed Assets-Turnover Ratio (Cost of sales)	2 Times
Debtors	2 Months
Fixed Assets to Shareholders' Net Worth	0.8
Reserves & Surplus to Capital	0.5
Long - Term Loans	Rs. 15,000

**Ans : 1,10,000**

## Short Question and Answers

### 1. Importance of Financial Statement Analysis.

*Ans :*

The financial statement analysis is important for different reasons:

#### i) Holding of Share

Shareholders are the owners of the company. They may have to take decisions whether they have to continue with the holdings of the company's share or sell them out. The financial statement analysis is important as it provides meaningful information to the shareholders in taking such decisions.

#### ii) Decisions And Plans

The management of the company is responsible for taking decisions and formulating plans and policies for the future. They, therefore, always need to evaluate its performance and effectiveness of their action to realise the company's goal in the past. For that purpose, financial statement analysis is important to the company's management.

#### iii) Extension of Credit

The creditors are the providers of loan capital to the company. Therefore they may have to take decisions as to whether they have to extend their loans to the company and demand for higher interest rates. The financial statement analysis provides important information to them for their purpose.

### 2. Horizontal Analysis

*Ans :*

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.

### 3. Vertical Analysis

*Ans :*

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.

### 4. Objectives of Ratio Analysis

*Ans :*

The objectives of ratio analysis are as follows:

- i) **Measuring the Profitability:** The profitability of the business can be measured by calculating gross profit, net profit, expenses ratio and other.
- ii) **Judging the Operational Efficiency of Business:** The operational efficiency of the business can be ascertained by calculating operating ratio.

**iii) 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.

**iv) 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. Limitations of Ratio Analysis.**

*Ans :*

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.

**6. What is liquidity ratio.**

*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.

**7. 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.

### 8. Du point chart.

*Ans :*

Du-Pont control chart has been designed by an American company, namely Du-Pont 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.

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$$\text{Mathematically, percentage of profitability} = \frac{\text{Earnings}}{\text{Sales}}$$

### 9. International Financial Reporting Standards (IFRS).

*Ans :*

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# JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

M.B.A I Year I Semester Examination

**R19**

## MODEL PAPER - I

### FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

PART - A (5 × 5 = 25 Marks)

(Short Answer Questions)

#### ANSWERS

1. (a) What are Accounting Principles? (Unit-I, S.Q.A 3)
- (b) What are the causes of depreciation. (Unit-II, S.Q.A 11)
- (c) 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. (Unit-III, Prob. 16)
- (d) Advantages of cashflow statement. (Unit-IV, S.Q.A 6)
- (e) Limitations of Ratio Analysis. (Unit-V, S.Q.A 5)

PART - B (5 × 10 = 50 Marks)

(Essay Type Questions)

2. (a) Define Accounting. What are the objectives of accounting. (Unit-I, Q.No. 1, 5)
- (OR)
- (b) What is accounting cycle ? Explain the various steps involved in it. (Unit-I, Q.No.23)
3. (a) The Machinery Account of a factory showed a balance of ₹ 1,80,000 on 1<sup>st</sup> April, 2000. Accounts were closed on 31<sup>st</sup> March of each year and 10% per annum depreciation is written off under Diminishing Balance Method. On 1<sup>st</sup> September, 2000 new Machinery was acquired at a cost of ₹ 30,000 and installation charges incurred was ₹ 890 on the same date. On 30<sup>th</sup> September, 2000, a Machine which had cost ₹ 6,000 on 1<sup>st</sup> April 1997 was sold for ₹ 750, another Machine which had cost ₹ 600 on 1<sup>st</sup> April, 1998 was scrapped on the same date and it realized nothing.  
  
Write up Plant and Machinery A/c for the year 2000 allowing the same rate of Depreciation as in the past calculating Depreciation the nearest multiple of a Rupee. (Unit-II, Q.No.51)
- (OR)
- (b) Distinguish between capital expenditure and revenue expenditure. (Unit-II, Q.No.20)
4. (a) General Traders are the distributors for a certain brand of products. Following information is available for Jan. 2014.



Sales: Rs. 9,50,000

Administrative overheads: Rs. 20,000

Opening stock: 1,000 units @ Rs. 300 each

Purchases for the month:

Jan. 5<sup>th</sup> : 2,000 units @ Rs. 285 each

Jan. 22<sup>nd</sup>: 1,000 units @ Rs. 303 each

Closing stock on Jan. 31: 1,300 units

Compute

- (i) Value of inventory on 31<sup>st</sup> January
- (ii) Amount of cost of goods sold for January; and
- (iii) Profit or Loss for January

Under

FIFO and LIFO methods.

(Unit-III, Prob.4)

(OR)

- (b) Mrs. Renu could not keep complete records. She provides you with the following details

Particulars	As on 1.4.2008 Rs.	As on 31.3.2009 Rs.
Bank balance	9,000	1,200 (Cr.)
Stock in trade	41,000	70,000
Sundry Debtors	30,000	40,000
Sundry Creditors	15,000	6,000
Bills payable	5,000	3,000
Bill receivable	13,000	17,000
Furniture and fixtures	6,000	6,000
Buildings	1,20,000	1,20,000

Further Information

She sold her private investments of Rs 6,000 @ 33 1/3% premium and brought this money in her business on June 1, 2008. Her drawings were Rs 1,500 per month. Stock costing Rs 9,000 was taken by her for personal use. Rs 5,000 is outstanding for wages and Rs 2,000 for salaries. Prepaid insurance Rs 500. outstanding medical expenses amounted to Rs 2,000. A provision @ 10% is required for doubtful debts. Depreciation is to be written off @ 5% on furniture and fixtures and 10% on buildings.

You are required to compute profit and loss by statement of affairs method for the year 2008-2009 and Balance Sheet as on Mar 21, 2009.

(Unit-III, Prob.18)

5. (a) Write in detail about paid cost and unpaid cost or paid expenses and unpaid expenses.

(Unit-IV, Q.No. 15)

(OR)

- (b) From the summarised balance sheets of Kalpana Ltd. as on 31st March. 2008 and 2009, you are required to prepare a schedule of changes in working capital and a fund flow statement.

Liabilities	31st March 2008 (Rs.)	31st March 2009 (Rs.)	Assets	31st March 2008 (Rs.)	31st March 2009 (Rs.)
Share Capital	3,00,000	4,50,000	Fixed Assets	5,00,000	6,00,000
Borrowings (Long term)	1,10,000	1,30,000	Less: Accumulated Depreciation	50,000	60,000
Borrowings (Short term)	80,000	70,000		4,50,000	5,40,000
Current Liabilities	40,000	30,000	Current Assets	50,000	1,00,000
			Profit and Loss Account	30,000	40,000
	<u>5,30,000</u>	<u>6,80,000</u>		<u>5,30,000</u>	<u>6,30,000</u>

(Unit-IV, Prob.9)

6. (a) Explain the meaning, objectives, and procedure of analysis and interpretation of financial statement.

(Unit-V, Q.No. 1)

(OR)

- (b) From the following Balance Sheet Calculate

- (a) Current Ratio (b) Quick Ratio  
(c) Absolute Quick Ratio (d) Debt Equity Ratio  
(e) Proprietary Ratio (f) Solvency Ratio  
(g) Fixed Assets to Net worth Ratio (h) Fixed Assets Ratio  
(i) Capital Gearing Ratio (j) Ratio of Inventory to working capital  
(k) Ratio of current assets to fixed assets.

Liabilities	Amount	Assets	Amount
Equity Share Capital	10,00,000	Goodwill	5,00,000
6% Preference Share Capital	5,00,000	Plant & Machinery	6,00,000
General Reserve	1,00,000	Land & Building	7,00,000
Profit & Loss A/c	4,00,000	Furniture	1,00,000
12% Debentures	5,00,000	Stock in trade (Inventory)	6,00,000
Creditors	80,000	Bills Receivables	30,000
Bank over draft	20,000	Debtors	1,50,000
Bills Payable	1,24,000	Bank Balance	2,00,000
Provision for Taxation	1,76,000	Marketable Securities	20,000
	<u>29,00,000</u>		<u>29,00,000</u>

(Unit-V, Prob.10)

## JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

## M.B.A I Year I Semester Examination

R19

## MODEL PAPER - II

## FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

## PART - A (5 × 5 = 25 Marks)

## (Short Answer Questions)

ANSWERS

1. (a) Generally Accepted Accounting Principles (GAAP) (Unit-I, S.Q.A 7)
- (b) Rectify the following errors.
- (i) Received cash from Laitha ` 200 has been posted to her account as ` 180.
  - (ii) Goods sold to Ashok ` 75 were omitted to be entered in his account.
  - (iii) Credit side of Hari's account was overcast by ` 200.
  - (iv) Goods returned from Ramesh ` 650 were not posted to his account.
  - (v) Sales book under cast by ` 500. (Unit-II, Prob. 38)
- (c) Factors Affecting the Value of Goodwill. (Unit-III, S.Q.A 9)
- (d) What are the differences between cash profit and book profit. (Unit-IV, S.Q.A 4)
- (e) International Financial Reporting Standards (IFRS). (Unit-V, S.Q.A 9)

## PART - B (5 × 10 = 50 Marks)

## (Essay Type Questions)

2. (a) Explain various accounting concepts and conventions. (Unit-I, Q.No. 8, 9)
- (OR)
- (b) Explain the implications of GAAP on accounting system. (Unit-I, Q.No.15)
3. (a) Ramya is not an expert in accountig she prepared the following trial abalance your are requested to correct it and prepare a correct trial balance of Ramya.

Particulars	Dr	Cr
Ramya Capital		25,500
Ramya drawings	500	
Promises	7,000	
Sales		50,000
Debtors		5,500
Purchases	20,000	
Purchase returns	2,000	
Loan from the bank		2,500
Creditors	6,000	
Trade and Office expenses	700	
Cash at Bank	1,500	
Bills Payable	1,000	

Salaries	1,300	
Opening stock		3,000
Rent	2,500	
Sales returns	6,000	
Machinery	39,000	
Discount allowed		1,000
Discount received	1,000	
Bills receivable		1,000
Sold old news paper	500	–
Old Furniture Sold	–	500

(Unit-II, Prob.13)

(OR)

- (b) Distinguish between straight line method and written down value method.

(Unit-II, Q.No.57)

4. (a) 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) Vektatesh 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.

(Unit-III, Prob.15)

(OR)

- (b) Ascertain missing figures through trading, profit and loss and balance sheet.

Mr. Praveen keeps single entry system accounts in his cash book analysis,

Interest charges ` 100

Balance at bank as ` 2,425 on 31-3-2014

Personal withdrawals ₹ 2000

Cash in hand as on ₹ 75 on 31-3-2014

Cash sales ₹ 15,000

Staff salaries ₹ 8,500

Other business expenses ₹ 7,900

Received from debtors ₹ 25,000

Payments to creditors ₹ 15,000

Additional Information :

Particulars	1-4-2013 (₹)	31-3-2014 (₹)
Stock on hand	9,000	10,220
Furniture	1,000	1,000
Creditors	8,000	5,500
Office premises	15,000	15,000
Debtors	22,000	30,000

Determine trading, profit and loss a/c and balance sheet for the year ending 31-3-2014,

- By providing ₹ 1500 for doubtful debts
- 5% interest on capital as on 1-4-2013
- 5% depreciation on all fixed assets
- After meeting all expenses and commission, provide 5% group incentive commission to staff for net profit.

**(Unit-III, Prob.26)**

5. (a) From the following balance sheets of Vivek Ltd. prepare cash flow statement.

Liabilities	2008	2009	Assets	2008	2009
Equity Share Capital	2,00,000	2,50,000	Goodwill	30,000	20,000
12% Preference Share Capital	50,000	40,000	Building	1,00,000	80,000
General Reserve	35,000	55,000	Plant	40,000	70,000
P&LA/c	15,000	17,000	Debtors	1,20,000	1,60,000
Creditors	23,000	5,000	Stock	18,000	20,000
			Cash	15,000	17,000
	<u>3,23,000</u>	<u>3,67,000</u>		<u>3,23,000</u>	<u>3,67,000</u>

Depreciation charged on Plant was ₹ 30,000 and on building ₹ 50,000.

**(Unit-IV, Prob.13)**

(OR)

- (b) What are the Difference between Fundsflow and Cashflow Statement.

**(Unit-IV, Q.No. 20)**

6. (a) 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. 21)

(OR)

- (b) Calculate the Balance Sheet items given in the undermentioned proforma with the help of following ratios:

Total Assets /Net Worth	=	3.5
Sales /Fixed Assets	=	6
Sales / Inventory	=	8
Sales / Inventory	=	15
Sales / Debtors	=	18
Current Ratio	=	2.5
Annual Sales	=	Rs. 25,00,000

(Unit-V, Prob.15)

## JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

M.B.A I Year I Semester Examination

**R19**

MODEL PAPER - III

## FINANCIAL ACCOUNTING AND ANALYSIS

Time : 3 Hours]

[Max. Marks : 75

PART - A (5 × 5 = 25 Marks)

(Short Answer Questions)

**ANSWERS**

1. (a) Features of Double Entry System **(Unit-I, S.Q.A 8)**  
 (b) Prepare a trial balance as on 31<sup>st</sup> 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		

**(Unit-II, Prob. 11)**

- (c) 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.

**(Unit-III, Prob. 9)**

- (d) Define working capital.

**(Unit-IV, S.Q.A 3)**

- (e) Current liabilities of a company are ₹ 5,60,000. Current Ratio is 5:2. Quick ratio is 2:1. Find the value of the stock.

**(Unit-V, Prob. 7)**

PART - B (5 × 10 = 50 Marks)

(Essay Type Questions)

2. (a) Explain the meaning of GAAP and identify the institutions that influence the development of GAAPs. **(Unit-I, Q.No. 12)**

(OR)

- (b) Define double entry system. Explain the advantages and disadvantages of double entry system. **(Unit-I, Q.No.19, 20)**

3. (a) Journalize the following transactions in the journal of Mr. Ranbir Malhotra. 2004

Nov. 1<sup>st</sup> Ranbir commenced business with a capital of ₹ 1,00,000

Nov. 4<sup>th</sup> Bought furniture for cash ₹ 10,000

Nov. 6<sup>th</sup> Purchased goods for cash ₹ 5,000

Nov. 7<sup>th</sup> Sold goods to Mr. Mahesh ₹ 25,000

Nov. 10<sup>th</sup> Purchased a cycle for office use ₹ 2,000

Nov. 15<sup>th</sup> Paid insurance premium ₹ 800

Nov. 19<sup>th</sup> Purchased goods from Mr. Suresh ₹ 10,000

Nov. 21<sup>st</sup> Rent paid ₹ 5,400

Nov. 25<sup>th</sup> Returned goods to Mr. Suresh ₹ 1,250

Nov. 30<sup>st</sup> Paid salaries ₹ 4,200.

(Unit-II, Prob.5)

(OR)

- (b) From the following trial balance of Arun Goyal, prepare trading and profit & loss account for the year ended on 31st March, 2006 and a balance sheet as on that date :

Name of Accounts	Dr.	Cr.
Capital	—	3,00,000
Drawings	22,000	—
Fixed Assets	2,90,000	—
Purchases and Sales	3,40,000	6,50,000
Returns Inwards	8,000	—
Returns Outwards	—	6,000
Carriage	15,600	—
Wages	36,000	—
Salaries	20,000	—
Rent	—	13,000
Insurance	1,200	—
Audit Fees	500	—
Debtors and Creditors	1,68,000	47,500
Bills Receivable and Bills Payable	4,800	3,600
Printing and Stationery	1,500	—
Commission	—	400
Opening Stock	45,000	—
Cash in hand	14,300	—
Cash at bank	62,250	—
Bank Loan	—	10,000
Interest on Loan	1,350	—
	10,30,500	10,30,500



**Adjustments**

- (i) Stock at the end Rs. 51,700.
  - (ii) Depreciate fixed assets by 10%.
  - (iii) Allow 7% p.a. interest on capital and charge Rs. 2,600 as interest on drawings.
  - (iv) Rent received in advance Rs. 1,000.
  - (v) Commission earned but not received amounted to Rs. 150.
  - (vi) Interest on bank loan @ 18% p.a. is unpaid for the last 3 months. **(Unit-II, Prob.30)**
4. (a) Distinguish between Single Entry System and Double Entry System. **(Unit-III, Q.No.13)**
- (OR)
- (b) Show the stores ledger entries as would appear when using, (i) FIFO (ii) LIFO method of pricing issues in connection with the following transactions.

April 2012		Units	Value
1	Balance in hand B/F	300	600
2	Purchased	200	440
4	Issued	150	--
6	Purchased	200	460
12	Issued	150	--
20	Issued	200	--
25	Purchased	200	480
30	Issued	250	--

**(Unit-III, Prob.5)**

5. (a) Differences between Gross Working Capital Vs Net Working Capital. **(Unit-IV, Q.No. 8)**
- (OR)

(b) From the following balance sheets of XYZ Ltd. Prepare fund flow statement:

Liabilities	2012 (₹)	2013 (₹)	Assets	2012 (₹)	2013 (₹)
Equity share capital	3,00,000	4,00,000	Goodwill	1,15,000	90,000
Preference shares	1,50,000	1,00,000	Buildings	2,00,000	1,70,000
Reserve fund	40,000	70,000	Machinery	80,000	2,00,000
Profit & loss A/c.	30,000	48,000	Bills receivables	20,000	30,000
Bills Payable	20,000	16,000	Debtors	1,60,000	2,00,000
Proposed dividend	42,000	50,000	Stock	77,000	1,09,000
Creditors	55,000	83,000	Cash on hand	15,000	10,000
Provision for taxation	40,000	50,000	Cash at bank	10,000	8,000
Totals	<u>6,77,000</u>	<u>8,17,000</u>		<u>6,77,000</u>	<u>8,17,000</u>

Additional Information:

- (i) Dividend provision made during 2012 has been paid during 2013.
- (ii) Depreciation: ` 10,000 on Machinery and ` 20,000 on Buildings.
- (iii) An interim dividend of ` 20,000 has been paid in 2013.
- (iv) Income Tax of ` 35,000 has been paid during 2013.

**(Unit-IV, Prob. 10)**

6. (a) Explain briefly about du point chart. What are the advantages and limitations of dupoint chart.

**(Unit-V, Q.No. 19)**

(OR)

- (b) Prepare a comparative statement showing differences between IAS, Indian GAAP and US GAAP.

**(Unit-V, Q.No.23)**