PGBA (S1) 03-02

Accounting for Managers

SEMESTER - 1

BUSINESS ADMINISTRATION

BLOCK - 2

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER IN BUSINESS ADMINISTRATION

ACCOUNTING FOR MANAGERS

Block 2

DETAILED SYLLABUS

UNIT 6 : Trial Balance **Page 117-145**

Concept of Trial Balance, Format of Preparing Trial Balance, Objectives of Preparing a Trial Balance, Methods of Preparing a Trial Balance, Adjusting Entries, Errors and their Rectification and Errors Disclosed and Not Disclosed by a Trial Balance and Steps to Locate the Errors.

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Preparation of Final Accounts, Trading Account, Profit and Loss account , Preparation of profit and loss account, Distinction between Trading and Profit and Loss A/c, Format of Profit and Loss Accounts, Closing entries for Preparation of Profit and Loss Account, Balance Sheet

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UNIT 10 : Financial Statement **Page 246-273**

Financial Statement,Profit And Loss Account, Meaning of Fund Flow Statement, Ascertainment of Flow of Funds, Technique of Preparing Funds Flow Statement, Schedule of Changes in Working Capital,Adjusted Profit and Loss account and Funds Flow Statement

BLOCK INTRODUCTION:

This is the Second Block of the course '***Accounting for Managers***'. After completing this block, which consists of five units, you will be able to get a fair idea on the different concepts on Final accounts, depreciation, partnership accounts and ratio analysis.

This block comprises the following five units :

The sixth unit is about Trial balance, Objectives of Preparing a Trial Balance, Methods of Preparing a Trial Balance, Adjusting Entries, Errors and their Rectification and Errors Disclosed and Not Disclosed by a Trial Balance and Steps to Locate the Errors.

The seventh unit highlights the Preparation of Final Accounts , Trading Account, Profit and Loss account and Balance Sheet

The eighth unit help us in understanding the variuos aspects of Meaning of Management Accounting, role of Management Accounting , Management Accounting Framework, Functions of Management Accounting, Tools of Management Accounting, Cost Management System.

The ninth unit is about meaning of Ratio, Steps in Ratio Analysis, Classification of Ratios, Advantages of Ratio Analysis and Limitation of Ratio analysis

The tenth unit hieghlights on the concept of Financial Statement, Profit And Loss Account, Meaning of Fund Flow Statement, Ascertainment of Flow of Funds, Technique of Preparing Funds Flow Statement, Schedule of Changes in Working Capital, Adjusted Profit and Loss account and Funds Flow Statement.

The structure of Block 2 is as follows :

UNIT 6 : Trial Balance

UNIT 7 : Presentation of Final Accounts

UNIT 8 : Management Accounting

UNIT 9 : Ratio Analysis

UNIT 10: Financial Statement

UNIT 6: TRIAL BALANCE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept of Trial Balance

6.4 Format of Preparing Trial Balance

6.5 Objectives of Preparing a Trial Balance

6.6 Methods of Preparing a Trial Balance

6.7 Nature of Ledger Account Balances

6.8 Adjusting Entries

6.9 Errors and their Rectification

6.10 Errors Disclosed and Not Disclosed by a Trial Balance

6.11 Steps to Locate the Errors

6.12 Let Us Sum Up

6.13 Further Reading

6.14 Answers to check your progress

6.15 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- discuss the meaning of Trial Balance
- outline the preparation of Trial Balance
- explain the format of trial balance
- discuss the how errors are rectified

6.2 INTRODUCTION

You are aware that whenever a transaction takes place, it is first recorded in journal, and then it is posted in ledger. After that all ledger accounts are balanced.

In this unit, we will discuss trial balance, which is prepared after balancing all the ledger accounts. Trial balance is a statement which is

prepared with the ledger balances. Trial balance helps in detecting the errors which may have been committed in recording or posting the transactions. At the same time, it facilitates the preparation of final accounts at the end of the accounting period.

This unit will help you in gaining knowledge about the preparation of trial balance and the importance of preparing it. At the same time you will come to know certain limitation of trial balance.

6.3 CONCEPT OF TRIAL BALANCE

Any business will be interested to know the net result i.e. profit earned or loss suffered after a certain period of time. The business will also be interested to know the position of its assets and liabilities after a certain period of doing business. In order to find the profit or loss or to know the financial position of the business, it is necessary that the business prepare its final accounts. Again, before preparing the final accounts, it is also necessary to ensure that the books of accounts that are maintained do not contain any error. For this a statement is prepared to check the arithmetical accuracy of the books of accounts. This statement is called a Trial Balance.

Let us go through some of the definitions of trial balance-

Cropper defined trial balance as, “A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made.”

Thus, the trial balance is a statement which contains the ledge balances. It is prepared at the end of an accounting period. It ensures that no journal entry is left without posting it to the respective ledger and no ledger remains unbalanced. The book- keeper assures that journal and ledger books are arithmetically correct.

The Trial Balance is a statement of accounts, the main purpose of which is to prove that the books of accounts are arithmetically accurate. It is a statement prepared on a certain date and on the basis of debit and credit balances of ledger accounts to verify the arithmetical accuracy of the books. The total of the debit and credit side of the trial balance must be equal. If the two sides are not equal, than we can assume that a mistake

has been committed at some place while preparing the books of accounts. But, sometimes even if the debit and credit total are equal, still there can be mistake. We will discuss about these in the later part of the chapter.



LET US KNOW

In the double entry system of book- keeping, at least two accounts are involved in a transaction. In other words, for every debit entry or for every series of debit entries there is a credit entry or a series of credit entries with equal amounts. From the journal, each and very debit account and credit account is posted to the respective ledger accounts with the same amount as entered in the journal. After balancing the accounts in the ledger book, when all closing balances are placed in trial balance, then debit side and the credit side of the trial balance becomes equal. If debit side and the credit side of the trial balance become equal, it implies that journalising and ledger posting are arithmetically correct.

6.4 FORMAT OF PREPARING A TRIAL BALANCE

A trial balance is usually prepared in the following format-

Trial Balance of M/S..... as at.....

Particulars	L.F. (Rs.)	Debit Amount (Rs.)	Credit Amount (Rs.)
Account Head 1	—	—	—
Account Head 2	—	—	—
Account Head 3	—	—	—
Account Head 4	—	—	—
Account Head 5	—	—	—
Total		—	—

Particulars column: In the 'particulars' column, the names of the account heads are written.

L.F. column: In the 'ledger folio' column, the page numbers are written from where the information of a particular ledger is taken.

Debit Amount column: In this column, the debit amount of the particular ledger is written.

Credit amount column: In this column, the credit amount of the particular ledger is written.

6.5 OBJECTIVES OF PREPARING A TRIAL BALANCE

The main objectives of preparing trial balance may be discussed as under-

a) To test arithmetical accuracy: The trial balance is prepared to test the arithmetical accuracy of the transactions entered in journal and posted in the ledger.

b) To ensure recording of two aspects: Preparation of trial balance ensures the fulfilment of the principles of double entry system while recording transactions i.e. both the aspects of the transactions (debit and credit) are recorded and posted.

c) To detect errors: Trial balance helps in detecting and locating some of the errors that may have been committed in journalising the transactions and while posting them into ledger or balancing the ledgers or while preparing the trial balances itself.

d) To summarise the financial transactions: Trial balance helps in summarising the business transactions. As the business transactions are recorded in the journal book date- wise and these are posted into the ledger periodically, transactions in the summarised form is available only in trial balance.

e) To facilitate preparation of final accounts: Final accounts help in ascertaining the financial position of a business concern. Trial balance facilitates the preparation of final accounts.

CHECK YOUR PROGRESS

Q1: What is trial balance?

.....

.....

.....

Q2: State any four objectives of trial balance.

.....

.....

.....

6.6 METHODS OF PREPARING A TRIAL BALANCE



The trial balance is an important statement that is prepared in order to prepare the final accounts. Trial balance contains balances of all ledger accounts, which may be related to incomes, expenses, assets, liabilities and capital of the business. The trial balance is generally prepared at the end of the accounting period. However, an organisation may prepare its trial balance monthly, quarterly, half yearly.

There are two different methods to prepare trial balance which we will discuss in this section. Let us first go through the steps of preparing the trial balance.

The preparation of trial balance involves the following steps-

- All the ledger accounts are closed at the end of an accounting period. The ledgers will show either debit or credit balance ;
- The ledgers which show debit balances will be put on the debit side of the trial balance with the respective amounts. On the other hand, the ledgers which show credit balances will be put on the credit side of the trial balance with the respective amounts;
- The debit amount column and the credit amount column of the trial balance will be calculated;
- If both the columns show the same results, the trial balance is complete.

To recapitulate it, the journal entries are posted from the journal book in the respective ledgers maintained in the ledger book. The accounts which have been debited in journal will be posted on the debit side of that particular ledger and the account which have been credited in the journal will be recorded in 'Particulars' column as- "To .....(Name of the Account Credited). For example, for the transaction- Goods purchased for Rs. 5000 from XY Co. on credit, will be recorded in journal as –

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Purchase A/c Dr. To XY Co. (Being goods purchased on credit)	5,000		5,000

The journal entry will be posted in the respective ledgers of Purchase and XY Co. and will be balanced as under-

Dr. Purchase Account Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To XY Co.		5, 000		By Balance c/d		5, 000
			5, 000				5, 000
	To Balance b/d		5, 000				

Dr. XY Co. Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To Balance c/d		5, 000		By Purchase A/c		5, 000
			5, 000				5, 000
					By Balance b/d		5, 000

In the above example, Purchase account is showing debit balance whereas the account of XY Co. is showing credit balance. Therefore, in the trial balance, purchase account will be placed on the debit side and the account of XY Co. will be placed on the credit side. In this case, both the debit and credit amount columns will show the same result indicating that the trial balance is agreed. This procedure is followed for all the accounts. The trial balance will be look as under-

Trial Balance of ..... as on .....

Account Heads	L.F.	Debit (Rs.)	Credit (Rs.)
Purchase	-	5, 000	
XY Co.	-		5, 000
-	-		
-	-		
-	-		
-	-		
Total		5, 000	5, 000

Let us move to the next important topic i.e. the different methods of preparing trial balance.

In general, trial balance can be prepared in any of the following methods-

1. Total or Gross Trial Balance;
2. Net or Balance Trial Balance.

Now we will discuss these three methods -

1. **Total or Gross Trial Balance:** In this method, the totals of the debit side and the credit side of each ledger account are entered in the debit column and credit column respectively of the trial balance. If an account has equal debit and credit i.e. the account has neither debit balance nor credit balance, such accounts may or may not be included in this method. This method is not generally followed in practice.

Under this method, the steps followed for the preparation of trial balance are stated below-

- The amount columns of each ledger and the cash book is totalled up;

- A list is prepared by placing the names of the ledgers along with two amount columns - one for debit amounts and the other for the credit amounts;
- The debit total and the credit total of each ledger is put in the debit amount column and the credit amount column against the names of the accounts in the list;
- The amount columns are added up separately to ascertain whether the columns agree or not.

Example 6.1: Trial balance as on 31-12-2017

Name of accounts	L.F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Purchases		40,000	-
Sales		-	60,000
Wages		5,000	-
Salary		6,000	-
Furniture		10,000	2,000
Rent		6,000	-
Remesh		10,000	6,000
Paresh		8,000	14,000
Cash		15,000	12,000
Bank		24,000	10,000
Total		1,24,000	1,24,000

This method is not generally followed because it is a laborious and time-consuming method and balances cannot be easily obtained which are necessary for the preparation of Final Accounts.

2. **Net or Balance Trial Balance:** This method of preparing a trial balance is most common in practice. In this method, the balances of the ledger accounts are found and the accounts having debit balances are entered in the debit side of the trial balance with the amount of the balance and the accounts having credit balances are entered in the credit side. An account where the total of the debits is more than the total of the credits, it is called an account having debit balance. On the other hand an

account where the total of the credits exceed the total of the debits, the account is said to be having credit balance.

Under this method, the steps followed for the preparation of trial balance are as under-

- Each ledger account and the cash book is balanced at the end of a certain period;
- A list is prepared by inserting the names of the ledgers with two amount columns - one for debit amounts and the other for the credit amounts;
- The amounts of the ledgers which have shown debit balances are put in the debit column of the list;
- The amounts of the ledgers which have shown credit balances are put in the credit column of the list;
- The debit and the credit amount columns are added up to see whether the two columns show the same result.

This method is generally followed in the preparation of trial balance. In this unit we will follow this method.

6.7 NATURE OF LEDGER ACCOUNT BALANCES

While preparing a Trial Balance, we are to ascertain the nature of balances of Ledger Accounts. The rules of ascertaining Ledger Account Balance are given below:

1. Asset Account: Asset Accounts shows debit balances. Therefore the following accounts being assets Accounts will show debit balances:

Goodwill Account

Land and Building Account

Machinery Account

Furniture Account

Patent Account

TradeMark Account

Live stock Account

Vehicles Account

Cash (in hand) Account

Bank (Cash at bank) Account

Loans and advances (granted to others) Account

Prepaid Expenses Account

Accrued Interest Account

Stock of Stationery (in hand) Account

2. Liabilities Accounts: Liabilities Accounts shows Credit Balances. Therefore, the following Accounts being Liabilities Accounts will show Credit balances.

Sundry Creditors Account

Bills Payable Account

Loans and Advances Taken Account

Debenture Account

Outstanding Expenses Account

Income Received in Advance and

Interest Payable Outstanding

3. Revenue Accounts Show Credit Balances.

Sales Account

Interest Received Account

Rent Received Account

Dividend Received Account

Royalties Received Accounts

Profit from Branches

Profit on Consignment

Sundry / Miscellaneous Receipts Account

Subsidies Account

Discount Received Account

Bad Debts Recovered Account

Interest on drawings Account

4. Expenses and Losses show Debit balance:

Purchase Account

Carriage Inward Account

Wages Account

Salaries Account

Insurance Premium Account

Commission Account

Rent (Paid) Account

Traveling Expenses Account

Printing and Stationery Accounts

Bad Debts Accounts

Depreciation Account

Fire Loss Account (not covered by insurance)

Sundry Expenses

Interest on Capital

Capital Account shows a Credit balance

Drawings Account show Debit balances

Reserve and fund Accounts show Credit balance

5. Miscellaneous Accounts

Returns Inward shows a Debit balance

Returns Outward shows a Credit balance

Preliminary Expenses show Debit balance

Deferred Expenses show Debit balances



Exercise 6.1

Prepare Trial Balance from the following items of ledger balances as on 31st December. 2017

	Amount (Rs.)
Capital of Sri Bora	20,000
Furniture	10,000
Prepaid insurance	500
Purchases	50,000
Sales	80,000
Unpaid Salaries	1,500
Interest on Investment Accrued	2,000
10% Investments	20,000
Commission Received	2,000
Carriage	1,000
Printing & Stationary	3,000
Salaries and Wages	9,000
Cash in hand and at bank	7,000
Depreciation	1,000

Solution :

Particulars	L.F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Furniture		10,000	-
Prepaid insurance		500	-
Purchases		5,000	
Sales		-	80,000
Unpaid Salaries		-	15,000
Interest on Investment accrued		2,000	-
10% Investments		20,000	-
Commission received		-	2,000

Carriage	1,000	-
Printing and stationery	3,000	-
Salaries and wages	9,000	-
Cash in hand and at Bank	7,000	-
Depreciation	1,000	
	1,03,500	1,03,500

Let us consider the following transactions (for which we passed journal entries in unit-3) and prepare a trial balance:



Exercise 6.2

Pass journal entries, post them into ledger accounts, balance the ledger accounts and prepare a Trial Balance as on April, 30, 2016 from the following transactions:

2016	
April 1	Rajiv started business with Rs. 10,00,000 in cash in the name of Rajiv Trading Concern.
April 2	Opened a bank account with Rs. 9,00,000.
April 5	Purchased furniture worth Rs. 20,000 and paid through cheque.
April 6	Bought goods in cash Rs. 50,000 and on credit from Shyam Rs. 5,00,000.
April 10	Sold goods in cash Rs. 2,00,000
April 14	Sold goods to Mukesh worth Rs. 4,00,000.
April 20	Purchased goods for Rs. 6,00,000 and paid through cheque
April 25	Paid wages in cash Rs. 500
April 26	Sold goods Rs. 8,00,000 and payment received through cheque
April 30	Paid salary Rs. 5,000 and rent Rs. 8,000 in cash.

Solution:

In the books of Rajiv Trading Concern

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
2016 01/04	Cash A/c Dr. To Capital A/c (Being starting of business by Rajiv with cash)		10,00,000	10,00,000
02/04	Bank A/c Dr. To Cash A/c (Being bank account opened with cash)		9,00,000	9,00,000
05/04	Furniture A/c Dr. To Bank A/c (Being furniture purchased and paid through cheque)		20,000	20,000
06/04	Purchase A/c Dr. To Cash A/c To Shyam A/c (Being goods purchased in cash and from Shyam on credit)		5,50,000	50,000 5,00,000
10/04	Cash A/c Dr. To Sales A/c (Being cash sales)		2,00,000	2,00,000
14/04	Mukesh A/c Dr. To Sales A/c (Being goods sold to Mukesh)		4,00,000	4,00,000
20/04	Purchase A/c Dr. To BankA/c (Being goods purchased and payment made through cheque)		6,00,000	6,00,000
25/04	Wages A/c Dr. To Cash A/c (Being wages paid)		500	500

26/04	Bank A/c Dr. To Sales A/c (Being goods sold and payment received through cheque)		8,00,000	 8,00,000
30/04	Salary A/c Dr. Rent A/c To Cash A/c (Being salary and wages paid)		5,000 8,000	 13,000

In the books of Rajiv Trading Concern

Ledger Accounts

Dr. Cash Account Cr.

Date	Particulars	J. F.	Amount (Rs.)	Date	Particulars	J. F.	Amount (Rs.)
				2016			
	To Capital A/c		10,00,000	02/04	By Bank A/c		9,00,000
	To Sales A/c		2,00,000	06/04	By Purchases A/c		50,000
				25/04	By Wages A/c		500
				30/04	By Salary A/c		5,000
					By Rent A/c		8,000
				30/04	By Balance c/d		2,36,500
			12,00,000				12,00,000

Dr. Capital Account Cr.

Date	Particulars	J. F.	Amount (Rs.)	Date	Particulars	J. F.	Amount (Rs.)
				2016 01/04	By Cash A/c		10,00,000
2016 30/04	To Balance c/d		10,00,000				
			10,00,000				10,00,000

Dr. Bank Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
02/04	To Cash A/c		9,00,000	05/04	By Furniture A/c		20,000
26/04	To Sales A/c		8,00,000	20/04	By Purchases A/c		6,00,000
				30/04	By Balance c/d		10,80,000
			17,00,000				17,00,000

Dr. Furniture Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
05/04	To Bank A/c		20,000	30/04	By Balance c/d		20,000
			20,000				20,000

Dr. Purchases Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016							
06/04	To Cash A/c		50,000	2016			
	To Shyam A/c		5,00,000	30/04	By Balance c/d		11,50,000
20/04	To Bank A/c		6,00,000				
			11,50,000				11,50,000

Dr. Shyam Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 30/04	To Balance c/d		5,00,000	2016 06/04	By Purchases A/c		5,00,000
			5,00,000				5,00,000

Dr. Sales Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 30/04	To Balance c/d		14,00,000	2016 10/04	By Cash A/c		2,00,000
				14/04	By Mukesh A/c		4,00,000
				26/04	By Bank A/c		8,00,000
			14,00,000				14,00,000

Dr. Mukesh Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 14/04	To Sales A/c		4,00,000	2016 30/04	By Balance c/d		4,00,000
			4,00,000				4,00,000

Dr. Wages Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 25/04	To Cash A/c		500	2016 30/04	By Balance c/d		500
			500				500

Dr. Salary Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016 30/04	To Cash A/c		5,000	2016 30/04	By Balance c/d		5,000
			5,000				5,000

Dr. Rent Account Cr.

Date	Particulars	J. F.	Amount (Rs)	Date	Particulars	J. F.	Amount (Rs)
2016				2016			
				30/04	By Balance c/d		8,000
30/04	To Cash A/c		8,000				
			8,000				8,000

In the books of Rajiv Trading Concern

Trial Balance

As on 30th April, 2016

Debit Balances	Amount (Rs.)	Credit Balances	Amount (Rs.)
Cash Account	2,36,500	Capital Account	10,00,000
Bank Account	10,80,000	Shyam Account	5,00,000
Furniture Account	20,000	Sales Account	14,00,000
Purchases Account	11,50,000		
Mukesh Account	4,00,000		
Wages Account	500		
Salary Account	5,000		
Rent Account	8,000		
	29,00,000		29,00,000

6.8 ADJUSTING ENTRIES

Adjusting entries are those journal entries which are recorded at the end of an accounting period to adjust income and expense accounts

so that they comply with the accrual concept of accounting. An adjusting journal entry is typically made just prior to preparing final accounts of a business concern.

The main objectives of adjusting entries is to match incomes and expenses to appropriate accounting periods. The transactions which are recorded using adjusting entries are not spontaneous but are spread over a period of time. Again, all journal entries recorded at the end of the accounting period may not be an adjusting entry. For example, a journal entry for sales on the last day of the accounting period is not an adjusting entry. An adjusting entry always involves either income or expense account.

Types of Adjusting Entries:

- **Adjusting Entries Related to Accruals:** These entries include revenues accrued but, not yet received nor recorded and expenses incurred but, not yet paid nor recorded. For example, interest expense on loan accrued in the current period but not yet paid.
- **Adjusting Entries Related to Prepayments:** Rrevenues received in advance are recorded as liabilities.Expenses paid in advance are recorded as assets. For example, adjustments for unearned revenue, prepaid insurance, prepaid rent, etc.
- **Adjusting Entries Recording Non-cash Items:** These adjusting entries record non-cash items such as
  i. Provision for depreciation
  ii. Provision for bad and doubtful debts
  iii. Inventory at the end
  iv. Interest on Capital
  v. Interest on drawings and so on..

6.9 ERRORS AND THEIR RECTIFICATION

Errors are the mistakes that have been committed while preparing the books of accounts. The errors may be in principle or it may be a numerical error. Again, errors may also be intentional and unintentional errors. Intentional errors are those errors which are committed with a purpose.

But unintentional errors are committed without the knowledge of the person committing those errors.

Types of Errors: There are various types of errors. For example, errors disclosed and not disclosed by the trial balance, one sided and two sided errors. The various types of errors are given below:

1. **Errors of Omission:** Errors of omission are committed at the time of recording the transactions in the journal book or during the posting of entries in ledger. Error of omission may take place in the form of complete omission or partial omission. Let us go through the following example-

   Purchase goods from Ram on credit for Rs. 5, 000. The journal entry fro the transaction is given below-

Journal				
Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Purchase A/c Dr. To Ram (Being goods purchased on credit)		5, 000	 5, 000

   While recording the transaction, if the book- keeper does not record the transaction in the books at all, it is the error of complete omission. This type of error will not affect the trial balance. On the other hand, if the book- keeper records only one aspect of the transaction, say, the Purchase aspect, then it is the error of partial omission.

2. **Errors of Commission:** Error of commission may take place on account of incorrect posting, incorrect additions, wrong balancing of accounts etc. These types of errors affect the trial balance. However, wrong entry in original record and will not affect the trial balance. For example, if a credit sale of goods to Rakesh amounting to Rs. 2, 000 is recorded in the books as Rs. 200 against Purchase account and Rakesh account, it will not affect the trial balance. Similarly, posting to wrong head of account will not affect the trial balance. Let us take the above example. If the book- keeper posted the above transaction to Purchase

account and Rahim account instead of Rakesh Account, then the trial balance will not be able to detect that error. This error will increase the credit balance of Rahim but will trial balance will not be affected. This is because both Rakesh and Rahim are the creditors and their accounts appear on the credit side of the trial balance.

3. **Errors of Principle:** This type of error occurs due to non- compliance of double entry principle in recording the transactions. Errors of principle will affect the financial statements but the trial balance will not be affected. For example, if the rent paid to the landlord is wrongly debited to landlord account instead of rent account, it is an error of principle but there will be no impact on trial balance.
4. **Compensating Errors:** When an error or a series of errors are committed but they are compensated by another error or series of errors, they are called compensating errors. These errors do not affect the trial balance. Let us go through the following example-
   A) Goods sold to Mr. X on credit for Rs. 1, 000
   B) Goods sold to Mr. Y on credit for Rs. 100.

Let us assume that Mr. X account is wrongly debited with Rs. 100 and Mr. Y's account is debited with Rs. 1, 000.

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Mr. X Dr.		100	
	To Sales A/c			100
	(Being goods sold on credit)			
	Mr. Y Dr.		1, 000	
	To Sales A/c			1, 000
	(Being goods sold on credit)			

Thus, under debit of Rs. 900 in X account is compensated by over debit of Rs. 900 in Mr. Y's account. Sales account is credited with a total of Rs. 1, 100. As Mr. X and Mr. Y's account will appear on the debit side and Sales

account will appear on the credit side of the trial balance, therefore, trial balance will agree in spite of the error.

4. **Duplicating Errors:** Duplicating error takes place when a transaction is recorded twice in the journal or posted twice in the ledger. For example, a credit sale of goods amounting to Rs. 500 to Mr. X, if recorded twice or posted twice in the ledgers, will not affect trial balance.

6.10 ERRORS DISCLOSED AND NOT DISCLOSE BY A TRIAL BALANCE

Errors from the view point of Trial Balance are:

- Errors disclosed by a trial balance
- Errors not disclosed by a trial balance

A. Errors Disclosed by a Trial Balance

There are a number of errors which, if committed, will lead to the disagreement of the trial balance. These are:

1. Omission of Posting: The periodical total of a subsidiary books are to be posted in the respective ledger accounts. If the periodical total of any subsidiary book is omitted to be posted, then the trial balance will not agree i.e. two sides of the trial balance will show different total. Similarly, the following errors may also occur:

a) An item may not have been posted from a subsidiary book to ledger account

b) The totals for balances of an account may not have been included in the trial balance

c) The totals of the subsidiary books may not have been posted to the relevant impersonal accounts.

2. Wrong totaling or casting: There may also be wrong totaling of the subsidiary book. Wrong casting means over or under casting than what it should be. The over or under casting of any subsidiary book, the total of which is debited or credited in the ledger will not allow the trial balance to agree. Besides,

a) The total or balance of cash may be incorrect

b) The total of other subsidiary books may be wrong

c) The totals of accounts in ledger and their balances may be wrong

d) The totals of trial balance itself may be wrong.

3. Posting of wrong amount: Sometimes a wrong amount may be posted in the ledger account. Such wrong may be:

a) Incorrect copying of one or more figures

b) Double posting of an entry from a subsidiary book to ledger.

4. Posting on the wrong side: Sometimes the posting from book of primary entry to ledger account may be on wrong side. That is, if instead of debiting an account, it is credited and vice versa, the trial balance would not tally.

Suspense Account

If all the efforts of detecting errors fail and trial balance do not tally, then a new account is opened for such difference amount which is known as Suspense Account. So, a suspense account is an account opened for tallying the trial balance despite the errors remains undetected. The opening of suspense account for making both the sides of the trial balance equal does not mean that the error/s may be forgotten. The amount standing to the debit or credit of the suspense account represents the net effect of one sided errors. After rectification of errors in next accounting period, the suspense account will be automatically closed up.

B. Errors not Disclosed by a Trial Balance

A trial balance cannot be considered as a conclusive proof of the accuracy of the books of accounts. A trial balance is a proof of accuracy of posting but it is not a conclusive or definite proof. There are some errors which do not affect the agreement of the trial balance. The trial balance fails to disclose these errors. These errors are:

a) Errors of Principle

b) Errors of Omission

c) Errors of Commission

d) Compensating Errors

a) Errors of Principle: These errors violate some fundamental principle of accountancy. The errors of principle do not affect the agreement of

trial balance as the amount remains on the correct side though in a wrong account. This means that even if there is an error involving accounting principles, the trial balnce will still agree. An error of principle takes place in the following cases:

i. Treating an expense as an asset
ii. Treating an asset as an expense
iii. Treating an income as a liability
iv. Treating a liability as an income

b) Errors of Omission: This error is committed due to omission in recording a transaction or posting of transaction into ledger account. Such errors are committed erroneously. The entry may be omitted by oversight, loss of vouchers or invoices, non-receipt of invoice, ineffective communication etc.

c) Errors of Commission: This type of errors refers to the errors committed in posting into ledger accounts. It is an error in posting not in the primary entry.

d) Compensating Errors: Compensating errors are also not shown by the trial balance. These errors are those errors which cancel out one another and equal the trial balance to agree. At least two errors are required to be compensating errors. But in actual practice, there may be numerous errors which compensate and neutralize the debit side and credit side errors and the trial balance will tally despite the errors.

CHECK YOUR PROGRESS

Q3: Write the two methods of preparing Trial Balance.

a. ……

b. ……

Q4: What is errors of omission and errors of commission

.....

.....

.....

Q5: What is errors of omission and errors of commission

.....

.....

6.11 STEPS TO LOCATE THE ERRORS

When the trial balance does not agree, efforts to spot the errors and correcting them should be initiated. The following procedures for detecting errors may be adopted:

1. Check carefully the casting of the trial balance.
2. Ascertain the different debit and credit total of the trial balance and divide it by two. Then check whether there is any account head with a balance identical to this quotient. If there is, then see whether this balance has been put in the proper column.
3. See that the balance of all accounts, including cash and bank balances, have been written in the trial balance.
4. See that there is no mistake in the balancing the ledger accounts.
5. Confirm that all postings are made.
6. Re-check the totals of the subsidiary books.
7. See that all the opening balances are brought forward correctly.
8. Scrutinize all postings thoroughly.
9. Open suspense account for the difference amount.

Exercise 6.3



Let us pass rectification journal entries for the following errors:

i. Purchase book was undercast by Rs. 10,000.

ii. Sales book was overcast by Rs. 5,000.

iii. Repairs to machine debited to Machinery account, Rs. 4,000.

iv. Purchase of furniture debited to Purchases account amounting to Rs. 15,000.

v. A sale of Rs. 430 to Ram has been credited to his account as Rs. 340.

vi. Wages paid Rs. 500 wrongly posted in Salary account.

vii. Rent paid Rs. 5,000 wrongly passed through the personal account of the landlord.

Solution:

Rectification Journal Entries

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
i	Purchase A/c	Dr.		10,000	
	To Suspense A/c				10,000
	(Being undercast in purchase book rectified)				
ii	Sales A/c	Dr.		5,000	
	To Suspense A/c				5,000
	(Being overcast in sales book rectified)				
iii	Repairs A/c	Dr.		4,000	
	To Machinery A/c				4,000
	(Being repairs of machinery wrongly debited to repairs account, now rectified)				
iv	Furniture A/c	Dr.		15,000	
	To Purchases A/c				15,000
	(Being purchase of furniture wrongly debited to purchases account, now rectified)				
v	Ram A/c	Dr.		770	
	To Suspense A/c				770
	(Being sale to Ram amounting to Rs. 430 wrongly credited to his account by Rs. 340, now rectified)			770	

vi	Wages A/c Dr. To Salary A/c (Being wages paid Rs. 500 wrongly posted to Salary account, now rectified)		500	 500
vii	Rent A/c Dr. To Landlord's Personal A/c (Being rent paid wrongly passed through the personal account of the landlord, now rectified)		5,000	 5,000



6.12 LET US SUM UP

- A trial balance ensures about correct record of debit and credit amounts and the balances obtained from the ledger accounts.
- There are basically two methods of preparing a trial balance:
  a. Total Method, and
  b. Balance Method
- Adjusting entries are those journal entries which are recorded at the end of an accounting period to adjust income and expense accounts so that they comply with the accrual concept of accounting.
- Errors are the mistakes that have been committed while preparing the books of accounts. The errors may be in principle or it may be a numerical error. Again, errors may also be intentional and unintentional errors.
- The opening of suspense account for making both the sides of the trial balance equal does not mean that the error/s may be forgotten. The amount standing to the debit or credit of the suspense account represents the net effect of one sided errors.



6.13 FURTHER READING

1. B. B Dam and H C Gautam, '*Theory and Practice of Financial Accounting*', Capital Publishing Company, Guwahati.
2. Hanif and Mukherjee (2003), '*Financial Accounting*' , Tata McGraw Hill Education.
3. P.C Tulsian (2002) , '*Financial Accounting*', Pearson Education India.

6.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made.

Ans to Q2: The four objectives of Trials balance are:

1. To test arithmetical accuracy
2. To summarise the financial transactions:
3. To detect errors:
4. To ensure recording of two aspects

Ans to Q3: Trial balance can be prepared in any of the following methods:

1. Total or Gross Trial Balance;
2. Net or Balance Trial Balance.

Ans to Q4: Errors of Omission is the committed due to omission in recording a transaction or posting of transaction into ledger account. Such errors are committed erroneously. The entry may be omitted by oversight, loss of vouchers or invoices, non-receipt of invoice, ineffective communication etc.

Errors of Commission are a type of errors refers to the errors committed in posting into ledger accounts. It is an error in posting not in the primary entry.

Ans to Q5: If all the efforts of detecting errors fail and trial balance do not tally, then a new account is opened for such difference

amount which is known as Suspense Account. So, a suspense account is an account opened for tallying the trial balance despite the errors remains undetected.



6.15 MODEL QUESTIONS

1. What is a trial balance? How is it prepared?
2. Does a trial balance shows arithmetical accuracy? Explain.
3. What are the objectives of preparing a trial balance?
4. What are errors? What are its types? How are errors rectified?
5. What is a suspense account?

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UNIT 7: PRESENTATION OF FINAL ACCOUNTS

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Preparation of Final Accounts

7.4 Trading Account

- 7.4.1 Meaning of trading account and gross profit
- 7.4.2 Contents of Trading Account
- 7.4.3 Journal entries relating to preparation of Trading Account.
- 7.4.4 Specimen form of Trading Account

7.5 Profit and Loss account

- 7.5.1 Preparation of profit and loss account
- 7.5.2 Balancing of profit and loss account
- 7.5.3 Distinction between Trading and Profit and Loss A/c
- 7.5.4 Format of Profit and Loss Accounts
- 7.5.5 Provisions & Reserves
- 7.5.6 Provision for Bad and Doubtful Debts
- 7.5.7 Usual Adjustment Entries
- 7.5.8 Closing entries for Preparation of Profit and Loss Account.

7.6 Balance Sheet

- 7.6.1 Meaning of Balance Sheet
- 7.6.2 Steps for Preparation of Balance Sheet
- 7.6.3 Classification of Assets
- 7.6.4 Classification of Liabilities
- 7.6.5 Items appearing in the Balance Sheet
- 7.6.6 Format of Balance Sheet

7.7 Let us Sum Up

7.8 Further Reading

7.9 Answers to Check Your Progress

7.10 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- prepare final accounts
- learn trading account
- discuss the profit and Loss account
- learn about Balance Sheet

7.2 INTRODUCTION

In this unit we are going to discuss about Final accounts. Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger(dicussed in unit 6). It includes the accounts of all expenses, incomes, assets, liabilities, capital and drawings. Let us discuss in detail about final accounts in this unit. We will come to know how to prepare a trading account and balance sheet.

7.3 PREPARATION OF FINAL ACCOUNTS

Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger. The final accounts can be produced more often than once a year in order to give information to the owner(s) on how the business is progressing. However, it is customary to produce annual or final accounts for the benefit of the interested parties.

A trading firm prepares a Trading and Profit and Loss Account; a manufacturing business prepares a Manufacturing Account in addition to the Trading and Profit and Loss Account; a social club prepares and Income and Expenditure Account; and a professional man prepares only a Profit and Loss account; in addition to a Balance Sheet.

In case of sole proprietorship form of business, preparation of Final Accounts involves the preparation of accounts:

(a) Trading Account;

(b) Profit and Loss Account; and

(c) Balance Sheet.

The starting point for preparing final accounts is the trial balance. All the figures recorded on the trial balance are used in the final accounts. The trading account and the profit and loss account are both 'accounts' in terms of double-entry book-keeping. This means that amounts recorded in these accounts must also be recorded elsewhere in the book-keeping system. By contrast, the balance sheet is not an account, but is simply a statement of account balances remaining after the trading and profit and loss accounts have been prepared.

The following points are to be noted while preparing final accounts:

(i) In examination problems, if the question is not given in the form of a trial balance, a Trial Balance should be prepared before preparing the final accounts because the balance sheet will not agree if the trial balance does not agree, if there is a difference in the Trial Balance, the difference should be placed to 'Suspense A/c' and shown in the Balance Sheet in order to get the balance sheet agreed.

(ii) All items which appear in the Trial Balance should be shown only once for the same amount whereas items which appear outside the Trial Balance, known as adjustments, have to be shown at two places.

(iii) Items which appear on the debit side of the trial balance is shown on the debit side of the Trading Account or on the debit side of the Profit and Loss Account or on the assets side of the Balance Sheet depending on the nature of account.

However, item such as Returns Inward which appears on the debit side of the trial balance is shown on the credit side of the Trading Account as deduction from sales.

(iv) Items which appear on the credit side of the trial balance is shown on the credit side of the Trading Account or on the credit side of the Profit and Loss Account or on the liabilities side of the Balance Sheet depending on the nature of account.

However, Returns Outward account although shows credit balance and appears on the credit side of the trial balance is shown on the debit side of Trading Account as a deduction from Purchases.

Drawings account, although appears on the debit side of the trial

balance, is shown as a deduction from Capital on the Liabilities side of the Balance sheet.

(v) The direct expenses are shown on the debit side of the Trading Account and indirect expenses are shown on the debit side of the Profit and Loss Account and other incomes are shown on the credit side of the Profit and Loss Account.

(vi) Remaining accounts will be the accounts of Assets, Liabilities, Capital and Drawings which will be shown in the Balance Sheet.

(vii) Additional information or adjustments given by way of notes are the matters which have not been recorded in the books of account. These are to be considered by adjusting the items of expenses, losses, assets, drawings, incomes, liabilities or capital as applicable while preparing the Final Accounts. Adjustments requires both the Trading and Profit and Loss Account and the Balance Sheet depending on the nature of the adjustment. Sometimes an adjustment may have effects on both sides of the balance sheet only. For example, credit purchase of asset omitted to be recorded on the books.

(viii) No column for L.F. is required to be given in Final Accounts.

(ix) The total of both sides of the Balance Sheet will always be equal. (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

7.4 TRADING ACCOUNT

7.4.1 Meaning of Trading Account and Gross Profit

Meaning of Trading Account:

Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods. Ascertainment of overall result of trading is the ascertainment of gross profit earned or gross loss incurred as a result of the trading activities by a business during a particular accounting period.

If the amount of sales exceeds the amount of purchases

and the expenses directly connected with such purchases, the difference is termed as **gross profit**. On the contrary, if the purchases and direct expenses exceed the sales, the difference is called **gross loss**.

All expenses which relate to either purchase of raw material or manufacturing of goods, called 'Direct Expenses', which are recorded in the Trading Account. Thus, trading account is a part of Income Statement.

Meaning of Gross Profit

Gross profit generated from carrying on the basic activity of a business. The basic activity of a business comprises of buying and selling of goods. The excess of revenue generated over cost of manufacture or purchase of goods is known as **gross profit**. In other words, gross profit is the excess of Net Sales over the cost of goods sold. This is explained as under:

Gross Profit	=	Net Sales – Cost of goods sold.
Net Sales	=	Sales – Sales Returns or Returns Inward.
Cost of Goods sold	=	Opening Stock (Inventory) + Net Purchases – Closing Stock
Net Purchases	=	Purchases – Purchase Returns or Returns Outward

Or

Cost of goods sold	=	Opening Stock (Inventory) + Purchases + Expenses incurred in connection with purchases and manufacture (Direct expenses) – Closing Stock.



EXERCISE: 7.1

From the following information, calculate: **(i)** Cost of Goods sold; and **(ii)** Gross profit:

	Rs
Opening Inventory	12,000
Cash Purchases	16,000

Credit Purchases	28,000
Purchase Return	3,000
Cash Sales	39,000
Credit Sales	72,000
Sales Return	4,000
Wages	8,000
Salaries	9,000
Rent	3,000
Other Direct Expenses	14,000
Closing Inventory	5,000

Solution:

(i) **Cost of Goods sold** = Opening Inventory + Net purchases + Expenses incurred in connection with purchases (Direct Expenses) - Closing Inventory.

= Rs. [12,000 + (16,000 + 28,000 – 3,000) + (8,000 + 14,000) – 5,000]

= Rs. 70,000

(ii) **Gross Profit** = Net Sales – Cost of goods sold.

= Rs. [(39,000 + 72,000) – 4,000] – 70,000

= Rs. (1,07,000 – 70,000)

= Rs. 37,000

7.4.2 Contents of Trading Account

Trading Account is an account like any other account. It has two sides – Debit and Credit. All expenses which relate to either purchase or manufacturing of goods are written on the debit side of the Trading Account.

A. Items shown on the Debit side of the Trading Account:

(1) **Opening Stock (Opening Inventory):** The stock of goods remains unsold at the end of the last year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current

year. This item is shown as the first item on the debit side of the Trading account. It should be kept in mind that there will be no opening stock in case of newly started business. Opening Stock will include the Stock of Raw Materials, Semi-finished goods and finished goods. This item appears on the debit side of the trial balance. Stock of goods is also termed as inventory and, therefore, opening stock is termed as opening inventory.

(2) Purchases: Purchases includes goods which have been bought for resale. The amount of Purchases appearing in the trial balance includes cash purchases as well as credit purchases. Purchases account shown debit balance and hence it appears on the debit side of the Trial balance. While preparing the final account, it is shown on the debit side of the Trading account.

(3) Purchases Returns: When goods are returned by the business, for some reasons, "Returns Outwards Account" or "Purchase Returns Account" is credited in the books of account and supplier's account is debited. "Purchases Returns Account" shows credit balance and appears on the credit side of the Trial balance. There are two ways of showing purchase returns in the Trading Account. It may be shown by way of deduction from Purchases on the debit side of the Trading Account or it may be shown on the Credit side of the Trading Account. However, normally it is shown by way of deduction from Purchases in order to show the figure of net purchase in the Trading Account.

(4) Direct Expenses: In case of a trading concern, all expenses incurred in purchasing the goods, bringing them to the godown and into saleable condition are treated as direct expenses and charged to trading account. For example, carriage inward, freight, wages etc. In case of manufacturing concern, cost of converting the raw materials into finished products form part of direct expenses. Direct expenses to be debited to trading

account include the following.

(a) **Wages:** Wages are paid to workers who are engaged in the production of goods and as such are debited to the trading account. While preparing Trading Account, it should be noted that :

a) If the item 'Wages and Salaries' is given in the problem, it will be shown in the trading account. On the contrary, if 'Salaries and Wages' are given it will be shown in the profit & loss account.

b) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence such expenses or wages will not be shown in the trading account.

(b) **Carriage or Carriage Inward or Freight:** Carriage or Carriage Inward or Freight is the expenses which are paid for bringing the goods to the shop or to the factory and hence should be debited to trading account. However, if any carriage or freight is paid for carrying charge of an asset, the amount should be added to the asset account and should not be debited to trading account.

(c) **Manufacturing Expenses:** Manufacturing Expenses such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc. are the expenses which are incurred in the manufacture of goods and hence these are shown on the debit side of the Trading account (where manufacturing account is not prepared).

(d) **Dock Charges:** Dock Charges are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of trading account. If dock charges are paid on export of goods they are shown on the debit side of the Profit and Loss account. In the absence of specific instructions, these are debited to trading account.

(e) **Import Duty or Custom Duty:** Custom Duty is paid on import as well as on export of goods. Custom duty when paid on the purchase of goods is charged to trading account and when it is paid on the sale of good it is charged to profit and loss account. In the absence of specific instructions, these are debited to trading account.

(f) **Excise Duty:** Excise Duty is the amount of duty or charges paid to the government on goods manufactured and is, therefore, debited to the trading account.



Levied: Impose and collect

(g) **Octroi:** Octroi is the amount ***levied*** by the municipal authority when the goods enter the city and hence debited to trading account because they are connected with purchases.

(h) **Royalty:** Royalty is the amount paid to the owner of a mine or patent for using his right or patent. Where the payment of royalty is based on production, it is usually charged to trading account because it increases the cost of production. However, if it is specifically started in the problem that the Royalty is payable on the basis of sales, it will be charged to Profit and Loss account.

(i) **Packing Charges/Packing Expenses:** Packing material is used for packing of materials at different stages.

(a) If packing charges are incurred to make goods saleable or to bring it in a saleable condition, these are direct expenses. They are as such debited to the Trading Account.

(b) If the packing expenses are connected with sales or they have been incurred after the goods have been sold, they are treated as selling expenses and are debited to the Profit and Loss Account.

For example, a manufacturer of biscuits sell biscuits packed in poly packs. In order to make the biscuits available in saleable condition, this primary packing is necessary. Therefore, they are treated as direct expenses. Now, a person purchases three

packets of such biscuits and the seller packs these three packets for handing over the purchaser, the expenses incurred on such secondary packing is indirect and will be treated as selling expenses and debited to Profit and Loss Account.

B. Items shown on the Credit side of the Trading Account:

(1) Sales: Sales account appearing in the Trial Balance, shows the total sales made during the accounting period. This includes both cash and credit sales. Sales account shows credit balance. It is treated as revenue and as such it is shown on the credit side of the Trading account. In respect of sales, the following points must be noted :

1) Only the sale of goods is treated as sales for the purpose of preparation of Trading Account.
2) If sales include sale of fixed asset, it should be deducted from sales.
3) If any goods have been sold on approval and included in sales, it should be deducted from sales, if the approval period has not expired. Such sales should be recorded separately.

(2) Sales Return: When goods are returned by the buyers, for some reasons, “Returns Inwards Account” or “Sales Return Account” is debited in the books of account and the buyer’s account is credited. ‘Sales Return Account’ appears on the debit side of the Trial Balance. There are two ways of showing sales returns in the Trading Account. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns is to put it in the debit side of the Trading Account. But normally it is shown by way of deduction from sales in order to show the figure of net sales.

(3) Closing Stock (Closing Inventory): The goods remain unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the Closing Stock of raw material, Closing Stock of semi-

finished goods and Closing Stock of finished goods. Accounting treatment of closing stock will be as under :

(a) Where the amount of closing stock is stated outside the Trial Balance

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry:

Closing Stock A/c Dr.

To Trading A/c

(Being the incorporation of Closing Stock in the books of account.)

Closing stock account will be posted to the credit side of the trading account and on the other hand, debit aspect of the closing stock account will be shown on the Asset side of the Balance Sheet, in order to complete the double entry.

(b) Where the amount of Closing Stock is stated inside the Trial Balance:

Sometimes, the Closing Stock may be given inside (on the debit side) the Trial Balance. This means that the entry for incorporating the closing stock in the books has already been passed. It implies that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear only on the Assets side of the Balance Sheet.

Again, the Closing Stock may be given both on the debit side and credit side of the Trial Balance. In such a case, the debit balance will be shown on the asset side of the balance sheet and the balance appearing on the credit will be shown on the credit side of the Trading account.

c) Valuation and recording of closing stock:

Closing stock should be valued either at cost or market price whichever is lower and should be recorded accordingly. While preparing final account, if the figure of both cost price and market price of the closing stock is given, the closing stock will be shown both in the Trading account and the balance sheet either **at the cost price or market price whichever is lower.** (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

For example, the cost price of stock held by a trader on 31-3-2004 is Rs.12, 000 and will be recorded in the books of account accordingly.

7.4.3 Journal Entries (Closing entries) relating to preparation of Trading Account

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as closing entries. These will be as follows:

(1) **For transfer of opening stock:**

Trading A/c Dr.

To Opening Stock A/c

(2) **For transfer of purchases:**

Trading A/c Dr.

To Purchases A/c

(3) **For transfer of purchases returns:** The balance of purchases return account is transferred to purchases account or Trading account.

Purchases Return A/c Dr.

To Purchases A/c or Trading A/c

(4) **For transfer of direct expenses:**

Trading A/c Dr.

To Direct Expenses (Individually) A/c

(5) **For transfer of Sales**

Sales A/c Dr.

To Trading A/c

(6) **For transfer of Sales Returns or Returns Inward :**

Trading A/c / Sales A/c Dr.

To Returns Inward A/c

(7) **For transfer of Closing Stock :**

Closing Stock A/c Dr.

To Trading A/c

(8) **Entry for closing the Trading account:**

(a) If the credit side of the Trading Account exceeds the debit side: After passing the above entries, if the total of amounts of the credit side of the Trading Account exceeds the total of amounts of debit side, the difference is termed as Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit and Loss account. The following entry is passed for the same:

Trading A/c Dr.

To Profit and Loss A/c

(Being the transfer of Gross Profit to the Profit and Loss A/c)

(b) If the debit side of the Trading Account exceeds the credit side: If the total of amounts of debit side of the Trading Account exceeds the total amounts of the credit side, the difference will be termed as Gross Loss. It will be transferred to the debit of Profit and Loss Account by means of the following entry:

Profit and Loss A/c Dr.

To Trading A/c

(Being the transfer of Gross Loss to the Profit and Loss A/c)

7.4.4 Specimen Form of Trading Account

In the books of ……..

Trading Account

For the year ended on ……

Dr. Cr.

Particulars Amount	Amount	Particulars	
	(Rs.)		(Rs.)
To Opening Stock		By Sales	
To Purchases		Less : Sales Returns Or	
Less : Purchase Returns Or		Returns inward	
Returns outward		By Closing Stock	
To Wages		By Profit and Loss A/c	
To Wages & Salaries		(Gross loss transferred)	
To Direct Expenses		(Balancing figure)	
To Carriage, or			
Carriage on Purchase			
To Duty on Purchase			
To Gas, Fuel and Power			
To Freight/ Cartage			
To Manufacturing Expenses,			
Or Productive Expenses			
To Factory Expenses, such as :			
Factory Lighting			
Factory Rent etc.			
To Octroi			
To Dock charges			
To Clearing charges			
To Import Duty or			
Custom Duty			
To Excise Duty			
To Insurance Premium			
(factory)			
To Royalty on production			
To Profit and Loss A/c			
(Gross Profit transferred)			
[Balancing Figure]			



Exercise: 7.2

Following is the extract of the Trial Balance of Ram and Shyam firm as on 31.3.2015.

Particulars	Debit	Credit
	Rs.	Rs.
Stock on 1.4.99		10,000
Carriage on Sales		2,000
Purchases		80,000
Discount		2,000
Sales		1,20,000
Purchase returns		2,000
Octroi Duty		5000
Returns inward		3,000
Productive wages		15,000
Freight		2,000
Excise Duty		1,000
Coal, gas and water		1,500
Salaries		5,000
Trade Expenses		1,000

Additional information:

(i) Stock on 31.3.2015 Rs.15,000

(ii) Outstanding wages 500

(iii) Goods taken by Ram for Personal Use 1,000

Prepared the Trading Account of the firm for the year ended 31.3.2015

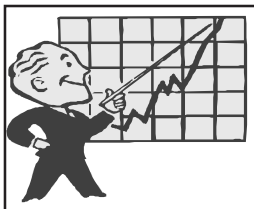
Solution: **In the books of Ram and Shyam**

Trading Account

For the year ended 31st March, 2015

Particulars		Amount (Rs.)	Particulars		Amount (Rs.)
To Opening Stock		10,000	By Sales	1,20,000	
To Purchases	80,000		Less : Returns		
Less : Purchase			inward	3,000	1,17,000
Returns	2,000		By Closing Stock		15,000
	78,000				
Less : Goods taken by Ram transferred to his Drawings A/c	1,000	77,000			
To Octroi Duty		500			
To Freight		2,000			
To Excise Duty		1,000			
To Coal, gas and water		1,500			
To Productive wages	15,000				
Add : Outstanding	500	15,500			
To Profit & Loss A/c (Gross Profit c/c)		24,500			
		1,32,000			1,32,000

Note: Trade expenses ordinarily indicate General Expenses and it is indirect in nature and, therefore, taken to Profit & Loss A/c. In case the Trial balance contains both Trade Expenses and General Expenses, Trade Expenses will be treated as direct and will be taken to the Trading A/c and General Expenses will be taken to the Profit & Loss A/c.



CHECK YOUR PROGRESS

Q 1: Fill in the Blanks:

a) Final accounts are prepared after the preparation of .....

b) Every adjustments has ..... effects in Final Accounts.

c) All ..... expenses are recorded in trading account.

Q 2: State True or False:

a) Every adjustment in final account has three effects. True/ False

b) Carriage outward is debited to trading account. True/ False

c) Closing Stock is always valued at Market Price. True/ False

d) Gross Profit =Net Sales – Cost of Goods Sold. True/ False

Q 3: What do you mean by Opening stock.

.....

.....

7.5 PROFIT AND LOSS ACCOUNT

Meaning of Profit and Loss Account:

After preparing a Trading Account and ascertaining Gross Profit or Gross Loss, we are to prepare Profit and Loss Account in order to ascertain Net Profit or Net Loss. Profit and Loss Account is the statement wherein the various items of profit and revenue earned on one hand and the losses, and expenses incurred on the other hand are collected and set off and the resulting balance represents the Net Profit or Net Loss of the period under review. It means, the expenses for earning the income are set off against that income to ascertain Net Profit or Net Loss.

If the gains exceed the losses; the excess is the Net Profit. If the losses exceed the gains, the excess is the Net Loss. American Accountants call this Account a “Loss and Gain Account” which is more appropriate in relation to its formation.

7.5.1 Preparation of Profit and Loss Account

A Profit and Loss Account starts with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account will now be debited to Profit & Loss Account. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on the credit side of this account.

These expenses are incidental to carrying on business; these are called 'Indirect Expenses'. and are broadly grouped under three categories of expenses; viz.

a) Administrative Expenses which include Salaries to Staff, Office Rent, Printing and Stationery etc.

b) Financial Expenses which include Interest on Loan, etc.

c) Selling and Distribution Expenses which include Carriage Outward, Advertisement, etc.

If the credit total is heavier, the difference is called Net Profit and if the debit total is heavier, the difference is called Net Loss.

Transfer of Net Profit or Net Loss:

Net Profit indicates an increase in proprietor's equity or capital by the amount of profit while Net Loss indicates a decrease in owner's equity or capital by the amount. So Net Profit or Net Loss is to be transferred to the Proprietor's Capital Account by passing a journal entry as given below:

(a) For Transfer of Net Profit:

Profit and Loss account		Dr.
	To Capital Account.	

(b) For Transfer of Net Loss :

Capital Account		Dr.
	To Profit and Loss Account.	

A. Items shown on the Debit side of Profit & Loss Account:

(1) Gross Loss: If trading account discloses Gross Loss, it is

shown as the first item on the debit side of the Profit and Loss Account.

(2) Indirect Expenses: Each and every business house is required to incur some other expenses other than the direct expenses in course of their day to day business activities. Such expenses include expense of revenue nature other than the direct expenses such as Office and Administrative expenses, Selling and Distribution expenses, financial charges etc. These expenses are termed as indirect expenses because they are not directly related to purchase of goods and bringing them into saleable condition. Indirect expenses debited to profit and loss account are state below :

(a) Office and Administrative Expenses: Expenses such as salary of office employees, office rent, lighting, postage, printing, stationery, audit fee, legal charges etc. are treated as Office and Administrative Expenses.

(b) Selling and Distribution Expenses : Expenses such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc. are treated as Selling and Distribution Expenses.

(c) Financial Charges: Expenses such as interest on loan, interest on capital, interest on overdraft etc. are treated as financial charges.

(d) Miscellaneous Expenses: Expenses such as interest on loan, interest on capital, repair charges, depreciation, charity etc. are treated as Miscellaneous Expenses.

(e) Other Losses: Such as loss by fire, loss due to accident etc.

(f) Provisions: Such as Provision for doubtful Debts, provision for Discount on Debtors etc.

B. Items shown on the Credit side of Profit & Loss Account:

(1) Gross Profit: If the Trading Account discloses Gross Profit, Gross Profit is shown as the first item on the credit side of

Profit and Loss Account.

(2) Other Incomes and Gains: All items of incomes and gains such as income from investments, rent received, discount received, commission earned, and interest received, bad debts recovered etc. are shown on the credit side of the Profit & Loss Account.

7.5.2 Balancing of Profit and Loss Account

The balance of the Profit & Loss Account, after posting all nominal accounts to the respective side, is termed as Net Profit or Net Loss. If the credit side of the profit and loss account is more than the total of the debit side, the difference is termed as net profit. On the other hand, if the total of the debit side exceeds the total of the credit side, the difference is termed as net loss. The Net Profit/ Net Loss is transferred to the capital account. Net profit is added to the capital whereas net loss is deducted from the capital in the balance sheet.

7.5.3 Distinction between Trading Account and Profit and Loss Account

Sl. No.	Basis of Distinction	Trading Account	Profit & Loss Account
1.	Items included	Sales and all the items relating to ascertainment of cost of sales are shown in this account.	All the items of indirect expenditure such as salary, rent, bad debts, discount etc. are shown in this account.
2.	Result	The balance of this Account is named as gross profit/ gross loss.	The balance of this Account is named as net profit/ net loss.
3.	Transfer of balance	The balance of this Account is transferred to Profit and Loss Account.	The balance of this Account is transferred to Capital account.

4.	Utility	Trading Account shows the trend of business activities.	This Account shows the net result of the business. By comparing net results of consecutive periods, steps can be taken for an all round development of the business.
5.	Sequence of preparation	By comparing the Trading Account of consecutive periods steps can be taken to increase profitability. It is prepared before the preparation of Profit and Loss Account.	It is prepared after the preparation of Trading Account.

7.5.4 Format of Profit and Loss Account

Profit and Loss Account

(for the year ending .....)

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Trading A/c		By Trading A/c	
(Gross Loss Transferred)		(Gross Profit transferred)	
Office & Administrative			
Expenses :		By Rent (Cr.)	
To Salaries		By Rent of premises sub-let	
To Salaries & Wages		By Discount received	
To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage & Telegram		By Interest on Investments	
To Lighting		By Dividend on Shares	
To Insurance Premium (office)		By Sundry Receipts	
To Telephone Charges		By Bad debts Recovered	
To Legal Charges		By Profit on sale of assets	
To Audit Fees		By Income from other Sources	
To Traveling Expenses		By Apprenticeship Premium	
To Establishment Expenses.		By Sale of Scraps	
To Trade Expenses [see note (ii)]		By Royalty Received	
To General Expenses.		By Subsidy from Govt.	
To Royal on sales.		By Interest on Drawings	
To Establishment		By Capital A/c	
To Commission of Office Manager		[Net Loss Transferred to]	

Selling and Distribution Expenses :			
To Carriage Outwards, or Carriage on Sales			
To Advertisement			
To Commission			
To Discount			
To Rebate			
To Brokerage			
To Bad debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses.			
To Wages (Unproductive)			
To Commission to Sales Manager			
Financial Charges :			
To Interest on Loan			
To Bank Charges			
To interest on Overdraft.			
Sundry Expenses :			
To Sales Tax			
To Repairs			
To Depreciation on fixed assets			
To Entertainment Expenses			
To Contingencies			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
Provisions :			
To Provision for Doubtful Debts			
To Provision for Discount on Debtors			
To Capital A/c(Net Profit Transferred)			

7.5.5 Provisions & Reserves

Meaning and Characteristics of Provisions:

In course of carrying out business activities, each and every

entity is required to prepare itself for meeting all eventualities both expected and unexpected. In order to ensure that the profit has not been distributed out of capital, it is important that necessary provisions are made and reserves are created out of profit at the time of preparation of final accounts. The terms 'Provisions' and 'Reserves' are different forms each other.

The term 'Provision' means the setting aside of an estimated amount to meet known liability or loss the amount of which may not be exactly ascertained. It is a charge against profit to meet certain known liabilities or contingencies. Charge against profit means that the amount should be provided for even if there is no profit. For the purpose of making provision, the amount of provision to be made is debited to the Profit and Loss account in order to ascertain the correct profit.

According to Companies Act, 1956, the term 'Provision' refers to any one of the following amounts:

1 The amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets; or

2 The amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Examples of provisions:

(i) Provision for Income Tax;

(ii) Provision of Sales Tax;

(iii) Provision for liability for disputed claim.

(iv) Provision for depreciation;

(v) Provision for Repairs and Renewals;

(vi) Provision for doubtful debts;

(vii) Provision for discount on debtors;

Characteristics / Features of Provisions:

a) Provision is made to meet a known liability.

b) Although the liability is known, the amount of such liability cannot be determined with reasonably accuracy. For example, it is

almost certain that some of the amount receivable from debtors will become bad but it is not possible to predict the exact amount of such bad debts.

c) Provision is a charge against profits and as such the creation of provision reduces the profits or increases the loss of the year in which it is created. The loss when actually occurs is adjusted against such provision and thus the profit of the year in which such loss occurs is not affected.

d) Provision is created even if there is loss.

Need for creating Provisions:

a) To ascertain the true net profit of the business: For the purpose of ascertaining the true profit of a business, it is necessary that all expenses pertaining to that year, whether paid or not, must be debited to Profit and Loss account. Hence, provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for doubtful debts, because the amount of such bad debts cannot be estimated correctly.

b) To ascertain the true financial position of the business: In order to see that the Balance Sheet discloses the true and fair view of the financial position of the business, it is necessary that provision is made for all the anticipated losses and expenses.

c) To provide for known losses in future : Provisions are made to provide funds for meeting those which are likely to occur in the near future such as provision for bad debt, provision for taxation, provision for repairs, provision for damages likely to arise from a pending suit and such others.

d) For proper allocation of expenses: Provision is also required to be made for proper allocation of expenses. For example;

total amount to be spent on repairs and renewals during the life of an asset is estimated and spread over on an average basis because the amount of expenses in earlier years would be comparatively lower than that of the later years. Therefore, in order to allocate the expenses on repairs on an equitable basis it is necessary to create provision for repairs. Actual expenses of repairs incurred each year will then be debited to this account. Hence, it will put equal burden each on the Profit and Loss account of each year in respect of expenses of repairs.

Nature of balances of Provision and Reserves Accounts:

Any reserve or Provision account usually show credit balance. But there is only one exception i.e. Reserve for Discount on Creditors Account which shows debit balance.

Disclosure in the Balance Sheet:

The amount of provision created is required to be shown in the balance sheet as under:

(i) If the provision is created for liabilities and charges, the amount of provision should be shown on the liability side of the Balance sheet. For example, Provision for Income Tax, Provision for Repairs and Renewals.

(ii) If the provision is created for a definite object such as to meet expected contingency, e.g., doubtful debts, discount on debtors, the provision is shown as deduction from Sundry Debtors on the assets side of the balance sheet.

Accounting Treatment of Provisions:

Provisions are charged against profit. Provisions are created by debiting profit and loss account for specific and known contingency or expected loss, e.g., provision for doubtful debts, provision for discount on debtors and provision for taxation etc. A definite sum is charged every year out of profit and loss account to meet the known contingency. Provisions account should be compulsorily posted at the debit side of profit and loss account,

whether the firm earns profit or suffers loss.

The provision against any asset is generally shown as deduction from concerned asset in the balance sheet. For example; Provision for doubtful debts and provision for discount on debtors. They are shown as deduction from debtors on the assets side of the Balance Sheet. Sometimes, the provision may also be shown at the liabilities side of the balance sheet. For example; provision for taxation.

Provision for doubtful debts generally has old balance. The old provision is deducted from the total of bad debts and new provision at the debit side of profit and loss account. In case old provision exceeds the total of bad debts and new provision, the treatment should preferably be made at the credit side of profit and loss account, where the total of bad debts and new provision should be deducted from old provision.

7.5.6 Provision for bad debts and doubtful debts

It is a common feature for every business to sell goods on credit. The people to whom goods have been sold on credit are known as 'Debtor' and the total of all the debtors is termed as 'Sundry Debtors'. Sundry Debtors are also termed as 'Book Debts'. The total debtors of a firm may be classified into: Good debts, Bad debts and Doubtful debts.

(i) **Good Debts:** Good debts are those debts which will be recovered in full. In other words, that portion of sundry debtors which will be recovered in full is termed as 'Good Debtors'.

(ii) **Bad Debts:** Sometimes due to the financial difficulty, death or insolvency or dishonesty of a Debtor, full amount due from them may not be recovered from such person/persons. When the business firm finds that a particular amount due from a particular debtor cannot be recovered either in full or in part, the unrecoverable portion is termed as 'Bad Debts'.

When the business entity feels that a particular amount cannot be recovered from a particular debtor, it is meaningless to carry forward the balance in the account of such debtor in the ledger every year. The balance standing to the debit of that account is cancelled. The process of cancellations of balance in the account of a debtor is called 'writing off' bad debts. This is done by recording the following journal entry:

Bad debts A/d Dr.

To Debtors A/c (Individually)

(Being bad debts written off)

In examination problems where the name of the debtor is not given, the entry for 'writing off' bad debts will be as under:

Bad debts A/c Dr.

To Sundry Debtors A/c

(Being bad debts written off)

Need for creating Provision for Doubtful Debts:

As credit sales are made in a particular year during which debtors are created, the profit on such sales is included in the Trading and Profit and Loss Account of that year as revenues are ascertained on the basis of accrual assumption. Doubtful Debts is a business loss arising from credit sales; so it is logical that such a loss is charged against the revenue earned through credit sales of that year according to the matching principle. Moreover, on the basis of the modifying principle of conservatism and according to the principle of revenue recognition, expected loss must be taken into account during that year while ascertaining net profit.

Hence, it is not only fair but also logical that doubtful debts being a business loss in connection with credit sales must be provided for out of the revenue earned during the period so that the Profit and Loss Account of the following year is not burdened with the loss of earlier years.

Provision for Doubtful Debts – How Created:

Since doubtful debts can only be estimated, a provision is

created on estimated basis. This is calculated at a certain percentage on the amount of Debtors at the end of the year. The percentage is fixed on the basis of past experience in connection with the reliability of debtors. The provision so created is called 'Provision for Doubtful Debts' or 'Provision for Bad Debts' or 'Provision for Bad and Doubtful Debts'. All these three terms are used interchangeably. Sometimes the term 'Reserve' is used in place of the 'Provision'. It is not proper to use the term Reserve in place of 'Provision' for Doubtful Debts created for the first time in a particular year is carried forward to the next year. In the next year, this provision is terms as 'Old Provision' or 'Existing Provision' and the provision to be created in that year is termed as 'New Provision'. Following journal entry is passed for creating 'Provision for Doubtful Debts':

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry debtros)



Exercise : 7.3

On 31-12-2017, the Sundry debtors of a firm amounted to Rs.60, 800. Out of debtors Rs. 800 is irrecoverable and the same is to be written off as bad debt.

Pass journal entries relating to bad debts and show how the accounts will be reflected in the Profit and Loss Account and the Balance Sheet.

Journal

Date	Particulars	L F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2017 Dec.31	Bad Debts A/c Dr. To Sundry Debtors (Being the amount of bad debts written off)		800	800
Dec.31	Profit and Loss Account Dr. To Bad Debt Account (Being the transfer of bad debts to Profit and Loss A/c)		800	800

Note: Since the bad debts are to be written off, the entry for writing off bad debts is required to be passed.

Dr. Profit and Loss Account for the year ended 31-12-2017 Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bad Debts	800		

Dr. Balance Sheet as at 31-12-2014 Cr.

Liabilities	Amount (Rs.)	Assets		Amount (Rs.)
		Sundry Debtors	60,800	
		Less: Bad Debts	800	60,000

Creation and Accounting Treatment of Provision for Doubtful Debts:

Where an entity decides to make provision for doubtful debt, a new account called 'Provision for Doubtful Debts Account'/ 'Provision for Bad Debt Account'/ 'Provision for Bad and Doubtful Debts Account' is required to be opened in the ledger. The balance of this account will be carried forward to the next year. While preparing final accounts the amount of provision for doubtful debts will be shown on the debit side of the Profit and Loss Account

and the same will be shown as deduction from Sundry Debtors in the Balance Sheet.

The following journal entry is required to be passed for creating 'Provision for Doubtful Debts' :

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry Debtors)

Note : It should be kept in mind that the creation of Provision for Doubtful Debts does not reduce the balance of sundry debtors. The Provision for Doubtful Debts is shown as deduction from sundry debtors in the assets side of the balance sheet for the purpose of showing the amount of sundry debtors at its estimated realizable value.



Exercise: 7.4

Following is the extract of Trial Balance as on 31st December, 2017.

Trial Balance

Sundry debtors	40,000

Create Provision for Doubtful Debts @5% on Debtors. You are required to pass Journal entry for creating provision for Doubtful Debts. Show the Provision for Doubtful Debts Account as it will appear in the Ledger. Also show how the Provision for Doubtful Debts will appear in the Profit and Loss Account and the Balance Sheet. The accounting year ends on 31st December each year.

Solution : Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2017				
Dec.31	Profit and Loss Account Dr.			2,000
	To Provision for Doubtful Debts A/c			2,000
	(Being the creation of Provision for Doubtful Debts % 5% on Sundry Debtors)			

Dr. Provision for Doubtful Debts Account Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2017				2017			
Dec. 31	To Balance c/d		2,000	Dec. 31	By Profit and Loss A/c		2,000
				2018			
				Jan.1	By balance b/d		2,000

Profit and Loss Account

For the year ended 31st December, 2017

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.
To Provision for Doubtful Debts A/c	2000		

Balance Sheet as on 31st December, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors 40,000	
		Less: Provision	
		For doubtful debts 2,000	38,000

7.5.7 Usual Adjustment Entries

Journal entries are necessary to adjust the revenue and expenses accounts at the end of each accounting year. They are given below in a tabular form with their effect in the Profit and Loss Account and the Balance Sheet.

USUAL ADJUSTMENT ENTRIES

Adjustment items	Adjustment Entries	Effect to be shown in	
		Profit & Loss Account	**Balance Sheet**
I. To provide for outstanding expenses	Expense Account (concerned) (a) Dr. To Outstanding Expenses A/c (b)	(a) Debit Side, as an addition to the concerned A/c	(b) Liabilities side
II. To adjust prepaid expenses :	Prepaid Expense A/c (a) Dr. To Expense Account (concerned)(b)	(a) Debit side, as a deduction from the concerned Expense A/c	(b) Assets side.
III. To adjustincome earned but not received	Outstanding Income A/c (a) Dr. To Income A/c (concerned) (b)	(b)Credit side, as an addition to the concerned Income A/c	(a) Assets side
IV. To adjustIncome received in advance	Income A/c (concerned) (a) Dr. To Income Received in Advance A/c(b)	(a) Credit side, as a deduction from Income A/c concerned	(b) Liabilities side
V. To write off bad debt	Bad Debt. A/c(a) Dr. To Debtors A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VI. To provide for doubtful debt	Profit and Loss A/c(a) Dr. To Reserve for Doubtful Debt A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VII. To provide for discount on Debtors	Profit and Loss Account(a) Dr. To Reserve for Discount on Debtors A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VIII. To provide for discount on Creditors	Reserve for Discount on Creditors A/c(a) Dr. To Profit and Loss A/c (b)	(b) Credit side	(a) Liabilities side, as a deduction from Sundry Creditors
IX. To provide for depreciation on a permanent asset	Depreciation A/c(a) Dr. To (concerned) Asset A/c(b)	(a) Debit side	(b) Assets side, as a deduction from the concerned assets.
X. To adjust interest on proprietor's capital	Interest on Capital A/c(a) Dr. To Capital A/c(b)	(a) Debit side	(b) Liabilities side, as a addition to Capital.
XI. To adjust interest on drawings	Capital A/c(a) Dr. To Interest on Drawing A/c(b)	(b) Credit side	(a) Liabilities side, as deduction from Capital
XII. For goodsused as free samples	Free Samples A/c(a) Dr. Or Advertisement A/c(a) To Purchase A/c(b) Dr.	(a) Debit side, and (b) a deduction from Purchase A/c in the Trading Account.	

XIII. Goods used as stationery in office.	Printing and Stationery A/c(a) Dr. To Purchases A/c(b)	(a) Debit side of the Profit and Loss A/c and (b) a deduction from Purchases in Trading A/c.	
XIV. Loss of stock by fire etc. insured and claim admitted.	Insurance Claim A/c(a) Dr. To Trading A/c(b)	(b) Credit side of Trading A/c	(a) Assets side as Insurance Claim
XV. Loss of stock partially insured and admitted by insurance Co.	Insurance Claim A/c(a) Dr. Loss by Fire A/c(b) Dr. (to be transferred to P/L. A/c) To Trading A/c (c)	(b) Debit side of the Profit and Loss A/c and (c) credit side of the Trading A/c	(a) Insurance claim on the Asset side.
XVI. Loss of stock by fire uninsured	Loss by Fire A/c(a) Dr. To Trading A/c(b)	(a) Debit side of the Profit and Loss A/c and (b) Credit side of Trading A/c	

7.5.8 Closing entries for Preparation of Profit & Loss Account

The preparation of the Profit & Loss Account requires that the balances of such accounts which are due to appear in the Profit & Loss Account are transferred to it. The entries required for such transfer are termed as closing entries. These are as follows:

(1) For transfer of account of various items of expenses and losses:

Profit and Loss A/c Dr.
To Salaries A/c
To Rent, Rates and Taxes A/c
To Printing and Stationery A/c
To Postage and Telegram A/c
To General Expenses etc

(Being the transfer of nominal accounts showing debit balances to the debit of Profit and Loss A/c)

(2) For transfer of accounts of various items of incomes and gains :

Interest received A/c Dr.
Commission Received A/c Dr.
Rent Received A/c Dr.
To Profit and Loss A/c

(Being the transfer of nominal accounts showing credit balances to the credit of Profit and Loss A/c)

(3) For the transfer of credit balance of Profit & Loss A/c, known as net profit:

Profit and Loss A/c Dr.
To Capital A/c
(Being the transfer of net profit to Capital A/c)

(4) For the transfer of debit balance of Profit & Loss A/c, known as net loss:

Capital A/c Dr.
To Profit and Loss A/c
(Being the transfer of net loss to Capital A/c)



Exercise: 7.5

From the following particulars, pass necessary journal entries and prepare a Profit & Loss Account of Mr. K. Baruah for the year ending 31st March, 2017.

Particulars	Rs.	Particulars	Rs.
Gross Profit	3,12,000	Discount allowed	3,000
Trade Expenses	2,000	Lighting	780
Carriage on Sales	10,000	Commission Received	840
Office Salaries	15,800	Bad-debts	1,200
Postage and Telegram	720	Discount (Cr.)	600
Office Rent	7,500	Interest on Loan	2,200
Legal Charges	400	Wages (Unproductive)	1,400
Audit fee	1,600	Export Duty	2,300

Donation	1,100	Miscellaneous Receipts	500
Sundry Expenses	360	Advertisement	4,100
Selling Expenses	5,320	Travelling Expenses	2,500

Solution: **In the books of Mr. K. Baruah**

Journal Entries

Date	**Particulars**	**L. F.**	**Dr. Amount (Rs.)**	**Cr. Amount (Rs.)**
2017	Profit and Loss Account Dr.		62,280	
Mar.31	To Trade expenses Account			2,000
	To Carriage on sales Account			10,000
	To Office Salaries Account			15,800
	To Postage & Telegram Account			720
	To Office Rent Account			7,500
	To Legal charges Account			400
	To Audit Fee Account			1,600
	To Donation Account			1,100
	To Sundry expenses Account			360
	To Selling expenses Account			5,320
	To Discount allowed Account			3,000
	To Lighting Account			780
	To Bad Debts Account			1,200
	To Interest on Loan Account			2,200
	To Wages (Unproductive) Account			1,400
	To Export duty Account			2,300
	To Advertisement Account			4,100
	To Travelling expenses Account			2,500
	(Being the transfer of nominal accounts showing debit balances to the Profit & Loss A/c)			
	Commission Received Account Dr.		840	
	Discount Received Account Dr.		600	
	Miscellaneous Receipts Account Dr.		500	

	To Profit & Loss Account (Being the transfer of nominal accounts showing credit balances to the Profit & Loss A/c)			1,940
	Profit and Loss Account Dr. To Capital Account (Being the transfer of net profits to the Capital account)		2,51,660	2,51,660

In the books of Mr. K. Baruah

Profit and Loss Account

For the year ending on 31st March, 2017

Dr. Cr.

Particulars	**Amount** (Rs.)	**Particulars**	**Amount** (Rs.)
To Trade expenses	2,000	By Trading Account	3,12,000
To Carriage on sales	10,000	(Gross Profit transferred)	
To Office Salaries	15,800	By commission received	840
To Postage & telegram	720	By Discount	600
To Office Rent	7,500	By Miscellaneous	500
To legal charges	400	Receipts	
To Audit Fee	1,600		
To Donation	1,100		
To Sundry expenses	5,320		
To Selling expenses	3,000		
To Discount allowed	780		
To Lighting	1,200		
To Bad Debts	2,200		
To interest on Loan	1,400		
To Wages (Unproductive)	2,300		
To Export duty	4,100		
To Advertisement	2,500		
To Travelling expenses	2,51,660		
To Capital Account			
(Net Profit transferred)	3,13,940		3,13,940

7.6 BALANCE SHEET

7.6.1 Meaning of Balance Sheet

At the end of the accounting year, a trader naturally desires to know two things viz.

(a) The results of his trading operation for the period and;

(b) His true financial position at the end of the period.

In order to ascertain the financial results, he prepares Trading and Profit and Loss Account. The Trading Account shows gross profit while the Profit and Loss Account shows the net profit. After ascertaining net profit, the businessman desires to know his financial position and the correctness of his net profit disclosed by the Profit and Loss Account. As assets and liabilities continuously change during the operation of the business, he is also interested in knowing the composition of various assets and liabilities and the amount of capital standing at the end of the period. In order to obtain this information at the end of a trading period, a businessman sets out various assets and liabilities as on that date in the form of a statement which is known as Balance Sheet.

Definition of Balance Sheet:

According to CARTER 'A Balance Sheet is a statement drawn up at the end of each trading or financial period, setting forth the various assets and liabilities of the concern as at this date.

However, it is also described as a classified summary of debit and credit balances existing in the ledger after the Profit and Loss Account has been constructed. This is a better definition because it often contains items which are not either assets or liabilities. It is prepared with a view to measure the exact financial position on a certain fixed date. So it is also called a 'Position Statement'.

7.6.2 Steps for Preparation of Balance Sheet

Following steps should be followed for preparation of a balance sheet:

(i) All accounts of Assets (i.e. the accounts remaining in the trial balance after the preparation of Trading and Profit and Loss Account) appearing on the debit side of the trial balance will be shown on the 'Assets side of the balance sheet' i.e. the right hand side of the balance sheet, except drawings account which will be shown on the liabilities side as a deduction from Capital account.

(ii) All the accounts of Liabilities (i.e. the accounts remaining in the trial balance after the preparation of Trading and Profit and Loss Account) appearing on the credit side of the trial balance will be shown on the 'Liabilities side of the balance sheet' i.e. the left hand side of the balance sheet.

(iii) Net Profit/ Net Loss as shown by the Profit and Loss Account will be added / deducted from capital on the liabilities side of the balance sheet.

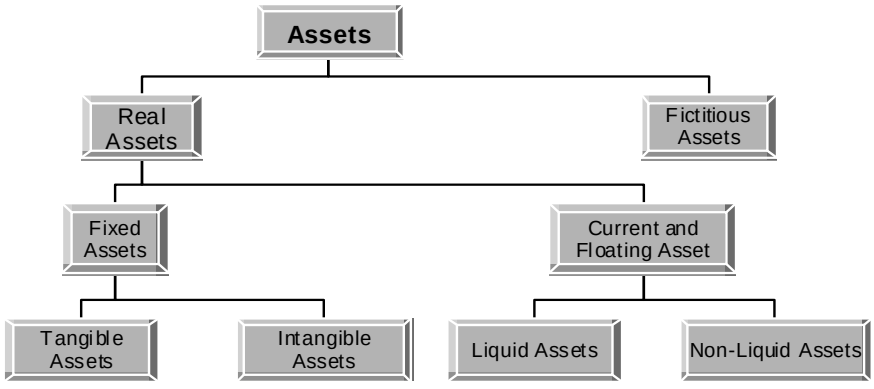
(iv) Drawings account which appears on the debit side of the trial balance will be shown on the liabilities side as a deduction from Capital account.

(v) The assets and liabilities should be shown under proper groups.

(vi) The assets and liabilities should be shown in certain order.

7.6.3 Classification of Assets

Assets may be classified as follows:



Assets: Kohler defines asset as "any cost benefiting a future period". Thus anything which gives a benefit in future may be termed as an asset. Assets, therefore, are various properties or possessions under the ownership of a concern, with the help of which the activities of the concern are carried on, e.g. land, buildings, plant and machinery, furniture, cash, etc. All assets are shown on the Assets Side of the Balance Sheet.

Real Assets: Real assets are those assets which have some market value. They include assets of permanent as well as of floating nature. Examples are – buildings, plant, stock, cash, etc.

Fixed Assets: "Fixed Assets are those assets of a business which are of a permanent nature and are held for the purpose of earning revenue and not with a view to resale". W. Pickles. Examples are – buildings, plant, machinery, furniture, etc. They depreciate- due to wear and tear.

Tangible Fixed Assets: The fixed assets which have physical existence and which can be seen and touched are known as Tangible Fixed Assets viz. – buildings, land, furniture, etc.

Intangible Fixed Assets: The fixed assets which have no physical existence and which cannot be seen and touched are known as Intangible Fixed Assets viz. – goodwill, patent right, trade marks etc. However, they are not fictitious assets as they are represented by value.

Wasting assets: Wasting assets are those fixed assets whose value gradually reduces on account of use and finally exhausts completely viz. – mines, forest, leasehold properly etc.

Fictitious Assets: Fictitious assets are merely some debit balances not written-off. They are items of expenditure or losses of an unusual character and are not recoupable. They are not represented by any tangible possession or property and hence they have no market value. Examples are – removal of (Business from one place to other) expenses, preliminary expenses, loss or issue of shares and debentures, etc. Fictitious are also called Paper Assets or Nominal

Assets.

Current Assets: They are those assets which are made or acquired and merely held for a short period of time with a view to reselling them at a profit in the ordinary course of business such as stock. They also include such other assets as are constantly circulating and arise out of the business dealings. They are temporarily held for subsequent conversion into money. As for example, debtors, bill, cash at bank etc.

Contingent Assets: Contingent Assets are such assets which are not at present under the possession of the business but which may or may not be acquired on the happening of a certain event on future. Examples are, claim against damage suit under a contract. They are not recorded in the books of accounts but are shown in the Balance Sheet, on the Assets side as notes in the inner column.

Investments: Investments may be short-term investment or long-term investments. When the investments are made for a short period representing temporary surplus of funds, they are treated as current assets as they will be soon converted into cash but investment of long term period which are held for a definite purpose or which represent permanently unutilized funds are called fixed assets.

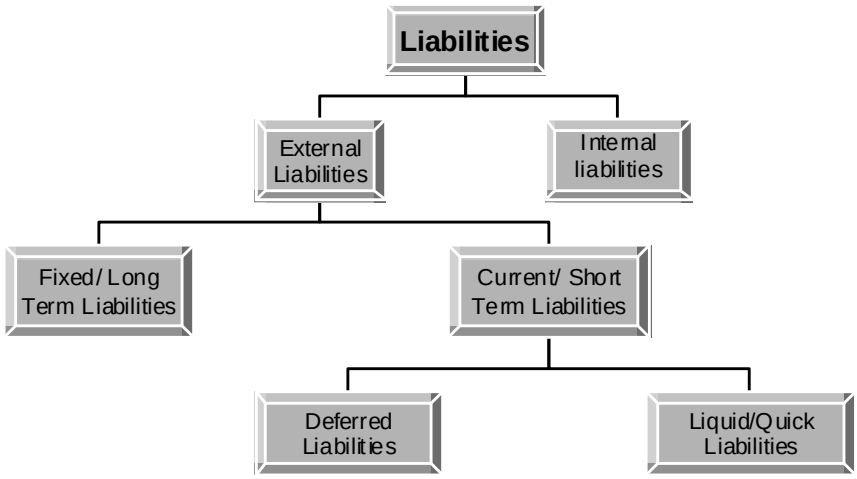
Sundry Debtors and Creditors: Sundry debtors and creditors indicates the total of balances of debtors and creditors at the end of the year. They do not represent any particular ledger account. At the end of each financial period, all the outstanding balances of the debtors and creditors are taken out from the Ledger and two separate lists are prepared with those balances. The total of the list of balances of customers' accounts is called Sundry Debtors; while the total of the list of balances of creditors is called Sundry Creditors.

7.6.4 Classification of Liabilities

The term liability denotes claims against the assets of the business by the outsiders and the proprietor. According to the American Accounting Association, Liabilities are "claims of Creditors

against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilization of corporate resources". All liabilities are shown in the liabilities side or left hand side of the Balance Sheet.

Classification of Liabilities



1. **Internal Liabilities:** Internal Liabilities denote proprietor's equity, which consists of capital, reserve and net profit. In case of a net loss, it is deducted from capital.
2. **External Liabilities:** External liabilities are the claims of outsiders against the assets of the business. They are loans taken, creditors, bills payable, bank overdraft, etc. External liabilities are classified into long-term liabilities and short-term liabilities.
   a. **Long-Term Liabilities or Fixed Liabilities:** Long term liabilities are repayable after a long period of time and not repayable in one year. They do not require current assets for repayment Viz. Loan on mortgage, debentures, long term loan from banks or other financial institutions.
   b. **Current Liabilities:** Current liabilities are those liabilities which are usually payable within a year. Generally they are paid out of current assets or by creation of current liabilities. The following are the current liabilities in a business.

(i) Accounts payable or bills payable and trade creditors,

(ii) Liabilities for outstanding expenses,

(iii) Bank overdraft,

i) **Deferred Liabilities:** Deferred liabilities are those liabilities which are repayable in course of less than one year but more than one month.

ii) **Liquid or Quick Liabilities:** Debts which are repayable in course of a month are called liquid or quick liabilities viz. outstanding expenses like salaries, rent, etc.

iii) **Contingent Liabilities:** Contingent liabilities are those liabilities which are at present not liabilities but which may or may not arise in future on the happening of a certain event viz. liability on bills discounted, liability under a damage suit, etc.

7.6.5 Items appearing in the Balance Sheet

Capital: It is shown in the Balance Sheet on the liabilities side as the excess of assets over liabilities. It denotes a debt of the business to the proprietor.

Reserve: It is a portion of profit, not yet paid to the proprietor. It is kept aside to strengthen the financial position of the business and is shown on the Liabilities Side of the Balance Sheet.

Loan: If money is borrowed by the business from somebody for the purpose of the business, it is credited to Loan Account. It is a liability of the business and is shown on the liabilities side of the Balance Sheet. If any interest on loan is outstanding, such outstanding interest is also shown in the liabilities side of the Balance Sheet as a separate item named 'Outstanding Interest'.

Conversely, if any loan is granted to any person by the business, 'Loan Account' is debited as an asset. It is to be shown on the assets side of the Balance Sheet. Any interest accrued but not received is also shown on the assets side as a separate item named

'Accrued Interest'.

Bank Overdraft: When the business withdraws money from the bank in excess of its deposits with or without a previous arrangement with that bank, the excess amount so withdrawn is known as 'Bank Overdraft'.

Bills Payable: It denotes the amount of bills issued to creditors but not yet due for payment. It is a liability of the business and will be shown on the liabilities side of the Balance Sheet.

Liabilities for Outstanding Expenses: It signifies the liability of the business for expenses incurred during this year and will be shown on the 'Liabilities Side' of the Balance Sheet.

Investments: When the business has excess money compared to the needs of the business, it invests such fund outside the business in shares, debentures and government bonds. These are 'grouped under the heading' Investments. They are assets and will be shown in the Balance Sheet on the 'Assets Side' as a separate item named as 'Accrued Income from Investment'.

Bill Receivable: It is the total of the bills received from debtors but not yet due for payment. It is an asset and will be shown on the assets side of the Balance Sheet.

Working Capital: It denotes the excess of current assets over current liabilities. Current assets consist of stock debtors, bills receivable, short term investments, cash at bank, cash in hand and prepaid expenses, while current liabilities consist of creditors, bills payable, bank overdraft and liabilities for outstanding expenses. It is that part of the Capital, which is left after the purchase of, fixed assets and any long term investment.

Prepaid Expenses: It denotes payment for services not yet received. So it is an asset and will be shown on the 'assets side' of the Balance Sheet.

Valuation of Assets:

i) **Fixed Assets :** Fixed assets are used in the business for the purpose of earning revenue. So they must be valued on the basis of their usefulness to the business which is a going concern. Market value or replacement value need not be considered while valuing fixed assets.

ii) **Current or Floating Assets:** Current Assets or Floating Assets are held for the purpose of conversion into cash within a short period. So they are to be valued at the figures at which they are likely to be realized in near future.

In short, fixed assets mush be valued at cost less depreciation while current assets must be valued a cost price or not realizable market price whichever is lower except book debt which should be valued always at realizable value.

7.6.6 Format of Balance Sheet

Forms of Balance Sheet (Under Permanency Order)

Balance sheet of Mr. X as on …….. 20 …….

Liabilities	**Rs.**	**Assets**	**Rs.**
Proprietors' Equity :		**Fixed Assets :**	
Capital		Goodwill	
Reserve/ Reserve Fund		Freehold Land and Building	
Long term Liabilities :		Leasehold Land & Building	
Long term Loans		Buildings	
Current liabilities:		Plant and machinery	
Short term Loans		Furniture and Fittings	
Income Received in Advance		Loose Tools	
Outstanding Expenses		Vehicles	
Sundry Creditors		Patents and patterns	
Bills Payable		Trade Marks	
Bank Overdraft		**Long Term Loans & Advances Current Asset :**	
		Closing Stocks :	

		Raw Materials	
		Work-in-Progress	
		Finished goods	
		Stationery (Stock)	
		Goods on Consignment	
		Prepaid Expenses	
		Accrued Incomes	
		Sundry Debtors	
		Bills Receivable	
		Investment (Short-Terms)	
		Cash at Bank	
		Cash in hand	



Exercise: 7.6

From the following information draft a Balance Sheet of M/s Goswami Traders as on 31st December 20…..

Trial Balance as on 31st December, 20…

	Rs.		Rs.
Land and Buildings	40,000	Bills Payable	15,350
Investments	15,000	Loan from Bank	10,000
Good will	20,000	Loan on Mortgage	20,000
Sundry Debtors	22,750	Sundry Creditors	25,500
Prepaid Expenses	1,000	Outstanding expenses	1,500
Cash in Hand	1,400	Reserve Fund	10,000
Cash at Bank	10,700	Capital	1,05,000
Drawings	9,000	Net Profit	47,000
Bills Receivable	6,500		
Plant and Machinery	20,000		
Closing Stock	50,000		
Furniture	18,000		
Freehold Landx	20,000		
	2,34,350		2,34,350

Solution: Ref. Under Liquidity Order:

as on the 31st December. 20…..

Balance Sheet of M/s Goswami Traders

Liabilities		Rs.	Assets	Rs.
Current Liabilities :			**Current Assets :**	
Bills Payable		15,350	Cash in hand	1,400
Sundry Creditors		25,500	Cash at Bank	10,700
Outstanding expenses		1,500	Investment	15,000
Long term liabilities :			Bills Receivable	6,500
Loan from Bank		10,000	Sundry Debtors	22,750
Loan on Mortgage		20,000	Prepaid Expenses	1,000
Capital and Reserve :			Closing Stock	50,000
Reserve Fund		10,000	**Fixed Assets :**	
Capital on 1,1.20…	1,05,000		Furniture	18,000
Add. Net Profit	47,000			
	1,52,000		Plant and Machinery	20,000
Less Drawings	9,000	1,43,000	Land and Buildings	40,000
			Freehold Land	20,000
			Goodwill	20,000
		2,25,350		2,25,350



CHECK YOUR PROGRESS

Q 4. State True or False:

a) Capital is shown in the Balance Sheet on t h e liabilities side as the excess of assets over liabilities. True/False

b) Balance sheet is an account. True/False

c) Bill Receivable is the total of the bills received from debtors but not yet due for payment. True/False

d) Provisions are made to meet a known liability. True/false

Q 5: Write some examples of Provisions

.....



7.7 LET US SUM UP

- Final accounts are prepared after the preparation of trial balance.
- For most businesses, the final accounts, which are produced at the end of each financial year, comprise:
  - Trading account
  - Profit and loss account
  - Balance sheet
- Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods.
- The Profit & Loss Account (P&L) is a report of the company's profit on the sale of their goods or the provision of their service over a trading period, normally one year.
- A balance sheet is a statement of the total assets and liabilities of an organization at a particular date - usually the last date of an accounting period.
- In order to measure the result of the business operations with reasonable accuracy, it is required to match revenues of an accounting period with cost in earning the same revenue. If the revenue does not match with cost, the same is accounted for by passing adjusting entries.



7.8 FURTHER READING

1. Ashis Bhattacharya (2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari (2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*",Capital Publishing Company, Guwahati

4. R. L. Gupta and M. Radhaswamy (2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.
5. Jain & Narang (2006),"*Accounting Theory and Management Accounting*",Kalayani Publishers.

7.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Trail Balance b) Two c) Direct

Ans to Q No 2: a) False b) False c) False d) True

Ans to Q No 3: The stock of goods which remained unsold at the end of the last year is termed as the opening stock of the current year.

Ans to Q No 4: a) True b) False c) True d) True

Ans to Q No 5: Examples of provisions:

a) Provision for Income Tax;
b) Provision of Sales Tax;
c) Provision for liability for disputed claim.
d) Provision for depreciation;
e) Provision for Repairs and Renewals;
f) Provision for doubtful debts;
g) Provision for discount on debtors;



7.10 MODEL QUESTIONS

Q 1: What do you mean by final Account? Explain.

Q 2: Write a note on trading account and also write the items that are shown in the debit side of the trading account. Explain and illustrate with a specimen form of trading account.

Q 3: Explain Profit and loss account with a specimen form.

Q 4: How Profit and loss account is balanced.

Q 5: Distinguish between Trading Account and Profit and loss account.

Q 6: Explain how to prepare a Profit and loss account.

Q 7: What do you mean by Balance Sheet .Explain the steps for preparing Balance Sheet?

Q 8: What the different types of Assets. Explain and classify them.

Q 9: Write Short notes on the following:

a) Gross Profit

b) Opening Stock

c) Provisions and Reserves

d) Provisions for bad and doubtful debts

e) Bills payable and Bills receivable

f) Prepaid Expenses

Q 10: From the following Trial Balance of M/s Ram and Sons; prepared a Trading and Profit and Loss Account for the year ended 31st December….20… and a Balance Sheet as on that date.

Trail Balance of M/s ram and Sons

Particulars	**Dr.Rs.**	**Cr.Rs.**	**Particulars**	**Dr.Rs.**	**Cr.Rs.**
Purchases	21,750		Traveling Expense	400	
Discount Allowed	1,300		Commission	425	
Wages	6,975		Carnage Inward	275	
Salaries	2,000		Trade Expenses	705	
Sales		35,000	Interest	100	
Outstanding Trade		475	Insurance	150	
expenses			Furniture	200	
Buildings	5,000		Capital		13,000
Debtors	4,250		Cash	7,045	
Creditors		2,100			
	50,575	50,575		50,575	50,575

Adjustments:

(a) Stock on 31st December Rs.6, 000

(b) Wages Outstanding Rs.500

(c) Salaries Outstanding Rs.425

(d) Prepaid Insurance Rs.50

11. From the following information of Kalita Printers prepare a Trading Account for the year ended 31st March, 2017.

	Rs.
Fuel	100
Purchases (Adjusted)	9,800
Sales	15,000
Trade Expenses	500
Postage and Telegrams	100
Commission (received)	300
Discount (allowed)	200
Rent paid	1,500
Returns Inward	200
Carriage Outwards	300
General Expenses	300
Closing Stock	8,000

12. From the following information of M/s. Baruah Enterprise prepare a trading Account for the year ended 31st March, 2017

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Opening Inventory	5,000	Salaries to Clerk	500
Purchases less returns	8,000	Wages of Office	
Sales less returns	10,000	and Shop Assistant	2,000
Wages	2,000	Rent of Office and Shop	100
Freight on Purchases	800	Sundry Expenses	3,000
Marine insurance		Motive Power	50
on purchases	100	Office lighting and heating	50
Duty on goods imported	300	Carriage inward	100
Closing Inventory	4,000		

13. From the following information of Bulbul Enterprises prepare a Profit & Loss Account for the year ended 31st December, 2016.

Particulars	Rs.	Particulars	Rs.
Gross Profit	21,000	Capital	18,000
Salaries	4,000	Discount received	100
Rent and taxes	500	Repairs	150
Trade expenses	100	Interest paid	50
Discount (Dr.)	200	Bank charges	20
Selling commission paid	2,120	Reserve	4,000
Rebate	100	Bad debts	150
Contingencies	50	Commission (Cr.)	210
Conveyance	200	Machinery	3,500
Petty Cash in hand	80	Sundry receipts	10
Bad debt recovered	120	Goodwill	8,000

*** ***** ***

UNIT 8: MANAGEMENT ACCOUNTING

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning of Management Accounting

8.4 The Role of Management Accounting

8.5 Management Accounting Framework

8.6 Functions of Management Accounting

8.7 Tools of Management Accounting

8.8 The Balanced Scorecard

8.9 Merits and Demerits of Management Accounting

8.10 Distinctions between Management Accounting and Financial Accounting

8.11. Cost Management System

8.12. Let Us Sum Up

8.13. Further Reading

8.14. Answer To Check Your Progress

8.15. Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the basic concept of management accounting
- discuss the role and function of management accounting
- describe the tools of management accounting
- explain the basic concepts of The Balanced Scorecard, Cost Management System and Value Added Concept
- outline the difference between Management Accounting and Financial Accounting

8.2 INTRODUCTION

In the first block of the course 'Accounting for Managers' we had discussed the various concepts under financial accounting. In this unit, we

will discuss the concepts related to management accounting. Management accounting has been defined in different ways by a variety of management experts and institutes worldwide. In this unit you will be able to understand the role and functions of Management accounting, Cost Management System, Value Added Concept, Merits and Demerits of Management Accounting and the distinction between Management Accounting and Financial Accounting

8.3 MEANING OF MANAGEMENT ACCOUNTING

Let us try to understand the basic concept of management accounting by some definition given by some important pioneering institutes and experts. A team of British Industrial Accountants and Managers defined Management Accounting:-

"Is the presentation of accounting information in such a way as to assist the management in creation of policy and the day to day operation of an undertaking"

A management expert, Robert N. Antony defined Management Accounting as:-

"Any form of accounting, which enables a business to be conducted more efficiently can be regarded as Management Accounting."

On the other hand, the Institute of Chartered Accountants of England and Wales defined Management Accounting as:-

"Application of professional knowledge and skill in the preparation of accounting information in such a way as to assist management in the formation of policies and in the planning and control of the operations of the undertakings".

Again, the Institute of Cost and Management Accountants, London defined "Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives in the making of rational decisions with a view towards these objectives."

The American Accounting Association defined it in a different way as:-

"Management accounting is concerned with accounting information which is useful to management."

Thus we understand from the above definitions that management accounting deals with accounting information, internal reporting and efficiency of the management. It is also concerned with the furnishing of relevant data to management for planning, organising, and controlling which will ultimately help in better decision making. The main objective of management accounting is to use the accounting information for higher efficiency and productivity of the management.

From the above definitions it can be concluded that management accounting provides a system of generating information from all source including cost and financial accounting system for the use by management in formulating policies and strategies , setting of standards, plans, budget or targets and reporting deviations by comparing the planned and actual performance for corrective action so that available resources of the organisation needs of the management for effective planning, decision making and control. To perform these functions efficiently, it uses:

i. Data from different sources like costing, accounting , socio-economic
ii. Various planning and decision making techniques like marginal costing, cost volume profit analysis, break even analysis.etc.
iii. Various control and evaluation techniques like standard costing, budgetary control, statistical control methods, ratio analysis..etc
iv. Internal auditing and management reporting

8.4 THE ROLE OF MANAGEMENT ACCOUNTING

The present business and economic world is well integrated with the world economy and is largely influenced by globalisation. It is dynamic in nature and full of uncertainty. Within this uncertainty, it is the manager who needs to take the right decision based on the available micro and macro information. Management accounting basically deals with all the micro

information that is related to the particular business organisation. Within this unpredictable business world, decision making is ever more challenging and complex which require right information at the right time. Management accounting helps the management of a business organisation by providing all sorts of information that are useful and valuable for the growth and sustainability of the organisation.

The role role of the management accounting is to serve the management by preparing different reports which help management to take a number of decisions for different level of management.

Besides the above discussion, management accounting has a big role to assist the management in performance of its functions such as planning, coordinating, communication, control, decision making, financial analysis and interpretation effectively and efficiently.

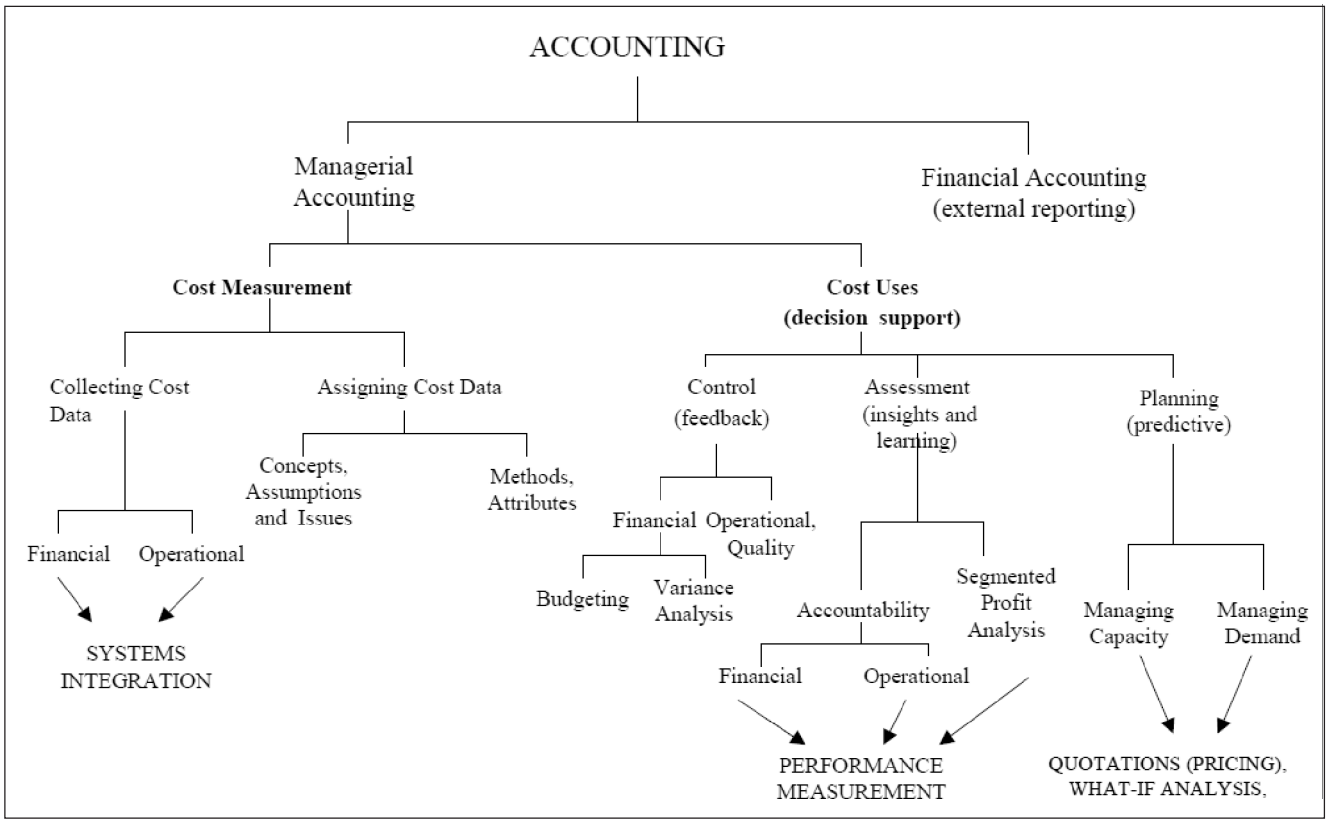
The following are some of the role and objectives of management accounting:

1. **To help management in effective planning and decision making:** management accounting helps in formulation of short and long term plans for the future activities of the business undertaking.
2. **To help management in effective coordination of various functions:** Management accounting helps in achieving effective coordination among the various functional activities like marketing, production, material , budgeting and etc.
3. **To help increasing profitability:** management accounting helps in deciding optimum product-mix and most profitable operations among the different alternatives and discontinuance of loss making operations leading to the maximum profitability of the organisation
4. **Helps in cost reduction:** management accounting helps in reducing and control cost by eliminating wastages, inefficiencies in operating activities.
5. **Evaluation of performance:** by the means of plans, standards, norms or budget management accounting helps in evaluating the performance of various divisions, departments, product line etc.

8.5 MANAGEMENT ACCOUNTING FRAMEWORK

An effective management accounting framework becomes a significant business tool to support economic, social, and environmental aspects of decision-making. This framework assists companies in providing disclosure of performance, while adding value to an organization and ensuring its sustainability. In business, management accounting framework basically deals with data formats, data identification, data accumulation etc. Data accumulation is conducted through financial accounting and cost accounting. Data accumulation is also done from the different levels of the organisational staffs and management which consists of quantitative as well as qualitative in nature. Moreover, data accumulation is also done from external sources. Accumulated data or information is again reclassified as per the requirement of the management personnel to take effective decision.

Fig: 8.1 Management Accounting Framework



CHECK YOUR PROGRESS

Q1: What is "Management Accounting"?

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Q2: Write the role of Management Accounting.

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8.6 FUNCTIONS OF MANAGEMENT ACCOUNTING

Management accounting may also be referred to as management oriented accounting. The main objective of management accounting is to assist management by providing relevant information for taking appropriate decisions and discharge their responsibilities effectively. In order to fulfil this objective, management needs to perform some important functions which may be discussed as follows:-

1. **Provides Crucial Information:** For many instances, the management cannot take a rational decision based on the quantitative data available from the financial accounts, cost accounts or other statement of accounts. All most all the information available from these accounts is quantitative in nature and many times these types of data is not sufficient for the management to take a proper decision. Management accounting provides important relevant quantitative as well as qualitative business information by preparing a suitable form and collect it from the various internal authorities and members of the organisations.
2. **Assists in Planning:** Information provided by the management accountants help the management in organisational planning and forecasting. The management need to prepare both short-term as well as long-term planning. Information provided by the management accountants' help the overall management in preparing short-term as

well as long-term planning. Some of the management accounting techniques used are Budgeting, Standard and Marginal Costing etc.

3. **Facilitates Coordination of Various Activities:** Management accounting acts like a facilitator which brings a proper coordination amongst various related business activities like marketing, finance, operation, systems, logistics, purchases etc. by proving required financial reports.
4. **Brings Control:** Management accounting helps management for achieving greater control over organisational resources by applying various management accounting techniques like internal audit, budgetary control, financial ratios, responsibility accounting, profit centres, cost centres, revenue centres etc.
5. **Provides Qualitative Information:** Besides various quantitative information, management accounting also provides vital qualitative information which helps management to take better decision making. Some of qualitative information are – customer sentiments, employee motivations, legal judgements, quality of the goods and services etc.

8.7 TOOLS OF MANAGEMENT ACCOUNTING

There are many techniques that are considered as a tool of management accounting some of which are briefly mentioned below:-

1. **Net Profit Margin:** If we deduct all the expenses from the overall revenue of an organisation during a particular financial period, we get the net profit margin. Thus we can say that it is the percentage of revenue left after deducting all expenses from the sales figure.
2. **SWOT Analysis:** SWOT analysis helps an organisation to identify its organisational Strength and Weakness. It also find out the opportunities available for the business by scanning the business, social, political, legal and economic environment as well as the threats the business may face in future.
3. **Budgeting:** Budgeting is a process which tries to balance future income and expenditure. In other words, a budget is a statement of estimated income and expenditure that may occur in future. Budgeting ensures

that weather money is available to undertake different activities that you want to perform or is required to be performed.

4. **Marginal Costing:** Marginal cost represents the cost of producing one more additional unit of production. In other words, it is the incremental cost of producing the next unit. In business, important decision are taken based on this concept of marginal costing.
5. **Cost Volume Profit Analysis:** Cost Volume Profit analysis is also known as CVP analysis and helps to determine the break-even level of an organisation which is useful for the short-term decision making of the business. CVP analysis basically tries to find out the changes in cost and volume of a business organisation affects its profitability or income level.
6. **Variance Analysis:** Variance analysis is a budgetary control technique which tries to find out the deviations between the budgeted expenditure amount and actual expenditure amount. Higher the amount of this deviation, higher is the variance which the organisation needs control.
7. **Financial Statement Analysis**: Profit and Loss account and Balance Sheet are important financial statements. These statements are analysed for different period. This type of analysis helps the management to know the rate of growth of business concern. This analysis is done through comparative financial statements, common size statements and ratio analysis.
8. **Cost Accounting**: Cost accounting presents cost data in product wise, process wise, department wise, branch wise and the like. These cost data are compared with predetermined one. This comparison of two costs enables the management to decide the reasons responsible for the difference between these costs.
9. **Fund Flow Analysis**: This analysis find out the movement of fund from one period to another. Moreover, this analysis is very useful to know whether the fund is properly used or not in a year when compared to the previous year. The working capital changes and funds from operation are also find out through this analysis.

10. **Cash Flow Analysis**: The movement of cash from one period to another can be find out through this analysis. Besides, the reasons for cash balance and changes between two periods are also find out. It studies the cash from operation and the movement of cash in a period.
11. **Standard Costing**: Standard costing is predetermined cost. It provides a yard stick for measuring actual performance. It is used to find the reasons for the deviations if any
12. **Budgetary Control**: Under Budgetary control techniques, future financial needs are estimated and arranged according to an orderly basis. It is used to control the financial performances of business concern. Business operations are directed in a desired direction.
13. **Ratio Analysis**: It is used to management in the discharge of its basic functions of forecasting, planning, coordination, communication and control. It paves the way for effective control of business operations by undertaking an appraisal of both the physical and monetary targets.

8.8 THE BALANCED SCORECARD

David Norton and Robert S Kaplan introduced the concept of Balanced Scorecard in a 1992 Harvard Business Review article. The main objective of developing the balanced scorecard was to measure the performance of an organisation relating financial measures and key non-financial measures with respect to the customers or clients, internal processes, and organisational learning and growth needs. In other words, the balanced scorecard provides a systematic approach to measure the organisational performance considering financial, customers, internal processes, learning and growth in a summarised 'scorecard'. This scorecard is called Balanced Scorecard and is used to monitor the overall organisational performance. Then the Balanced Scorecard tries to find out important links amongst organisational financial, customers, internal processes, learning and growth. After proper identification and establishment of the relationships, Balanced Scorecard helps to translate strategic vision into specific plan of actions which will help the organisation to achieve its goal. The Balanced Scorecard approach basically helps an organisation in

executing strategic initiatives and provides a guiding force for the achievement of strategic objectives. The approach of Balanced Scorecard is flexible in nature because of which it is widely practiced worldwide. Let us now look at the Balanced Scorecard as developed by Robert S Kaplan and David P Norton which is given below:-

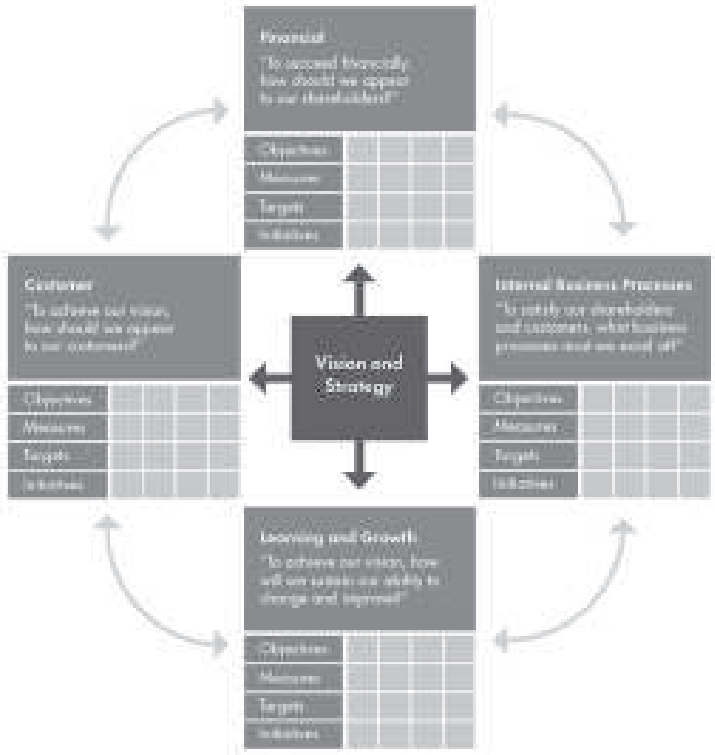
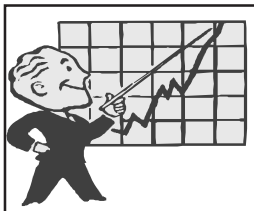


Figure 8.2: Adapted from Robert S Kaplan and David P Norton, *Using the Balanced Scorecard as a strategic management system*, Harvard Business Review (January-February 1996)



CHECK YOUR PROGRESS

Q3: What is the objective of conducting Cost Volume Profit analysis?

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Q4: Distinguish between budgeting and marginal costing.

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8.9 MERITS AND DEMERITS OF MANAGEMENT ACCOUNTING

Merits of Management Accounting

The merits of management accounting may be briefly discussed as below:-

(a) Management accounting helps to perform each of the five managerial functions viz., planning, organising staffing, leading and controlling more effectively and profitably by providing crucial information to the different levels of management as required.

(b) In order to provide crucial information to management, management accounting prepares suitable formats for collecting relevant information from different levels of staff and management. This function of management accounting is beyond the scope of financial accounting as well as cost accounting. Thus we see that management accounting renders a valuable service for the smooth and efficient performance of management functions.

(c) Management accounting basically helps in decision-making process of the business. For example, if a Board of Management finds specific problem and interested to know the possible alternative solutions to the problem, then management accounting helps to identify the alternative solutions to the problem.

(d) Management accounting not only helps management to identify the possible alternative solutions but also conducts the cost benefit analysis of each of the possible alternative solutions of the problem. After finding the cost benefit analysis, management accounting helps management to arrange the alternative solutions in descending order on the basis of net benefits. This really helps management to take the right decision in a scientific manner and finally assist management to take a rational decision under various problematic situations.

(e) Management accounting helps the management team in the organisation exclusively as the report of the management accounting is circulated only among the managerial personnel.

Demerits of Management Accounting

Management accounting is a relatively new branch of accounting and it is in the development stage. As we have discussed above that management accounting is very useful and exclusively helps management in taking right decision but it suffers from the following demerits:-

(a) *Complex Procedure:* As there is no specific structure of conducting management accounting like financial accounting and cost accounting where the activities are well structured and outcomes are also well defined. For example, the outcomes of financial accounting are Trial Balance, Trading Account, Cash Account, Profit and Loss Statement, Balance Sheet, Fund Flow Statement, Cash Flow Statement. The outcomes of cost accounting are Cost Sheet etc. But in case of management accounting there are no such specific outcomes so there is no well-defined procedure which makes the performance of the task of management accounting very complex.

(b) *Lack of Objectivity*: The report of management accounting comprises mostly the opinions and feedbacks which are subjective in nature. Some information may suffer from personal bias and the interpretation of the information supplied to management accounting may be biased.

(c) *Regressive in Nature*: Management accounting basically relies on the historical information of the organisation. But the interpretation of this information is used for taking future decisions. For some events or usual circumstances this may fetch useful result but for some other situations the interpretation of the historical information may not work.

(d) *Costly Exercise*: Installation of management accounting system in an organisation requires huge investment in Human Resource and Information Technology. The organisation would require good number of management personnel to conduct this exercise and lose lots of time of their management executives. Moreover, there is a huge cost of installation of management information system which needs to be installed connecting all the management functions.

8.10 DISTINCTIONS BETWEEN MANAGEMENT ACCOUNTING AND FINANCIAL ACCOUNTING

Management accounting is different from financial accounting in the following ways:-

(a) Financial accounting records past transactions which have already taken place whereas management accounting is futuristic in nature and is concerned about what is going to happen.

(b) Financial accounting prepares all its reports for the usage of external parties whereas the management accounting report is prepared only for the internal managerial personnel.

(c) Financial accounting reports must be completed at the end of the accounting period usually once in a year whereas management accounting reports are very frequently prepared depending upon the requirement of the management which may be hourly, daily, weekly, fortnightly, monthly, quarterly, half-yearly, annually or for a specific period of time.

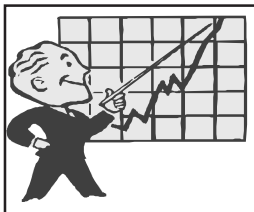
(d) Financial accounting reports are prepared based on Double Entry System where as for preparing management accounting report Double Entry System is not followed.

(e) Financial accounting reports are prepared as specified by the Provisions of Companies Act, 1956 whereas there is no specific guidelines for the preparation of management accounting reports which are basically prepared based on the requirements of the management.

(f) Financial accounting reports comprise of Trial Balance, Trading Account, Cash Account, Profit and Loss Statement, Balance Sheet, Fund Flow Statement, Cash Flow Statement etc. as per the Provisions of Companies Act 1956 whereas for preparing management accounting reports no such rigidity is found.

(g) Financial accounting reports are mandatory and statutory requirement of the business under the provisions of Companies Act 1956, [section 210(1), 216, 217(1), 209(1)] whereas management accounting reports are not mandatory.

(h) Generally Accepted Accounting Principles (GAAPs) and practices controls financial accounting reports which needs to follow Double Entry Principle whereas GAAPs do not govern the management accounting reports.



CHECK YOUR PROGRESS

Q5: What is the objective of a cost management system?

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Q6: What are the benefits of Management Accounting?

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8.11 COST MANAGEMENT SYSTEM

A cost management system refers to a set of systematic procedures established for the purpose of planning and controlling an organization's cost-generating activities in order to serve short term objectives and long term strategies. The two most important problem of any business organisation is to attain profitability in the short run and to maintain its competitive position in market in the long run. An efficient cost management system provides input for the management accounting which ultimately assists the management personnel to overcome the two above mentioned problems. An effective cost management system not only provides information for all the functional areas but also it helps the organisation to improve quality, content, relevance, and timing of cost information that managers use for short-term and long-term decision making. The goals of a cost management system would be:-

(a) develop reasonably accurate product costs, especially through the use of cost drivers (activities that have direct cause-and-effect relationships with costs);

(b) assess product/service life-cycle performance;

(c) improve understanding of processes and activities;

(d) control costs;

(e) measure performance; and

(f) allow the pursuit of organizational strategies.

Cost management is employed by many businesses as an integral part of business management. Cost management is also considered a form of management accounting that helps to identify future expenditures in a business to reduce budget overages.

When cost management is applied to a specific project, the expected costs in the business are analyzed in the beginning phase of the planning period. The project manager then approves the predicted expenses in purchasing the materials required for the project.

The costs and expenses are recorded and monitored during the project execution period to ensure that the cost is in line with the actual cost management plan. Once the project is complete, the actual costs are compared with the predicted costs, which will help in predicting future expenses.

Advantages of cost management

- It helps in controlling the project specific cost, in turn also the overall business cost.
- One can predict the future expenses and costs and accordingly work towards the expected revenues.
- Predefined costs can be maintained as records for the business.
- It helps in taking those actions that are necessary to assure that the resources and business operations aim at attaining the chalked objectives and goals.
- It helps in analysing the long term trends of the business.
- The actual cost incurred can be compared to the budgeted to see if any component of the business is spending more than expected.
- It helps in analysing the business positioning in terms of making an acquisition factoring the cost component involved.



8.12 LET US SUM UP

In this unit we have discussed the concept of management accounting.

- Management accounting basically deals with accounting information, internal reporting and efficiency of the management.
- It is concerned with the furnishing of relevant data to management for planning, organising, and controlling which will ultimately help in better decision making.
- The main objective of management accounting is to use the accounting information for higher efficiency and productivity of the management.
- The different tools of management accounting like budgeting, marginal costing etc.
- Moreover the concepts of the Balanced Scorecard, Cost Management System and Value Added Concept are also discussed.



8.13 FURTHER READING

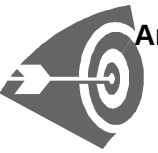
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2. Ishikawa, Kaoru (1985) *'What Is Total Quality Control? The Japanese Way*.' Englewood Cliffs, NJ: Prentice-Hall, Kaplan, R. S., D. P. Norton, 'The Balanced Scorecard - Measures that Drive Performance', Harvard Business Review, January - February 1992.
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5. Munro-Faure and L., M. Munro-Faure(1992), *'Implementing Total Quality Management*', The Free Press,.

6. Schneiderman, A. '*The first Balanced Scorecard: Analog Devices*, 1986-1988', Journal of Cost Management, September/October 2001

8.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for the achievement of reasonable economic objectives. Management accounting is concerned with accounting information which is useful to management.

Ans to Q2: The main role of the management accounting is to serve the management by preparing different reports which help management to take a number of decisions for different levels of management.



Ans to Q3: Cost Volume Profit analysis is also known as CVP analysis and helps to determine the break-even level of an organisation which is useful for the short-term decision making of the business. CVP analysis basically tries to find out the changes in cost and volume of a business organisation affects its profitability or income level.

Ans to Q4: Budgeting is a process which tries to balance future income and expenditure. In other words, a budget is a statement of estimated income and expenditure that may occur in future. On the other hand, Marginal cost represents the cost of producing one more additional unit of production. In other words, it is the incremental cost of producing the next unit. In business, important decision are taken based on this concept of marginal costing.

Ans to Q5: A cost management system refers to a set of systematic procedures established for the purpose of planning and

controlling an organization's cost-generating activities in order to serve short term objectives and long term strategies.

Ans to Q6: The benefits of management accounting may be briefly discussed as below:-

(a) Management accounting helps to perform each of the five managerial functions viz., planning, organising staffing, leading and controlling

(b) In order to provide crucial information to management, management accounting prepares suitable formats for collecting relevant information from different levels of staff and management.

(c) Management accounting helps in decision-making process of the business.

(d) Management accounting not only helps management to identify the possible alternative solutions but also conducts the cost benefit analysis of each of the possible alternative solutions of the problem.

(e) Management accounting helps the management team in the organisation exclusively as the report of the management accounting is circulated only among the managerial personnel.



8.15 MODEL QUESTIONS

(a) What are the merits and demerits of a management accounting system?

(b) Explain briefly some tools of management accounting that are usually used by the corporate world.

(c) What is Balanced Scorecard? Explain briefly the concept and its utility for business organisations.

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UNIT 9: RATIO ANALYSIS

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Ratio Analysis : Its meaning

9.4 Steps in Ratio Analysis

9.5 Classification of Ratios

- 9.5.1 Liquidity Ratios
- 9.5.2 Financial Leverage Ratios
- 9.5.3 Turnover Ratios
- 9.5.4 Profitability Ratios
- 9.5.5 Valuation Ratios

9.6 Practical Problems

9.7 Advantages of Ratio Analysis

9.8 Limitation of Ratio analysis

9.9 Let us Sum Up

9.10 Further Reading

9.11 Answer To Check Your Progress

9.12 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:-

- explain the meaning of ratio analysis and calssify the ratios
- outline the various financial ratios
- discuss the advantages and limitations of ratio analysis

9.2 INTRODUCTION

In this unit, we are going to discuss about ratio analysis, the basic objective of ratio analysis is to present to the potential user brief statements which describes the status of the company. Ratios involve establishing a financial relationship between components of financial statement. We will explain about different types of ratios in this unit.

Financial ratios over different time periods need to be calculated for comparison, because of this we require time series analysis which gives an indication of the direction of change and reflects whether the company's financial performance has improved, deteriorated or remained constant over time. After going through this unit you will be able to analyse financial conditions of different companies.

9.3 RATIO ANALYSIS: ITS MEANING

Sometimes information or figures given in the balance sheet and profit and loss account are not enough for proper interpretation regarding the financial performance of the firm. These information or figures need to be worked out to establish proper relationship between the items of balance sheet and the profit and loss account. Ratio analysis is a powerful tool of financial analysis. A ratio is defined as "the indicated quotient of two mathematical expressions" and as "the relationship between two or more things".

Ratio analysis helps to understand the performance of the business on different perspectives. Information from the financial statements is the inputs for the ratio analysis. Ratio analysis helps management to know the performance of their company on various perspectives like profitability scenario, status of financial assets and liability, business turnover performances, financial leverage positions of the company and so on. Ratio analysis also helps investors to assess the performance of their investments by calculating valuation ratios. Thus we see that ratio analysis is a vital tool to assess the overall performance of a business organisation by calculating various financial ratios taking input from financial statements.

In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm. An accounting figure conveys meaning only when it is related to some other relevant information. For example, Rs.10 crore net profit may be considered impressive but it has to be related to the investment to find whether it is good or bad performance. Ratios help to summarize large quantities of financial data and to make qualitative judgment about the firm's financial performance.

As ratio is used as a benchmark, a single ratio in itself does not indicate favourable or unfavourable condition. It needs to be compared with some standard. Standard of comparison may consist of the followings:

a. Past ratio i.e. ratios calculated from the past financial statements of the same firm.

b. Competitors' ratios i.e. ratios of some selected firms, especially the most progressive and successful competitor at the same point of time.

c. Industry ratios, i.e. ratios of the industry to which the firm belongs and

d. Projected ratios i.e. ratios developed using the projected financial statements of the same firm.

9.4 STEPS IN RATIO ANALYSIS

Ratio analysis is used to find out the financial health of a business organization. Ratio analysis establishes mathematical relationship between two variables and is expressed in the form of a mathematical equation. Financial analysts calculate different ratios to assess the overall financial performance of a company. There are basically three steps involved in order to perform ratio analyses which are briefly discussed below:-

Step 1: The first step of performing ratio analysis is to collect relevant information which is required to compute the particular financial ratios under consideration. For example, if one wants to know the liquidity position of a firm, then one has to find the current ratio. Then the first step is to identify the current asset and current liability from the balance sheet of the organization for a particular period and then collect the figures for the current asset and current liability for the required period. So, the numerator and denominator for the current ratio are ready.

Step 2: The second step is to calculate the ratio with the information collected from the financial statements for the particular firm. In other words, in this step a quantitative figure is determined based on the established relationship from the values collected from the financial statements. For example, in order to calculate the current ratio, we perform a mathematical operation by dividing current assets by current liabilities.

Step 3: The final step is all about interpretation and drawing of inferences from the computed quantitative results of the ratios found in step 2. Interpretation is basically done comparing its current year's performance with that of its previous years in order to assess its performance. Moreover, the ratio of a particular firm is also used to compare with its competitors to assess the performance of a firm. Ratio of a firm is also compared with that of the industry averages of that sector to which the firms belongs.

9.5 CLASSIFICATION OF RATIOS

There are different types of financial ratios calculated from the financial statements of business organisations. The ratios are basically classified into the following five categories:-

(i) ***Liquidity ratios***: Liquidity ratios show the short-term solvency of an organisation or its ability to meet immediate future financial obligations.

(ii) ***Financial leverage ratios***: Financial leverage ratios show the stake of the owners in the business in relation to outside borrowings or long-term solvency of a firm.

(iii) ***Turnover ratios***: Turnover ratios show efficiency of management of different types of assets acquired by the organisation. These ratios are also referred to as activity ratios.

(iv) ***Profitability ratios***: Profitability ratios are the most important financial ratios which show the current status of profitability of a firm.

(v) ***Valuation ratios***: Valuation ratios are very important from the investment point of view which measures valuation of the equity stock of a firm in the capital market.

Let us briefly discuss these ratios below –

9.5.1 Liquidity Ratios

Liquidity refers to the ability of a firm to meet its obligations in the short run, usually one year. Liquidity is essential to conduct business activity, particularly during shut down or strike or recession. If liquidity

is insufficient to cushion such losses, serious financial difficulty may arise. A company should ensure that it does not suffer from lack of liquidity at any time, and also that it does not have excess liquidity as it will affect profitability. If the company fails to meet its short term obligations due to lack of sufficient liquidity, then it will result in poor credit worthiness and loss of creditors' confidence.

Liquidity refers to the ease with an asset can be converted into cash and measures the ability of a firm to meet its obligation in the short-term, usually one year. Higher the current ratio, higher is the short-term solvency of the firm. The liquidity ratios are (a) Current ratio (b) Acid test ratio (c) Cash ratio and (d) Net Working Capital ratio.

(a) Current Ratio: The Current ratio is calculated by dividing the current assets of a firm by its current liabilities for the required period which is given below:-

$$\text{Current Ratio} = \frac{Current\ Asset}{Current\ Liability}$$

Current asset refers to cash, current investments, bank, sundry debtors, bills receivable, loans and advances, and short-term marketable securities. Inventories are not included under current assets as it cannot be converted into cash immediately at the purchase price.

Current liabilities refer all those liabilities that are due in the next one year and usually include creditors, secured and unsecured loans that are due in the next one year, bills payable, outstanding expenses, short-term advances, income tax payable, dividends payable, etc. Usually a current ratio of 2:1 is considered to be satisfactory.

(b) Acid Test Ratio : The second popular liquidity ratio is Acid Test ratio which is a stringent measure of liquidity of a firm and measured by the following formula –

$$\text{Acid Test ratio} \quad \frac{\text{Quick Asset}}{Current\ Liability}$$

Quick assets refer to the current assets which are highly liquid excluding inventories as it cannot be immediately converted into cash. Prepaid expenses are also excluded from the current assets because it cannot be converted into cash. Usually an acid-test ratio of 1:1 is considered to be satisfactory.

(c) Cash Ratio: It gives the amount of cash available in terms of liquidity. The ratio is calculated by dividing cash and marketable securities by current liabilities. This ratio measures the amount of cash and near cash items the company has in terms of its current liabilities.

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

(d) Net Working Capital Ratio: The difference between current assets and current liabilities excluding short term bank borrowing is called net working capital. Net working capital to total assets measures the company's potential reservoir of funds.

$$\text{Net Working Capital Ratio} = \frac{\text{Net Working Capital}}{\text{Total Assets}}$$

9.5.2 Financial Leverage Ratios

Financial leverage measures the use of debt finance in the capital structure of a firm. Use of debt finance refers to the use of loans from financial institutions or banks to support the capital of the business. The two types of finances available for any firm are debt finance and equity finance. Leverage ratios help management to determine the level of risk associated with the business arising from the use of debt finance in the capital structure of the firm. These are also known as debt ratios or equity ratios. The important types of leverage ratios are (a) Debt Equity Ratio and (b) Interest Coverage Ratio (c) Debt Ratio which are briefly discussed below.

(a) Debt-Equity Ratio refers to the relationship between borrower's fund and owner's capital in a business. Debt-to-Equity ratio measures the relationship between the outsider's funds (as provided

by financial institutions) and equities or shareholders' funds. Debt equity ratio is calculated as follows:-

$$\text{Debt Equity Ratio} = \frac{Total\ Debts}{Total\ Equities}$$

In the above equation, total debts refers to all short-term and long-term debts such as debentures, bonds, mortgages, bills etc. Total equity refers to the long-term funds which includes equity share capital, preference share capital, capital reserves, revenue reserves, and reserves representing accumulated profits, reserves for contingencies, sinking funds, etc. Usually, financial analysts interpret lower the debt equity ratio as the higher degree of protection enjoyed by the creditors.

(b) Interest Coverage Ratio is commonly used by the lenders to evaluate firms' debt paying capacity to the financial institutions from where loan is availed for the business. A high interest coverage ratio means that a firm can easily meet its interest burden obligations even if profit before interest and taxes decline. Again, low interest coverage ratio signals a financial embarrassment if PBIT declines. Interest coverage ratio is calculated as follows:-

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest \& } Taxes\ (PBIT)}{Interest}$$

(c) Debt Ratio: This ratio is calculated by dividing total debt (TD) by capital employed (CE). Total debt includes short and long-term borrowings from financial institutions, debentures/bonds, bank borrowings, public deposits and any other interest-bearing loan. Capital employed includes Net fixed assets (NFA) and net current assets (NCA). Net current assets are current assets (CA) less current liabilities (CL) excluding interest-bearing short-term debt for working capital.

$$\text{Debt Ratio} = \frac{\text{Total Debt (TD)}}{\text{Capital employed (CE)}}$$

The debt-equity and debt ratio show how excellently debt financing has been used in the business. A high ratio for both the case means

that claims of creditors are greater than those of owners. A high level of debt introduces inflexibility in the firm's operations due to the interferences from creditors. But a low debt-equity ratio implies a greater claim of owners than creditors. From the point of view of creditors, it represents a satisfactory situation since a high proportion of equity provides a larger margin of safety for them. Together with the level of indebtedness, the company's capacity to bear interest needs to be measured.

9.5.3 Turnover Ratios

Activity or turnover ratios measure the speed with which accounts are converted into sales or cash. These ratios are employed to evaluate the efficiency with which a company manages and utilises its assets. These ratios involve a relationship between sales and assets. Turnover ratios are also known as activity ratios or inventory turnover ratio. Turnover ratios basically assess the efficiency of the usage of the assets of a firm. The common Activity or Turnover ratios are discussed below:

(a) Inventory Turn over Ratio: Turnover ratios are important as it shows the number of time the inventory has been turned over during a particular period of time in an organisation. Therefore the turnover ratios assess the overall operational efficiency of an organization's inventory management system during a particular period of time. Higher is the turnover ratio higher may be the sales of a company during a particular period. The inventory turnover ratio is calculated as follows:-

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

If values for the cost of goods sold are not available, then Net Sales figure is used in place of cost of goods sold. If average inventory figure is not available, then the close inventory or the opening inventory is used to measure the average inventory.

A high inventory turnover ratio reveals efficient management of inventory because the inventories are sold more frequently and thereby the amount of money required to finance the inventory is also very less. Again, a low inventory turnover ratio reveals an inefficient management of the inventories of the firm. If the inventory turnover ratio is low that means the inventory of the firm is moving slowly and thereby this indicates unnecessary blockage of capital which would have used in the business. This blocked capital in inventories would have been invested in the business and might have fetched extra revenue for the firm. Thus we see that, the inventory turnover ratio is very important and sends as a signal of profitability of a firm. Usually, a high inventory turnover ratio indicates extra profit whereas a low inventory turnover ratio indicates less profit.

(b) Debtors (Accounts Receivable) Turnover*:* A company sells goods for cash and credit. When the company extends credits to its customers, debtors (accounts receivables) are created in the company's accounts. Debtors are convertible into cash over a short period, hence are included in current assets. This ratio has to be compared together with the other liquidity ratios to assess the liquidity position of the company. It is calculated by dividing credit sales by accounts receivables or debtors amount.

$$\text{Debtors turnover} = \frac{\text{Credit sales}}{\text{Debtors}}$$

This turnover ratio indicates the number of times receivables are turnover each year. The higher the value of this ratio, the more efficient is the management of credit.

(c) Total Asset Turnover Ratio: This ratio indicates the efficiency with which the company uses its assets to generate sales. Generally, the higher a company's total assets turnover, the more efficiently its assets have been used. It is calculated by dividing sales by total assets. This measure is probably of greater interest

to management as it indicates whether the company's operations have been financially efficient.

$$\text{Total assetsturnover} = \frac{\text{Sales}}{\text{Total assets}}$$

Some analyst exclude intangible assets like goodwill, patents etc, while computing total assets turnover. Similarly, fictitious assets, accumulated losses or deferred expenditures may also be excluded for calculating total asset turnover ratio.

(d) Fixed Asset Turnover Ratio: Sometimes, analyst wants to measure the efficiency only with respect to fixed assets. This ratio measures sales per rupee of investment in fixed assets. A high ratio indicates a high degree of efficiency in asset utilisation and a low ratio reflects inefficient use of assets. However, while interpreting this ratio, one has to examine the quality of the asset, as old and substantially depreciated fixed assets would tend to show a high turnover ratio.

$$\text{Fixed assets turnover} = \frac{\text{Sales}}{\text{Fixed Assets}}$$

9.5.4 Profitability Ratios

Profitability ratios are the most important as it finally finds whether the company has incurred profit or loss during a particular period of time. In other words, profitability ratios determine the results of all business operations or overall performance of a firm during a period of time. The popular ratios of the first group are the **Gross profit margin**, **Net profit margin** and **Operating ratio**. The common ratios for the second group are **Return on Investment**, **Return on Equity**, **Earnings per share** and **Price-Earnings Ratio**.

(a) **Gross Profit Ratio** is the ratio of gross profit to net sales. This ratio is expressed in percentage and shows the relationship between gross profit and sales. Gross profit is the difference between net sales and cost of goods sold. For a trading type of business, cost of goods sold would be equal to opening stock plus

purchases plus all direct expenses relating to purchases minus closing stock. For a manufacturing type of business, it would be equal to the sum of the cost of raw materials, wages, direct expenses and all manufacturing expenses. Usually, the expenses charged to profit and loss account or operating expenses are excluded from the measurement of cost of goods sold. The gross profit ratios is calculated by the following formula:-

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

Gross profit ratio implies the overall efficiency of a firm's operations. Higher the gross profit better it is as the gross profit is calculated by deducting cost of goods sold from net sales. The gross profit earned should be sufficient to recover all operating expenses and to build up reserves after paying all fixed interest charges and dividends. An increase in the Gross Profit ratio indicates that the sales have gone up without much increase in the overall costs. Similarly a decrease in the Gross Profit ratio indicates that the sales have declined without an increase in the overall costs of the firm.

(b) **Net Profit Margin:** Net profit is obtained when operating expenses, interest and taxes are subtracted from the gross profit. This ratio establishes a relationship between net profit and sales and indicates management's efficiency in manufacturing, administering and selling the products. This ratio is measured by dividing profit after tax by sales.

$$\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}$$

A company with a high net profit can survive in the face of falling selling prices, rising costs of production or declining demand for the product but it would not be possible for a low net profit margin company to withstand these adversities.

(c) **Operating Expense Ratio**: The operating expense ratio explains the changes in the profit margin ratio. This ratio is computed by dividing operating expenses i.e. cost of goods sold plus selling

expenses and general and administrative expenses (excluding interest) by sales.

$$\text{Operating expense ratio} = \frac{\text{Operating expense}}{\text{Sales}}$$

A high operating expenses ratio is unfavourable to a company as it means high cost of goods sold or high general and selling expenses. A high operating ratio will leave a small amount of gross profit to pay interest, dividends etc. A company desires a low operating ratio as it is a yardstick of operating efficiency.

(d) **Return on Investment**: The Return on Investment also called as Return on Asset, measures the company's overall effectiveness in generating profits with its available assets. The higher the company's return on total investment, the better is the profitability. It is calculated by dividing profit after tax by total asset.

$$\text{Return on Investment} = \frac{\text{Profit after tax}}{\text{Total assets}}$$

(e) **Return on Equity Capital (ROEC) Ratio:** Return on Equity Capital (ROEC) Ratio assesses the performance of a firm from the equity shareholders perspective on the basis of return on equity capital of the company. Return on equity capital measures the relationship between profits of a company and its equity share capital which is calculated as follows:-

$$\text{Return on Equity Capital} = \frac{\text{Net Profit after Tax} - \text{Preference Dividend}}{\text{Equity Share Capital}}$$

Equity share capital represents the total called-up value of equity shares of a company. The preference dividend and taxes are excluded from the gross profit in order to arrive at net profits after tax.

9.5.5 Valuation Ratios

Valuation ratios determine how the equity stock of a company is valued in the stock market. So, valuation ratios are important basically for the stock market investors. This valuation ratio helps

investors to take a rational investment decision before investing in the stock market as it represents a comprehensive evaluation of the overall financial health and performance of a firm. There are two most important valuation ratios viz., (a) Price earnings (P/E) ratio and (b) Earnings per share (EPS) ratio, mostly used by the investors as well as it is also used by the management of the particular firm which is briefly discussed below:

(a) Earnings Per Share (EPS) Ratio is another important indicator of earning or profitability especially for the investors in a company. EPS ratio measures net return on equity capital invested in a company and is calculated by dividing the net profit after taxes minus preference dividend by the total number of equity shares. Higher the EPS ratio of a company, higher would be the profitability. The formula of earnings per share is as follows:-

$$\text{Earning per Share (EPS) Ration} = \frac{\text{Net Profit After Tax - Preference Divident}}{\text{No. of Equity Shares}}$$

(b) Price Earnings Ratio (P/E) : It is an excellent tool for the investors which help them to take buy or sell decision of equity share in the stock at a specific market price. This ratio is popular and largely used by the investors as it indicates whether a stock is undervalued or overvalued. Usually, the higher the price earnings ratio, the better performance and prospects of the company. A decrease in the P/E ratio of a company indicates that the company is not performing well and the management of the company must find out the reason of this decreasing P/E ratio. P/E ratio is calculated by the following formula:

$$\text{Price Earning Ration} = \frac{\text{Market Price Per Equity Share}}{\text{Earning Per Share}}$$

The P/E ratio is more meaningful when analyzed with the P/E ratio of similar companies of same size. For example, if the earning per share of BPDL limited is 20, its market price Rs.200 and earnings ratio of some other companies belonging to the same sector is 15, it means that the market value of a share of BPDL Ltd. should be

Rs.300 (i.e., 15 × 20). The share of BPDL Ltd. is undervalued in the market by Rs.100 (300 – 200). Similarly, if the price earnings ratio of some other companies belonging to the same sector is only 8, the value of the share of BPDL Ltd. should have been Rs.160 (i.e., 8 × 20), thus the share would be overvalued by Rs.40 (200 – 160). This is the usefulness of the P/E ratio to the investors for determining the true economic value of shares in the stock market.



CHECK YOUR PROGRESS

Q1: State the diferent types of financial leverage ratios.

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Q2: What is the purpose of liquidity ratios?

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Q3: What does P/E ratio indicate ?

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Q4: State true or false for the following statements:

(i) Gross Profit Ratio is the ratio of gross profit to net sales.

(ii) Liquidity means the ease with a liability can be converted into T-Bill.

(iii) Valuation ratios are important basically for the stock market investors.

9.6 PRACTICAL PROBLEMS



Exercise: 9.1

From the following financial information of Falcon Ltd., find current ratio and acid-test ratio. The given assets are matured within one year and liabilities need to be repaid within the next one year.

Cash	Rs. 40,000
Debtors	Rs. 210,000
Inventory	Rs. 400,000
Bills payable	Rs. 35,000
Creditors	Rs. 75,000
Accrued expenses	Rs. 25,000
Tax payable	Rs. 20,000

Solution

From the available financial information, we must first calculate current assets, current liabilities, and quick assets.

Current Assets = 40,000 + 210,000 + 400,000

= 650,000

Current Liabilities = 35,000 + 175,000 + 25,000 + 20,000

= 155,000

The current ratio of the company Falcon Ltd. is calculated below:-

$$\text{Current Ratio} = \frac{\text{Current Asset}}{\text{Current Liability}}$$

$$= \frac{650{,}000}{155{,}000}$$

= 4.19 : 1

Thus, we can interpret that the liquidity position of Falcon Ltd. is very good and the firm is able to meet all its current liabilities. A current ratio of 4.19 : 1 indicates that the firm has approximately four times of its current assets compared to its current liabilities.

Let us now calculate the acid-test ratio of Falcon Ltd. from the above financial information.

To calculate acid-test ratio, at first we need to calculate the quick asset.

Quick Assets = Current Assets – Inventories

= 650,000 – 400,000

= 250,000

Therefore, $$\text{Acid Test ratio} = \frac{\text{Quick Asset}}{\text{Current Liability}}$$

$$= \frac{250{,}000}{155{,}000}$$

= 1.61 : 1

Thus, we can interpret from the acid-test that the liquidity position of Falcon Ltd. is excellent as the firm is able to meet all its current liabilities immediately without even selling its inventories.



Exercise: 9.2

From the following financial figures of GHL Ltd., calculate debt to equity ratio.

Equity share capital	5,00,000
Capital reserve	2,00,000
Profit & Loss Account	50,000
4% debentures	2,00,000
Sundry creditors	70,000
Bills payable	10,000
Provision for taxation	40,000
Outstanding creditors	30,000

Solution

To calculate the debt equity ratio, let us first find out the total debt and total equity of GHL Ltd.

Total Equity = Equity share capital + Capital reserve + Profit & Loss Account

= 500,000 + 200,000 + 50,000

= 750,000

Total Debt = 4% debentures + Sundry creditors + Bills payable + Provision for taxation + Outstanding creditors

= 200,000 + 70,000 + 10,000 + 40,000 +30,000

= 350,000

Therefore, debt equity ratio is calculated by the following formula:-

$$\text{Debt Equity Ratio} = \frac{\text{Total Debts}}{\text{Total Equity}}$$

$$= \frac{350,000}{750,000}$$

= 0.46 or 46 : 100

Thus we can interpret that for every forty six rupees worth of the creditors investment the shareholders have invested hundred rupees. Debt equity ratio shows the proportionate claims of owners and the outsiders against the firms' assets. In case of liquidation of the firm, the total assets of the firm must be divided according to the debt equity ratio.



Exercise: 9.3

Suppose the PBIT of Falcon Ltd. is Rs. 2000,000 and the total interest payable is Rs.400,000 during a given financial year. Then the interest coverage ratio is calculated as follows:-

Solution:

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Interest}}$$

$$= \frac{\text{Rs. } 2000,000}{\text{Rs. } 400,000}$$

= 5.00

Thus we see that interest coverage ratio is high. So, we can conclude that the company can easily meet its interest burden even if earnings before interest and taxes suffer a considerable decline.

Exercise: 9.4

For TCPIL Ltd., the cost of goods sold for the financial year 2015-2016 is Rs.5,00,000. The opening stock is Rs 3,00,000 and the closing stock is Rs.75,000. What is the inventory turnover ratio of TCPIL Ltd.?

Solution:

In order to find out inventory turnover ratio, let us first calculate the average inventory

$$\text{Average Inventory} = \frac{(\text{Opening Inventory} + \text{Closing Inventory})}{2}$$

$$= \frac{(3,00,000 + 75,000)}{2}$$

$$= 1,87,500$$

Therefore,

$$\text{Inventory Turnover Ratio (ITR)} = \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

$$= \frac{5,00,000}{1,87,500}$$

$$= 2.67$$

Thus we may conclude that an average one rupee invested in inventories will become nearly three (2.67) times in sales and the firm is managing its inventory in an efficient way.

Exercise: 9.5

The following financial information of APDCIL Ltd. is available. Find the gross profit ratio (GP ratio) of the company.

Particulars	Amount (Rs.)
Gross sales	500,000
Sales returns	80,000
Opening stock	100,000
Purchases	295,000
Purchases returns	35,000
Closing stock	22,500

Solution:

Let us calculate the Gross Profit first.

Now, we can compute the gross profit ratio as follows:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

$$= \frac{82{,}500}{420{,}000}$$

$$= 0.1964$$

The GP ratio is 19.64%. We may conclude that the company may reduce the selling price of its products by 19.64%.

Exercise: 9.6

During the financial year 2015-2016, DPTL Ltd. generated a total sales of Rs.3,40,000; Sales returns is Rs.40,000; cost of goods sold is Rs.2,50,000. You task is to calculate the gross profit ratio of the company.

Solution:

Considering the given information of the company, the gross profit is calculated as follows:-

Gross Profit = Net Sales – Cost of Goods Sold

= (Total Sales – Sales Return) – Cost of Goods Sold

= [(3,40,000 – 40,000) – 250,000]

= 50,000

Now, the gross profit ratio is calculated as follows:-

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$= (50{,}000 / 340{,}000) \times 100$$

$$= 14.7\%$$

The GP ratio is 14.7%. We may conclude that the company may reduce the selling price of its products by 14.7%.



Exercise: 9.7

Equity share capital of GCPTIL Ltd. is Rs.10,00,000. The company issued 15% preference share capital of Rs.4,00,000. The corporate rate of taxation was 30% of net profit and the net profit before tax was Rs.4,50,000 during the financial year 2015-2016. Calculate return on equity share capital of the company.

Solution:

$$\text{Return on Equity Capital} = \frac{\text{Net Profit after Tax - Preference Dividend}}{\text{Equity Share Capital}}$$

$$= \frac{450{,}000 - 15\% \text{ of } 4{,}00{,}000 - 30\% \text{ of } 4{,}50{,}000}{10{,}00{,}000}$$

$$= 0.2550$$

$$= 25.5\%$$

Higher the ROEC ratio, better the profitability of the company and hence better is the chance of earning of its shareholders. Thus we can conclude that the Return on Equity Capital (ROEC) ratio of the company is very high as it is found to 25.5%.



Exercise: 9.8

The market price of a NTL Auto Ltd. share is Rs.330 on 16th March, 2016 and earning per share is 5.50. Calculate price earnings ratio of NTL Auto Ltd.

Solution 8.7:

$$\text{Price earnings ratio} = \frac{\text{Market price per equity share}}{\text{Earnings per share}}$$

$$= \frac{330}{5.50}$$

$$= 60$$

Thus we can conclude that the market value of every one rupees of earning is sixty times or Rs.60.



Exercise: 9.9

Expan Ltd. has equity share capital of Rs.60,00,000 with a 10% preference share capital of Rs.4,50,000. The face value of the Expan Ltd. is Rs.10. The net profit before tax of the company for the financial year 2016-2017 is Rs.7,50,000. Calculate the earnings per share (EPS) of the company?

Solution 8.7:

To find EPS of Expan Ltd., first we have to find the total number of equity shares which can be calculated as follows:-

$$\text{Number of Equity Shares} = \frac{\text{Total Value of Equity Capital}}{\text{Face Value of the Share}}$$

= Rs.60,00,000 / Rs.10

= 6,00,000

The formula of earnings per share is given below:-

$$\text{Earnings per share (EPS) Ratio} = \frac{\text{(Net Profit after Tax - Perference Dividend}}{\text{No. of Equity Share}}$$

$$= \frac{(7,50,000 - 10\% \text{ of } 4,50,000)}{6,00,000}$$

= 7,05,000 / 6,00,000

= Rs.1.175 per share.

Therefore, the earnings per share of Expan Ltd. is Rs.1.175 per share. This figure may be compared with the similar type of companies and this will thus help investors to take a rational investment decision.

Exercise : 9.10



The following is the Balance Sheet and Statement of Profit for the year ended March 31,2016 of North East Chemicals Ltd.

Balance Sheet as on March 31, 2016

Liabilities	**(Rs)**	**Assets**	**(Rs)**
Equity Share Capital	10,00,000	Plant and Equipment	6,40,000
(Rs 100 each)		Land & Building	80,000
Reserves & Surplus	3,68,000	Cash	1,60,000
Creditors	1,04,000	Debtors	3,20,000
Bills payable	2,20,000	Inventory	4,92,000
Total	16,92,000	Total	16,92,000

Statement of profit for the year ended March 31, 2016

Particulars	**(Rs)**
Net Sales	40,00,000
Less: Cost of goods sold	30,80,000
Gross Profit on Sales	9,20,000
Less: Operating expenses	6,80,000
Net Profit	2,40,000
Less taxes @ 50%	1,20,000
Net profit after taxes	1,20,000

Determine the following ratios for North East Chemicals: Current ratio, Quick ratio, Inventory Turnover ratio, Receivables Turnover ratio,

Gross Profit ratio, Net Profit ratio, Operating ratio, Earnings per share, Return on Equity Capital and P/E ratio.

Solution:

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

$= \frac{\text{Cash} + \text{Debtors} + \text{Inventory}}{\text{Creditors} + \text{Bills payable}}$

$= \frac{\text{Rs } 1,60,000 + 3,20,000 + 4,92,000}{\text{Rs } 1,04,000 + \text{Rs } 2,20,000}$

$= \frac{\text{Rs } 9,72,000}{\text{Rs } 3,24,000}$

= 3 : 1

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

$= \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$

$= \frac{\text{Rs } 9,72,000 - 4,92,000}{\text{Rs } 3,24,000}$

$= \frac{\text{Rs } 4,80,000}{\text{Rs } 3,24,000}$

= 1.48:1

Inventory Turnover ratio $= \frac{\text{Cost of goods sold}}{\text{Inventory}}$

$= \frac{\text{Rs } 30,80,000}{\text{Rs } 4,92,000}$

= 6.3:1 times

Gross Profit ratio $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$

$= \frac{\text{Rs } 9,20,000}{\text{Rs } 40,00,000} \times 100$

= 23%

Net Profit ratio $= \frac{\text{Net Profit}}{\text{Sales}} \times 100$

$$= \frac{\text{Rs } 1,20,000}{\text{Rs } 40,00,000} \times 100$$

= 3%

Operating ratio $= \frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Sales}} \times 100$

$$= \frac{\text{Rs } 30,80,000 + \text{Rs } 6,80,000}{\text{Rs } 40,00,000} \times 100$$

= 94%

Earnings per share (EPS) $= \frac{\text{Net Profit}}{\text{Number of equity shares}}$

(Number of equity shares $= \frac{\text{Equity Capital}}{\text{Par value}} = \frac{\text{Rs } 10,00,000}{\text{Rs } 100}$

= 10,000)

Earnings per share (EPS) $= \frac{\text{Rs } 1,20,000}{10,000}$

= Rs 12

Rate of return on equity capital $= \frac{\text{Net Profit}}{\text{Equity capital}} \times 100$

Rate of return on equity capital $= \frac{\text{Rs } 1,20,000}{\text{Rs } 13,68,000} \times 100$

= 8.8



Exercise : 9.11

From the ratio's and other data given below for the Asian Ltd, indicate your interpretation of the Company's financial condition.

Particulars	2016	2015	2014
Current Ratio	3.02	2.78	2.65
Acid-test	0.99	1.10	1.55
Working Capital turnover(times)	3.29	3.00	2.75
Receivable turnover (times)	7.20	8.41	9.83

Inventory Turnover (times)	5.41	6.01	6.11
EPS (Rs)	2.5	4.05	5.10
Op. exp. To sales (%)	25	23	18
Sales growth (%)	23	16	10
Net Profit Margin.(%)	2	5.09	7.03
Fixed Assets Turnover (%)	22.7	18.0	16.4
Return on Equity	7	8.5	11.07

Solution:

- Declining profitability is evident from the following.
- Decrease in net profit margin from 7% in 2014 to 2 % in 2016, even though, sales growth has increased from 10% to 23%. The main reasonmay be raising Operating expense ratio. The return to owners is very poor as the return on equity stands at only 7 %.
- Current Ratio is comfortable, even though the quick ratio has declined. This is mainly attributed to the fall in inventory turnover. But the company is likely to encounter difficulty in payment of short-term obligations as the receivable turnover is also low.

9.7 ADVANTAGES OF RATIO ANALYSIS

The ratio analysis is one of the most vital tools for analysing financial statements like Balance Sheet, Profit and Loss Accounts, Fund Flow Statement and Cash Flow Statement etc. A lot of information is given in these financial statements. Ratio analysis summarizes and simplifies these financial statement information for better understanding and draws conclusions regarding different aspects of the working of an organization in terms of liquidity, leverage, turnover, profitability and valuation aspects

for a required period. Ratio analysis is mostly useful to determine the efficiency and performance of an organisation during a specific period of time in the following ways:-

(a) Ratio analysis helps an organisation to find out the overall financial health in terms of profitability, liquidity, leverage, business turnover and valuation position of the organisation.

(b) Ratio analysis helps an organisation to find out whether incomes are more that the expenditure or not, whether adequate profits are being generated on the invested capital or not, whether the organisation has a capacity to pay the interest and dividend to its shareholders or not.

(c) The primary benefit of ratio analysis is that it helps to make a common platform where comparative Analysis of various companies across time can be done. Ratio analysis assists the management of an enterprise to find out the financial position of a particular company and its competitors in terms of different performance parameters like profitability, leverage, sales, expenses, inventory, valuations, turnover, etc. So, ratio analysis helps to find out the financial health of a company over last few years. It also helps to compare its financial health with its various competitors.

(d) Ratio analysis facilitates to form an industry average of various parameters by calculating the average of the ratios of the participants belonging to that industry. Then individual performances of the companies with respect to different performance categories can be compared with that of the particular industry average.

(e) Ratio analysis can help in business forecasting by calculating financial ratios of last few years. These ratios for the last few years become an input for the trend analysis of various business activities. For example, studying the trend of the profitability ratios for the last five to ten years of a firm, we can have some idea about its profitability for the next year.

(f) Ratio analysis also helps in preparing an organisational budget.

(g) Ratio analysis determines operational efficiency as measured by the turnover ratios. The turnover ratios assesse the degree of

operational efficiency of the management as well as the level of utilisation of the assets of a firm.

(h) Ratio analysis is an excellent way to communicate the performance of a firm in a simplified way to the various shareholders as well as to the stakeholders of the firm.

(i) Financial ratios are also used as a control devise for the intrafirm comparison as well as for the interfirm comparison of the business performance during a particular period of time.

(j) A proper and effective ratio analysis helps an organisation to assess its long term solvency position and also send signals of corporate growth prospects or bankruptcy.

9.8 LIMITATION OF RATIO ANALYSIS

As discussed above, ratio analysis is a powerful and popular tool for analysing the financial statements. We have already seen that ratio analysis has many advantages but it suffers from the following demerits:-

(a) A financial ratio of a firm in isolation for a particular year does not help and one cannot make any inference. Moreover, no conclusion can be drawn for a single ratio in isolation.

(b) There is lack of uniformity in the definition of various terms used in ratio analysis across various companies and across different industries.

(c) Ratios are calculated from the figures supplied by the financial statements. If these input figures suffer from some errors, then the ratio may provide a wrong conclusion.

(d) If the accounting principles and methods are different, the comparison of the financial ratios becomes meaningless exercise and would fetch a wrong interpretation of the performance of a business organisation.

(e) Financial ratios facilitate trend analysis over the past few years. But if there are changes in the price levels, then the comparison of a firm with that of its past performances may be misleading.

(f) Ratios are quantitative in nature and do not consider qualitative facts which are important to assess the operation and overall business performance of a firm.

(g) Financial ratios assess the performance of a firm based on the historical facts and may not be very useful in forecasting.



CHECK YOUR PROGRESS

Q5: Point out five merits of ratio analysis?

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Q6: Point out any five limitations of ratio analysis?

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Q7: State true or false for the following statements :

(i) A stock is overvalued means its market price is less than its true economic value.

(ii) Ratio analysis determines operational efficiency as measured by the turnover ratios.



9.10 LET US SUM UP

- In this unit, we have discussed some financial ratios that can be used to make the financial statement analysis for a firm.
- Financial statements represent the true economic and financial health of an organisation and facilitates in proper decision making on important organisational issues.
- Analysis and interpretation of financial statements is needed to assess the efficiency and performance of an organisation. Based on the financial statements, various financial ratios are calculated.
- Financial ratios basically establishes the relationship of interrelated items of the financial statements and represent different important organisational parameters profitability, liquidity, inventory, turnover, productivity, efficiency etc.

- Ratios are classified as liquidity ratios, leverage ratios, activity ratios, profitability and valuation ratios.
- Liquidity ratios represent the short-term solvency of an organisation or state its ability to meet financial obligation on their due dates.
- Financial leverage ratios represent stake of the owners in the business in relation to outside borrowings or long-term solvency.
- Activity ratios represent efficiency of management of various assets by the organisation.
- Profitability ratios represent the profitability of the organisation.
- Valuation ratios represent valuation of the equity stock of the company in the capital market.
- The advantages and disadvantages of ratio analysis.



9.11 FURTHER READING

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9.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q.1: There are different types of financial ratios calculated from the financial statements of business organisations. The financial leverage ratios are basically classified as –

(a) Debt-equity ratio

(b) Intertest Coverage ratio

(c) Debt ratio.

Ans to Q.2: Liquidity refers to the ability of a firm to meet its obligations in short run, usually one year. It is necessary for conducting business activity particularly during shut down or strike or recession.

Ans to Q.3: P/E indicates both whether a stock is undervalued or overvalued. Heigher the P/E ratio, better the performance of the company. Decrease in P/E ratio, company is not performing well.

Ans to Q.4: (i) True, (ii) False, (iii) True.

Ans to Q5: Ratio analysis is mostly useful to determine the efficiency and performance of an organisation during a specific period of time in the following ways:-

(a) Ratio analysis helps an organisation to find out the overall financial health in terms of profitability, liquidity, leverage, business turnover and valuation position of the organisation.

(b) Ratio analysis helps an organisation to find out whether incomes are more that the expenditure or not, whether adequate profits are being generated on the invested capital or not, whether the organisation has a capacity to pay the interest and dividend to its shareholders or not.

(c) The primary benefit of ratio analysis is that it helps to make a common platform where comparative Analysis of various companies across time can be done.

(d) Ratio analysis facilitates to form an industry average of various parameters by calculating the average of the ratios of the participants belonging to that industry.

(e) Ratio analysis can help in business forecasting by calculating financial ratios of last few years.

Ans to Q.6: The following are some of the disadvantages of ratio analysis

(i) No conclusion can be drawn for a single ratio in isolation.

(ii) Ratios are quantitive in a nature and do not consider qualitative facts which are also important.

Ans to Q7: (i) False, (ii) True.



9.13 MODEL QUESTIONS

1. What are the benefits of computing financial ratios of a company?
2. How liquidity ratios can be a useful tool to understand the liquidity position of an organisation?
3. What does the interest coverage ratio of a firm indicates?
4. What are the uses of valuation ratios?
5. For stock market investors, what are the most important ratios need to be considered before an investment?
6. On 01/02/2016, the market price of one TCS share is Rs.2220 and the stock's earning per share is Rs.42. Calculate price earnings ratio of TCS on 01/02/2016.
7. ITCP Ltd. has equity share capital of Rs.3,00,00,000 with a 10% preference share capital of Rs.2,00,000. The face value of the ITC Ltd. is Rs.1. The net profit before tax of ITC Ltd. for the financial year 2016-2017 is Rs. 39,00,000. What is the earnings per share (EPS) of the company?

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UNIT 10: FINANCIAL STATEMENTS

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Financial Statements

10.4 Profit And Loss Account

10.5 Balance Sheet

10.6 Components of Balance Sheet

10.7 Meaning of Fund Flow Statement

10.8 Ascertainment of Flow of Funds

10.9 Technique of Preparing Funds Flow Statement

10.10 Schedule of Changes in Working Capital

10.11 Adjusted Profit and Loss account

10.12 Practical Problems

10.13 Let Us Sum Up

10.14 Further Reading

10.15 Answer To Check Your Progress

10.16 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:-

- describe the concept of financial statment
- explain the concept of profit & loss account and balance sheet
- describe the concept of Fund Flow Statement
- discuss the ascertainment of Flow of Funds
- discuss the technique of Preparing Funds Flow Statement
- discuss the Schedule of Changes in Working Capital

10.2 INTRODUCTION

In this unit we are going to discuss about different financial statements, like- balance sheet, profit and loss account and fund flow statement.

The unit will start with the concept of financial statement. Financial statements provide information about a company and its performance over a period of time on the basis of which its credit worthiness, share price, future perormance etc can be judged.

An important financial statement is Profit and loss account, which represents the summary of revenues, expenses and net income (or net loss) of a company.

Moreover, we are going to discuss the concept of Funds Flow statement. A fund flow statement is a statement which explains the various sources from which funds were raised and the uses to which these funds were put. In other words, a fund flow statement is used to explain the movement of working capital. You will find this unit very interesting because, after going through this unit you will able to analyse the financial position of different companies.

10.3 FINANCIAL STATEMENTS

Financial statements are the sources of information for financial decisions. These statements provide information on how a company has been performing over the years and are useful for financial forecasting and planning. A financial statement is a collection of data organized in accordance with logical and consistent accounting procedures. In the words of John Myer : " The financial statements provide a summary of the accounts of a business organization, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period." Thus financial statements are periodic financial reports of a company.

The commonly used financial statements are the followings- Profit and Loss Account, Balance Sheet, Statement of Cash Flows and Statement of Fund Flow.

10.4 PROFIT AND LOSS ACCOUNT

Profit and loss account represents the summary of revenues, expenses and net income (or net loss) of a company. This statement is a

performance report recording the changes in income, expenses, profits and losses as a result of business operations. When the revenues are more than expenditures, there will be a profit. If the expenditures are in excess of revenues, there will be loss. This profit and loss or income statement is prepared for a particular period, generally a year for determining the performance of the company.

The Companies Act specifies that the profit and loss accounts must show information as required by Schedule IV. This account may be presented in the account form or the report form. The report form statement may be a single-step statement or a multi-step statement. In a single step statement, all revenue items are recorded first then the expenses items are shown and finally the net profit is given. But a multi-step profit and loss account provides disaggregated information. Table 10.3 represents a single step Profit and Loss account and Table 10.4 represents a multi-step Profit and Loss account.

Table 10. 3: Profit and Loss Account of ABC Ltd. for the year ending on March 2017.

Particulars	**Rs. in million**
Income:	
(i)Sales	701
Expenditure:	
(ii)Material & other expenditure	582
(iii)Interest	21
(iv)Depreciation	30
(v)Profit before tax[(i)-(ii)-(iii)-(iv)]	68
(vi)Provision for tax	34
(vii)Profit after tax [(v) – (vi)]	34

Table 10.4: Profit and Loss Account of ABC Ltd. for the year ending on March 2017.

Particulars	**Rs. in million**	
A. Net Sale		701
B. Cost of goods sold		552
Stocks	421	
Wages & salaries	68	
Other manufacturing expenses	63	
C. Operating expenses		60
Depreciation	30	
General administration	12	
Selling	18	
D. Operating profit/Profit before interest & Tax (A-B-C)		89
E Interest		
F Profit before tax (D-E)		21
G Provision for tax (@50%)		68

10.5 BALANCE SHEET

Balance sheet is the most significant financial statement. The balance sheet shows the financial condition of a business at a given point of time. It lists the sources of funds as well as their uses. It is

a classified summary of assets and the sources of financing the assets. However, it is a static statement as it shows the position of the business at a certain moment of time. The companies registered under the Companies Act, 1956 have to show their assets and liabilities in the balance sheet in accordance with the form prescribed under this Act. As per the Companies Act, the balance sheet of a company may be in either the account form or the report form, the structure of both forms are given below:

Balance sheet of Assam Warehousing Ltd.'s as on March 31,2017

Table 10.1: Account Form

Liabilities	**Rs. In million**	**Assets**	**Rs. in million**
Share capital	250	Fixed assets	330
Resources & surplus	112	Investment	115
Secured loans	143	Current assets, loans & advances	234
		Miscellaneous expenditures and loans	
Unsecured loans	69		0
Current liabilities and provisions	105		
Total	**679**	**Total**	**679**

Table 10.2: Report Form

II. **Application of funds**		
I. Sources of funds		
1. Fixed Assets		330
2. Investments		1 15
3. Current Assets, Loans & Advances	234	
Less: Current Liabilities and Provisions	105	
Net Current Assets		129
4. Miscellaneous expenditures and losses		-
TOTAL		574

10.6 COMPONENTS OF BALANCE SHEET

a. Liabilities: Liabilities defined broadly, means what the company owes others. Liabilities represent debts payable in the future by the company to its lenders and creditors. Liabilities are of two

types (i) current liabilities and (ii) long-term liabilities. Current liabilities are debts payable within an accounting period whereas long term liabilities are the obligations or debts payable in a period of time greater than the accounting period. The components of long term and current liabilities are described below:

(i) Equity Capital: Equity capital represents ownership capital, as equity shareholders collectively own the company. Their liability is limited to their capital contribution. Though the paid-up share capital is shown against the share capital, but the balance sheet also provides information on authorised capital, issued capital, subscribed capital. The amount of capital that a company can potentially issue, as per its memorandum, represents the authorised capital. The amount offered by the company to the investors is called the issued capital and the part of issued capital which has been subscribed to by the investors is called the subscribed capital

(ii) Reserves and Surplus: This comprises of retained earnings as well as non-earnings items like share premium and capital subsidy.There are two kinds of resources, namely - Capital Reserves and Revenue Reserves.

- Capital Reserves includes items such as share premium account, revaluation reserve, and capital redemption reserve. A capital reserve cannot be distributed as dividend to shareholders.
- Revenue reserves represent accumulated retained earnings from the profits of business. They are held in accounts like investment allowance reserve, dividend reserve, taxation reserve and general reserve.

The reserves and surplus along with paid up capital represent owners' equity which is also called shareholders' funds or net worth

(iii) Secured Loans: These loans are secured by a charge on the assets of the company. The charge may be created in the form of pledge or hypothecation of movable assets such as

inventories and debtors or in the form of mortgage of immovable assets such as land, buildings and plant and machinery.

(iv) Unsecured Loans: These loans are not secured by a charge on the assets of the company. The most common forms of unsecured loans are public deposits, commercial paper, unsecured loans from promoters, commercial banks and financial institutions.

(v) Current Liabilities and Provisions: These include items such as bills payable, sundry creditors, advance payments and interest accrued but not due on loans. Provisions include items such as provision for taxes, provision for dividend, and provision for provident fund, gratuity etc.

b. Assets: Assets are resources, which are expected to provide a company with future economic benefits. Assets represent (a) stored purchasing power (e.g. cash), (b) money claims (e.g. receivables, stock) and (c) tangible and intangible items which generate earnings. Under the Companies Act, assets can be classified as :

i. Fixed Assets,
ii. Investments,
iii. Current Assets, Loans and Advances and
iv. Miscellaneous expenditure and loans.

Let us discuss these in detail:

i. Fixed Assets*:* These are assets that are expected to produce benefits for more than one year. Fixed assets are divided into two categories-tangible or intangible. Tangible fixed assets include items such as loans, buildings, plant, machinery and other assets, which can be used more than one year. These assets are reported in the balance sheet at their net book value, which is the gross value less accumulated depreciation whereas intangible fixed assets include items like – patents, copyrights, trademarks and goodwill. Intangible fixed assets are reported at their net book value, which is simply the gross value less accumulated amortisation.

ii. **Investments*:*** Investments represent financial securities owned by the company. These can be divided into two categories-long term and current investments. Long-term investments comprise of financial securities like equity shares, preference shares and debentures of other companies. Current investment represents short-term holdings of units or shares of mutual fund schemes. These investments are made primarily to generate income from short-term cash surpluses of the company.

iii. **Current Assets, Loans and Advances:** These are called as liquid assets as these assets are either held in the form of cash or are expected to be converted in cash within the accounting period of the business. Current assets include cash, tradable (marketable) securities, debtors (account receivables) and stock of raw materials, work-in-process and finished goods. Further loans and advances comprise of items such as advances and loans to subsidiaries, advances recoverable in cash and deposits with governmental authorities.

iv. **Miscellaneous Expenditure and Loans*:*** Miscellaneous expenditure comprises of items such as preliminary expenses, discount allowed on the issue of securities, interest paid out of capital during construction and development expenditure to the extent not written off or adjusted. Whereas “losses” are the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any exist.

10.7 MEANING OF FUND FLOW STATEMENT

The two most important financial statements are Profit and Loss Accounts and Balance Sheet which represents the financial health of a business. This is true but these two statements are not able to address some important issues. For example, the Balance Sheet shows the position of total assets and total liabilities in a particular financial year. It also shows the changes in the assets and liabilities of a particular year with respect to its previous years. But Balance Sheet does not show the major financial and investment transactions which largely influence the business decisions

in the short as well as in the long run. Moreover, the Balance Sheet also fails to explain why and how the changes in assets and liabilities have taken place. Again the Balance Sheet depicts the financial position of a business on a particular day (usually the last day of the current financial year). So it is static in nature and on the very next day, we may find a different position of asset and liability with only few big transactions. So under this kind of circumstances, Balance Sheet may not actually reflect the true picture of the financial position of a business. Although, it is understood that because of the various business activities, there are changes in assets and liabilities. Finally we see that a Balance Sheet does not reflect the business activities of a firm, it only shows the final position of assets and liabilities on a particular day. In this context, the fund flow statement is a statement of changes in financial position. Here, the word 'fund' represents the working capital of the business. Working capital is the difference between current assets and current liabilities. By 'fund' we mean cash, short-term monetary assets, net monetary assets, working capital and financial resources. In the words of Almand Coleman, fund flow statement is:-

"…a statement summarising the significant financial changes which have occurred between the beginning and the end of company's accounting period."

Fund Flow Statement is a supplementary statement and shows the sources of mobilisation of the funds and their detailed utilisation during a particular financial year. Finally the Fund Flow Statements clearly identify the changes in working capital and also help the management to find out the factors responsible for this working capital changes. It is the Fund Flow Statement which helps management about the allocation of resources and shows the operational aspects of the business activities which is not available in Profit and Loss Account and Balance Sheet.

10.8 ASCERTAINMENT OF FLOW OF FUNDS

In order to depict the ways and reasons for the movements in the funds of a business organisation for a specific purpose, a fund flow statement is prepared. Preparation of fund flow statement is not legally mandatory.

So, there is no such specific format available for the preparation of the fund flow statement. The main objective of preparing the fund flow statement is to ascertain the changes in the funds position for a specific purpose during an accounting period. Ascertainment of the flow of fund depends on the sources of fund and application of fund which may be explained with the help of the following relationship:-

Source of Fund – Application of Fund = Change in Working Capital

In the above equation, source of fund includes changes in equity, liabilities and non-current assets which increase the working capital. On the other hand, application of fund represents the decrease in the working capital due to changes in equity, non-current liabilities and non- current assets. Thus we see that in order to ascertain flow of funds in an organisation, a clear understanding of the changes in working capital. Working capital is defined below:-

Working Capital = Current Assets – Current Liabilities

10.9 TECHNIQUE OF PREPARING FUND FLOW STATEMENT

There are basically three steps to prepare Fund Flow Statement which is illustrated below:-

(a) Prepare the Statement of Changes in Working Capital: The first step to prepare the Fund Flow Statement is to formulate the statement of changes in working capital. Working capital is the difference between current assets and current liabilities. So any changes in the current assets and current liabilities bring changes in the working capital statement. For example, an increase in the amount of current assets will increase the working capital. This could be understood from the following table:-

Again, an increase in the amount of current liabilities will decrease the working capital. This could be understood from the following table:-

Particulars	As on March 31, 2015	As on March 31, 2016	Increase (in Rs.)
Current Assets:			
Stocks	10,00,000	13,00,000	3,00,000
Debtors	5,00,000	8,00,000	3,00,000
Cash	2,00,000	3,00,000	1,00,000
Total Current Assets	17,00,000	24,00,000	7,00,000
Current Liabilities:			
Creditors	6,00,000	7,00,000	1,00,000
Bills Payable	2,00,000	3,00,000	1,00,000
Outstanding Expenses	3,00,000	4,00,000	1,00,000
Total Current Liabilities	11,00,000	14,00,000	3,00,000
Working Capital	6,00,000	13,00,000	7,00,000
Working Capital	6,00,000	3,00,000	-3,00,000

Working Capital: But a decrease in the amount of current liabilities will increase the working capital of the business for the particular financial year.

(b) Prepare the Statement of Sources and Application of Funds: This statement is prepared taking information from the Balance Sheet. At first a statement is prepared identifying the changes in the Share Capital, Long-Term Liabilities, and Other Long Term Fixed Assets from the Balance Sheet.

Statement of Sources and Applications of Fund of XYZ Ltd. for the year ending

Sources	Amount (in Rs.)	Applications	Amount (in Rs.)
Fund from operations**		Funds Depleted by Operation**	
Issue of Shares & Debentures		Redemption of Preference Share & Debentures	
Long-Term Loans		Purchase of Investments, Fixed Assets etc.	
Sale of Investments, Fixed Assets, etc.,		Repayment of Loan	
Non-Trading Income		Non-Trading Expenses	
Decrease in Working Capital		***Increase in Working Capital***	
Total Sources of Fund		Total Applications of Fund	

CHECK YOUR PROGRESS

Q1: What are the issues that Profit and Loss Accounts and Balance Sheet fails to address?

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Q2: What is Fund Flow Statement?

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Q3: State true or false for the following statements:

(i) A Balance Sheet does not reflect the business activities of a firm, it only shows the final position of assets and liabilities on a particular day.

(ii) An application of fund represents the increase in the working capital due to changes in equity, non-current liabilities and non-current assets.

(iii) A decrease in the amount of current liabilities will increase the working capital of the business for the particular financial year.

10.10 SCHEDULE OF CHANGES IN WORKING CAPITAL

Once we are ready with all the changes that has been taken place with respect to the Share Capital, Long-Term Liabilities, and Other Long Term Fixed Assets, we are ready to prepare the Fund Flow Statement. There is no specific standard format to prepare the Fund Flow Statement as such. The schedule of changes in working capital may be shown following way:-

Particulars	**At the End of**		**Changes in Working Capital**	
Current Assets:	Previous Year (in Rs.)	Current Year (in Rs.)	Increase (in Rs.)	Decrease (in Rs.)
Cash on Hand				
Cash at Bank				
Stocks				
Debtors				
Bills Receivable				
Prepaid Expenses				
Accrued Income				
Total Current Assets (A)	A1	A2	A2 - A1 = M	
Current Liabilities:				
Creditors				
Bank Overdraft				
Bills Payable				
Outstanding Expenses				
Unclaimed Dividend				
Unpaid Dividends				
Total Current Liabilities (B)	B1	B2	B2 - B1 = N	
Working Capital (A – B)	A1 – B1 = X1	A2 - B2 = X2		
Total Increase/Decrease in the Working Capital			M - N	

If X1 > X2, this implies the working capital has increased. On the other hand, if X1 < X2, this implies the working capital has decreased. It must be noted that only changes in the working capital i.e., X2 – X1 is taken to the Fund Flow Statement. An increase in the working capital is considered as application of fund and a decrease in the working capital is regarded as source of fund. Symbolically we can write as follows:-

X1 > X2 Application of Fund

X1 < X2 Source of Fund

10.11 ADJUSTED PROFIT AND LOSS ACCOUNT

The main source of fund is the current operating profit which is the excess of sales revenue over operating cost. Sales revenue represents inflow of funds which includes sundry debtors, cash and bills receivables. Operating cost represents outflow of funds. This outflow of funds in turn reduces cash and bank balances and increase in sundry and expense creditors. Thus we understand that fund inflow denotes source of fund whereas fund outflow denotes application of funds.

Basically there are two types of fund transactions viz., operation transactions and non-fund transactions. There are some non-fund transactions like depreciation, write-offs, dividend received, interest on investment, refund of tax, profit on sale of fixed assets, appropriation etc. which are charged to profits. These types of non-fund transactions are shown separately as a source of funds and adjusted to the profit and loss account of the current financial year. as given below:-

Proforma of Adjusted Profit & Loss Account

While preparing the adjusted profit and loss account, it must be noted that if a business has accumulated losses, then in the adjusted P and L account opening balance should be shown in the debit side and closing balance must be shown in the credit side.

Let us take an example to understand the concept.



Exerciese 10.1

Financial information is provided by XYZ Ltd. for the accounting period 2015 – 2016. Your task is to calculate the fund from operation and also prepare an adjusted profit and loss account.

Trading and Profit & Loss Account

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash purchase of materials	875,000	By Sales	1050,000
To Gross profit c/d	175,000		
	1050,000		1050,000
To start-up expenses written-off	8,750		
To Discount on issues of bonds	26,250	By Gross profit c/d	175,000
To Goodwill written off	17,500	By Bonus received	52,500
To Salaries	140,000	By Interest on investments	52,500
To Rent	122,500		
To Depreciation	35,000	By Net loss	70,000
	350,000		350,000

Solution:

Calculation of Funds from Operations

10.12 PRACTICAL PROBLEMS

The proforma of a fund flow statement is shown below:-

Proforma of a Fund Flow Statement



Exerciese 10.2

From the following balance sheet of Expan Ltd., prepare a fund flow statement.

Balance Sheet of Expan Ltd. as on March 31st …..

Solution: We have to first calculate the statement of changes in working capital.

Statement of Changes in Working Capital of Expan Ltd.

Particulars	2015	2016	Increase in Working Capital	Decrease in Working Capital
Current Assets:				
Debtors	50000	62,500	12,500	
Cash in Hand	25000	25,000		
Stock	25000	37,500	12,500	
Total (1)	100000	125,000		
Current Liabilities:				
Creditors	25,000	137,500		112,500
Total (2)	25,000	137,500		112,500
Net Working Capital (1) – (2)	87,500	75,000		
Decrease in Working Capital		12,500	12,500	
Totals	87,500	87,500	112,500	112,500

Assets	2015	2016	Liabilities	2015	2016
Land			Equity Share Capital		
Building	75000	125000	Capital	62500	62500
Debtors	50000	62,500	Preference Share Capital	62,500	25000
Cash in Hand	62500	125,000	Long-term Loans	25,000	50000
Stock	25,000	37,500	Creditors	12,500	
Total (1)	25000	112,500		25000	137500
	25000	37500	Profit & Loss a/c	87500	112500

Now we are ready to prepare the Fund Flow Statement.

Fund Flow Statement of Expan Ltd.



Exerciese 10.3

From the following balance sheet of GCTIL Ltd., prepare a fund flow statement.

Balance Sheet of GCTIL Ltd. as on March 31, ……

Solution: We have to first calculate the statement of changes in working capital.

Statement of Changes in Working Capital of GCTIL Ltd.

Particulars	2016	2017	Increase in Working Capital	Decrease in Working Capital
Sources				
Funds from operations (Increase in Profit)	84375	168750	84375	
Increase in Long Term Loan	33750	67500	33750	
Decrease in Working Capital				16875
Total (1)	118125	236250		
Applications				
Increase in Stock	33750	50625	16875	
Increase in Debtors	84375	185625	101250	
Total (2)	118125	236250		
Net Working Capital (1) – (2)	118125	101250		16875
Increase in Working Capital	0	16875	16875	
Totals	118125	118125	151875	151875

Now we are ready to prepare the Fund Flow Statement.

Fund Flow Statement of GCTIL Ltd.

Particulars	Amount
Current Assets:	
Debtors	84375
Cash	33750
Total (1)	118125
Current Liabilities:	
Creditors	33750
Total (2)	33750
Net Working Capital	84375
Add: Decrease in Working Capital	16875
Total	101250
Sources	
Funds from operations (Profit)	168750
Long Term Loan	67500
Total	236250
Applications	
Increase in Stock	50625
Increase in Debtors	185625
Total	236250



Exercise 10.4

From the following financial information of Vijay Cements Ltd., prepare a fund flow statement for the year ended March 31, 2017.

Assets	2016	2017	Liabilities	2016	2017
Closing Stock	577,500	665,000	Creditors	350,000	376,250
Fixed Assets	787,500	1050,000	Share Capital	350,000	525,000
Investment in T-Bills	175,000	262,500	Preference Shares	350,000	175,000
Debtors	192,500	201,250	Debentures	175,000	262,500
Bank Balance	87,500	236,250	Reserves	262,500	708,750
Cash in Hand	17,500	35,000	Bad Debt Provisions	17,500	26,250
Start-up Expenses (Not written-off)	17,500	8,750	Bills Payable	262,500	262,500
			Short-Term Loans	87,500	122,500

Some preference shares of the company were redeemed worth Rs.17,500 in the beginning of the year 2017. The company also paid dividend of Rs.17,500 on equity shares and 21,000 on preference shares during the year.

Solution: We have to first calculate the statement of changes in working capital.

Next step is to prepare the statement of sources and application of funds. To do so, we have to prepare first the fund from operation statement to arrive at the source or application of the funds. Fund from operation statement is prepared after removing the effect of non-operating items.

Fund from Operation Statement of Vijay Cements Ltd.

Particulars		Amount
Net Profit for the Year		446,250
(Increase in Reserve)		
Add: Non-operating Expenses		
Redemption of Preference Shares	17,500	
Dividend on Equity	17,500	
Dividend on Preference Shares	21,000	
Total Fund from Operations		511,000

Let us now prepare the Fund Flow Statement below:-

Fund Flow Statement of Vijay Cements Ltd. for the Year 2017.

Particulars		Amount
Sources		
Funds from operations		511,000
Issue of Share Capital	8,750	175,000
Issue of Debentures	17,500	87,500
Total (1)		773,500
Applications		
Fixed Assets		262,500
Preference Shares Redemption		192,500
Investment in T-Bills		87,500
Preference Dividend Paid		21,000
Equity Dividend Paid		17,500
Increase in Working Capital		192,500
Total (2)		773,500

CHECK YOUR PROGRESS

Q4: Briefly discuss the schedule of change in working capital.

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Q5: What would be the effect of decrease in working capital in the fund flow statement?

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Q6: While preparing the adjusted profit and loss account, if a business has accumulated losses, where the opening balance should be shown in the adjusted P & L account?

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Q7: State true or false for the following statements:

(i) There is no specific standard format to prepare the Fund Flow Statement.

(ii) If total current asset exceeds total current liability, this implies the working capital has decreased.

(iii) Non-fund transactions are shown separately as a source of funds and adjusted to the profit and loss account of the current financial year.



10.13 LET US SUM UP

In this unit the following topics have been leraned:

- In this unit we have disussed the concept of financial Statement analysis and Funds Flow Statement.

- Financial statements are the sources of information for financial decisions
- The profit and loss account reflects the performance of a firm over a period of time.
- The balance sheet shows the financial position of a firm at a given point of time.
- The unit discusses the ascertainment of Flow of Funds and the technique of preparing a Fund Flow Statement.
- The unit focussed the schedule of changes in Working Capital and adjusted Profit and Loss account.
- The first step to prepare the Fund Flow Statement is to formulate the statement of changes in working capital. Working capital is the difference between current assets and current liabilities. So any changes in the current assets and current liabilities bring changes in the working capital statement.
- An increase in the amount of current assets will increase the working capital. Again, an increase in the amount of current liabilities will decrease the working capital. Similarly, a decrease in the amount of current assets will decrease the working capital. But a decrease in the amount of current liabilities will increase the working capital of the business for the particular financial year.
- The Statement of Sources and Application of Funds is prepared taking information from the Balance Sheet.



10.14 FURTHER READINGS

1. Srinivasan, N.P & Murugan, M.S.(2011), '*Accounting for Management',* S Chand Publishing, India
2. Ramachandran, N. & Kakani, R.K. (2011), '*Financial Accounting for Management*', McGraw Hill Education
3. Bhattacharya, A.K. (2012), '*Financial Accounting for Business Managers*',PHI.

10.13 ANSWER TO CHECK YOUR PROGRESS

Ans to Q.1: The two most important financial statements are Profit and Loss Accounts and Balance Sheet which represents the financial health of a business. The balance sheet address some important issues like

a. It does not show the major financial and investment transactions which largely influence the business decisions in the short as well as in the long run.

b. The Balance Sheet also fails to explain why and how the changes in assets and liabilities have taken place.

c. The Balance Sheet is static in nature and on the very next day, we may find a different position of asset and liability . So under this kind of circumstances, Balance Sheet may not actually reflect the true picture of the financial position of a business.

Ans to Q.2: Fund Flow Statement is a supplementary statement and shows the sources of funds and their detailed utilisation during a particular financial year. The Fund Flow Statements clearly identify the changes in working capital and also help the management to find out the factors responsible for this working capital changes.

Ans to Q.3: (i) True; (ii) False; (iii) True

Ans to Q.4: The schedule of changes in working capital may be shown following way:-

Particulars	At the End of		Changes in Working Capital	
Current Assets:	Previous Year (in Rs.)	Current Year (in Rs.)	Increase (in Rs.)	Decrease (in Rs.)
Cash on Hand				
Cash at Bank				
Stocks				
Debtors				
Bills Receivable				
Prepaid Expenses				
Accrued Income				
Total Current Assets (A)	A1	A2	A2 - A1 = M	
Current Liabilities:				
Creditors				
Bank Overdraft				
Bills Payable				
Outstanding Expenses				
Unclaimed Dividend				
Unpaid Dividends				
Total Current Liabilities (B)	B1	B2	B2 - B1 = N	
Working Capital (A - B)	A1 - B1 = X1	A2 - B2 = X2		
Total Increase/Decrease in the Working Capital			M - N	

If X1 >X2, this implies the working capital has increased. On the other hand, if X1<X2, this implies the working capital has decreased. It must be noted that only changes in the working capital i.e., X2 – X1 is taken to the Fund Flow Statement. An increase in the working capital is considered as application of fund and a decrease in the working capital is regarded as source of fund. Symbolically, we can write as follows:-

$X1 > X2 \Longrightarrow$ Application of Fund

$X1 < X2 \Longrightarrow$ Source of Fund

Ans to Q.5: The decrease of working capital would be treated as a source in the fund flow statement.

Ans to Q6: While preparing the adjusted profit and loss account, it must be noted that if a business has accumulated losses, then in the adjusted P & L account opening balance should be shown in the debit side.

Ans to Q.7: (i) True; (ii) False; (iii) True

10.16 MODEL QUESTIONS

Q1. Distinguish between Balance Sheet and Profit and Loss Statement.

Q2. What comes under fixed assets and current assets?

Q3. Write the different steps for preparation of funds flow statement on cash basis.

Q4. From the following accounting information of a company, prepare a fund flow statement.

Assets	31-03-2015	31-03-2016
Cash	162,500	50,000
Debtors	125,000	200,000
Stock	293,750	318,750
Land and building	675,000	1275,000
Plant and machinery	3505,000	4430,000
Furniture	262,500	262,500
	5023,750	6536,250
Liabilities		
Long-term loans		668,750
Provisions for dividend		250,000
Creditors	398,750	456,250
Net Worth		
Equity Share Capital	4500,000	5000,000
Surplus	125,000	161,250
	5023,750	6536,250

Q5. For a company TCIL Ltd., prepare a Fund Flow Statement from the following information derived from the Balance Sheet.

Particulars	1st April 2016 (in Rs.)	31st March 2017 (in Rs.)
Land	100000	100000
Buildings	500000	400000
Equipment	375000	425000
Accounts Receivable	250000	517500
Accumulated Depreciation	-125000	-70000
Patents	15000	12500
Copyrights	10000	10000
Inventories	375000	375000
Cash	1000000	1110000
Total Assets	***25,00,000***	***28,80,000***
Capital Stock	875000	1087500
Retained Earnings	375000	487500
Debentures Payable	550000	550000
Debenture Payable Discounts	-50000	-45000
Current Liabilities	750000	800000
Total Liabilities	***25,00,000***	***28,80,000***

For the financial year 2016 – 2017, the income of TCIL Ltd. was 2,50,000. The company issued common stock of Rs.1,25,000 as well as cash dividends of Rs.50,000 and stock dividends of Rs.87,500 were announced. Moreover, it has been found from the Annual Report that the company possesses a building that cost Rs.1,00,000 and which had a book value of Rs.25,000 was sold for Rs.35,000. The depreciation charged for the same financial year was Rs.20,000.

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